A Case Study: The Wall Street Bailout

By Congressman J. Randy Forbes
Virginia's Fourth Congressional District

This weekend, after several months of economic unrest and a number of patchwork "bailouts", the U.S. Treasury proposed a $700 billion Wall Street bailout. They have called this a systematic attempt to jump start our economy. In the midst of the discussions and decisions regarding this potential massive "bailout" are two valid, but very different, economic principles.

First is the principle that the federal government should not intervene to save businesses whose unwise decisions have resulted in financial trouble. This principle is bolstered by the idea that the cost for bailing out these companies should not be placed on the shoulders of American taxpayers, who are not responsible for mistakes made in the financial market.

Second is the idea that government institutions must intervene in unusual situations where the integrity of our market's infrastructure is at risk. When a large sector of our economy faces drastic consequences that will impact basic economic operations, some argue that government has a critical role in preserving the integrity of our market's infrastructure.

The Wall Street bailout has raised many valid questions regarding these two principles. Are we in such a precarious economic situation that the only warranted option is a massive government bailout to be shouldered by American taxpayers? What is the appropriate role of the federal government in such situations as we are seeing today? How do we make sure that government bailouts do not reward the poor choices made by financial institutions or others?

The challenge we face today is in reconciling these two principles in respect to these and other questions. I have created *A Case Study: The Wall Street Bailout* to take an objective look at our financial system as it is right now and to address these important questions surrounding our economy. I look forward to hearing from you on this issue as well. I invite you to visit my website, http://randyforbes.house.gov, and email me with your questions, comments, and concerns regarding our economic situation in the United States. With kind personal regards, I am

Yours truly,

J. Randy Forbes
Member of Congress

THE ECONOMIC ENVIRONMENT

While there is no precise definition of "financial crisis," many would broadly agree that a financial crisis occurs when the flow of credit to households and businesses is constrained and the exchange of goods and services is adversely affected.

In mid-2007, liquidity abruptly dried up for many firms and securities markets. As a result, many firms found it difficult to borrow needed money and many investors found it difficult to sell investments. The liquidity crunch was most severe for institutions with links to subprime mortgages, but it also spread rapidly – and somewhat unexpectedly - into seemingly unrelated areas. According to the Congressional Research Service (CRS), many of the losses occurring in diverse firms and markets have certain features in common:

- the use of complex, hard-to-value financial instruments;
- large speculative (or risky) investments made with borrowed money, or leverage; and
- the use of off-the-books entities to remove risky trading activities from the balance sheets of a financial institution.

WHAT IS LIQUIDITY?

Liquidity is the degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Firms are said to be liquid when they are able to meet current obligations or short-term demand for funds. Markets are said to be liquid when a large volume of financial securities can be traded without price distortions because there is a ready and willing supply of buyers and sellers. Liquid markets are a sign of ahealthy economy.

As fear of risk increased, credit in the markets disappeared and companies struggled to meet existing financial commitments and handle financial losses. While financial "paper losses" do not have direct impact on economic output or employment, they are indirectly transmitted to the larger economy. For example when a business cannot get a loan for plant improvements or equipment, the business may not grow, thus reducing output and hindering job growth.

In reaction to this trend, the Federal Reserve – the central bank for the United States which formulates the nation's monetary policy and supervises and regulates banks – liberally used the tools granted to it to contain the looming financial uncertainty. In the last several years, the Fed has lowered short-term interest rates dramatically and injected billions of dollars into the banking system to support market liquidity and to keep credit flowing.

Today on Capitol Hill and throughout our nation there are widespread disagreements on the impact that the current financial market problems will have on the overall economy. Some argue that the current situation is a natural, although severe, downside of a credit cycle – a "market correction" to several years of abnormally easy credit conditions. Others, however, forecast a scenario where the current market dynamics amplify severe financial shocks sending the economy into a self-reinforcing, downward spiral.

A BACKGROUND ON RECENT BAILOUTS

Until this year, the federal government has never injected so much money into the U.S. financial market since the Great Depression. In addition to using interest rate adjustments to address the looming financial situation, the Federal Reserve and the U.S. Treasury have stepped in to "bail out" large financial institutions that were nearing bankruptcy or facing grave financial distress. The bailouts have raised questions over whether the federal government has a role in staving off consequences of bad business decisions to protect further losses in the market, and whether the economic

crisis today is of such grand proportion that it would warrant the federal government to step in on the free market economy. The following provides a breakdown of each bailout that has occurred this year, and the situations leading up to each bailout.

