Congressional Research Service

Financial Market Intervention

Edward V. Murphy
Specialist in Financial Economics

Baird Webel
Analyst in Financial Economics

January 29, 2009

Congressional Research Service
7-5700
www.crs.gov
RS22963

CRS Report for Congress
Prepared for Members and Committees of Congress

Summary

Financial markets continue to experience significant disturbance and the banking sector remains fragile. Efforts to restore confidence have been met with mixed success thus far. This report provides answers to some frequently asked questions concerning ongoing financial disruptions and the Troubled Asset Relief Program (TARP), enacted by Congress in the Emergency Economic Stabilization Act of 2008 (EESA, Division A of H.R. 1424/P.L. 110-343). It also summarizes legislation in the 111th Congress such as H.R. 384, the TARP Reform and Accountability Act of 2009 and H.R. 703, "Promoting Bank Liquidity and Lending Through Deposit Insurance, Hope for Homeowners, and other Enhancements." The report also describes the option of a good-bank, bad-bank split.

Contents

Contacts

Current Concerns

What, if anything, 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 of troubled counterparties. 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 that need to raise capital have had trouble doing so because potential investors are afraid that the full extent of damage to banks' assets has not yet been revealed. Furthermore, the possibility that a future intervention by the government will dilute shareholder value might also deter private investors from recapitalizing banks. Under these conditions it is difficult for people who depend on regularly accessing credit markets to get loans, which in turn can affect the broader economy. Often, this lack of confidence in other financial institutions expresses itself in wide spreads between market interest rates and the yield on Treasury securities. These spreads have been relatively wide for the past year. They spiked following recent interventions intended to prevent disorderly bankruptcies, an indication of significant loss of confidence.[1]

In addition to the financial turmoil that initially arose from higher than expected default rates among residential real estate loans and lower than expected returns on mortgage-backed securities and related financial derivatives, the banking sector is experiencing increasing stress as the broader economy weakens. If the recession deepens and unemployment increases, as many economists project, then default rates will increase for non-real estate loans. Worsening performance rates, and expectations of further declines, for broad classes of loans has caused banking regulators to remind each bank to maintain "... the adequacy of its loan loss allowance."[2] Because loan losses are rising, banks are attempting to increase the funds they keep available for loan loss provisions.

When did trouble in the financial markets start?

Loss of market confidence can be proxied by spreads in interest rates between Treasury securities and riskier assets of similar maturities. These spreads first spiked in August 2007.[3] Although spreads declined following policy responses by the Federal Reserve, the Treasury, and the passage of the 2008 stimulus package, the spreads did not return to their pre-August 2007 level. The persistence of historically wide spreads during 2007-2008 suggests that full confidence has not been restored.

[1] CRS Report RS22956, *The Cost of Government Financial Interventions, Past and Present*, by Baird Webel, N. Eric Weiss, and Marc Labonte.

[2] Office of Thrift Supervision, OTS 08-053 - Interagency Statement on Meeting the Needs of Creditworthy Borrowers, press release, November 12, 2008, available at http://www.ots.treas.gov/?p=PressReleases&ContentRecord_id=912275af-1e0b-8562-eb24-7c8442d1e8d3.

[3] CRS Report RL34182, *Financial Crisis? The Liquidity Crunch of August 2007*, by Darryl E. Getter et al.

What caused financial market turmoil?

Most observers agree that rising defaults among residential mortgage borrowers sparked the initial loss in financial market confidence.[4] Reasonable people will continue to disagree as to the initial cause of rising defaults and how these defaults were multiplied through the financial system. Some believe that low interest rates and loose monetary policy caused a housing bubble that was bound to burst when interest rates rose.[5] Others place more emphasis on loose lending standards that may have been fostered by a lack of regulation of non-bank lenders and a lack of market discipline by mortgage-backed securities issuers who sold the loans to other investors.[6] Another group places the blame on the failure of officials to regulate relatively recent innovations in finance. Still others emphasize potentially irresponsible marketing practices or fraud by subprime lenders. Some observers blame investors and borrowers who did not adequately investigate the risks of their decisions.

