The Economic Bailout: An Analysis of the Economic Emergency Stabilization Act

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INTRODUCTION

With a vote of 263 to 171, the House of Representatives, on Oct. 3, 2008, approved legislation aimed to address the credit and liquidity crisis affecting the nation's financial system. The Senate approved the legislation, the "Emergency Economic Stabilization Act of 2008" or "EESA," on Wednesday, Oct. 1, 2008, by a vote of 75 to 24.

President Bush signed the legislation into law within two hours of its final passage, and declared in a Rose Garden speech that the legislation is "essential to helping America's economy weather this financial crisis."

The legislation provides the Treasury Department up to $700 billion to purchase, manage and sell assets held by financial institutions that are considered to be "troubled" or "toxic."

BACKGROUND

The current credit crisis, which led to the enactment of the EESA, has its deepest roots in the subprime mortgage crisis, known in the popular media as the "mortgage meltdown," that came into prominence in 2007. While many experts originally believed that the mortgage crisis would be contained within the mortgage industry, few at that time predicted its vast reach into the financial markets.

Experts point to a number of causes for the mortgage meltdown:

- the bursting of the U.S. housing bubble that had peaked in 2005;
- historically low interest rates that led to the inflation of the housing bubble;
- a housing market correction that stemmed from the over valuation of homes during the bubble period; and
- the rise of subprime lending.

With the collapse of the housing bubble came increasingly higher default rates on subprime, adjustable rate and other mortgage loans made to higher-risk borrowers with lower income or lesser credit history than "prime" borrowers. The number of subprime loans rose as rising real estate values led to lenders taking more risks. Many experts believe that Wall Street encouraged this type of behavior by bundling the loans into securities that were sold to pension funds and other institutional investors seeking higher returns.

Securitization

One of the causes of the subprime mortgage meltdown is a prominent factor in the current credit crisis: securitization. Securitization is defined as a structured finance process in which assets, receivables or financial instruments are acquired, classified into pools and offered as collateral for third-party investment.

Due to securitization, investor appetite for innovative new products like mortgage-backed securities (MBSs), along with the tendency of rating agencies to assign investment-grade ratings to MBSs, loans with a high risk of default could be originated, packaged and the risk easily transferred to others.

MBSs were attractive to investors because they offered a relatively high yield, had a steady stream of income and were backed by an asset unlikely to lose value: U.S. houses. However, the potential impact of new products like MBS was not understood until after the fact.

When the value of U.S. houses plummeted, the value of the MBSs and other securitization instruments followed, leaving financial institutions holding the mortgage-backed assets with trillions of dollars in bad debt.

EVENTS IMMEDIATELY LEADING TO CURRENT CRISIS

The current credit crisis had been building as the subprime mortgage meltdown spread from the mortgage industry to the national and global markets and throughout the economy. While the focus was on the subprime industry and the effects of the meltdown fallouts, the credit crisis grew steadily until a series of events brought the crisis to the forefront.

- **September 7: Fannie Mae, Freddie Mac Control Shifts to Government**
  The Federal Housing Finance Agency announced that it had placed the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae) into conservatorship. In making the announcement, FHFA Director James B. Lockhart noted that balance between the mission of Freddie Mac and Fannie Mae to provide liquidity to the housing market and their ability to raise and maintain capital "has been lost." Lockhart added that FHFA's action addresses safety and soundness concerns and "pervasive weaknesses across the board" regarding Fannie Mae and Freddie Mac.

- **September 9: Lehman Shows Signs of Losing Battle to Survive**
  It was reported that Lehman Brothers was struggling after losing more than 50 percent of its market value.

- **September 14: Lehman Brothers Bankrupt; Merrill Lynch Sold; AIG Failing**
  Lehman Brothers announced it is filing for bankruptcy and Merrill Lynch agreed to be sold to Bank of America for approximately $50 billion. Insurance giant American International Group sought a $40 billion bridge loan from the Federal Reserve Board to stay in business. In response to these events, the Fed announced initiatives to provide additional support to financial markets, including enhancements to its existing liquidity facilities, such as expanding the collateral eligible to be pledged at the Primary Dealer Credit Facility and Term Securities Lending Facility.

- **September 15: Dow Plummets**

The Dow fell 504 points over news of Lehman's bankruptcy filing and the sale of Merrill Lynch.

- **September 16: $85 Billion Loan Authorized to Save AIG**

The Fed announced that it had authorized the Federal Reserve Bank of New York to lend up to $85 billion to the AIG under Section 13(3) of the Federal Reserve Act. According to the Fed, the secured loan was structured to protect the interests of the U.S. government and taxpayers. The Fed took this action based on its assessment that "a disorderly failure of AIG could add to already significant levels of financial market fragility and lead to substantially higher borrowing costs, reduced household wealth, and materially weaker economic performance."

- **September 17: Credit Markets Panic**

Credit markets stumbled as panicked investors moved their money into the safest investments, such as Treasury bills. The Dow Jones industrial average fell 449 points.

