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CRS Report for Congress

The Cost of Government Financial Interventions, Past and Present

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Summary

In response to ongoing financial turmoil that began in the subprime mortgage-backed securities market, the federal government has intervened with private corporations on a large scale and in an *ad hoc* manner three times from the beginning of 2008 through September 19, 2008. The firms affected were Bear Stearns, Fannie Mae and Freddie Mac, and AIG. Another large investment bank, Lehman Brothers, sought government intervention, but none was forthcoming; subsequently, the firm sought bankruptcy protection.

These interventions have prompted questions regarding the taxpayer costs and the sources of funding. The sources of funding are relatively straightforward, the Federal Reserve (Fed) and the U.S. Treasury. The costs, however, are difficult to quantify at this stage. In the most recent interventions (Fannie Mae and Freddie Mac, and AIG), all the lending that is possible under the interventions has yet to occur. Also, in all the current cases, the government has received significant debt and equity considerations from the private firms. At this point, Fannie Mae, Freddie Mac, and AIG are essentially owned by the federal government. Depending on the proceeds from the debt and equity considerations, the federal government may very well end up seeing a positive fiscal contribution from the recent interventions, as was the case in some of the past interventions summarized in the tables at the end of this report. The government may also suffer significant losses, as has also occurred in the past.

This report will be updated as warranted by legislative and market events.

Where Has the Money Come From?

In the recent interventions, there have been two primary sources of funding: the Federal Reserve (Fed) and the U.S. Treasury. The Fed has the general authority under its founding statute to loan money "in usual and exigent circumstances" to "any individual, partnership, or corporation" provided five members of the Board of Governors of the

Federal Reserve system agree.[1] This authority has been cited in two of the three interventions this year, Bear Stearns and AIG. The source of money loaned under this section derives from the Fed's general control of the money supply, which is essentially unlimited subject to the statutory mandates of controlling inflation and promoting economic growth.[2] Since the profits of the Fed are ultimately remitted to the Treasury, the indirect source of the funds is the Treasury. In the case of Fannie Mae and Freddie Mac, the direct source of funding is the Treasury, pursuant to the statutory authority granted in the Housing and Economic Recovery Act of 2008.[3]

The Cost of Financial Interventions

Determining the cost of government interventions, particularly those currently in progress, is not straightforward. Assistance often comes in forms other than direct monies from the Treasury, including loan guarantees, lines of credit, or preferred stock purchases, which may have little or no initial cost to the government. A loan guarantee, which can be thought of as a sort of insurance, has value even if it is never used. Many insurance policies are never used, but individuals and companies purchase them to reduce risk of loss. In many past cases, the value to various companies of federal guarantees was to allow them to access the private credit markets, issuing bonds or obtaining bank loans that they would not otherwise have been able to obtain. In other past cases, the federal guarantee resulted in a lower interest rate on the bonds or loans.

Depending on the conditions attached to each specific intervention and how events proceed thereafter, the government may even see a net inflow of funds from the actions taken, rather than a net outflow. The summaries below address the maximal amounts promised in federal assistance and attempt to quantify the amounts that have actually been disbursed, although particularly in the most recent cases (Fannie Mae and Freddie Mac, and AIG), there is little information as to the exact amounts disbursed. There are also other, more diffuse costs that could be weighed. For example, many would argue that the cost to the taxpayers of any intervention should be weighed against the potential costs of financial system instability resulting from inaction, or that one intervention may lead to more private sector risk-taking, and thus necessitate additional future interventions (moral hazard). Such costs, however, are even harder to quantify than the realized cost of the interventions. This report does not attempt to address them.

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[1] 12 U.S.C. Sec. 343.

[2] For more information on the Federal Reserve's actions, please see CRS Report RL34427, *Financial Turmoil: Federal Reserve Policy Responses*, by Marc Labonte.

[3] P.L. 110-289, Title I.

Recent Financial Interventions

AIG

On September 16, 2008, the Fed announced that it was taking action to support AIG, a federally chartered thrift holding company with a broad range of businesses, primarily insurance subsidiaries, which are state-chartered. This support took the form of a secured two-year line of credit with a value of up to $85 billion. The interest rate on the loan is relatively high, approximately 11.5% on the date it was announced. In addition, the government received warrants to purchase up to 79.9% of the equity in AIG. According to the Fed, $28 billion has been lent to AIG as of September 18, 2008.[4]

Fannie Mae and Freddie Mac[5]

On September 7, 2008, the Federal Housing Finance Agency (FHFA) placed Fannie Mae and Freddie Mac into conservatorship. As part of this conservatorship, Fannie Mae and Freddie Mac have signed contracts to issue new senior preferred stock to the Treasury, which has agreed to purchase up to $100 billion of this stock from each of them. If necessary, the Treasury agreed to contribute cash in the amount equal to the difference between each company's liabilities and assets. Each company issued the Treasury $1 billion of senior preferred stock and warrants (options) to purchase common stock for which the Treasury did not compensate the company. If the warrants are exercised, Treasury would own 79.9% of each company. Treasury agreed to make open market purchases of Fannie Mae and Freddie Mac mortgage-backed securities (MBS). Treasury has said that it expects to profit from the spread between the interest rate that it pays to borrow money through bonds and the mortgage payments on the MBS. Fannie Mae and Freddie Mac will guarantee payment of the MBS. Treasury agreed that if the companies have difficulty borrowing money, which has apparently not been the case to date, Treasury will create a Government Sponsored Enterprise Credit Facility to provide liquidity to them, secured by MBS pledged as collateral. There are no specific limits to these purchases or loans, but they are subject to the statutory limit on the federal government's debt. The authority for both preferred stock purchase and the credit facility will terminate December 31, 2009. At this point, there has been no announcement that the credit facility has been accessed, nor that any purchase of preferred stock has occurred.