The Housing Bailout

Fannie Mae and Freddie Mac are Government Sponsored Enterprises (GSEs), or privately owned, Congressional chartered financial institutions created for public policy purposes. They were created to increase liquidity and improve distribution of capital available for home mortgage financing. As GSEs, the charters of Fannie Mae and Freddie Mac limit them to purchasing single family and multifamily home mortgages. As a result, they lack diversification in the types of mortgages they buy which makes them more susceptible to problems and fluctuations in the home mortgage market.

According to a report by the Heritage Foundation, experts have warned for decades that both Fannie Mae and Freddie Mac lacked sufficient capital to protect against losses. While most banks have $1 of capital for every $12 in assets, Fannie Mae and Freddie Mac only have $1 for every $20 in assets. Fannie Mae and Freddie Mac hold about 70 percent of the national market share of home mortgages, and they both guarantee mortgages and hold about $5 trillion worth of them in their investment portfolios. Beginning in 2004, their portfolios began to grow primarily with subprime and alternative-A loans. From 2003 to 2006, subprime and alternative-A originations in the U.S. rose from less than 8% of all mortgages to over 20%.

Between the end of 2007 and August 2008, Fannie Mae's stock lost 72 percent of its value and Freddie Mac lost 77 percent of its values, which many attributed to improper accounting practices and homeowners falling behind on subprime mortgages, putting 70 percent of the home mortgage market share at risk.

On July 30, the President signed into law H.R. 3221, a $800 billion housing aid bill to rescue Fannie Mae and Freddie Mac. On September 7, the U.S. Treasury announced the federal government seized control of Fannie Mae and Freddie Mac, arguing if the crisis had continued, lack of cash would have made it more difficult for consumers to obtain home loans.

Cost of the Bailout: $800 Billion
Congressional approval was sought for this bailout. Congressman Forbes did not support the bailout. Read his statement here.

Bear Stearns
At the beginning of the year, Bear Stearns was the nation's fifth largest investment bank. When the housing market took off earlier in the decade, Bear Stearns became actively involved in the residential mortgage market. As a result, it held a large amount of mortgage-backed securities. When the housing market plunged, Bear Stearns began to experience financial trouble. In response, Bear Stearns poured more money into subprime mortgage funds. When the housing market continued to decline, Bear Stearns found itself in an even deeper financial struggle. In March 2008, it was virtually crippled by a liquidity squeeze related to devalued mortgage-backed securities and neared bankruptcy.

In response, the Federal Reserve System announced on March 14 that it would provide a short-term loan to help Bear Stearns. Two days later, JP Morgan Chase, a commercial bank, agreed to buy Bear Stearns, and the Federal Reserve agreed to provide special financing to help with the transaction for up to $30 billion of Bear Stearns' less liquid assets. After additional negotiations between Bear Stearns and JP Morgan Chase, the transaction ended with the Federal Reserve agreeing to finance $29 billion of Bear Stearns' less liquid assets. Before this point, the Federal Reserve had never "bailed out" a financial institution that was not a commercial bank.

Cost of the Bailout: $29 Billion
No Congressional approval was sought for this bailout.

Lehman Brothers
Lehman Brothers is a global financial services firm who, like Bear Stearns, held a large share of mortgage backed securities. When the subprime mortgage market took a hit,

the Lehman Brothers faced substantial losses just as Bear Stearns did. In the first half of 2008 alone, Lehman's stock lost 73% of its value.

On September 14, Lehman brothers announced that it would file for bankruptcy protection, subsequently sending the stock market down 500 points on September 15, the largest drop in a single day since the terrorist attacks of September 11, 2001. Lehman Brothers sought government intervention to no avail. On September 16, Barclays PLC acquired a portion of Lehman brothers and no government bailout was instituted.

Cost of Bailout: None. No government bailout occurred.

AIG
After Lehman Brothers, investors began looking at national insurance company American International Group's (AIG) securities and found that they were similar to Lehman Brothers'. AIG's credit rating was downgraded and it suffered a liquidity crisis because it could no longer access capital. As such, AIG's share prices fell 95% on September 16. At AIG's request, the Federal Reserve loaned money of up to $85 billion to AIG to prevent its collapse, in exchange for a 79.9% equity stake in the company because there was concern that many U.S. banks would fail if AIG did not keep operating.

Cost of the Bailout: $85 Billion
No Congressional approval was sought for this bailout.