- **September 18: Fed Steps in**

The Treasury Department and Fed began discussions on a plan that would bail out the failing institutions. The Fed joined with five other central banks to add liquidity to the short-term funding markets. The Federal Open Market Committee authorized a $180 billion expansion of its swap lines to provide dollar funding for term and overnight liquidity operations by the other central banks.

Also on September 18, the Treasury Department announced that it has started a temporary Supplementary Financing Program at the Fed's request. The Treasury Department noted that the financing program was necessary to manage the balance sheet impact of the Fed's lending and liquidity initiatives. Under the program, there will be a series of auctions of Treasury bills, apart from the Treasury Department's current borrowing program. The auctions will be governed by existing Treasury Department auction rules.

- **September 19: Congress Called to Act**

Treasury Secretary Henry M. Paulson Jr. and Fed Chairman Ben S. Bernanke asked Congress to take quick action on legislation intended to restore confidence in the financial system by removing illiquid mortgage assets from the balance sheets of financial institutions. Paulson said that "until we get stability in the housing market we're not going to get stability in our financial markets." He explained that illiquid mortgage assets, which have lost value as the housing correction has proceeded, are choking off the flow of credit in the economy and are "undermining the strength of our otherwise sound financial institutions."

- **September 20: Bush Bailout Proposed**

President Bush formally proposed an historical bailout of U.S. financial institutions, requesting virtually unfettered authority for the Treasury Department to buy up to $700 billion in distressed mortgage-related assets from private firms.

- **September 21: Goldman Sachs and Morgan Stanley Transform**
  The Fed announced that the last big investment banks on Wall Street, Goldman Sachs and Morgan Stanley, would transform themselves into bank holding companies subject to greater regulation and closer supervision by bank examiners from several government agencies, as opposed to only the Securities and Exchange Commission. The change provides access to the Fed's lending facilities, making them more financially sound.

- **September 23: Treasury Secretary Paulson Seeks Authority for Rescue**
  Treasury Secretary Henry M. Paulson Jr. appeared before the Senate Banking Committee to ask Congress to promptly give him wide authority under the plan to rescue the nation's financial system.

THE PATH TO EESA

The week after the Treasury Department submitted a three-page, 12-section legislative proposal seeking $700 billion to address the credit and liquidity crisis affecting the nation's financial system, Congressional leaders announced on Sept. 28, 2008, that they had reached an accord on a 110-page, 45-section revised plan, which they intended to take to their respective chambers.

The House of Representatives defeated the measure by a vote of 228-205 on Monday, Sept. 29, 2008. The Senate was then expected to take action on Wednesday, Oct. 1, 2008. It should be noted that after the House defeated the legislation on Sept. 29, 2008, the legislation was deemed to be a "rescue" package.

Before the House's September 29 vote, President Bush said the bill "provides the necessary tools and funding to help protect our economy against a system-wide breakdown." Bush acknowledged that lawmakers face a "difficult vote," but added that he was "confident Congress will do what is best for our economy by approving this legislation promptly."

With the Senate vote looming during the evening of October 1, Senate leaders added tax breaks, dealing with energy, tax extenders and alternative minimum tax relief, as well as higher limits for insured bank deposits in a bid to attract enough votes to reverse defeat in the House. The measure passed the Senate by a vote of 75-24.

The House approved the Senate version on Oct. 3, 2008, by a vote of 263 to 171, and President Bush signed the Act into law within hours of the House vote.

EMERGENCY ECONOMIC STABILIZATION ACT OF 2008

The Emergency Economic Stabilization Act of 2008 provides the Treasury Department $250 billion immediately, and requires the president to certify if an additional $100 billion is necessary. The remaining $350 billion disbursement will be subject to Congressional approval. The Treasury Department is required to report on the use of funds and progress made in addressing the crisis. An oversight board and a special inspector general also will be created to watch over the Treasury. The procedures for Congressional approval regarding the remaining $450 billion are set forth in Section 115 of the EESA.

Under its Sept. 21, 2008, proposal, the Treasury Department requested that the entire $700 billion be authorized at once to address the financial system's credit and liquidity crisis.

Troubled Asset Relief Program

The central feature of the EESA is the establishment of a troubled asset relief program or TARP by the Treasury Secretary "in accordance with [EESA] and the policies and procedures developed and published by the Secretary." Ultimately the TARP will be run by the Office of Financial Stability.

Under Section 101 of the EESA, the TARP will purchase "troubled assets" from "financial institutions." The TARP purchases will begin immediately and the policies and procedures called for by Section 101(a)(1) of the EESA are not "intended to delay the commencement of the TARP."

This purchase authority ends on Dec. 31, 2009.

Troubled Assets. A "troubled asset" is defined under Section 3(9) of the EESA as:

- residential or commercial mortgages; and
- any securities, obligations or other instruments that are based on or related to such mortgages.

To qualify as a troubled asset, any mortgage, security, obligation or other instrument must have been originated or issued on or before March 14, 2008. In addition, the Treasury Secretary must make a determination that the purchase of the asset will promote financial market stability.