If 97% of mortgage borrowers are not in foreclosure, why is the financial turmoil so large?

Several factors magnify the effects of loan defaults on the financial system. First, banks are leveraged, which means that for a given dollar reduction in the value of their assets they must either raise additional capital or reduce their lending by a multiple of the loss.[7] Second, banks have become less transparent because of changes in accounting and risk management. This lack of transparency has made it more difficult for banks to raise additional capital as an alternative to reducing lending or selling assets. Third, the use of financial derivatives that should have reduced risk in the banking system may have had the effect of increasing leverage and making it even harder to identify sound counterparties.

Where are the problem loans located?

Two of the problem loan categories, subprime and Alt-A, are disproportionately located in areas that had previously experienced rapid price appreciation. This includes Florida, California, Arizona, and Nevada. In addition, subprime loans are disproportionately located in relatively low income and minority neighborhoods across the country.[8]

Who is affected by the financial turmoil?

The financial turmoil also affects anyone seeking credit, including troubled home owners who wish to refinance out of a troubled mortgage. Restrictions in credit have contributed to a downward spiral in home prices. The people most directly affected by financial market turmoil are investment bankers and investors. These people may lose their jobs and livelihood. Business

---

[4] CRS Report RL33775, *Alternative Mortgages: Causes and Policy Implications of Troubled Mortgage Resets in the Subprime and Alt-A Markets*, by Edward V. Murphy.

[5] CRS Report RL33666, *Asset Bubbles: Economic Effects and Policy Options for the Federal Reserve*, by Marc Labonte.

[6] CRS Report RS22722, *Securitization and Federal Regulation of Mortgages for Safety and Soundness*, by Edward V. Murphy.

[7] CRS Report RL34412, *Containing Financial Crisis*, by Mark Jickling.

[8] CRS Report RL34232, *The Process, Data, and Costs of Mortgage Foreclosure*, by Darryl E. Getter et al.

firms are also affected because their cost of financing possible projects has risen, which in turn can hurt the broader economy.

How have policymakers responded to financial turmoil?

Policymakers have responded in several ways. The tools of standard macroeconomics have been used to try to stimulate the broader economy. The tools of banking and financial regulators have been used to try to restore order in financial markets. Congress has given Treasury and housing finance regulators additional tools to stabilize mortgage markets and address troubled financial assets.

Many modern macroeconomists believe that there are two basic policy responses to avoid an economic slowdown.[9] First, the Federal Reserve can provide expansionary monetary policy by lowering interest rates, as it did starting in the fall of 2007.[10] Second, the government can provide expansionary fiscal policy by spending more than it collects in taxes, as it did with the stimulus package.[11] These expansionary macroeconomic policies have not prevented further financial turmoil.

In addition to pursuing both of these responses, financial regulators have tried to restore order in the financial sector using existing authority. Liquidity was increased by expanding the range of collateral accepted at the Federal Reserve's discount window and by holding regular liquidity auctions.[12] The Federal Reserve and Treasury have also tried to help arrange buyers of distressed firms, as it did for Bear Stearns and Lehman Brothers (even though the government was unwilling to also provide funding to facilitate a purchase of Lehman Brothers). Similarly, the Federal Deposit Insurance Corporation (FDIC) has sought buyers for distressed banks. In addition, the FDIC and the Department of Housing and Urban Development (HUD) have tried to help organize loan servicers through the HOPE Now program. The Securities and Exchange Commission (SEC) and Internal Revenue Service (IRS) have issued rules clarifying the ability of loan servicers to modify loans held in securitized trusts.[13]

Congress gave HUD and the newly created Federal Housing Finance Agency (FHFA) additional authority to address mortgage markets. The Housing and Economic Recovery Act (HERA) (P.L. 110-289) contains a voluntary plan to allow banks to write down the balance of existing loans so that borrowers can refinance into FHA to avoid foreclosure.[14] The act also provided some Community Development Block Grant (CDBG) funds to allow local communities to acquire and redevelop vacant and foreclosed properties.[15] The act also created a new regulator for the government-sponsored enterprises (GSEs), Fannie Mae, Freddie Mac, and the Federal Home

---

[9] CRS Report RL34349, *Economic Slowdown: Issues and Policies*, by Jane G. Gravelle et al.

