

An hourglass-shaped graphic with a globe inside. The top bulb is dark blue, and the bottom bulb is light blue. The globe is centered in the narrow neck of the hourglass. The top bulb is filled with a dark blue color, and the bottom bulb is filled with a light blue color. The globe is centered in the narrow neck of the hourglass.

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*The Emergency Economic Stabilization Act's Insurance for  
Troubled Assets*

Baird Webel, Analyst in Financial Economics

Updated January 13, 2009

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# The Emergency Economic Stabilization Act's Insurance for Troubled Assets

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**CRS Report for Congress**

*Prepared for Members and Committees of Congress*

## Summary

Many observers trace the root cause of recent instability in financial markets to uncertainty surrounding the value of widely held securities that are based on mortgages and mortgage-related assets. Losses on these securities have led to the unexpected and relatively sudden failure of several large financial institutions. Credit markets have nearly frozen at times as financial institutions demanded very high interest rates on traditionally routine short-term lending. While there is limited evidence that financial turmoil has caused widespread damage in the broader economy, it is feared that significant real economic effects may be forthcoming, particularly if credit markets remain frozen.

Responding to these economic fears, the House took up the Emergency Economic Stabilization Act of 2008 (EESA) as an amendment to H.R. 3997 on September 29, 2008. This amendment failed by a vote of 205-228. Following this, the Senate took up a bill of the same title with a number of additions and passed it by a vote of 74-25 on October 1, 2008, as an amendment to H.R. 1424. On October 3, 2008, the House passed the amended version of H.R. 1424 by a vote of 263-171. The President signed the bill into law, P.L. 110-343, on the same day. The centerpiece of both versions of the act is the Troubled Assets Relief Program (TARP), intended to address recent instability in the financial market through a variety of measures, including an insurance program for “troubled assets.” This insurance program would provide U.S. government guarantees for some of the securities that are perceived as being at the root of the current financial instability.

The EESA required a report on the Treasury’s implementation of the TARP insurance provisions within 90 days of enactment. This report was filed on December 30, 2008. It describes a relatively small program to be used “with extreme discretion.” No guarantees have been made under the program, though it may be used in conjunction with the asset guarantee announced in the November 23, 2008 assistance for Citigroup.

In the 111<sup>th</sup> Congress, Chairman Barney Frank introduced a bill amending TARP (H.R. 384) on January 9, 2009 and the bill has been scheduled for floor action the week of January 12, 2009. Although not amending the insurance portion of TARP (Section 102) directly, it includes language that would clarify the authority under TARP to provide support to the municipal securities market, which has been undermined by the failure of private insurers. Such support could come through the insurance section of TARP, however, there may also be issues regarding Section 149(b) of the Internal Revenue Code that limits federal guarantees for tax-exempt securities.

This report briefly summarizes and analyzes the insurance program contained in the enacted version of the EESA, the Treasury announcement of the guarantee program to be implemented under the EESA, and current legislation that would affect the TARP insurance program. It will be updated as warranted by legislative and market events.

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## Introduction

Over the past two decades, mortgages have increasingly been funded indirectly through asset-backed securities and non-bank lenders, rather than directly through deposits in the traditional banking model. In most cases, once a mortgage was made, the mortgage was sold by the entity that originated the loan to another institution, which pooled a large number of these loans together. From this pool of loans, the institution then issued securities whose returns were based on the payments made on the underlying mortgages in the pool. For a variety of market and regulatory reasons, these mortgage-backed securities (MBS) became widely held by nearly every financial institution in the United States and in many institutions worldwide. In addition to the securities directly backed by mortgages, financial institutions created numerous other complex securities and derivatives based on the initial MBS. These secondary products, such as collateralized debt obligations (CDO) and credit default swaps (CDS) were also very widely held.