Other financial instruments can be considered to be troubled assets if the Secretary determines that their purchase is necessary to promote financial market stability. This determination can only be made after consulting with the Chairman of the Federal Reserve Board and providing the determination in writing to the House Financial Services Committee and Senate Banking Committee.

Financial Institutions. The definition of "financial institution" is covered by Section 3(5) of EESA. The language of the definition states that "the term 'financial institution' means any institution . . . established and regulated under the laws of the United States or any State, territory, or possession of the United States, the District of Columbia, Commonwealth of Puerto Rico, Commonwealth of Northern Mariana Islands, Guam, American Samoa, or the United States Virgin Islands…"

Section 3(5) provides a number of examples of institutions such as banks, savings associations, credit unions, securities brokers or dealers and insurance companies. This is not an exhaustive list.

In addition, the language of Section 3(5) provides that a "financial institution" includes any institution "having significant operations in the United States," thereby allowing foreign banks to participate in the TARP. There is one qualification to foreign participation in the TARP in that "any central bank of, or institution owned by, a foreign government" is excluded.

Secretary's Powers. The Secretary is authorized under Section 101(c) to take actions that it deems necessary to facilitate the TARP. For example, the Secretary would be given flexibility to establish vehicles to purchase, hold and sell troubled assets so as to minimize the cost of the TARP to taxpayers.

Program Considerations. The protection of taxpayers' interest is also one of the factors that the Secretary must take into consideration when exercising the authorities granted in the EESA. Other factors that the Secretary must consider under Section 103 include:

- keeping families in their homes;
- using funds efficiently in purchasing troubled assets; and
- ensuring that all financial institutions are eligible to participate in the TARP.

Program Guidelines. Section 101(d) requires the Secretary to publish guidelines governing the TARP. The timing of these guidelines depends on two events:

- the first purchase of troubled assets; and
- the enactment of the EESA.

If a there is a purchase of troubled assets, then the guidelines must be issued within two business days. Otherwise, the guidelines are to be issued 45 days after the EESA's enactment.

The guidelines are to provide:

- mechanisms for purchasing troubled assets;
- methods for pricing and valuing troubled assets;
- procedures for selecting asset managers; and
- criteria for identifying troubled assets for purchase.

Contracting Procedures. In carrying out the TARP provisions, the Secretary may waive specific provisions of the Federal Acquisition Regulation (FAR) under Section 107 of the EESA. The waiver would be based on a determination that urgent and compelling circumstances make compliance with the FAR provisions contrary to the public interest.

Section 112 of the EESA requires the Secretary to coordinate with foreign financial authorities and central banks to work toward the establishment of programs similar to TARP. If assets are held as troubled assets under the foreign-based TARP, then the assets qualify for purchase by the Secretary under the Section 101 TARP.

Insurance of Troubled Assets

Once the Secretary establishes the TARP, Section 102 of the EESA requires the Secretary to also establish a program to insure troubled assets originated or issued prior to March 14, 2008. This guarantee includes mortgage-backed securities.

This guarantee authority ends on Dec. 31, 2009.

Premiums. A financial institution participating in the guarantee program is required to pay premiums to the Secretary. These premiums are to be set at an amount that is necessary to meet the purposes of the EESA and provide sufficient reserves.

Product Risk. In establishing any premium under the guarantee program, the Secretary may take into consideration the credit risk associated with a particular troubled asset being guaranteed.

Management of Assets

Once the Secretary acquires a troubled asset, Section 106 of the EESA provides the Secretary with a number of powers to administer those troubled assets. Section 106 allows the Secretary to:

- exercise any rights received in connection with the troubled assets;
- have the authority to manage the troubled assets including revenues and portfolio risks; and
- sell any of the troubled assets.

Debt Reduction. Any revenues realized from a sale of troubled assets are to be paid into the general fund of the Treasury for reduction of the public debt. In order to provide funding for the bailout package, Section 122 of the EESA raises the statutory limit on the public debt to $11.315 trillion.

Program Oversight and Taxpayer Protection

As first proposed by the Treasury Department, the asset purchase program had no oversight provisions, which troubled members of Congress, taxpayers and members of the commentariat in the mainstream media and the blogosphere.

In addition, the Treasury Department’s original draft had no provisions to protect the interests of taxpayers.

The EESA addresses this lack of oversight and taxpayer protection in a number of ways.

Taxpayer Protection. As mentioned above, Section 103 of the EESA, regarding "Program Considerations" addresses the protection of taxpayers' interests when purchasing troubled assets under TARP.

Unjust Enrichment. In making purchases of troubled assets under the TARP, Section 101(e) of the EESA requires the Secretary to take the necessary steps to prevent unjust enrichment of financial institutions participating in the TARP.

One step explicitly set forth in the EESA is that the sale of a troubled asset to the Secretary cannot be set at a higher price than what the seller paid to purchase the asset.

The prohibition on unjust enrichment does apply to troubled assets acquired in a:

- merger or acquisition;
- purchase of assets from a financial institution in conservatorship or receivership; or
- bankruptcy proceeding.