THE PROPOSED WALL STREET BAILOUT BILL

The Paulson Plan

The U.S. Treasury Secretary Henry Paulson is asking for authority from Congress to buy the troubled assets from financial firms that are said to be causing the current financial crisis. Secretary Paulson is asking for $700 billion to buy primarily mortgage-related debt, which will allow financial institutions to raise capital and begin lending and investing again, resulting in a theoretical "jump start" of the economy. The plan is for the government to hold the assets until the market can recover. It then would sell the assets back into the market through a "reverse auction," where the government sets a minimum price for the asset and financial institutions bid on the asset for purchase.

The proposal is now being considered on Capitol Hill where some lawmakers and interest groups are pushing for additional provisions to allow bankruptcy judges to modify mortgage terms, adding terms to provide plan oversight and market regulation, and provisions to curb executive compensation in companies that participate in the bailout. Leadership in Congress has suggested that the proposal is likely to be voted on this week.

Who is going to come up with the $700 billion?

American taxpayers will shoulder the cost of the bailout, which could actually be anywhere from $500 billion to $1 trillion, depending on how the assets are priced and how many are sold. The Treasury will attempt to resell them to investors, which some argue could result in profit and, ultimately, a lower price tag. There is no assurance of this profit, however, and many argue that the government is at risk of losing a great deal of taxpayer dollars through the purchase of this mortgage debt. In order to finance this plan, the Treasury will need to borrow money to buy the assets. It has asked for an increase in the debt ceiling, which means we must increase the federal deficit for the second time this year and increase interest payments on our federal debt. In addition, the $700 billion will be on top of the $900 billion tax dollars that have already been obligated for Bear Stearns, Fannie Mae, Freddie Mac, and AIG.

How long will the government hold these assets?

Ideally, the government should hold assets for the shortest amount of time possible. However, in reality they could end up holding them until maturity. For example, the government could hold a 30-year mortgage for the entire 30 years, or they could sell it at its discretion. With respect to the reverse auction, the number one priority should be to maximize the price for the American taxpayer. While the government may hold these assets at their discretion, the current Paulson plan would allow the government to purchase these assets for only two years.

What is the rationale for acting now?

According to a Congressional Research Service report, a press release from the Treasury stated illiquid mortgage-related assets had clogged the financial system. The combination of the government's refusal to intervene on behalf of Lehman Brothers the same week that a bridge loan was extended to AIG has led many to believe that a case-by-case approach needs to be replaced with broad intervention. In addition, the sudden spike in interest rate spreads and declines in financial activity following the AIG intervention caused some policymakers to believe that the fragile financial market could worsen if it were not addressed. On the other hand, many argue that while addressing disruptions in the market as soon as possible is preferable, the urgency to address the situation immediately is caused in part by issues unrelated to the financial markets such as congressional schedules and political elections.

Arguments for the Bailout

Proponents for the Wall Street bailout are concerned that the financial crisis is starting to impact historically safe assets like money market accounts, and that retirement savings and investments of middle class Americans may be at risk. While these "safe" assets have no direct reason to suffer financial distress, they may suffer due to lack of market confidence. When this sort of market panic has developed, proponents say the federal government has an important role in calming the markets. As such, Secretary Paulson has created a plan to restore confidence in the financial market, which the Administration argues would address financial market distress and would preserve an individual's capacity to borrow money to buy a home or to finance a college loan or allow small businesses to obtain credit. Without this government intervention, he argues, we would experience dire economic conditions – tax dollars would provide insurance against economic disaster.

Arguments Against the Bailout

Opponents of the bailout plan argue that buying troubled debt provides the most help to firms who have made the worst investments. According to Douglas W. Elmandorf, Senior Fellow at the Brookings Institute, banks which made responsible decisions to stay clear of bad debt or cut their losses would receive little or no gain from the bailout. Banks with the weakest balance sheet will reap the best rewards. Opponents of the plan argue that this will undermine an important financial principle that companies which have failed should have a smaller role in the market and it sends companies the signal that the government will be there to bail them out when they make bad business decisions. Under this assumption, opponents question what incentive businesses would have to take steps to ensure their own survival, such as voluntarily renegotiating troubled loans. This type of action could put the U.S. on a dangerous and unsustainable path where fundamental market principles gradually disappear to an economy in which the federal government owns significant assets and controls liquidity.

In addition, the bailout is a big risk for taxpayers with little gain. Because the amount the Treasury will use to buy assets must be borrowed, it will raise the federal deficit. This liability, on top of other long-term liabilities for Social Security, Medicare, and Medicaid, means American taxpayers could be liable for more than $53 trillion, or $455,000 per household in federal debt.

