Emergency Economic Stabilization Act of 2008

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*** Note: On November 12, 2008, the U.S. Treasury set aside the TARP plan in favor of a capital purchase program.**

This paper provides a brief summary of the Emergency Economic Stabilization Act of 2008 (EESA or the Act) enacted on October 3, 2008. This legislation was a reaction to the turmoil in the U.S. economy arising from the subprime mortgage crisis. This crisis erupted when the market for securities (financial instruments like stocks, bonds, and derivatives) that were based on "subprime" mortgages (riskier mortgages made to people with less-than-perfect credit) collapsed after these mortgages began defaulting at unexpectedly high rates. Many financial institutions in the United States and abroad had purchased large amounts of these securities on the assumption that they were relatively low-risk investments. When the market for the securities collapsed, the institutions holding these mortgage-backed securities found themselves with billions of dollars worth of now-worthless assets. This caused a global domino effect of institution failures (or near-failures) and government rescues on a case-by-case basis. It also caused banks to stop lending money generally.

Congress passed the EESA with the goal of stabilizing the economy by thawing the frozen credit markets, both for consumer lending and for lending between banks. It also hoped to avoid further failures of "too-big-to-fail" financial institutions and to restore investor confidence in the markets by creating a market for these institutions' so-called "toxic" subprime mortgage-related assets.

The legislation first establishes the Troubled Asset Relief Program (TARP) and spells out how it will function in general terms. It also addresses concerns about the use of taxpayer money by requiring companies that participate in the program to issue equity warrants to the government, so that the government will share in any benefit the institutions accrue as a result of the bailout. Additionally, the recoupment provision is designed to protect against abuse of taxpayer money by permitting the government to recoup from the financial industry any losses TARP suffers after five years of operation. Legislators also included restrictions on executive compensation for those institutions that participate. The Act includes additional measures for economic stabilization, such as (1) the provision giving the Federal Reserve (the Fed) the right to pay interest on bank reserves deposited with it and (2) the guarantee program to allow companies to insure their assets. Finally, the Act addresses "Main Street" economic concerns by increasing the Federal Deposit Insurance Corporation's (FDIC) consumer bank deposit insurance limit to $250,000. It also expands eligibility for the HOPE Act and requires the

Department of the Treasury (Treasury) to make an effort to modify the terms of "troubled" mortgages so as to reduce foreclosures.

The EESA is often referred to in the press as the "$700 billion bailout plan." This is because the Act authorizes the Treasury to spend up to $700 billion on the programs in the Act. The Treasury does not immediately get unfettered access to the entire sum, however. Initially, the Treasury can use up to $250 billion to get the program started. Upon certification by the President that additional funds are needed, another $100 billion will be released. The final $350 billion can then be requested from Congress, subject to its disapproval.

I. The Troubled Asset Relief Program (TARP)

a. What is it?

The TARP is the largest part of the so-called "$700 billion bailout plan." It allows the government to purchase "troubled" or "toxic" assets—for example, securities based on subprime mortgages—from struggling financial institutions. This allows the participating institutions to clean up their balance sheets. In other words, this program allows financial institutions to sell the assets to decrease their debt to capital ratios, which will help improve their financial situation and increase investor confidence in the institutions and, hopefully, the markets. Another important goal of TARP is to create incentives for banks to begin lending again, both to each other and to consumers and businesses. The hope is that once the toxic assets are removed from the banks' balance sheets, they will resume their lending. As banks gain increased lending confidence, the interbank lending interest rates (the rates at which the banks lend to each other on a short term basis) should decrease, further facilitating lending.

The TARP will operate as a "revolving purchase facility." The Treasury will have a set spending limit, $250 billion at the start of the program, with which it will purchase the assets and then sell them. The money earned from the sale will go back into the pool, facilitating the purchase of more assets. As noted above, the initial $250 billion can be increased to $350 billion upon the President's certification to Congress that such an increase is necessary. The remaining $350 billion may be released to the Treasury upon a written report to Congress from the Treasury with details of its plan for the money. Congress then has 15 days to vote to disapprove the increase before the money will be automatically released.

b. Who can participate?