Minimizing Impacts on Taxpayers. Taxpayers are further protected by Section 113 of the EESA. Under that provision, the Secretary is required to minimize any potential long-term negative impact on taxpayers by taking into account the direct outlays, potential long-term returns on assets purchased, and the overall economic benefits of the program.

Steps that the Treasury Secretary could take to minimize impact on taxpayers include:

- holding assets to maturity until market conditions are favorable to obtain the maximum return for taxpayers;
- selling assets at a price that would maximize return on investment for the federal government; and
- encouraging the private sector to participate in purchases of troubled assets and to invest in financial institutions.

Market Mechanisms. Another step that the Treasury Secretary is required to take to protect taxpayers is the use of market mechanisms, namely purchasing assets at the lowest price and using auctions or reverse auctions to maximize taxpayer resources. If the use of a market mechanism is not feasible or appropriate, then the Treasury Secretary will be able to make direct purchases from individual financial institutions provided that the prices paid for these direct purchases are reasonable and reflect the underlying value of the asset.

Warrants and Debt Instruments. Section 113(d) of the EESA also requires the Secretary to receive either warrants or senior debt instruments. Warrants will be received from financial institutions associated with the securities industry; all other financial institutions would have to give the Secretary senior debt instruments. The warrants would give the Secretary the right to receive nonvoting common stock or preferred stock in that financial institution.

The Secretary also is required to establish a floor to which the warrant and debt instrument requirement would apply. This floor is based on the size of the cumulative transactions of troubled assets purchased from any one financial institution for the duration of the TARP and is set at $100,000,000.

At a minimum, any warrants received by the Secretary will have to provide taxpayers an equity appreciation. In addition, any warrant has to contain anti-dilution provisions to protect the value of the securities from market transactions.

To protect taxpayers, any senior debt instrument must provide a reasonable interest rate premium.

Recoupment. Once the TARP has been established, the President is required to submit a plan to Congress proposing how to recoup from the financial services industry any projected losses to taxpayers. Section 134 of the EESA requires this presidential plan to be submitted within five years.

Conflicts of Interest. Section 108 of the EESA requires the Secretary to issue regulations or guidelines to address and mange or prohibit conflicts of interest that may arise in connection with the TARP. These regulations or guidelines may include:

- conflicts arising in the selection or hiring of contractors or advisors, including asset managers;
- the purchase of troubled assets;
- the management of the troubled assets held;
- post-employment restrictions on employees; and
- any other potential conflict of interest, as the Secretary deems necessary or appropriate in the public interest.

Oversight Board. Section 104 of the Act establishes the "Financial Stability Oversight Board" which is responsible for:

- reviewing the policies implemented by the Secretary under the TARP;
- making recommendations to the Treasury Secretary regarding the use of the authority under the TARP; and
- reporting any suspected fraud, misrepresentation or malfeasance to the Special Inspector General for the Troubled Assets Relief Program or the Attorney General.

The Special Inspector General for the Troubled Assets Relief Program is established by Section 121 of the EESA and has the duty to conduct, supervise and coordinate audits and investigations of the purchase, management and sale of assets.

Congressional Oversight. There is also a Congressional Oversight Panel created under Section 125. This Panel is composed of Congressional members and is required to review the current state of the financial markets and the regulatory system and submit a number of reports to

Congress**.** A regular report is required to examine how the TARP is being conducted, especially in regards to:

- the impact of assets purchases on the financial market;
- market transparency; and
- foreclosure mitigation.

This regular report is to be submitted within 30 days after the first asset purchases. Subsequent reports are to be made every 30 days.

The Panel is also to submit a special report on regulatory reform not later than Jan. 20, 2009. This report is to analyze the current state of the regulatory system and its effectiveness at overseeing the participants in the financial system and protecting consumers. The special report is also to provide recommendations for improvement, including recommendations regarding whether any participants in the financial markets that are currently outside the regulatory system should become subject to the regulatory system, the rationale underlying such recommendations, and whether there are any gaps in existing consumer protections.

Comptroller General Oversight. The Comptroller General of the United States is required under Section 116 of the EESA to conduct ongoing oversight of the activities and performance of TARP, and to report every 60 days to Congress. The Comptroller General is also required to conduct an annual audit of the TARP. In addition, the TARP is required to establish and maintain an effective system of internal controls.

Market Transparency. To facilitate market transparency, Section 114 of the EESA requires the Treasury Secretary to make certain disclosures that are available to the public regarding descriptions, amounts and pricing of assets acquired under the TARP. These disclosures must be made electronically within two business days of purchase, trade or other disposition.

The Treasury Secretary is also required under Section 114 to determine the adequacy of public disclosures with respect to financial institutions' off-balance sheet transactions, derivatives instruments, contingent liabilities and similar sources of potential exposure. This determination is required so that the public has sufficient information as to the true financial position of the institutions. If the Treasury Secretary determines that the disclosures are not adequate for that purpose, the Secretary is required to make recommendations for additional disclosure requirements to the relevant regulators.

