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An Initial Review of the Bailout Agreement

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Administration and congressional negotiators reached agreement early Sunday on a package of actions to address the alarming financial situation facing the U.S. economy.[1] Although several drafts of legislative language have been circulating, it is not yet possible to provide an overall assessment until the agreement's final language is examined carefully. The devil is always in the details, and so it is wise to look at the details. But several concerns and questions arose with earlier versions of a proposed package last week. So far, it appears that the negotiated agreement addresses these concerns in the following ways:

Major Financial Provisions. The agreement creates a new Office of Financial Stability within Treasury that is empowered both to purchase troubled assets from financial institutions and other bodies and to use other methods to address the current financial situation. This office would be immediately empowered to purchase up to $250 billion worth of troubled assets at any one time. If necessary, the Secretary of the Treasury could increase that amount by an additional $100 billion after notifying Congress that this additional sum is necessary.

If still more taxpayer money is necessary, the Secretary could use up to an additional $350 billion, but only after providing Congress with a notice and if Congress does not pass a resolution of disapproval within 15 days. That notice would be in the form of a joint resolution that must be passed by both the House and the Senate and signed by the President.

In addition to buying troubled assets from financial institutions, the new Treasury office will also be allowed to purchase those assets from local governments, pension funds, and small banks that serve low- and middle-income families. In any case where the Treasury office purchases assets, if the entity subsequently fails, taxpayers will have first call on using its remaining assets to repay any assistance that the firm received.

These tools would appropriately address the dangerous situation currently facing the credit markets.

Oversight and Separation of Powers Concerns. The new oversight board would be responsible for the following:

- To review any and all actions taken by the Secretary and the new office in implementing the agreement, including the appointment of any private sector financial agents to implement the plan;
- To make recommendations to the Secretary on the implementation of the agreement: and
- To report to the Treasury Inspector General or the Attorney General any instances of fraud, misrepresentation, or malfeasance.

In addition, other sections of the draft law would provide for limited judicial review of actions made

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by the Treasury Secretary, with additional restrictions for transactions between the new office and participating companies. Further provisions would require that GAO have personnel permanently placed within the new Office, and both GAO and the Treasury would be responsible for a detailed series of reports to Congress. While such oversight would address economic policy concerns, these specific provisions, including the board itself, raise important constitutional concerns.

The current draft bill has not addressed several serious constitutional issues,[2] at least three of which warrant particular concern. With regard to the sweeping delegation of discretion to the Treasury Secretary (the "legislative delegation" problem), the latest text has not narrowed the scope of his authority. There is a possibility that the courts would strike down the law if it is challenged as an improper delegation of legislative authority—i.e., that the law provides no "intelligible principle" to guide and direct the Secretary's actions. As Heritage research has explained,[3] how the courts may rule is not the only concern; what the Constitution actually requires and whether separation of powers principles are significantly undermined also require careful consideration. Our Constitution allows no Czar, with standardless discretion to prop-up or manage various industry sectors. Previous Heritage papers elaborate on this concern and suggest ways to define the Secretary's range of discretion in a more objective manner that also permits more meaningful judicial review.[4]

It is also of considerable concern that several of the oversight mechanisms that were added as a substitute for the constitutional separation of powers amount to an attempted "power-sharing" arrangement. Instead of alleviating the separation of powers problems, these mechanisms make them worse. Congress and the President may be satisfied with a power-sharing deal that permits broad executive authority with opportunities for congressional micromanagement and political nitpicking (e.g., enhanced GAO audits, additional "independent" Inspectors General, new congressional oversight structures, and enhanced reporting), but the constitutional separation of powers was designed to protect the individual liberty of citizens precisely because the Framers feared the branches would otherwise work out such deals.

Of particular concern is the unprecedented structure and power of the Financial Stability Oversight Board. In sum, the Board would be granted broad power to "ensure that the policies implemented by the [Treasury] Secretary are" in accordance with the "purposes of" the act, which could be used as a blank check to veto or modify actions taken by the Secretary. At the same time, the President's ability to direct the Board may be unconstitutionally circumscribed. The Board would be composed of the Chairman of the Federal Reserve Board, the Treasury Secretary, the Director of the Federal Home Finance Agency, the Securities and Exchange Commission chair, and the Department of Housing and Urban Development (HUD) Secretary. A majority of these board members are not removable by the President except for cause. Two precedents cited by the White House for the constitutionality of this provision are distinguishable. Congress sometimes has granted less sweeping authority directly to a stabilization board, but it has never attempted to give the discretion and responsibility to one cabinet official who is directly answerable to the President, and then subject his actions to the direction, modification and veto of another board, especially one not wholly subject to the President's direction and control. It remains dubious whether such an entity would pass muster

