



CRS Report for Congress

Proposal to Allow Treasury to Buy Mortgage-Related Assets to Address Financial Instability

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Summary

Financial markets underwent severe stress during the week of September 15-22, 2008. After Lehman Brothers declared bankruptcy and AIG received a bridge loan from the Federal Reserve, policymakers reassessed their case-by-case approach to resolving financial problems. Secretary of the Treasury Paulson announced a plan to allow Treasury to purchase mortgage-related assets from U.S. financial institutions. The announced intent of the plan is to unclog financial markets, increase the health of the banking sector, and reduce ongoing risks to the economy. This report discusses a draft of the proposal as it stood on September 21, 2008, and analyzes frequently asked questions. This report will be updated as conditions warrant.

Following a week of severe stress in financial markets, the Secretary of the Treasury and the Chairman of the Federal Reserve met with congressional leaders on September 19, 2008, to ask for legislation to authorize direct intervention in the economy. An unofficial three-page draft of a specific proposal circulated over the weekend of September 20, 2008.¹ A revised draft circulated September 21. Both draft proposals allow Treasury to purchase up to \$700 billion in mortgage-related assets in an attempt to reduce disruptions in the financial system. This report describes the provisions of the draft legislative proposals that were circulated and provides an analysis of several questions that the proposals raise.

¹ This report is based on a draft acquired via email from CongressNow Alert. "Alert: Bush Administration Financial Plan," *CongressNow*, September 20, 2008, 10:21 a.m. CongressNow is a Roll Call Group Business and distributed the alert through emails@congressnow.com.

The Draft Proposals

Purchase of Mortgage-Related Assets. The proposal grants Treasury the authority to purchase mortgage-related assets for two years. The proposal would limit the amount of assets purchased to \$700 billion outstanding at any one time. Funding for the purchases comes from selling Treasury securities. The Secretary of the Treasury is granted discretion to administer the program, and decisions by the Secretary would not be reviewable in court or by any administrative agency.

Debt Limit. Both draft proposals increase the debt limit of the federal government. The new debt limit in each draft is \$11,315,000,000,000. This \$11.3 trillion new limit compares to the current debt limit of \$10.6 trillion. The total current debt is \$9.6 trillion. If the full authority of the program were immediately exercised and funded exclusively with new debt, and there were no additional new debt from existing government operations, the current debt would rise to \$10.3 trillion.

Definition of Troubled Asset. The September 20 draft defines mortgage-related assets as “residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was issued on or before September 17, 2008.”

The September 21 draft defines troubled assets in the same way but adds a clause allowing the Secretary of the Treasury in consultation with the Chairman of the Federal Reserve to add any other financial instrument, “the purchase of which the Secretary determines necessary to promote financial market stability.”

These definitions could encompass whole mortgage loans, mortgage-backed securities (MBS), and subordinated mortgage securities such as collateralized debt obligations (CDOs) or collateralized mortgage obligations (CMOs). It is unclear whether the September 20 definition also encompasses derivatives that reference the defaults of underlying mortgages in MBS such as certain credit default swaps (CDS). The September 21 draft would allow the purchase of credit default swaps if the Chairman of the Federal Reserve agreed. It is unclear whether the Secretary of the Treasury could purchase CDS without Federal Reserve consultation under the September 21 language.

Authority to Take Action. Using the term “necessary actions,” the draft proposals grant authority to administer the program and place certain limits on participation. Treasury may employ personnel, contract for services, and issue appropriate definitions, regulations, and guidances. Treasury may designate financial institutions as financial agents of the government. Treasury may also establish vehicles authorized to purchase mortgage-related assets and issue obligations. The administrative vehicles could encompass trusts or corporations to administer the assets. The September 21 draft also includes a provision to apply Federal Acquisition Regulation when awarding contracts to asset managers and requires the asset managers to acknowledge a fiduciary duty to the United States.

Restrictions. The draft proposals include two significant restrictions. First, purchased assets must have been originated or issued before September 17, 2008. Furthermore, the seller of the asset to the Treasury is limited to “any financial institution having its headquarters in the United States.” Under the September 20 draft proposal, it

is unclear whether U.S. affiliates of foreign institutions would be included. Similarly, it is unclear whether there are restrictions on the ability of U.S. institutions to serve as intermediaries, buying mortgage assets from foreign institutions and then selling them to Treasury.

Under the September 21 draft proposal, foreign central banks and institutions owned by foreign governments are specifically excluded. This draft directs the Treasury to coordinate with foreign financial authorities to work to establish similar authorities overseas and to coordinate activities.

Factors to Guide Intervention. The draft proposals listed two factors for Treasury to consider when exercising authority under the program. First, Treasury shall consider means for “providing stability or preventing disruption to the financial markets or banking system.” The proposal does not provide a definition for the terms stability, disruption, financial market, or banking system. Second, Treasury shall consider means for “protecting the taxpayer.” Protection is not defined.