Judicial Review. When the Bush Administration first proposed the rescue package, Section 8 of that proposal read:

> "Decisions by the Secretary pursuant to the authority of this Act are non-reviewable and committed to agency discretion, and may not be reviewed by any court of law or any administrative agency."

This became one the contentious provisions of the original proposal—possibly the most contentious since it effectively denied any type of review of actions taken by the Treasury Department in carrying out the asset purchase program.

Section 119 of the EESA substantially enhances review of the Secretary's actions under the TARP by subjecting those actions to the standards found in the Administrative Procedures Act—namely setting aside actions that are found to be arbitrary, capricious, an abuse of discretion or not in accordance with law.

Equitable Relief. Section 119 also places certain limits on equitable relief against the Treasury Secretary.

In particular, Section 119(a)(2)(A) prohibits injunctory and other equitable relief in regards to actions taken under the Section 101 TARP provisions, the Section 102 troubled assets guarantee provisions, the Section 106 sales provisions and the Section 109 foreclosure mitigation provisions. The only time equitable relief is available is to remedy a violation of the U.S. Constitution.

Any financial institution that divests it assets under the TARP is prohibited from bringing an action against the Treasury Secretary unless the claim is based on a violation of the Constitution.

Executive Compensation

Although not included in the Treasury Department's original three-page proposal, Section 111 of the EESA addresses limits on executive compensation for those financial institutions participating in the TARP.

Direct Purchases. If the Secretary directly purchases troubled assets from a financial institution and the Secretary "receives a meaningful equity or debt position in the financial institution," the institution is required to observe appropriate standards concerning executive compensation and corporate governance.

—Incentive Compensation. The EESA places limits on compensation that exclude incentives for executive officers of a financial institution to take unnecessary and excessive risks that threaten the value of the financial institution. This limitation is to last during the period that the Secretary holds an equity or debt position in the financial institution.

—Claw-Back Provisions. Another curb on compensation is implementation of a "claw-back" provision that would enable a financial institution participating in the TARP to recoup compensation that was based on earnings or gains that later proved to be inaccurate. This claw-back applies to "senior executive officers." It should be noted that about 40 percent of *Fortune* 100 companies and 28 of the 30 companies that make up the Dow Jones Industrial Average already have claw-back procedures.

—Golden Parachutes. The final compensation limitation prohibits golden parachutes being made to a financial institution's "senior executive officer" during the period that the Secretary holds an equity or debt position in the financial institution.

The EESA defines "senior executive officer" as an individual who is one of the top five executives of a public company, whose compensation is required to be disclosed pursuant to the Securities Exchange Act of 1934, and non-public company counterparts.

Auction Purchases. If the Secretary purchases troubled assets at auction, a financial institution that has sold more than $300 million in assets is subject to additional taxes, including a 20-percent excise tax on golden parachute payments triggered by events other than retirement, and tax deduction limits for compensation limits above $500,000.

Accounting Requirements

A number of provisions of the EESA address accounting issues governed by the Securities and Exchange Commission.

Suspending Mark-to-Market Accounting. Section 132 of the EESA restates the SEC's authority to suspend the application of Statement Number 157 of the Financial Accounting Standards Board (FASB) if the SEC determines that it is in the public interest and protects investors.

On Sept. 30, 2008, the SEC issued a press release announcing that the staffs of the SEC and FASB were jointly providing clarifications based on the fair value measurement guidance in FASB Statement No. 157—Fair Value Measurements. The clarifications were intended to help preparers, auditors and investors address fair value measurement questions that have been cited as factors in causing the credit and liquidity crisis.

Mark-to-Market Study. Section 133 of the EESA also requires the SEC, the Fed and Treasury Department to conduct a study on mark-to-market accounting standards as provided in FASB 157, including the effect on balance sheets, impact on the quality of financial information, and other matters. A report is to be submitted to Congress within 90 days of the agencies' findings.

Assistance for Homeowners

A number of provisions of the EESA address efforts to mitigate home foreclosures and to further assist homeowners facing foreclosure.

Loan Modifications. If the Secretary acquires troubled assets that are secured by residential real estate, Section 109(a) of the EESA requires the Secretary to implement a plan that seeks to maximize assistance for homeowners and to encourage the servicers of the underlying mortgages to take advantage of the HOPE for Homeowners Program. In carrying out the plan, the Secretary must consider the net present value to the taxpayer.

The HOPE for Homeowners Program, which was part of The Housing and Economic Recovery Act of 2008, permits the Federal Housing Administration to refinance the mortgages of at-risk borrowers living in their principal residence as a foreclosure mitigation effort. Certain conditions must be met before the FHA can refinance the mortgage. These conditions are:

- a mortgage holder writes down the principal of the mortgage;
- the homeowner agrees to share future equity with the federal government; and
- the homeowner demonstrates the ability to repay the new loan.

Section 124 of the EESA strengthens the Hope for Homeowners Program to increase eligibility and improve the tools available to prevent foreclosures.

To facilitate loan modifications, such as term extensions, rate reductions and principal write downs, the Secretary is permitted to use loan guarantees and credit enhancements.