The Act's criteria for participation are very unclear. It states that "financial institutions" will be included in TARP if they are "established and regulated" under the laws of the United States and if they have "significant operations" in the United States. The Treasury will need to

define what institutions will be included under the term "financial institution" and what will constitute "significant operations."

Certain institutions seem to be guaranteed participation. These include: U.S. banks, U.S. branches of a foreign bank, U.S. savings banks or credit unions, U.S. broker-dealers, U.S. insurance companies, U.S. mutual funds or other U.S. registered investment companies, tax-qualified U.S. employee retirement plans, and bank holding companies.

Whether hedge funds, as virtually unregulated institutions, will be included depends on the discretion of the Treasury, but it seems unlikely. Hedge funds (partnerships in which experienced investors pool their money to make complex, and often risky, investments using advanced investment strategies) have recently become politically unpopular in the U.S. as a result of their perceived role in creating the crisis. This perception of hedge funds makes it difficult for the Treasury to allow them to participate in a taxpayer-funded bailout program.

c. **What assets can the government buy?**

TARP allows the Treasury to purchase both "troubled assets" and any other asset the purchase of which the Treasury determines is "necessary" in order to further economic stability. Troubled assets include real estate and mortgage-related assets and securities based on those assets. This includes both the mortgages themselves and the various financial instruments created by pooling groups of mortgages into one security to be bought on the market. This category probably includes foreclosed properties as well.

Real estate and mortgage-related assets (and securities based on those kinds of assets) are eligible if they originated (that is, were created) or were issued on or before March 14, 2008, the date of the Bear Stearns bailout.

d. **How will the government value the assets it purchases?**

One of the most difficult issues facing the Treasury in managing TARP is the pricing of the troubled assets. The Treasury must find a way to price extremely complex and sometimes unwieldy instruments for which a market does not exist. In addition, the pricing must strike a balance between efficiently using public funds provided by the taxpayer and providing adequate assistance to the financial institutions that need it.

The Act encourages the Treasury to design a program using market mechanisms to the extent possible. This has led to the expectation that the Treasury will use a "reverse auction" mechanism to price assets. A reverse auction means that bidders (that is, the potential sellers of the troubled assets) will place bids with the Treasury for the right to sell a

specified type of assets. The sale price will be the lowest price at which the bid will provide the required quantity of the item. Theoretically, the system creates a market price because the bidders will want to sell at the highest price they can get, but they also want to be able to make a sale, so they must set a low enough price to be competitive. The Treasury is required to publish its methods for pricing, purchasing, and valuing troubled assets no later than two days after the purchase of their first asset.

II. How Does the Act Protect Taxpayer Investment in TARP?

a. **Equity stakes**

The Act requires financial institutions selling assets to TARP to issue equity warrants (a type of security that entitles its holder to purchase shares in the company issuing the security for a specific price), or equity or senior debt securities (for non-publicly listed companies) to the Treasury. In the case of warrants, the Treasury will only receive warrants for non-voting shares, or will agree not to vote the stock. This measure is designed to protect taxpayers by giving the Treasury the possibility of profiting through its new ownership stakes in these institutions. Ideally, if the financial institutions benefit from government assistance and recover their former strength, the government will also be able to profit from their recovery.

b. **Limits on executive compensation**

The Act sets some new limits on the compensation of the five highest-paid executives at companies that elect to participate significantly in TARP. The Act treats companies that participate through the auction process differently from those that participate through direct sale (that is, without a bidding process).

i. **<u>Companies who sell more than $300 million in assets through an auction process</u>**

For these institutions, the Act prohibits them from signing new "golden parachute" contracts (employment contracts that provide for large payments upon termination) with any future executives. It will also place a $500,000 limit on annual tax deductions for payment of each executive, as well as a deduction limit on severance benefits for any golden parachutes already in place.

ii. **<u>Companies in which the Treasury acquires equity because of direct purchases</u>**