In 2006 and 2007, the rates of default and non-payment by mortgage holders increased significantly. This, in turn, caused the securities and derivatives ultimately based on these mortgages to lose value. In some cases, securities thought to be safe were completely wiped out. These losses have rippled through the financial system, causing problems for institutions in a number of unexpected ways as well as stress to the general financial system. The failure of large financial institutions including Bear Stearns, IndyMac, Lehman Brothers, AIG, and Wachovia was largely due to this turmoil. Due largely to the uncertainty about what future mortgage default rates will be, as well as who is currently holding MBS, financial markets have nearly frozen at various points in time since August 2007. On September 19, 2008, the Secretary of the Treasury called for a broad program of financial intervention to stabilize markets. The Treasury proposal called for government purchases of up to \$700 billion in mortgage-related securities, in the hope that, by partially purging the system of these troubled assets, normal functioning of the financial markets could be restored.

The idea of broad asset purchases, as in the initial Treasury plan, is only one of a number of methods that could be used to address the uncertainties regarding mortgage-related assets. Among the other concepts put forward in Congress has been that of a federal guarantee program to insure mortgage-related assets. Insurance on municipal securities has been issued by private insurers since the 1970s, and in the past decade many insurers broadened their insurance offerings to include mortgage-related securities. Most of the insurers specializing in this type of insurance have suffered major losses and ratings agency downgrades in the last year.

As a legislative proposal, a federal insurance program for “troubled assets” appeared in the Troubled Asset Relief Program (TARP) portion of the Emergency Economic Stabilization Act of 2008 (EESA), a House amendment to H.R. 3997. This amendment failed in the House on a vote of 205-228 on September 29, 2008. Another version of the EESA, which included the original EESA plus several other provisions not in the first bill,<sup>1</sup> was offered on October 1 in the Senate as an amendment to the previously passed H.R. 1424. The amended version of H.R. 1424 was approved by a Senate vote of 74-25; it was then taken up by the House and passed by a vote of 263-171 on October 3, 2008. The President signed the amended version of H.R. 1414, now P.L. 110-343, the same day as House passage.

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<sup>1</sup> Additional provisions included a temporary increase in the limit on FDIC-provided depository insurance as well as extensive tax provisions that had previously been considered by one or both Houses of Congress.

## Federal Insurance of Troubled Assets

Section 102 of P.L. 110-343 provides that if the Secretary of the Treasury creates a program to purchase troubled assets (as authorized in Section 101), he or she shall also create a program to guarantee troubled assets. Troubled assets under the bill are defined as “residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages.”<sup>2</sup> The underlying mortgages in question must have been originated before March 14, 2008. The bill also gives the Secretary of the Treasury, after consultation with the Chairman of the Federal Reserve, the authority to purchase any other financial instrument necessary to promote market stability. Congress must be notified of such a purchase, but explicit approval from Congress is not needed.

Aside from the requirement to establish the program, the Secretary of the Treasury has relatively broad authority as to the structure of the program. He or she may not guarantee the prompt payment of more than 100% of the insured securities’ interest and principal payments—100% is typical of bond insurance in the private sector—but the Secretary is free to guarantee less than 100% as well. Aggregate premiums for the insurance are required to cover the expected losses from the insurance program, and the Secretary has the authority to base individual premiums on the risk of the security to be covered, but there is no requirement that premiums be risk-based. The combined size of the purchase and insurance programs for troubled assets authorized in the bill is limited to \$700 billion, but the Secretary of the Treasury is free to decide what percentage of the overall amount the two programs occupy. The Secretary must report within 90 days on the TARP insurance program.

## Impact of the Proposed Program

Given the authority that the Secretary has to shape the program, along with the host of other uncertainties in the current financial climate, it is difficult to assess the potential impact of the federal guarantee program. In theory, such a program could have a significant impact by improving confidence in the financial markets. In previous market experience with private bond insurance, once a security was guaranteed, it was generally treated as a security with the same credit rating as the insurer. Thus, for example, a single A rated municipal sewer authority could issue a bond that would be treated as AAA if the bond was then insured by a AAA-rated insurer. If the federal government were to issue a 100% guarantee on a mortgage-backed security, even one backed by subprime loans with a high default rate, the market may treat it essentially as a U.S. Treasury security, which is widely considered to be the safest and most liquid security that can be held.<sup>3</sup> If this occurred for a wide swath of the MBS that are currently illiquid and looked at with great skepticism by the markets, theory would suggest that it would restore the confidence that has been absent in the financial markets in recent weeks.