Home Renters. The EESA also protects persons renting homes. Under EESA Section 109, if a tenant is renting a home that is part of troubled assets acquired by the Secretary, the tenant must be able to remain in the home as long as he or she is current on the rent.

Federal Property Managers. A number of federal agencies—the Federal Housing Finance Agency, Fed and Federal Deposit Insurance Corp.—are deemed to be "federal property managers" and are also required, under EESA Section 110, to implement a similar plan encouraging the servicers of the underlying mortgages to take advantage of the HOPE for Homeowners Program. Section 110 also allows the federal property managers to enter into loan modifications.

Interestingly, Section 110, as opposed to Section 109, does not explicitly provide that home renters can continue living in their homes as long as their rent is current. However, Section 110 does provide that any loan modifications must ensure that rent subsidies and protections are continued and that there are sufficient operating funds to ensure that the rental property is properly maintained. Because there is a property maintenance requirement, it could be argued that Congress implicitly intended to allow home renters to continue to live in their homes since landlord-tenant law generally allows a tenant to terminate a lease if the landlord fails to maintain the rental property.

Increase in Deposit Insurance Limits

As an inducement to pass the rescue legislation, the Senate added a provision into the proposed language of the EESA that would increase the "standard maximum deposit insurance amount" from $100,000 to $250,000. This increase, found in EESA Section 136, would be temporary and end on Dec. 31, 2009. In addition, the increase in the "standard maximum deposit insurance amount" would not be taken into consideration when the FDIC sets the assessments that are used to fund the Deposit Insurance Fund.

Budget Considerations

There are a number of provisions in the EESA that deal with how the Act is to be treated in the budget.

The Secretary would be required to provide the Congressional Budget Office (CBO) and Joint Committee on Taxation with information the Secretary used in connection with activities under the EESA.

The Congressional Budget Office and Office of Management and Budget also would be required to report cost estimates and related information to Congress and the President regarding the authorities that the Secretary has exercised under the EESA.

The President would have to include in his annual budget submission to the Congress certain analyses and estimates relating to costs incurred as a result of the Act.

Tax Provisions

As originally proposed, the EESA had a number of tax provisions. The tax provisions addressed:

- changes in the tax treatment of losses on the preferred stock of Fannie Mae and Freddie Mac held by financial institutions;
- limits on executive compensation and golden parachutes for certain executives of employers who participate in the auction program; and
- tax forgiveness on the cancellation of mortgage debt.

As mentioned earlier, Senate leaders added tax breaks dealing with energy, tax extenders and alternative minimum tax relief in a bid to attract enough votes to reverse defeat in the House.

These tax provisions are analyzed in greater detail in a *CCH Tax Briefing* published by the CCH Tax Group.

ORIGINAL BAILOUT PROPOSAL HOTLY CONTESTED

As details began to emerge about Paulson's bailout plan, some lawmakers began to express skepticism. Several warned against rushing legislation too quickly through Congress. Senate Majority Leader Harry Reid, D-Nev., in a written statement, said a final package must protect the taxpayers "who are footing the bill for this legislation." Reid asserted on Sept. 22, 2008, that the plan should include "more oversight, more transparency, more accountability and more controls to prevent conflicts of interest." He added that the legislation should provide aid to homeowners at risk of losing their homes to foreclosure.

Reid was not alone in his stance. Most critics cited the lack of oversight protection as a chief concern, arguing that Paulson was afforded too much authority over the administration of the funds. The plan, opponents said, would give Paulson what amounts to a "blank check" on spending decisions.

Former Republican House Speaker Newt Gingrich, in an interview with National Public Radio, also strongly opposed rushing the complicated package through Congress without hearings or time “to catch your breath.” He noted that Paulson for more than a year maintained that the housing and financial sectors were healthy enough to weather any correction to an overheated housing market. Calling it “Wall Street welfare,” Gingrich criticized both the size of the package and the risk to taxpayers.

Bipartisan Criticism

At a Sept. 23, 2008, hearing of the Senate Banking Committee, Paulson and Bernanke faced bipartisan criticism on the unprecedented nature and size of the bailout, the potential risk to taxpayers and the uncertainty as to whether the proposal will actually work. Committee Chairman Dodd stressed the need to get things right the first time, saying “there is no second act in this.” He also criticized the plan’s failure to help individual homeowners and its lack of oversight.

Ranking Member Richard Shelby, R-Ala., said the bailout proposal “continues the ad-hoc approach on a grander scale…we’ve been given no credible assurances that this plan will work.” He added that while he has long been opposed to government bailouts for individuals or corporations, “if the government is going to get into the bailout business, shouldn’t we focus on average Americans?”

Sen. Charles Schumer, D-N.Y., cautioned members to be wary of acting too quickly and creating an ineffective solution without adequate safeguards. “Even on Wall Street, $700 billion is a lot of money,” Schumer said. He added that Congress must put taxpayers first, ahead of bondholders, shareholders and executives.

In reply, Bernanke told the Senators that failure to act would result in “significant adverse consequences.” He noted that the plan does not involve an expenditure of $700 billion, but rather a purchase of assets and, if done properly, the bailout will provide the taxpayer with “good value for money.” However, whether or not the $700 billion amount will be fully recouped is hard to know, Bernanke admitted.