Opponents also argue that much of the problem we now see has been the result of too much, rather than too little, government intervention. They say the current crisis is an example of what happens when politicians - Republicans and Democrats alike - enact policies in order to score political points or as knee-jerk reactions to perceived or real crisis without regard for the possible consequences and foresight as to future implications. Policies legislated in the past that have encouraged or even mandated lending to

low-income and under-qualified borrowers may have made for a good sound bite, but they forced private businesses to enter into risky and unwise transactions that they otherwise may not have considered.

WHERE I STAND

When we are considering a proposal that would double or triple our federal budget deficit, it is imperative that we discuss the proposal on the same scope or scale of its potential impact. American taxpayers need to be informed on such a proposal, especially when they will be asked to pay for it. We must also keep certain principles in mind when considering a bailout with consequences that could alter the nature of both the government and the economy. As such, I will keep the following principles in mind when considering the Wall Street bailout bill this week:

Any fix must be for the long-term, not the short-term. When the federal government makes decisions regarding our economy or market structure, it must be made through the lens of long-term impact. Earlier this year, I voted against the Economic Stimulus because it was a temporary boost to our economy at the expense of tomorrow. Today, we see that the economic stimulus has increased our federal deficit with little positive impact on the economy, a troubling trend that we have yet to address. The federal government must begin thinking about the long-term economic impact of its decisions.

We need to protect American taxpayers. American taxpayers who have made responsible financial decisions need to be given clear reasons why the bailout will be beneficial to them and not just to Wall Street bankers who made poor financial decisions. According to Washington Watch, the proposed bailout of $700 billion will cost every household in the U.S. $6,500 in increased federal debt.

If it is important enough to do, it is important enough to take the time to do it right. It is likely that the proposed bailout will be considered less than a week from its initial conception. If this action is absolutely critical to protect our economy, we should not hastily consider the proposal under an artificial timeline that says Congress must adjourn on September 26. Such a critical decision should be thoroughly examined, not made brashly or made under the umbrella of political pressure surrounding the upcoming elections.

Strong oversight is needed. $700 billion is more than the annual defense budget. If approved, this plan could double or triple the budget deficit for the next two years. Any proposal must include strong reporting and oversight by Congress rather than giving one person in the government – the Secretary of the Treasury – full control over how to spend $700 billion. In fact, the initial proposal prevents any agency or court of law from reviewing the execution of this proposal.

We need to demand accountability. It is fundamentally unfair for Wall Street firms who are taking advantage of tax payer-funded bailouts to provide their executives with massive compensation or "bonus" packages. Any proposal must ensure that executives of investment banks, mortgage lenders, and government regulators are held responsible and accountable for their actions, and that they share a portion of the burden of the bailout.

We should not pass on our problems to the next generation. If the bill costs $700 billion simply by increasing the national debt, we should be able to explain how making a bailout now will ensure that our sons, daughters, and grandchildren do not have to pay for the burdens we create for them.

Government should only be as big as absolutely necessary. The inherent functions of our government are national defense, enforcing the rule of law, and protecting individual rights to life, liberty and the pursuit of happiness. Any bailout must prove how it can contribute to these inherent government functions.

My Actions

As your Representative in Congress, I want to be sure that I am making decisions based on full knowledge of the consequences and impact of a government bailout on American taxpayers, on our economy, and on our government. For the past few days, I have received serious and valid questions and comments from constituents who are concerned about the size of the Wall Street bailout, the lack of accountability within the proposal, and the potential impact of the bailout on our economic future as a nation.

Today, I sent a letter to Secretary Paulson requesting that certain fundamental questions be answered clearly and succinctly for me and for the citizens of the Fourth Congressional District, so we can carefully weigh the complex consequences presented by a government bailout. The text of the letter reads:

September 23, 2008

The Honorable Henry M. Paulson Jr.
Secretary of the Treasury
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Dear Secretary Paulson:

Thank you for your service to the Nation during this critical time in our country's history. Over the past six months, we have faced increasingly challenging economic conditions. From the historic housing rescue plan that was intended to restore confidence in financial markets, to the government bailout of Fannie Mae and Freddie Mac, there is no question that we are in unchartered territory in so far as our financial markets and economic well-being are concerned.

I must tell you that I have been stunned by the transformational nature and sheer size of the proposal you have developed. I have only been more astonished by the speed with which the bailout proposal has been formulated, presented to congressional leadership, and scheduled for a vote in the House of Representatives and the Senate.