These companies must meet tougher standards to be established by the Treasury. These standards will require the companies to eliminate compensation structures that encourage "unnecessary and excessive" risk-taking by executives, provide for

claw-back (forced repayment of bonuses in the event of a post-payment determination that the bonuses were paid on the basis of false data) of bonuses already paid to senior executives based on financial statements later proven to be inaccurate, and prohibit payment of previously established golden parachutes.

c. **Recoupment**

This provision was a big factor in the eventual passage the EESA. It gives the taxpayer the opportunity to "be repaid." The recoupment provision requires the Director of the Office of Management and Budget to submit a report on TARP's financial status to Congress five years after its enactment. If TARP has not been able to recoup its outlays through the sale of the assets, the Act requires the President to submit a plan to Congress to recoup the losses from the financial industry. Theoretically, this prevents TARP from adding to the national debt. The use of the term "financial industry" in the provision leaves open the possibility that such a plan would involve the entire financial sector rather than only those institutions that availed themselves of TARP.

d. **Disclosure and transparency**

Though the Treasury will ultimately determine the type and extent of disclosure required for participation in the TARP, it is clear that these requirements will be extensive, particularly with respect to any asset acquired by TARP. It seems certain that institutions who participate in TARP will have to publicly disclose information pertaining to their participation, including the amount of assets they sold to TARP, what type of assets were sold, and at what price. More extensive disclosure may be required at the discretion of the Treasury.

The Act also seems to give a broad mandate to the Treasury to determine, for each "type" of institution that sells assets to TARP, whether the current disclosure and transparency requirements on the sources of the institution's exposure (such as off-balance sheet transactions, derivative instruments, and contingent liabilities) are adequate. If the Treasury finds that a particular institution has not provided sufficient disclosures, it has the power to make recommendations for new disclosure requirements to the institution's regulators, which will probably include foreign-government regulators for those foreign financial institutions that have "significant operations" in the United States.

e. **Judicial review of Treasury actions**

The Act provides for judicial review of the actions taken by the Treasury under the EESA. In other words, the Treasury may be taken to court for actions it took pursuant to the Act. Specifically, Treasury actions may be held unlawful if they involve an abuse of discretion, or are found to be "arbitrary, capricious . . . or not in accordance with law." However,

a financial institution that sells assets to TARP is not allowed to challenge the Treasury's actions with respect to its specific participation in TARP.

III. Oversight and Regulation of TARP

a. The Financial Stability Oversight Board (FSOB)

The FSOB is to be made up of the Secretary of the Treasury, the Chairman of the Fed, the Chairman of the Securities and Exchange Commission (SEC), the Director of the Federal Housing Finance Agency, and the Secretary of Housing and Urban Development. Its purpose is to review the operation of TARP, to make recommendations to the Treasury for improvements, and to watch for fraud and misrepresentation. The FSOB also has the power to ensure that the Treasury follows policies in accordance with the Act and the economic interest of the U.S. It is to meet on a monthly basis and report to Congress and the Oversight Panel quarterly.

b. The Congressional Oversight Panel (the Oversight Panel)

The Oversight Panel also consists of five members. These individuals are appointed by Congress; however, they do not have to be members of Congress themselves. This panel will monitor the general implementation of the Act and will report monthly to Congress.

c. Special Inspector General for TARP

The President will appoint, with the advice and consent of Congress, a Special Inspector General for TARP. This office will be responsible for auditing and monitoring the purchase, management, and sale of assets through TARP and for monitoring any insurance programs established under the Act. The Special Inspector General must keep lists of all institutions participating in TARP as well as running lists of the total amount of assets purchased, held, and sold. The Special Inspector General is to report to Congress on a quarterly basis.