Paulson admitted that he was unable to quantify the risk to taxpayers, noting that it depends on how well the economy and housing market recover and how well the bailout plan is executed. “I certainly have not told you there’s no risk to taxpayers,” Paulson said.

RESPONSE TO CRITICISM OF PLAN

In response to critics' concerns, Congressional negotiators worked to create oversights to the proposal. Additional measures were added to the original proposal, including:

- Installments of $250 billion.
- An oversight committee that would review the Treasury Department's purchase and sale of mortgages. The committee would be comprised of Federal Reserve Chairman Ben S. Bernanke and the heads of the Securities and Exchange Commission, the Federal Home Finance Agency and the U.S. Department of Housing and Urban Development.
- The authority for the Treasury Department to negotiate a government equity stake in companies that receive bailout assistance if it is in the government's best interest.
- Limits on executive compensation of rescued firms. Specifically, companies would not be able to deduct the expense of executive compensation above $500,000.
- Government-sponsored insurance of mortgage-backed securities, and other assets, purchased before March 14, 2008.
- A requirement that the President propose legislation to recoup losses from the financial industry if any still exist after five years.

Poor Marketing Plays a Part

It also has been suggested that poor marketing of the plan played a role in taxpayers' animosity. Commentators have noted that using the term "bailout" had a negative effect on taxpayers reluctant to aid those that they see as Wall Street "tycoons." The Administration later referred to the plan as a "financial rescue" measure, but the term "bailout" seemingly was firmly fixed in the public's mind.

HOUSE MEMBERS VOICE CONCERNS AFTER REJECTION OF BILL

Despite the addition of provisions to the measure to make it more palatable to opponents, the House failed to pass EESA on Sept. 29, 2008, voting 228-205 against the bill.

In the aftermath of the failure, legislators spoke of their concerns about the bill. Some Republicans cited ideological objections to the idea of government intervention, while more liberal Democrats voiced their reluctance to provide aid to "Wall Street tycoons." Critics also noted that the haste in the drafting, and what they saw as secrecy in assembling, the measure were troubling.

Imminent Elections

The upcoming elections, a mere five weeks away, appeared to be a major factor in the decision of a number of legislators to vote against the measure. It should be noted that all of the House seats currently are up for election. Rep. Roy Blunt, R-Mo., the Republican whip, said that before the vote he had tallied 75 votes in his conference in favor of the plan. By the time the votes were cast, the Republicans could deliver only 65 of them.

"People's re-elections played into this to a much greater degree than I would have imagined," said Representative Deborah Pryce of Ohio, a former member of the Republican leadership who is retiring this year and voted for the plan.

A number of legislators voted for the measure despite their concerns, taking a "better than nothing" position on the bill. Rep. Jim Marshall, D-Ga., who voted for the measure, said that he would prefer to see a bill that focuses less on acquiring mortgage-backed securities and more on minimizing foreclosures and home vacancies, two factors in the lowering of property values in communities. Marshall indicated that he would give bankruptcy courts the power to modify mortgage payments. He also would like to limit the pay of traders as well as top executives.

LAWMAKERS REVISE EESA PROVISIONS IN HOPES OF PASSAGE

After the measure failed in the House, lawmakers added further provisions intended to attract more votes in the House, in particular from House Republicans, two-thirds of whom voted against the bailout plan.

Some critics of the bill opposed the provision that was added to raise FDIC deposit insurance to $250,000 from $100,000, arguing that it is not enough to make a difference, especially since the Treasury already has guaranteed all money in money market funds. A $250,000 insurance limit would not be sufficient to protect the payroll accounts and other deposits of small- and medium-size businesses, critics said.

Another argument was that the increase in the limit also would require banks to pay higher premiums. While the FDIC may not charge member banks more to cover the increase in coverage, the bill doesn't prevent the agency from raising premiums to cover existing concerns with the insurance fund. Opponents say that many banks struggling in the current financial crisis could ill afford increased premiums.

Revisions Do Not Lead to Full Support

Despite the changes made by the Senate bill, the measure did not garner unanimous support. Those who opposed the bill feel strongly that it is the wrong approach needed to rescue the faltering economy.

Sen. Maria Cantwell, D-Wash., who championed the tax provisions in the Senate bill, said she still would vote against the bill because she opposes "giving the keys to the Treasury over to the private sector."

During the Senate debate on Oct. 1, 2008, Sen. David Vitter, R-La., likened the Bush administration's urgent request to lawmakers to pass the bill as "crying 'Fire!' in a crowded theater, then claiming the only [way out] is to tear down the walls when there are many exit doors."

Sen. Richard Shelby, R-Ala., said the Senate will have “failed the American people” by acting hastily. “I agree we need to do something. ... [But] we haven’t spent any time figuring out whether we’ve picked the best choice.”

Better Than Nothing

Supporters of the bill said that they were unhappy with the position that they are in but believe that it is better to do something now than to let the credit crisis continue.