[1] Stuart M. Butler, Ph.D., Alison Acosta Fraser, and James L. Gattuso, "What Should Be Done About the Financial Markets?" Heritage Foundation *WebMemo* No. 2070, September 19, 2008, at *http://www.heritage.org/Research/Economy/wm2070.cfm.*

[2] Andrew M. Grossman, Robert Alt, and Todd F. Gaziano, "The Housing Bailout: Constitutional Infirmities Remain, but a Ray of Hope," Heritage Foundation *WebMemo* No. 2086, September 26, 2008, at *http://www.heritage.org/Research/Economy/wm2086.cfm.*

[3] Todd F. Gaziano and Andrew M. Grossman, "All Deliberate Speed: Constitutional Fidelity and Prudent Policy Go Hand in Hand in Fixing the Credit Crisis," Heritage Foundation *WebMemo* No. 2079, September 24, 2008, at *http://www.heritage.org/Research/Economy/wm2079.cfm.*

[4] Grossman, Alt, and Gaziano, "The Housing Bailout."

in the courts, as it clearly offends Article II and the lines of democratic accountability that it established.

An Optional Federal Insurance Program and Other Ways To Deal with Troubled Assets. During the negotiations, House Republicans raised an alternative method of dealing with problem assets. This alternative has been included in the final agreement as an optional method. Under the plan, the federal government would be required to create a program to provide financial institutions with insurance against losses on mortgage backed securities (MBS). Currently, a large proportion of MBS are insured against loss of principal, and the new plan would cover the rest in return for an insurance premium that would be set by the Treasury Department and be at least partially determined by the risk of the securities. In addition to this insurance program, the Treasury would also have the ability to deal with the current economic crisis by using public/private auctions of troubled assets, loan guarantees, and direct support to financial institutions.

The insurance provision could prove to be very useful in some situations, and its inclusion into the final agreement will give the Treasury a valuable additional method to deal with potentially very large MBS losses.

Who Will Pay? While many of the assets acquired under the agreement will later be sold for more than their purchase prices, many probably will not. Although the overall cost of the plan is impossible to estimate reliably at this point, negotiators agreed that, if after five years the overall plan loses money, a fee will be assessed upon financial institutions to repay the taxpayers. Under the agreement, after five years, the President will be required to send to Congress a plan to implement this repayment provision. No new tax on financial institutions is included in the agreement.

In practice, such a repayment could operate very similarly to the existing FDIC trust fund used to protect bank deposits. Under the law, financial institutions are assessed a fee in the form of higher premiums when the FDIC trust fund drops below a set level. In this way, those institutions that benefit from FDIC insurance end up paying for the protection even if the Treasury has to advance money to them in the case of a major loss.

This could be a good compromise and, if well designed, would help protect taxpayers. If financial institutions recover quickly, it is only right that they should repay the costs of the rescue.

The final agreement also contains a provision allowing community banks to take capital losses that reflect the reduced value of preferred stock issued by Fannie Mae and Freddie Mac in their portfolios. Until those entities were taken into conservatorship, banks were encouraged to purchase their assets as part of their capital bases. Now that the two are in conservatorship, their preferred stock has lost value. This provision appears to be a good way to strengthen community banks that might not otherwise have the type of assets the plan would purchase but still have suffered from the current financial situation.

Executive Pay. In an effort to prevent the same executives who may have endangered their companies through poor decisions from benefiting from the plan, the agreement imposes restrictions on both the pay and termination compensation ("golden parachutes") received by such executives. But it draws important distinctions in how to handle particular cases. In the case where the government has taken over a firm, executives are prohibited from receiving any form of severance pay or other termination compensation. This is already the practice that the government has followed for its actions regarding AIG, Fannie Mae, and Freddie Mac. In addition, taken-over companies would be encouraged to seek to reclaim any bonuses paid that were based upon gains that subsequently failed to materialize.