I am sure you can appreciate the weight of decision that rests upon each Member of Congress that must vote on the merits of this monumental proposal. It is without question one of the most significant votes I will take as a Member of Congress. While some congressional leaders have been satisfied as to why a bailout is needed and why you believe it will succeed in stabilizing the financial market, it is not clear to me, or to many of the American people, why the bailout is so urgently required. Nor is it clear why the benefits of government intervention outweigh the proposal's massive cost and fundamental transformation of our economic system.

Therefore, before I will consider voting in favor of this massive bailout, I request that the following questions be explained clearly and succinctly for myself and the constituents of the Fourth Congressional District of Virginia:

1) You have stated that it is critical for Congress to act now or our economy and every American faces grave consequences. What are those grave consequences, and what evidence can you supply that they will occur?

2) Is a $700 billion government takeover the only option to save the economy? What other alternatives were considered, and were there any that did not include growing the size of government?

3) What assurances do we have that this fix will not only work in the short-term, but in the long-term as well? Why should we provide the largest bailout in history without any long-term reform to Fannie Mae/Freddie Mac and the regulation of securities and banking to prevent another bailout in 5, 10, or 20 years?

4) If this bailout fails to stabilize the market, what options are left then?

5) How does the average taxpayer, who has paid their mortgage and credit cards on time, benefit by paying roughly $2,000 per person (in new national debt) to bail out these firms?

6) Why shouldn't those who have made poor decisions face the consequences of their decisions and actions? Does this proposal not virtually guarantee a "moral hazard," whereby it is assumed the U.S. government will bailout any corporation that is "too big to fail" in the future?

7) Why does the Secretary of Treasury require, for the first time in history, the unilateral authority to control $700 billion of the taxpayers dollars?

8) This problem was not created by taxpayers. How are executives of investment banks, mortgage lenders, and government regulators being held responsible and accountable for their actions which led to this crisis? What is their portion of the burden for this bailout?

9) How will we ensure that these same individuals do not control the distribution of any bailout when the government hires asset managers to buy and sell securities?

10) I have no intention of leaving more debt to my grandchildren to pay for our mistakes. How, specifically, will the costs of this bailout be paid for, and will it be completely paid for within 15 years?

11) If this bailout is, in fact, absolutely critical to our economy, what would be the consequences if Congress were to exercise its constitutional responsibility to thoroughly debate and consider this legislation for a longer period time rather than considering it outside the committee process under an artificial deadline of September 26, 2008, which is only one week from when this proposal was announced?

12) How does this bailout contribute to inherently governmental functions, such as national defense, enforcing the rule of law, and protecting individual rights to life, liberty, and the pursuit of happiness?

13) How will this bailout fundamentally alter the nature of both the government and the economy?
I intend to give your proposal full consideration before casting my vote. I look forward to receiving the answers to these questions so I may carefully weigh the complex questions that are presented by the vote on a government bailout.

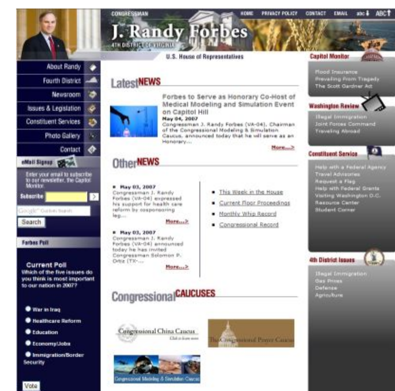
Sincerely,

J. RANDY FORBES
Member of Congress

CC:
Chairman Ben S. Bernanke
Board of Governors
Federal Reserve System
20th Street and Constitution Ave., NW
Washington DC 20551

FOR MORE INFORMATION…

For more information on work I am doing for our economy or for a list of valuable resources concerning our economy, please visit my website http://randyforbes.house.gov. I would appreciate hearing your thoughts on economic issues. Please take a moment to Email me via my website, or call my Washington, D.C. office at (202) 225-6365.



For more information:

Government Service Enterprises
http://www.congress.gov/erp/rs/html/RS21724.html

Fannie Mae and Freddie Mac
http://www.congress.gov/erp/rl/html/RL34661.html

Congress Should Fix the Fannie Mae and Freddie Mac Mess
http://www.heritage.org/Research/Economy/wm1993.cfm

Bear Stearns: Crisis and "Rescue" for a Major Provider of Mortgage-Related Products
http://www.congress.gov/erp/rl/html/RL34420.html#TOC1_1

Proposal to Allow Treasury to Buy Mortgage-Related Assets to Address Financial Instability
http://www.congress.gov/erp/rs/html/RS22957.html