[10] CRS Report RS22371, *The Pattern of Interest Rates: Does It Signal an Impending Recession?*, by Marc Labonte and Gail E. Makinen.

[11] CRS Report RS22850, *Tax Provisions of the Economic Stimulus Package*, by Jane G. Gravelle.

[12] CRS Report RL34427, *Financial Turmoil: Federal Reserve Policy Responses*, by Marc Labonte.

[13] CRS Report RL34372, *The HOPE NOW Alliance/American Securitization Forum (ASF) Plan to Freeze Certain Mortgage Interest Rates*, by David H. Carpenter and Edward V. Murphy.

[14] CRS Report RL34623, *Housing and Economic Recovery Act of 2008*, by N. Eric Weiss et al.

[15] CRS Report RS22919, *Community Development Block Grants: Legislative Proposals to Assist Communities Affected by Home Foreclosures*, by Eugene Boyd and Oscar R. Gonzales.

Loan Banks.[16] The act gave Treasury the temporary authority to purchase debt and equity securities of the GSEs.

Fall 2008 saw a series of financial market interventions. First, the FHFA placed the GSEs in a conservatorship with agreements by the Federal Reserve Bank of New York to assure liquidity and by the Treasury to purchase enough preferred stock and securities to ensure adequate capitalization.[17] On a single weekend, policymakers helped broker a deal to sell investment bank Merrill Lynch to Bank of America and failed to broker a similar deal for Lehman Brothers, reportedly because the government declined to provide financial support. Lehman Brothers subsequently declared bankruptcy. A policy of no financial support did not survive the week, as insurer AIG was granted a Federal Reserve loan three days later. The next day financial markets froze up and Treasury announced a proposal to buy mortgage-related assets from financial institutions.

Congress also gave Treasury additional tools to address financial market instability. The Emergency Economic Stabilization Act of 2008 (EESA, Division A of P.L. 110-343) created a Troubled Asset Relief Program (TARP) that allows Treasury to purchase up to $700 billion of assets from financial institutions. Although the plan was originally discussed in terms of purchasing assets from financial institutions similar to the Resolution Trust Corporation (RTC), some policymakers argued that it would be preferable to purchase stock in banks similar to the Reconstruction Finance Corporation (RFC). The definition of troubled asset is broad enough to encompass both approaches. The troubled assets purchase proposal has been used primarily to inject capital into banks. In addition to support of the banks, TARP funds have also been used for the automobile industry and as a backstop for Federal Reserve programs to support consumer finance markets through the purchases of commercial paper.

Why have the Federal Reserve's traditional tools not restored order in financial markets?[18]

The Federal Reserve's primary tools help provide liquidity but do not restore capital levels. Liquidity generally refers to the ability to access markets, either as a firm issuing bonds or as a person selling a good, without suffering "fire-sale" prices. An adequate capital level is generally determined as a relation between assets and liabilities. All of a firm's assets can be completely liquid (cash) but the firm can remain undercapitalized if small losses can reduce its capital to near insolvency. These concepts are related. Even if a firm has liquid assets, it may have difficulty accessing credit markets to borrow more funds because it is too close to insolvency to be perceived as a good credit risk. Complexities of mortgage-related securities have made it difficult to ascertain their value, thus those assets have become less liquid. Furthermore, investors know that some banks have suffered loan losses that reduced their capital, but the complexities of the mortgage-related assets have made it difficult to identify which banks are undercapitalized. As a result, the liquidity of mortgage-related assets has been reduced, and the liquidity of financial firms has been reduced. The Federal Reserve has taken steps to increase the liquidity of particular assets, for example, by expanding the categories of assets that it will accept as collateral for loans.

