Order Code RS22956
Updated October 15, 2008

CRS Report for Congress

The Cost of Government Financial Interventions, Past and Present

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Summary

In response to ongoing financial turmoil, the federal government intervened financially with private corporations on a large scale that resulted in the government receiving significant debt and equity considerations three times from the beginning of 2008 until the middle of September 2008. The firms affected were Bear Stearns, Fannie Mae and Freddie Mac, and AIG. Dissatisfaction with the case-by-case approach that had been pursued up to that point led to Treasury's decision to propose a more comprehensive solution to the turmoil on September 19, 2008. On October 3, 2008, P.L. 110-343 was signed into law, authorizing the Troubled Assets Relief Program (TARP). TARP gave Treasury the option of purchasing or insuring up to $700 billion of assets from financial firms. On October 14, 2008, Treasury announced it was purchasing up to $250 billion in financial firms' preferred stock under the TARP authority.

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 most of the interventions, all the financial outflows that are possible have yet to occur, and the ultimate value of the debt and equity considerations received from the private firms is uncertain. At this point, the federal government has the option to own nearly 80% of Fannie Mae, Freddie Mac, and AIG. Depending on the final proceeds from the various debt and equity considerations, the federal government may 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 immediate funding: the Federal Reserve (Fed) and the U.S. Treasury. The Fed has the authority under its founding statute to loan money "in unusual 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 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] Because the profits of the Fed are overwhelmingly 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] In the case of the Troubled Assets Relief Program, the direct source of funding is the Treasury, pursuant to the statutory authority granted in the Emergency Economic Stabilization Act of 2008.[4] Treasury finances these activities by issuing bonds and increasing the federal debt.

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. Such assistance may have little or no up-front cost to the government, although loan guarantees in legislation are scored by the Congressional Budget Office as an up front budgetary cost. This score reflects that 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 the risk of loss. In many past cases, the value to various companies of federal guarantees was to enable 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 maximum amounts promised in federal assistance and attempt to quantify the amounts that have actually been 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

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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.

[4] P.L. 110-343, Division A, Title 1.

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.

Recent Financial Interventions

Troubled Assets Relief Program (TARP)

As the government has intervened in 2008 to prevent the failure of troubled financial firms, market conditions seemed to get worse instead of better. After the AIG intervention, Treasury argued that a more comprehensive solution was needed to restore financial calm. It proposed creating a TARP to purchase up to $700 billion of troubled assets from financial firms as a way to restore investors' confidence in the health of the financial sector. It was argued that financial firms would be unable to replenish their capital (by selling equity to private investors) unless certain assets were transferred to the government. Once financial markets stabilized, Treasury would be able to sell these assets, recouping some or perhaps all (if asset prices rose above their purchase price) of the costs.

On October 3, 2008, P.L. 110-343 was signed into law, creating TARP. In addition to an asset purchase program, P.L. 110-343 included an insurance program providing federal guarantees for troubled assets in return for premiums paid by companies. It also allowed the government to take an equity stake in companies participating in the asset purchase program. P.L. 110-343 provided broad discretion to the Treasury to design the parameters of the program, making it difficult to evaluate the ultimate costs of the program at this time. On October 14, 2008, Treasury announced a TARP capital purchase program. Under this program, rather than purchasing troubled assets, Treasury will inject capital directly into financial institutions through the purchase of preferred stock.

American International Group (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. AIG must also pay interest on the amount of the credit line that it does not access. In addition, the government received warrants to purchase up to 79.9% of the equity in AIG. On October 8, the Fed announced that it would lend up to a further $37.8 billion AIG against investment-grade securities held by its insurance subsidiaries. These securities had been previously lent out and were not available as collateral at the time of the original intervention. The Fed reported that $70.3 billion had been lent to AIG as of October 8, 2008.[5]

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[5] See Federal Reserve Statistical Release, H.4.1, dated October 9, 2008, Table 1, "Other credit (continued...)

Fannie Mae and Freddie Mac

On September 7, 2008, the Federal Housing Finance Agency (FHFA) placed Fannie Mae and Freddie Mac into conservatorship.[6] 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. The Treasury agreed to make open market purchases of Fannie Mae- and Freddie Mac-issued 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. In return for the Treasury support, each company issued the Treasury $1 billion of senior preferred stock without additional compensation, as well as warrants (options) to purchase up to 79.9% of each company's common stock. Treasury's authority to provide financial support will terminate December 31, 2009.

Bear Stearns

On March 16, 2008, 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 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.[7] 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 will produce a 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,

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[5] (...continued)
extensions" available at [http://www.federalreserve.gov/releases/h41/Current/].

[6] 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*, by N. Eric Weiss.

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

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 direct loss on the loan. Any losses beyond $1.15 billion will be borne by the Fed.

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

Beneficiary	Action	Financial Commitment	Final Cost to Treasury
TARP (October 3, 2008)	Purchase of troubled assets from financial firms	Up to $700 billion	Unknown (Assets can be sold at future date. Treasury has the option to take an equity stake in participating companies.)
	Insurance of troubled financial assets		Unknown (By law, premiums paid for the insurance are to cover losses.)
	Purchase of preferred stock		Unknown (Treasury receives dividends on stock, plus sale value of stock at the end of the program.)
AIG (September 16, 2008)	Two-Year Secured Loan from the Federal Reserve	Up to $75 billion against the general assets of AIG; up to $37.8 billion against the securities held by AIG's insurance subsidiaries	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.)

Beneficiary	Action	Financial Commitment	Final Cost to Treasury
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 P.L. 96-185 (January 7, 1980)	Loan Guarantees	$1.5 billion	$311 million profit from sale of warrants.
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 plus 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.