Bear Stearns

On March 16, JPMorgan Chase agreed to acquire the investment bank Bear Stearns. As part of the agreement, the Fed lent $28.82 billion to a Delaware limited liability corporation (LLC) that it created to purchase financial securities from Bear Stearns. These securities are largely mortgage-related assets. The interest and principal will be repaid to the Fed by the LLC using the funds raised by the sale of the assets. The Fed's

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[4] See Federal Reserve Statistical Release, H.4.1, dated September 18, 2008, available at [http://www.federalreserve.gov/releases/h41/Current].

[5] For more information see the September 7, 2008 statement by Treasury Secretary Henry Paulson at [http://ustreas.gov/press/releases/hp1129.htm] and CRS Report RL34661, *Fannie Mae's and Freddie Mac's Financial Problems: Frequently Asked Questions*, by N. Eric Weiss.

loan will be made at an interest rate set equal to the discount rate (2.5% when the terms were announced, but fluctuating over time) for a term of 10 years, renewable by the Fed.[6] In addition, JPMorgan Chase extended a $1.15 billion loan to the LLC that will have an interest rate 4.5 percentage points above the discount rate. Thus, in order for the principal and interest to be paid off, the assets will need to appreciate enough or generate enough income so that the rate of return on the assets exceeds the weighted interest rate on the loans (plus the operating costs of the LLC). The interest on the loan will be repaid out of the asset sales, not by JPMorgan Chase.

Any difference between the proceeds and the amount of the loans is profit or loss for the Fed, not JPMorgan Chase. Because JPMorgan Chase's $1.15 billion loan was subordinate to the Fed's $28.8 billion loan, if there are losses on the $29.95 billion assets, the first $1.15 billion of losses will be borne, in effect, by JPMorgan Chase, however. Thus, if the assets appreciate in value by more than operating expenses, the Fed will make a profit on the loan. If the assets decline in value by less than $1.15 billion, the Fed will not suffer any loss on the loan.[7] Any losses beyond $1.15 billion will be borne by the Fed. It will likely be many years until all the assets are liquidated, and a final tally of the Fed's profit or loss can be calculated.

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[6] Federal Reserve Bank of New York, "Summary of Terms and Conditions Regarding the JP Morgan Chase Facility," press release, March 24, 2008.

[7] It will only have forgone interest it could have earned on other investments, namely U.S. Treasury securities.

Table 1. Summary of Current and Historical Financial Interventions by the Federal Government

Beneficiary	Action	Financial Commitment	Final Cost to Treasury
AIG (September 16, 2008)	Two-Year Secured Loan from the Federal Reserve	Up to $85 billion	Unknown (Government receives interest on loan plus stock warrants on up to 79.9% of AIG's equity.)
Fannie Mae and Freddie Mac (September 7, 2008)	Senior Preferred Stock Purchase	Initial commitment, $100 billion each; ultimately, no set limit	Unknown (Treasury receives $1 billion (each) of preferred stock and 10% accrual on the stock.)
	Purchase of Mortgage-Backed Securities issued by the companies	No set limit	Unknown (Treasury receives interest on any MBS purchased and may sell the securities in the future.)
	Credit Facility	No set limit; collateralized	Unknown (Treasury receives interest on any loans taken.)
Bear Stearns (March 14, 2008)	Asset Purchase through LLC controlled by the Federal Reserve	$28.8 billion	Unknown (The Federal Reserve LLC received $29.95 billion in relatively illiquid assets.)
U.S. Airlines P.L. 107-42 (September 22, 2001)	Loan Guarantees	Up to $10 billion	None except implicit value of loan guarantees; under $2 billion in loans made.
Savings and Loan Failures P.L. 101-73 (August 9, 1989)	Savings and Loan Failures and Insolvency of Federal Savings and Loan Insurance Corporation	Full faith and credit backing of Federal Savings and Loan Insurance Corporation	$150 billion.
Chrysler Loan Guarantee P.L. 96-185 (January 7, 1980)	Loan Guarantees	$1.5 billion	$311 million profit from sale of warrants.

Beneficiary	**Action**	**Financial Commitment**	**Final Cost to Treasury**
New York City P.L. 95-339 (August 9, 1978)	Loan Guarantees	$1.65 billion in guaranteed bonds	None, except the implicit value of loan guarantee.
New York City P.L. 94-143 (December 9, 1975)	Short-Term Loans	$2.3 billion	None, except the implicit cost of the risk of loan.
Penn Central P.L. 93-236 (January 2, 1974)	Loan Guarantees in the wake of Railroad Bankruptcy	$125 million loan guarantees; $7 billion in federal operating subsidies	$3 billion net loss after sale of ownership stake and the implicit value of loan guarantee.
Lockheed P.L. 92-70 (August 9, 1971)	Loan Guarantees	$250 million of loans guaranteed for five years with three year renewal; guarantee and commitment fees charged	$31 million profit from sale of warrants less the lost value of loan guarantee.