---

[16] CRS Report RL33940, *Reforming the Regulation of Government-Sponsored Enterprises in the 110th Congress*, by Mark Jickling, Edward V. Murphy, and N. Eric Weiss.

[17] CRS Report RS22950, *Fannie Mae and Freddie Mac in Conservatorship*, by Mark Jickling.

[18] CRS Report RL34427, *Financial Turmoil: Federal Reserve Policy Responses*, by Marc Labonte.

The TARP program has been used to provide additional capital to banks. Thus far, these programs have not been sufficient to restore confidence in the financial sector. .

What is contained in EESA, P.L. 110-343?[19]

The expressed purpose of EESA (Division A of P.L. 110-343) 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 original three-page Treasury plan. A short description of some of the provisions of the Troubled Asset Relief Program (TARP) follows.

- It has two definitions of troubled assets. The first definition specifies mortgages and mortgage-related assets. The second definition is more general, and includes any asset that the Treasury, in consultation with the Federal Reserve, believes the purchase of which from financial institutions would help restore financial stability.
- It includes an asset insurance program as an alternative to, or in addition to, purchasing troubled assets.
- It excludes foreign central banks from the definition of eligible financial institutions but includes institutions in U.S. territories, such as Guam and the Virgin Islands.
- It includes a variety of oversight mechanisms including a Financial Stability Oversight Board of executive branch officers to review the exercise of authority under the program; ongoing oversight by the Comptroller General; a Congressional Oversight board; and a special inspector to be appointed by the President and confirmed by the Senate.[20]
- The Treasury will manage the acquisition and sale of assets with any proceeds accruing to the general fund for reduction of the public debt.
- The measure 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.
- The measure puts limits on executive compensation of institutions that participate. Under certain circumstances, these 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 debt limit is raised to $11.3 trillion.

---

[19] CRS Report RL34730, *The Emergency Economic Stabilization Act and Current Financial Turmoil: Issues and Analysis*, by Baird Webel and Edward V. Murphy.

[20] CRS Report RL34713, *Emergency Economic Stabilization Act: Preliminary Analysis of Oversight Provisions*, by Curtis W. Copeland and CRS Report R40099, *The Special Inspector General (SIG) for the Troubled Asset Relief Program (TARP)*, by Vanessa K. Burrows.

- 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 has Treasury done under the EESA?

While the initial Treasury focus was on purchasing troubled mortgage-related assets, this portion of TARP has not been implemented. Instead, Treasury has focused on direct capital injections though preferred stock purchases. On October 14, 2008, Treasury announced the Capital Purchase Plan (CPP). Under the initial CPP announcement, nine large banks received $125 billion in capital with another $125 billion intended for the rest of the banking system. Approximately $62.5 billion of the second $125 billion had been disbursed as of December 31, 2008. In addition to the general capital purchase plan, there have been several other case-by-case interventions since the passage of the EESA. AIG received $40 billion in preferred share purchases as part of a revamp of an earlier rescue package. Citigroup received an additional $20 billion in preferred share purchases after an initial $25 billion from the CPP, along with a package of federal guarantees to cover losses on a $306 billion pool of assets, with $5 billion in losses covered under TARP. The U.S. automakers also received financial assistance through TARP, with a $5 billion preferred share purchase from GMAC, up to $14.4 billion in loans to GM and $4 billion in loans to Chrysler. Treasury also committed up to $20 billion in TARP funds to absorb losses on a $200 billion Federal Reserve credit facility intended to assist the credit markets in accommodating the credit needs of consumers and small businesses. In total, over $350 billion in funds have been committed through TARP, although less than this has actually been disbursed.

What legislation is being considered in the 111th Congress?