IV. Other Measures to Assist Financial Institutions

a. The Optional Guarantee Program

The Optional Guarantee Program was added to the final version of the EESA. Many details about the program's operation remain undefined as of now. Basically, this program would function like an insurance policy for assets held by financial institutions. An institution could choose to participate by paying a premium to the Treasury, which would then promise to pay the institution for any costs arising from any future default of the guaranteed asset. As with insurance, the cost of the premiums will likely vary with the amount of risk involved. However, the premiums must total a sum sufficient to meet anticipated claims. If there is a difference between the total amount guaranteed and total premiums

collected, the TARP pool must reduced by that amount so as to insure the payment of guarantees.

b. **Potential changes to mark-to-market accounting**

Mark-to-market accounting is the process by which a position or portfolio is revalued based on the closing price of an asset on the market on a particular day. Instead of being valued at the original purchase price, the portfolio is valued at its current market worth. Prior to the Act, the Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Standards 157 (FAS 157) principally regulated this practice in the United States.

Many within the financial and academic communities have blamed mark-to-market accounting—particularly its use in relation to inactive markets, such as the current markets for mortgage-backed securities—for much of the damage caused by the current financial crisis. These critics allege that requiring banks and financial institutions to value assets at current market rate, even if the market is temporarily depressed, causes these institutions to post massive, but ultimately artificial, losses. When an institution has to post such a loss it reduces investor confidence in the institution. The write-downs (that is, the process of reporting a loss on the asset) of mortgage-backed securities have been a significant factor in the death spiral of many important financial institutions in the United States and abroad. In response to concerns related to FAS 157's heavy reliance on the depressed market price for distressed assets in its accounting guidelines, the FASB and the SEC released a joint statement on September 30, 2008 attempting to offer guidance to institutions in their accounting for inactive or temporarily depressed assets. The FASB then released a new set of guidelines on October 10, 2008 clarifying that financial institutions may now rely on estimates and their own financial models instead of the now depressed market prices in order to determine the value of a particular asset. Nonetheless, many financial institutions are still unsatisfied with the new guidelines and have called on the SEC to take action to overrule them, though there has been no consensus on a counterproposal.

The SEC has the power to regulate these accounting practices because they are used to price securities and the SEC regulates the issuance and sale of securities. Recognizing the discontent on the part of financial institutions, the EESA reaffirms the SEC's power to suspend the mark-to-market requirement and orders it to conduct a study of the regulation to determine its value, and the role it has played in the current crisis.

c. **Interest on Federal Reserve balances**

The Act allows the Fed to pay interest on balances held by it on behalf of depository banks. The Fed requires banks to deposit a certain

amount of capital proportionate to a bank's specific deposit liabilities with it. This guarantees that banks will have sufficient funds to accommodate withdrawals and other transactions requiring capital reserves. This provision, which was previously scheduled to take effect in October of 2011, will remove the disincentive that such institutions had to deposit excess capital reserves with the Fed since they will now be earning interest on the money.

V. Additional Measures for Direct Assistance of Taxpayers

a. **Increase in deposit insurance**

The EESA extends the maximum federal deposit insurance to $250,000 from $100,000 until December 31, 2009. Deposit insurance guarantees that a consumer's deposit at an FDIC-insured bank will not be lost in the event of a bank failure. The FDIC will now be able to fund this increase through unlimited borrowing from the Treasury.

b. **HOPE Act amendments and foreclosure relief**

The HOPE Act was enacted in July 2008 as a temporary and voluntary relief for American homeowners struggling to make mortgage payments. The original Act provides relief for these mortgage borrowers if they have a debt-to-income ratio greater than 31 percent and their mortgage lender is willing to write down the principal to less than 90 percent of the appraised value of the property.

The EESA amends the HOPE Act to allow a wider range of mortgage borrowers to participate. The amendment expands eligibility by including borrowers who are "likely to have, due to the terms of the mortgage being reset," a mortgage to debt ratio greater than 31 percent. The amendment also gives the HOPE program the discretion to lower the previously required write-down of the mortgage principal.

The EESA requires the Treasury to implement a plan for mortgages acquired under TARP to maximize homeowner assistance and encourage lenders to participate in foreclosure reduction programs like HOPE. The EESA also gives the Treasury similar powers to issue loan guarantees and credit enhancements to prevent avoidable foreclosures.

c. **Tax relief**

The Act as ultimately passed also extends the alternative minimum tax relief, deductions for state and local taxes, and several other tax credits.