“There’s no doubt that there may be other plans out there that, had we had two or three or six months to develop…might serve our purposes better,” said presidential candidate Barack Obama during the floor debate. “But we don’t have that kind of time. And we can’t afford to take a risk that the economy of the United States of America and, as a consequence, the worldwide economy could be plunged into a very, very deep hole.”

INCENTIVES, SENSE OF URGENCY SPUR HOUSE PASSAGE OF EESA

In its second vote of the week, the House of Representatives passed the Emergency Economic Stabilization Act on Oct. 30, 2008. The crucial vote was 263-171. Most Democrats voted in favor (172 in favor to 63 against), while a slighter majority of Republicans voted against the measure, with 91 voting for the bill and108 voting against it. Every member of the House voted.

Incentives

The incentives added to the measure after the original bill was defeated on Sept. 29, 2008, helped to turn the House around despite the mixed feelings of its members. The measure that the House passed included tax provisions that offer taxpayers more than $100 billion in relief, exempting millions from the Alternative Minimum Tax and providing tax breaks for specific businesses. “Monday what we had was a bailout for Wall Street firms and not much relief for taxpayers and hard-hit families,” Rep. Ileana Ros-Lehtinen, R-Fla., told The Associated Press. “Now we have an economic rescue package.”

Although criticized by some, the increase in the FDIC deposit insurance limit for depositors in banks and credit unions from $100,000 to $250,000 also helped to convince reluctant House members to pass the revised version of the bill.

Many lawmakers who changed sides said they had agonized over the decision amid a torrent of calls and e-mail messages from constituents urging them to vote against the measure. Several cited that the added incentives prompted them to make the decision to change their vote.

Urgency

Another factor cited in the House turnabout was a sense of urgency. After the first vote in the House failed to pass the measure, the stock market was hit with a loss of 778 points, the single largest point drop in history. That staggering drop translated into an estimated $1.2 trillion loss to the economy. The loss raised further alarms in Congress, spurring members to rethink their earlier decision to reject the bill.

On the morning of Oct. 3, 2008, the day the House was scheduled to vote on EESA, it was reported that 159,000 American workers had lost their jobs in September, adding to signs of an economic slowdown. The decline was the steepest in five years and the ninth straight monthly decline. The news served to heighten anxiety about the economy, prompting House members to vote for a bill that many said might be less than perfect.

EXPERTS QUESTION WHETHER LEGISLATION WILL WORK

Few experts doubted that decisive action by the government was necessary to restoring confidence in the credit markets, but economists and analysts are split on whether the plan will have the desired effect of righting the economy.

The extraordinary decline in the housing market has increasingly devalued financial institutions' trillions of dollars in mortgage-related securities. As the value of those assets drops, losses have decreased the capital available to cover them, making it difficult for banks to lend.

Critics of the legislation argue that if the government pays current prices for the securities in the depressed market, selling firms may experience severe losses, leaving them vulnerable to the fate of such financial giants as Lehman Brothers and Goldman Sachs. However, critics reason that, should the government pay too high a price for the securities, any benefits that taxpayers may expect would be lessened.

Stumbling Blocks

Allowing companies to get rid of their portfolios of failing mortgage securities under the legislation would halt the current decline and make them more attractive to investors, providing them with the capital necessary to go about the business of lending. The problem, critics argue, is that the complexity of the mortgage securities market could work against this capital transfer.

The typical mortgage-backed security is a trust containing a portfolio of thousands of individual mortgages merged to create a specific risk profile. It offers investors a stream of payments (based on the underlying mortgage payments) at a given yield.

A single trust might be further blended to construct different derivative securities, each one subordinated to the next in terms of the claim on cash flow. Should a default occur, the highest-rated, and lowest-yielding, security has the priority claim to the remaining mortgage payments. The next-highest-rated security has the next claim and so on. As the market grew, underwriters got more creative in their construction. Risk went up and in many cases loan quality went down. When the real-estate market disintegrated, defaults rose, undermining values, and trading slowed until determining actual value, always difficult with mortgage-backed paper, became almost impossible. Critics suggest that the inability to accurately value the securities will be a stumbling block to the legislation's intended goal of stabilizing the economy.

EESA FIRST STEP TO ECONOMIC RECOVERY

In answer to doubts as to whether EESA would be successful in fixing the faltering economy, Congressional leaders and the White House emphasized that the legislation is just the initial stage in bolstering the economy and should not be viewed as the complete answer to fixing the financial system's weaknesses beyond the credit crisis.

Averting a Crisis

"No one should be over-promising what this legislation will do,'' White House spokesman Tony Fratto said after the vote. "This legislation is to fix a problem in our financial markets. It's not sold as giving a boost to our economy…It's averting a crisis.

"This bill will have an impact in…stabilizing the markets...If it works as we hope it will, credit will begin flowing again.''

"This is only the first step,'' said Rep. Rahm Emanuel, D-Ill., Chairman of the House Democratic Conference. "While we address the balance sheets of banks, the next steps must address the checkbooks of families, and the challenges they face."

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