Management of Mortgage-Related Assets. Treasury is given authority to manage the mortgage-related assets acquired through the program. Management includes exercising any rights acquired through purchase (presumably including any rights regarding foreclosure in the case of whole loans). Rights of management of assets acquired before the termination of the program extends beyond the termination date; that is, Treasury can continue to hold acquired mortgage assets after the expiration of authority to acquire new mortgage-related assets. Treasury may also manage the mortgage revenues and any portfolio risk of the program.

Loss Mitigation and Loan Modification. The September 20 draft did not contain any provisions for loss mitigation or loan modification of mortgage loans. The September 21 draft contains two provisions to address troubled borrowers. First, for whole mortgage loans acquired by Treasury, loan servicers must follow industry best practices for loan modifications. Best practices are identified by the Secretary in consultation with the Hope for Homeowners Oversight Board. Second, if the program acquires MBS or similar assets that put the government in the position of one of the investors with an interest in an underlying mortgage, then the government will consent to reasonable loan modifications.

Sunset. Authority to purchase mortgage-related assets under the program expires two years from the date of enactment. Recall that authority to manage already acquired mortgage-related assets continues after the sunset provision.

Reports to Congress. The Secretary of the Treasury must report to congressional committees with respect to authority exercised under the program. The first report is required within three months of first exercise of authority, and reports continue semiannually thereafter. The committees to report to include the Committee on the Budget, Financial Services, and Ways and Means of the House of Representatives and the Committees on the Budget, Finance, and Banking, Housing, and Urban Affairs of the Senate. The September 21 draft also requires a GAO study on the impact of troubled asset purchases.

Frequently Asked Questions

Does the proposal include provisions to help home owners facing foreclosure? The September 20 draft proposal did not include any provisions specifically designed to help home owners facing foreclosure. The September 21 draft requires loan servicers to follow industry best practices and to modify loans in accordance with the Hope for Homeowners Oversight Board.

Proponents of such measures might argue that actions to unfreeze mortgage markets will help liquidity flow back into mortgage markets, which in turn might make it easier for borrowers to refinance out of troubled mortgages or sell their homes to avoid foreclosure. Critics might counter that this is a relatively expensive and indirect way to aid troubled mortgage borrowers.

Is the program limited to home mortgages? No. The program also includes securities based on residential mortgages. It is unclear whether the program applies to derivatives that reference mortgage-related securities. In addition to residential mortgages, the draft proposals also include commercial mortgages and related assets.

What price will Treasury pay for the assets it purchases? The proposal leaves the price to the discretion of the Secretary of the Treasury. A press release states that the price of assets purchased will be established through market mechanisms where possible, such as through reverse auctions.²

What happens to funds the Treasury receives from disposing of the assets? Treasury's press release reports that returns from the sale of assets will be returned to Treasury's general fund for the benefit of taxpayers.

What is the potential cost of bad mortgage-related debt? The answer to this question depends in large part on real estate markets. On the residential side, if house prices continue to decline, then the number of home owners who cannot sell or refinance to avoid foreclosure will continue to rise. The performance of commercial mortgages going forward will be affected by developments in the broader economy. If a deep recession is avoided, then commercial mortgage defaults may be minimized.

The program appears to be targeted at the troubled mortgage-related assets that are burdening bank balance sheets. If this is the case, then certain categories of securities may be more likely to be acquired than others. For example, because of the explicit Treasury guarantees associated with the conservatorship of Fannie Mae and Freddie Mac, their securities (called agency debt and agency MBS) should be of less immediate concern. This suggests that the problem assets are more likely to be in the non-agency sector. According to one industry source,³ the estimate of outstanding non-agency MBS was \$1.3 trillion at the end of 2007, with another \$25 billion issued in 2008. There was also

² "Statement by Secretary Henry M. Paulson, Jr. on Comprehensive Approach to Market Developments," Press Release, Department of Treasury, September 19, 2008, available at [<http://www.treas.gov/press/releases/hp1149.htm>].

³ Statistics from the Securities Industry and Financial Markets Association (SIFMA), available at [<http://www.sifma.org/research/statistics/market-sector-statistics.shtml#mbs>].

another \$1.3 trillion in outstanding collateralized mortgage obligations. Thus, the total amount of mortgage-related assets that might be acquired by the program would be nearly four times the \$700 billion limit in the proposal.

The above estimate does not include any direct purchases of whole mortgage loans or derivatives that reference the mortgage-related assets. However, it might be double counting to include both the mortgage-related securities and the underlying mortgages or referenced derivatives. If issues with the underlying mortgages are resolved, then any mortgage-backed security or derivative that references those mortgages would not be in default.