On January 9, 2009, House Financial Services Chairman Barney Frank introduced H.R. 384, the TARP Reform and Accountability Act of 2009, which is scheduled for floor action during the week of January 12, 2009. H.R. 384 substantially amends the EESA to address several criticisms of the TARP since enactment. The bill includes provisions to: (1) increase reporting on the use of TARP funds; (2) apply stricter executive compensation rules to institutions receiving TARP funds; (3) condition the release of the second $350 billion on usage of at least $40 billion in foreclosure mitigation; (4) confirm the authority to provide assistance to automobile manufactures and conditions the assistance on long-term restructuring; (5) clarify authority to provide support to consumer loans, commercial real estate loans, and municipal securities; (6) amend the Hope for Homeowners program to expand availability; (7) make permanent the increase in deposit insurance included in the EESA.

On Wednesday, February 4, 2009, the Financial Services Committee is due to markup H.R. 703, “Promoting Bank Liquidity and Lending Through Deposit Insurance, Hope for Homeowners, and other Enhancements”. If enacted, H.R. 703 would make permanent the increase in FDIC deposit insurance for individual accounts, which Section 136 of EESA temporarily increases from $100,000 to $250,000. The FDIC’s automatic line of credit from Treasury would be raised from $30 billion to $100 billion. The FDIC line of credit refers to the funds that the FDIC can draw from Treasury if the Deposit Insurance Fund (DIF) proves insufficient to cover the FDIC’s guarantees. H.R. 703 also makes several changes to the Hope for Homeowner’s Program that may increase the incentive of people to participate in the program. It changes the initial loan write-down from 90% to 93% of the current appraised value of the house. It allows for reduced insurance premiums if Secretary determines that conditions warrant a decrease. It possibly reduces some barriers to modifying securitized mortgages by providing a safe harbor for loan servicers who modify loans as long as the servicers comply with several criteria, including a that default was reasonably foreseeable and that the expected net recovery of funds is not diminished.

What is a Bad Bank?

A bad bank is an institution set up to hold problem assets. In a good-bank, bad-bank split, a bank or a group of banks will have their bad assets removed with the intent of making the remaining bank or banks healthy.[21] Once healthy, these good banks can offer new loans and may be in a position to attract private capital. The bad bank or banks will have the job of trying to recover the value of impaired assets or liquidating them. For nonperforming loans, the bad bank may sometimes choose to restructure the loans with the current borrower. Because the troubled assets in the bad bank are not necessarily expected to return zero, it is sometimes possible to find private investors to provide partial financing or managerial expertise.

A good-bank, bad bank split requires consideration of funding sources. That is, the original institution is presumably undercapitalized in part because the bad assets are not performing as expected and, therefore, their current market price is less than the original price. Somehow, these losses must be recognized and absorbed. One method is for the bad bank to purchase the non-performing assets from the good bank. If the purchases occur at current market prices then the losses are absorbed by the good bank (the original) and the good bank will remain undercapitalized if no other action is taken. If the bad bank is underwritten by a third party, such as the government, and the bad bank pays the original price of the asset then the bad bank and the third party absorb the losses. Programs can be created that share losses. It is likely that a bad-bank would be at least partially funded with TARP money. Many of the features of a bad bank were part of the original TARP discussion.

There have been a number of variations on the good-bank, bad-bank split. In the United States, the use of the good-bank, bad bank structure was often used during the Savings and Loan Crisis. In some ways, the Resolution Trust Corporation itself was a form of a bad bank because it acquired and disposed of nonperforming assets while allowing some thrifts to re-emerge with more healthy balance sheets. Similar procedures are sometimes used by the FDIC when it serves as a receiver or conservator of troubled banks. Because of this expertise, some have proposed that the FDIC administer a larger bad bank program for the current financial turmoil.

Author Contact Information

Edward V. Murphy
Specialist in Financial Economics
tmurphy@crs.loc.gov, 7-6201

Baird Webel
Analyst in Financial Economics
bwebel@crs.loc.gov, 7-0652

[21] See IMF proposal for dealing with troubled assets through a bad bank, “Governments Must Take Stronger Measures to Strengthen Banks,” January 28, 2009, available at http://www.imf.org/external/pubs/ft/survey/so/2009/RES012809B.htm.