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<sup>2</sup> P.L. 110-343, Section 3.

<sup>3</sup> There is potentially an important difference between Treasury securities and securities that might be guaranteed under this insurance program. Treasury securities are clearly backed by the “full faith and credit” of the U.S. government, and are paid for out of the general taxing authority of the federal government. Under P.L. 110-343, claims on the troubled asset insurance program are to be paid for out of the premiums collected. There is no explicit authority for the program to borrow from the Treasury as with other federal insurance programs, such as flood insurance. If the claims exceed the funds collected through premiums, it is unclear how these claims would be paid.

While the asset purchase plan also contained in P.L. 110-343 could provide the same widespread boost to market confidence, an insurance program may have advantages compared with the purchase plan. The insurance plan would result in little or no government ownership of assets with the attendant questions of how these assets are then to be disposed of. The insurance plan, as structured, would be self-financing. There are no provisions in the plan for the outlay of taxpayer monies. An insurance program would also avoid accounting problems that could emerge if the purchasing plan results in asset sales at significant discounts to previous prices. Under mark-to-market accounting rules such asset sales may trigger accounting losses in other companies holding similar securities and might even threaten the solvency of other financial institutions. Such hoped for benefits of the insurance program, however, may also be offset to some degree by practical questions concerning how the plan might actually work. Many of these questions revolve around the overall cost of the insurance program and the individual premiums to be charged for the government guarantee.

Providing guarantees for MBS has, in practice, proved a very risky and costly business over the past year. Most of the bond insurance companies, if they have been able to remain solvent, have seen their stock prices collapse and their credit ratings downgraded as losses have mounted on guarantees for MBS. The primary new entrant to insuring bonds, a subsidiary of Berkshire Hathaway, has specifically indicated it will not insure such securities. It is unclear if and how a federal insurance program would be able to incur fewer losses than private insurers. If the goal of the program is to improve the functioning of the financial system by removing the impediments posed by troubled assets, some would argue the program would not be functioning as intended if the securities it guaranteed were not suffering losses. Some losses may be avoided by insuring the mortgage-related securities at less than 100% value, as specifically authorized in the act. The recent history on mortgage default rates, however, suggests that any significant guarantee program on mortgage-related securities might incur significant losses.

The program established in P.L. 110-343 specifies that the losses from the guarantee program will be covered by the aggregate premiums paid by financial institutions holding the guaranteed securities. This brings up the most critical point in any insurance endeavor whether public or private, namely determining the premiums to be charged for the coverage provided. If the overall premiums are set too low, the endeavor will ultimately fail as the money coming in will not cover the money going out. If the overall premiums are set too high, in this case, fewer mortgage-related securities would be insured than would be possible. This would presumably be counter to the act's goal of restoring liquidity and stability to the U. S. financial system. Setting optimal premiums for mortgage-related securities would require an accurate estimate of what mortgage default rates will be around the country in the future and how these default rates will affect the payment streams on mortgage-related securities. The inability to make such accurate estimates is identified by many to be at the heart of the uncertainty bedeviling the financial system today.

In addition to the question of setting overall premiums so the program remains solvent, the question of setting individual premiums for specific securities is also challenging. The bill includes the authority, but not requirement, to vary premiums "according to the credit risk associated with the particular troubled asset that is being guaranteed." If individual premiums are not risk-based, then the program may suffer from adverse selection, meaning that the program will attract primarily securities that are relatively high risk. If these high risk securities result in higher losses than anticipated, the overall premiums would ultimately have to be raised to keep the program solvent. Higher premiums would likely result in fewer institutions participating in the program and the remaining guaranteed securities being on the whole higher risk than before. If individual premiums are to be risk-based, the insurance will encounter the problems mentioned

above with regard to estimating future mortgage default rates. Indeed the difficulties in estimating the impact on individual securities, and thus establishing individual risk-based premiums, would be much greater than simply estimating the overall amount of premiums needed for the program to remain solvent.