What role did housing play in financial turmoil? Several factors have contributed to financial instability, but most observers agree that a major component of the financial stress has been the boom and bust in housing that coincided with low short-term interest rates. It has been argued that rapid house price appreciation in some areas and low interest rates led to overconfidence by investors, lenders, borrowers, and regulators. Builders responded to higher prices with increased construction, and the pace of home price increases could not be sustained. Inventories of unsold homes began climbing and prices stagnated at the same time as short-term interest rates began rising. Any borrowers, including in the subprime market, who had depended on being able to refinance at low interest rates or depended on rapid home price appreciation found their plans frustrated and defaults occurred at increasing rates. The value of financial assets that depended on home owners making their payments, such as mortgage-backed securities (MBS), declined significantly.

How did financial markets magnify the effects of mortgage defaults? Three factors in the financial system magnified the effects of defaults by reducing confidence, particularly in bank balance sheets.

(1) Lack of transparency — The financial structures used to fund mortgages had become very complex, making it harder for firms to assess the value of assets or the condition of potential counterparties.

(2) Leverage — Because financial firms had very little capital relative to their commitments, even small percentage declines in the value of their mortgage assets could significantly impair their solvency. Combined with poor transparency, this further contributed to caution on the part of counterparties in financial transactions.

(3) Derivatives — Increased use of complex derivatives, such as credit default swaps, made it very difficult to project how the failure of a financial firm would affect other firms. Would counterparties to derivatives contracts have the reserves to fulfill their obligations? If not, would the marking down of derivative values cause a new round of de-leveraging?

How, if at all, could financial turmoil affect the wider economy if nothing is done? There are several sectors of the economy that depend on regular financing to operate. Also, consumers frequently depend on financing to purchase expensive items. Therefore, disruptions to the financial system can cause problems for business investment and consumer expenditures on durable goods. In addition, declines

in the value of assets linked to finance, such as houses and retirement accounts, cause consumers to feel poorer and to cut back spending.

How, if at all, could intervention in mortgage-related securities markets calm financial markets? An intervention in financial markets could restore financial stability if it restores confidence. Removing bad debt from bank balance sheets directly addresses several problems. Shortcomings in transparency become a less pressing concern for institutions that can participate because counterparties would know that the institution has the opportunity to clean up its balance sheet. Similarly, the program may provide an orderly way to resolve derivatives contracts.

What is the rationale for acting now? According to a press release from the Treasury, illiquid mortgage-related assets had clogged the financial system.⁴ The juxtaposition of the refusal to intervene on behalf of Lehman Brothers the same week that a bridge loan was extended to AIG has convinced some that the case-by-case approach of recent weeks should be replaced by a more broadly based intervention. In addition, the sudden spike in interest rate spreads and declines in financial activity following the AIG intervention convinced some policymakers that financial fragilities could worsen if they are not addressed.

How did interest rate spreads indicate a sudden loss of confidence? “Spreads” often refers to the difference between a particular interest rate and the yield of a Treasury security of comparable maturity (although there are other spreads). So defined, high spreads are often an indicator that people believe the Treasury security to be less risky than the other asset (although there can be other reasons for widening spreads.) Although the Federal Reserve had lowered policy interest rates to 2% by April 2008, other interest rates remained relatively high. Examples include the interest rate that banks charge each other, the interest rate on asset-backed commercial paper, and mortgage rates. The Federal Housing Finance Agency (FHFA) indicated that the high spreads on Fannie and Freddie securities were a significant factor in the decision to put the companies into conservatorship. Then, during the week of September 15-20, following the Lehman Brothers bankruptcy and the loan to AIG, the spread on commercial paper almost tripled in a single day, and prompting concern that the entire financial system could shut down.

Couldn't the same assets be purchased through Fannie Mae and Freddie Mac now that they are in a conservatorship backed by the Treasury? Only parts of the proposal could be implemented through Fannie Mae and Freddie Mac. First, the charters of Fannie Mae and Freddie Mac do not allow them to acquire commercial mortgages. Second, some of the delinquent mortgages that contribute to the problem are jumbo loans in California (jumbo refers to mortgages too large to be purchased by Fannie Mae and Freddie Mac). However, Fannie Mae and Freddie Mac could acquire residential MBS that conform to their new higher loan limits. Operating a troubled MBS and mortgage purchase program through Fannie Mae and Freddie Mac would have a similar result as under the new proposal because Treasury is already committed to purchase preferred stock to maintain the solvency of the institutions.

⁴ “Statement by Secretary Henry M. Paulson, Jr. on Comprehensive Approach to Market Developments,” Press Release, Department of Treasury, September 19, 2008, available at [<http://www.treas.gov/press/releases/hp1149.htm>].