



CRS Report for Congress

Financial Market Intervention

Edward V. Murphy
Analyst in Financial Economics
Government and Finance Division

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. 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 provides answers to some frequently asked questions concerning the financial disruptions of September 2008 and the Troubled Asset Relief Program (TARP) in H.R. 3997.

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 fulfil 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. 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

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

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

of similar maturities. These spreads first spiked in August 2007.² Although spreads declined following policy responses by the Federal Reserve, the Treasury, and the passage of the 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.

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.⁴

If 97% of borrowers are still current on their mortgage, 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.⁵ 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.⁶

Why did the financial shocks happen? Reasonable people will continue to disagree as to the root cause of the turmoil. The following factors are not mutually exclusive. Some believe that low interest rates and loose monetary policy caused a housing bubble that was bound to burst when interest rates rose.⁷ Others place more

² CRS Report RL34182, *Financial Crisis? The Liquidity Crunch of August 2007*, by Darryl E. Getter, Edward V. Murphy, Marc Labonte, and Mark Jickling.

³ CRS Report RL33775, *Alternative Mortgages: Causes and Policy Implications of Troubled Mortgage Resets in the Subprime and Alt-A Markets*, by Edward V. Murphy.

⁴ CRS Report RS22932, *Credit Default Swaps: Frequently Asked Questions*, by Edward V. Murphy.

⁵ CRS Report RL34412, *Averting Financial Crisis*, by Mark Jickling.

⁶ CRS Report RL34232, *Understanding Mortgage Foreclosure: Recent Events, the Process, and Costs*, by Darryl E. Getter.

⁷ CRS Report RL33666, *Asset Bubbles: Economic Effects and Policy Options for the Federal Reserve*, by Marc Labonte.

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.⁸ 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.

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 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? 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 In addition to pursuing both of these responses, policymakers have also sought to prevent the financial sector from ceasing to function. Liquidity was increased by expanding the range of collateral accepted at the Federal Reserve's discount window and by holding regular liquidity auctions.¹² Policymakers at the Federal Reserve and the Treasury have also tried to overcome collective action problems among private investors 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).¹³

Policymakers have also sought to help stabilize mortgage markets. In addition to Treasury, the Department of Housing and Urban Development (HUD), and the Federal Deposit Insurance Corporation (FDIC) efforts 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

⁸ CRS Report RS22722, *Securitization and Federal Regulation of Mortgages for Safety and Soundness*, Edward V. Murphy.

⁹ CRS Report RL34349, *Economic Slowdown: Issues and Policies*, by Jane G. Gravelle, Thomas L. Hungerford, Marc Labonte, N. Eric Weiss, and Julie M. Whittaker.

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 RL34420, *Bear Stearns: Crisis and 'Rescue' for a Major Provider of Mortgage-Related Products*, by Gary Shorter.

loans held in securitized trusts.¹⁴ The government also enacted (P.L. 110-289) a voluntary plan to allow banks to write down the balance of existing loans so that borrowers can refinance into FHA to avoid foreclosure.¹⁵ The act also provided some Community Development Block Grant (CDBG) funds to allow local communities to acquire and redevelop vacant and foreclosed properties.¹⁶ The act also created a new regulator for the government-sponsored enterprises (GSEs), Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.¹⁷ The act gave Treasury the temporary authority to purchase debt and equity securities of the GSEs.

September 2008 saw a series of financial market interventions. First, the newly reorganized Federal Housing Finance Agency (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.¹⁸ 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 bridge loan three days later.¹⁹ The next day financial markets froze up and Treasury announced a proposal to buy mortgage-related assets from financial institutions.

Why has the Federal Reserve not restored order in financial markets?

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

¹⁴ 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.

¹⁵ CRS Report RL34623, *Housing and Economic Recovery Act of 2008*, by N. Eric Weiss, Darryl E. Getter, Mark Jickling, Mark P. Keightley, Edward V. Murphy, and Bruce E. Foote.

¹⁶ CRS Report RS22919, *Community Development Block Grants: Legislative Proposals to Assist Communities Affected by Home Foreclosures*, by Eugene Boyd and Oscar R. Gonzales.

¹⁷ CRS Report RL33940, *Reforming the Regulation of Government-Sponsored Enterprises in the 110th Congress*, by Mark Jickling, Edward V. Murphy, and N. Eric Weiss.

¹⁸ CRS Report RS22950, *Fannie Mae and Freddie Mac in Conservatorship*, by Mark Jickling.

¹⁹ CRS Report RS22956, *The Cost of Government Financial Interventions, Past and Present* Baird Webel, N. Eric Weiss, and Marc Labonte.

liquidity of particular assets, for example, by expanding the categories of assets that it will accept as collateral for loans, but the Federal Reserve has not restored bank capital.

What does Treasury propose to do? The Department of the Treasury proposed replacing the case-by-case approach to interventions in the financial markets that had prevailed from summer 2007 through summer 2008 with a systemic program.²⁰ Some believe that intervening on behalf of some ailing financial institutions but not others contributes to investor uncertainty. 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. Some policymakers have suggested that any program provide greater management oversight, limits on the executive pay of participating financial institutions, and other conditions to monitor the use of taxpayer funds. Some policymakers have also suggested that bankruptcy judges be granted the authority to modify loans of troubled borrowers under some circumstances. Another possibility is providing a government guarantee of payment on the assets rather than government acquisition.

What were some of the additions and deletions to the proposal offered in H.R. 3997? The expressed purpose of the Emergency Economic Stabilization Act of 2008, H.R. 3997, was to “...provide authority and facilities that the Secretary of the Treasury can use to restore liquidity and stability to the financial system.”²¹ This measure, voted down on September 29, 2008, addressed some of the concerns that some policymakers may have had regarding the three-page Treasury plan. A short description of some of the provisions of the Troubled Asset Relief Program (TARP) follows.

- 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 provides for insurance of some troubled assets as an alternative to, or in addition to, purchasing troubled assets.
- It 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.
- 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.

²⁰ CRS Report RS22957, *Proposal to Allow Treasury to Buy Mortgage-Related Assets to Address Financial Instability*, by Edward V. Murphy and Baird Webel.

²¹ H.R. 3997 was originally introduced as a tax relief measure to assist service members. The present discussion is based on a draft (as of 9:10 p.m., Sep. 28, 2008) offered by the House in the nature of a substitute.

- The measure 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.