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The "Bailout Bill" and the Financial Markets: A Plain-English Guide

On October 3, 2008, Congress passed, and the President signed, the Emergency Economic Stabilization Act of 2008 (EESA). The wide-ranging legislation contains a variety of tax relief measures and other provisions. However, the cornerstone of the bill--widely referred to as the "bailout bill"--was designed as a rescue plan for the financial markets.

Why the EESA?

The "bailout" portion of the Emergency Economic Stabilization Act of 2008 was passed in response to a request by U.S. Treasury Secretary Henry Paulson, who said quick action and expanded Treasury authority were needed to address turmoil in the financial markets (see sidebar "A brief chronology of what led to the bailout bill"). The financial world has become so tightly linked that when one portion of it--subprime mortgages and securities based on them--began to experience difficulties, the problems created a ripple effect that spread across the globe.

Greater Treasury authority to support financial institutions

The Act creates the Troubled Asset Relief Program (TARP), which gives the Treasury broad and flexible powers to offer support to financial institutions. TARP is designed to provide capital to banks and other financial institutions--money intended to help them continue lending to institutional investors, companies, and individuals.

> ***The bailout in action***
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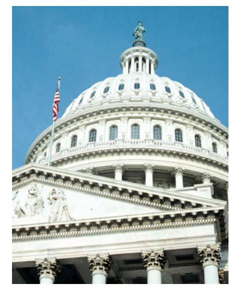
> *After the EESA was passed, the TARP established the Capital Purchase Program to handle the purchase of up to $250 billion of senior preferred shares in financial institutions that apply for help, and announced it may also use TARP funds to help increase the availability of consumer credit.*

The TARP administration, a division of the U.S. Treasury, has a great deal of latitude in how it can provide support and additional capital. It may purchase troubled assets--for example, residential and commercial mortgages, mortgage-backed securities or other mortgage-related instruments, and debt obligations--directly from a qualifying institution. It also may buy assets through a reverse auction. It may provide a federal guarantee for troubled assets, and charge banks a premium for that guarantee. It may lend money to troubled institutions. It may acquire an equity stake in financial institutions.



To try to ensure that taxpayers benefit from any government-financed improvement in the financial condition of companies that participate in the TARP, the Treasury will receive warrants to purchase company stock. A warrant entitles the holder to buy common stock, typically at a higher price than the market price when the warrant was issued.

The Act also permits banks and thrifts to treat gains or losses on Fannie Mae and Freddie Mac preferred stock as ordinary income for tax purposes rather than capital gains. The provision applies to stock held on September 8, 2008, or sold between January 1, 2008, and September 8, two days after the companies were placed under the conservatorship of the Federal Housing Finance Agency (FHFA).

Support of mortgage refinancing and expanded use of HOPE for Homeowners

The Act requires the Treasury Secretary to develop a plan for modifying loans--for example, by reducing interest rates or reducing the principal owed--to prevent mortgage foreclosures affecting assets purchased by the TARP. That plan also must encourage mortgage servicers to take advantage of the HOPE for Homeowners program, established as part of the July 2008 Housing and Economic Recovery Act. A similar plan is required of federal agencies that manage residential property or hold mortgage-backed securities, including the FHFA, FDIC, and the Federal Reserve Banks.

The Act also expands eligibility for the HOPE for Homeowners program. Homeowners whose mortgage is likely to represent more than 31% of their income because of a mortgage reset now qualify for the program. The requirement that a refinanced mortgage be limited to 90 % of the home's appraised value has been eliminated.

> ***Lubricating the engine***
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> *In business, credit works as a lubricant, much as oil does for your car. Just as the gears can seize up when your car runs out of oil, a similar situation was affecting the credit markets. The EESA was passed to try to ensure that a credit shortage did not bring the world's financial engines to a halt.*

Phased financing

The Act authorizes up to $700 billion in funding for the TARP. An initial $250 billion was made available initially. Another $100 billion will be made available if necessary, subject to Presidential approval. A final installment of $350 billion could be blocked by a vote of Congress after reviewing a Presidential report on the intended use of the money.

Limits on executive compensation

The Act imposes two separate sets of constraints on the compensation of senior (the top five highest paid) executives of companies helped by the TARP. Companies whose securities are purchased directly by the Treasury (1) may not compensate senior executives in ways that encourage "unnecessary and excessive risk-taking," (2) must be able to recover incentives or bonuses based on information later found to be inaccurate, and (3) may not make any "golden parachute" payments to senior executives while the Treasury holds its securities. If the Treasury buys more than $300 million worth of a company's securities (including direct purchases) at auction, the company may not offer senior executives a new contract with a golden parachute provision. These limits apply only while the Treasury holds a company's securities or assets.

Who's watching the till?

To oversee the program's implementation, the Act creates the Financial Stability Oversight Board. In addition to the Treasury Secretary, it includes the Chairman of the Federal Reserve Board, the Director of the Federal Housing Finance Agency, the Chairman of the Securities and Exchange Commission (SEC), and the Secretary of Housing and Urban Development (HUD).

This board will report quarterly to a five-member Congressional oversight panel that includes one member from each party in both the House and Senate, and one appointed by the Speaker of the House. That panel must report to Congress monthly. The President also will appoint a special inspector general to monitor potential waste, fraud, and abuse.

Bank deposit protection

The EESA also temporarily increases the Federal Deposit Insurance Corporation and National Credit Union Share Insurance Fund standard deposit insurance limits from $100,000 per account to $250,000 through December 31, 2009.

Other provisions

The Act also:

- Requires the Comptroller General to report by June 1, 2009, on the role of leverage in creating the credit crisis
- Increases the limit on the national debt to $11.315 trillion

The TARP's authority is scheduled to expire as of December 31, 2009, though the Treasury Secretary could extend that through October 3, 2010 with written justification to Congress.

A brief chronology of what led to the bailout bill

- *Low interest rates encouraged widespread use of credit, including mortgages and home equity loans.*
- *When home prices fell, many homeowners owed more on their homes than the homes were worth and began defaulting on their mortgages.*
- *As mortgage defaults rose, investors became concerned that securities backed by those mortgage payments would also default, and the value of those securities dropped.*
- *Banks and other financial institutions that had bought those securities and used them as collateral for other investments began having trouble maintaining their required capital reserves. Companies that had guaranteed repayment of many of those debt instruments also were at risk because they lacked enough resources to make good on all the guarantees they had made.*
- *Lenders became reluctant to lend money, even to other institutions, because of increased uncertainty about which borrowers might owe money to whom and how much. And investor uncertainty about the safety and stability of financial institutions in general began to prevent global credit markets from facilitating day-to-day business activities, such as ordering inventories and paying employees.*
- *The bailout bill was adopted to try to enable global credit markets to function normally.*

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