## Treasury Actions Since Enactment

The focus of the Treasury since enactment has been neither the asset purchase program, as initially envisioned in the Treasury proposal from September 2008, nor the insurance program outlined in Section 102 of the EESA. Instead, the majority of the actions under TARP have been direct capital injections through the purchase of preferred shares. On November 23, 2008, the Treasury agreed to guarantee up to \$5 billion in prospective losses on a \$306 billion pool of securities as part of an intervention to aid Citigroup, though the TARP insurance section was not specifically cited as authority to provide this guarantee.

On December 30, 2009, the Treasury released the required report to Congress on the TARP insurance program.<sup>4</sup> This report described an Asset Guarantee Program (AGP) that would bear little resemblance to the insurance for securities that exists in the private market. The Treasury AGP is to be used only for “assets held by systemically significant financial institutions that face a high risk of losing market confidence due in large part to a portfolio of distressed or illiquid assets.” Treasury indicates that such guarantees would be applied with “extreme discretion” and that the program is not anticipated to be “widely available.” The model for the AGP may be the previous guarantee of Citigroup assets and the report indicates that Treasury is considering using the AGP to provide this previously promised guarantee.

Treasury reports that it is reviewing options for developing further insurance programs under TARP, identifying two design considerations of particular importance. The first consideration is the accounting for the insurance program under the EESA. Section 102 specifies that the up to \$700 billion in purchasing authority under TARP is reduced by the total value of the asset guaranteed less the premium paid for the insurance. Thus, in accounting terms, insuring an asset under TARP has a similar impact as purchasing that asset. The second consideration is the impact of adverse selection and the difficulty of pricing the insurance as detailed in the analysis above.

## 111<sup>th</sup> Congress Legislation

### TARP Reform and Accountability Act of 2009 (H.R. 384)

On January 9, 2009, House Financial Services Chairman Barney Frank introduced H.R. 384. On January 13, 2009, the House Rules Committee is scheduled to hold a hearing considering a rule providing for prompt floor consideration. The House Majority Whip indicated that the bill would be brought to the floor during the week of January 12, 2009.

H.R. 384 substantially amends the EESA to address several criticisms of the TARP since enactment, but does not directly amend Section 102. H.R. 384 does include language that would

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<sup>4</sup> This report can be found on the Treasury website at <http://ustreas.gov/initiatives/eesa/congressionalreports102.shtml>.

clarify the authority under TARP to provide support to the municipal securities market, which has been undermined by the failure of private insurers as detailed above. A variety of forms of such support could be authorized under the insurance section of TARP, including a direct federal replacement for the private bond insurers who have largely disappeared from the market or some form of federal reinsurance backstop for the municipal bond insurance industry. Providing such insurance would likely face fewer logistical challenges than insuring mortgage-related assets because municipal securities tend to default at substantially lower rates and more data exists on such default rates.

One complication to applying TARP to supporting the municipal securities market, however, may be Section 149(b) of the Internal Revenue Code. This section limits federal guarantees for tax-exempt securities. Thus, under current law, if an explicit guarantee is to be provided for municipal bonds under TARP, these bonds would no longer be exempt from federal taxes. The loss of tax-exempt status would make these securities less attractive to some and thus counteract to some degree the attempt to support the market.

## Conclusion

Many argue that a central driver of the recent turmoil in financial markets has been uncertainty and fear regarding mortgage-related securities that are widely held in the financial system. Among the mechanisms recently passed by Congress to address these problems is a federal program to insure troubled assets. Private insurance to enhance the credit-worthiness and attractiveness of securities has operated for more than 30 years. This record shows that an insurance mechanism can have a role to play in the securities marketplace. Recent private experience insuring mortgage-related assets, however, has been negative; such insurers have experienced large losses and many have faced difficulties remaining solvent. The Department of the Treasury faces significant practical challenges as it implements a federal program to insure troubled assets. Particular difficulties include ensuring the overall solvency of the program through sufficient aggregate premiums and setting individual premiums commensurate with the risks posed by mortgage-related securities. The initial Treasury outline for the TARP insurance program seeks to minimize these difficulties by limiting the size and scope of the federal guarantees to be provided.

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