If the purchases of troubled assets from a single firm reach $300 million or more, the Treasury would impose similar restrictions on termination pay on the top five most highly paid executives in that particular company. In addition, the company would not allowed to deduct from its taxes any salary costs in excess of $500,000. The Treasury Secretary would issue guidelines that determine when such restrictions should be applied and to whom. This provision may spur litigation by executives who claim contractual rights to this now-prohibited compensation. Such lawsuits could limit the savings to the taxpayers if the government is forced to pay successful executives' claims pursuant to the Constitution's Takings Clause or Due Process clause for the loss of moneys that might occur through the operation of this executive pay restriction.

Although Americans are understandably insistent that executives of firms with troubled assets should not profit from the plan, government fixing of salaries and bonuses is dangerous and could undermine the plan's goal of encouraging an orderly market to develop for "toxic" assets. This provision appears to be a compromise that will not undermine the goal of the plan.

Returning Possible Profits to The Taxpayer. Taxpayers should expect to benefit from any realized profits on asset sales because hundreds of billions of dollars of their money is being used to purchase poor quality assets from financial services firms. If individual companies recover and prosper after selling their bad investments to the new Treasury office, taxpayers would recoup those costs through the use of warrants that empower Treasury to purchase and then resell stock in those companies. However, the agreement carefully structures taxpayer profit sharing so that it will avoid endangering the economy's recovery by discouraging firms to participate in the plan. Further, the provision wisely allows the government to obtain only nonvoting stock to prevent it from owning parts of a company or meddling in its management.

Under the agreement, the government would receive warrants for the future purchase of company stock at a set price in any total takeover situation. This is similar to the action taken in the AIG rescue. In addition, the Secretary of the Treasury would be able to require warrants proportional to the amount of assets purchased under the agreement if such a move is deemed appropriate.

Mark-to-Market. Many financial experts have criticized a recent accounting change that required financial institutions and others to revalue assets they held to their market value on the day that the reporting period ended. Previously, firms had either used an average value of their assets over a period of time or valued long-term investments that they had no intention of selling at their purchase price until they were eventually sold. Known as "mark-to-market," the new standard was intended to give investors a better idea of the current value of a firm's assets and to reduce the ability of firms to manipulate their earnings or to hide bad investments. However, mark-to-market introduced additional volatility to firms' balance sheets as asset prices changed, and under extreme conditions, firms' changed book value could trigger both regulatory actions and fear about their viability. Many experts have called for the mark-to-market standard to be suspended or repealed.

Accounting principles fall under purview of the private Financial Accounting Standards Board (FASB), which sets standards and determines their implementation with oversight by the Securities and Exchange Commission (SEC). Political interference in the setting or implementation of accounting standards could be very dangerous. The agreement restates the authority of the SEC to temporarily suspend the accounting rule if it determines that doing so is both in the public interest and protects investors. It also requires the SEC to undertake a study of the rule's contribution to the current financial situation. While it is important to leave accounting in the hands of the professionals and out of the way of political tinkering, this authority will enable the SEC to correct the flaws in the accounting rule.

Bad Policy Provisions That Were Dropped. During the early negotiations, a number of particularly bad policy options were added to the original Treasury proposal. The final agreement appears to drop all of them. Among the dropped provisions are:

- *Allowing bankruptcy courts to change mortgages.* An early draft of the legislation would have allowed bankruptcy judges to arbitrarily reduce mortgage payments by either reducing the interest rate to the current market level or reducing the amount owed to the current value of the house. This provision has been dropped from the final agreement. Its elimination is welcome because, if it had remained in, it would have been much harder for new or low-income homebuyers to find mortgages, and all homebuyers would have found it more expensive to get a mortgage.
- *Using the bailout plan to finance low-income housing and provide money to activist groups.* Another dropped provision would have required that 20 percent of any profitable transaction be

deposited into a special fund that pays for low-income housing. This would have applied regardless of whether the overall agreement was profitable. If it had remained, the provision would have both increased the cost to the taxpayer as well as circumventing the usual appropriations process, thus making it harder to keep track of spending.

- *Changing corporate governance and proxy rules.* Yet another dropped provision would have changed the corporate governance laws to enable any holder of 3 percent of a firm's stock to place its nominees on the same proxy statement as that used by management. It also would have facilitated stockholder votes on a number of issues including executive compensation. While superficially attractive, such a provision would have allowed interest groups to use shareholder meetings to advance their own agendas. It also would make it much harder for corporate boards to obtain the balance of skills and knowledge that the corporation needs for optimal management by making board of directors elections into popularity contests.

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