CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

Peter R. Orszag, Director

October 1, 2008

Honorable Christopher J. Dodd
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

The Congressional Budget Office (CBO) has reviewed the financial rescue legislation to be considered by the Senate.[1] That legislation contains three separate parts; the bill refers to these three components as "divisions."

Division A is the Emergency Economic Stabilization Act of 2008, most of which is identical to the financial rescue bill considered by the House of Representatives earlier this week. In addition to creating a Troubled Assets Relief Program (TARP), under which the Secretary of the Treasury would be authorized to purchase, insure, hold, and sell a wide variety of financial instruments, particularly those that are based on or related to residential or commercial mortgages issued prior to March 14, 2008, Division A also includes a provision that would provide for a temporary increase in federal deposit insurance coverage.

Division B is entitled the Energy Improvement and Extension Act of 2008. It contains numerous tax provisions related to energy production, transportation, and energy conservation. Division C extends various expiring tax provisions, including alternative minimum tax relief.

Although significant uncertainty surrounds the precise net budgetary impact from Division A of the bill, CBO expects that the bill as a whole (including Divisions B and C) would increase the budget deficit over the next decade.

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1. Specifically, this analysis addresses a draft amendment provided to CBO on October 1, 2008 (labeled AYO08C32), in the nature of a substitute for H.R. 1424.

Division A – Emergency Economic Stabilization Act of 2008

In addition to the TARP, the Senate legislation includes an expansion in deposit insurance. This section describes and analyzes the provisions of Division A, beginning with the changes to deposit insurance.

Deposit Insurance

Section 136 would provide for a temporary increase in the amount of deposits insured by the Federal Deposit Insurance Corporation (FDIC) and the National Credit Union Administration (NCUA), raising the limit for each insured account from $100,000 to $250,000 through December 31, 2009. Both agencies would be authorized to borrow such sums as may be necessary to cover any additional costs incurred as a result of the expanded coverage. The legislation also directs the agencies to exclude the increase in insurance coverage when assessing insurance premiums in the near term.

CBO estimates that the deposit insurance funds would incur larger losses in the near term as a result of higher coverage levels and the associated increase in insured deposits. (When institutions fail, the FDIC and NCUA pay for covered deposits and liquidate the assets held by the institution. Raising the amount of insured deposits would increase payments to depositors without affecting recoveries from liquidating assets, thereby increasing the net loss to the funds.) Such near-term losses would, however, be offset over the long term by higher insurance premiums because the agencies are required by law to restore the deposit insurance funds to certain levels over time, so any additional losses from the temporary expansion in coverage will gradually be offset by higher future premiums.

The effects of this provision on outlays over the next year or two are difficult to predict precisely because of uncertainty about the volume and distribution of insured deposits that would be added by this bill. Based on preliminary information from the FDIC, however, CBO estimates that raising the limit to $250,000 through 2009 would boost insured deposits nationwide by about 15 percent. (As of June 30, 2008, deposits at FDIC-insured institutions totaled about $7 trillion, of which $2.6 trillion were uninsured. The FDIC estimate suggests that this provision would extend coverage to about $700 billion of those uninsured deposits.)

Overview of TARP

The bill would appropriate such sums as are necessary, for as many years as necessary, to enable the Secretary to purchase or insure troubled assets and to cover all administrative expenses of purchasing, insuring, holding, and selling those assets. Under the legislation, the authority to enter into agreements to purchase such troubled assets would initially be set to expire on December 31, 2009, but could be extended through two years from the date of enactment upon certification by the Secretary that such an extension is necessary. The purchase price of all such assets outstanding at any one time could not exceed $700 billion (though cumulative gross purchases could exceed $700 billion as previously purchased assets are sold). Purchases would be limited as follows:

- Authority for purchases of $250 billion in assets would be available upon enactment;

- The authority would increase to $350 billion if the President submits to the Congress a written notification that the Secretary is exercising authority to purchase an additional $100 billion of assets; and

- The authority would increase to $700 billion if the President submits a report detailing a plan to use the remaining $350 billion in purchase authority; that expansion would be subject to a 15-day Congressional review for potential disapproval of the plan.

The bill would also enable the federal government, under terms and conditions to be developed by the Secretary of the Treasury, to insure troubled assets, including mortgage-backed securities, and collect premiums from participating financial institutions. The $700 billion limit would be reduced by the excess of obligations to net premiums, if any, under this insurance program.

To facilitate these activities, the federal debt limit would be increased by $700 billion. If, five years after enactment of the bill, the Director of the Office of Management and Budget in consultation with the Director of the Congressional Budget Office determines that the TARP has incurred a net loss, the President would be required to submit a legislative proposal to recoup that shortfall from entities benefiting from the TARP.

Cost of Division A

Under the TARP, the Secretary would have the authority—if deemed necessary to promote stability in the financial markets—to purchase any financial asset at any price and to sell that asset for any price at any future date. That lack of specificity regarding how the authority would be implemented and even what types of assets would be purchased makes it impossible at this point to provide a meaningful estimate of the ultimate impact on the federal budget from enacting this legislation. Although it is not currently possible to quantify the net budget impact given the lack of details about how the program would be implemented, CBO has concluded that enacting Division A would likely entail some net budget cost—which would, however, be substantially smaller than $700 billion. The net budget cost would reflect several factors:

- **Net gains or losses on the TARP transactions**. As noted in CBO's recent testimony before the House Budget Committee, the net gain or loss on the TARP transactions would reflect the degree to which the federal government sought to obtain, and succeeded in receiving, a fair market price for the assets it purchased, and the degree to which, because of severe market turmoil, market prices would be lower than the underlying value of the assets.[2]

  Although some classes of assets and purchase mechanisms are conducive to determining a fair market price, it is unlikely that the program would be limited exclusively to those classes of assets and purchase mechanisms. The program would probably include assets that have the worst credit risks and hence are difficult to price, making it likely that the government would, in some cases, pay prices that fail to cover those risks. Although it is possible that future increases in asset values would generate gains even on assets for which the government initially overpays, an overall net loss is more likely if the government initially overpays.

  The bill includes a provision intended to protect against such future net losses by requiring that firms selling troubled assets to the government

2. Statement of Peter R. Orszag, Director, Congressional Budget Office, *Federal Responses to Market Turmoil,* before the House Committee on the Budget (September 24, 2008).

also provide warrants or senior debt instruments.[3] CBO anticipates that this provision would not have a substantial effect on the net cost of the TARP, however. On the one hand, warrants or senior debt instruments might reduce the incentive for sellers to overcharge for low-quality assets. On the other hand, since the warrants or debt instruments would have value, Treasury would generally face higher prices because sellers would seek compensation for both the value of the troubled asset and the value of the warrant or debt instrument.[4] In addition, the warrants or senior debt instruments may be difficult for the government to value, complicating even those auctions in which the government is otherwise most likely to obtain a fair market price.

In any case, the ultimate cost to the government on the transactions would not be the total amount spent to purchase assets—limited to $700 billion outstanding at any one time—but rather the difference between the amount spent by the government and the amount received in earnings and sales proceeds when all of the assets are finally sold, presumably some years from now. That net cost is likely to be substantially less than $700 billion but is more likely than not to be greater than zero.

- **Recoupment mechanism.** The recoupment mechanism is designed to offset any net losses the government experiences on the TARP transactions. The mechanism, however, requires only that the President *submit* a proposal to offset such costs after five years. Even if it would be fully effective in offsetting any net losses, the President's proposal would require a future act of Congress to be implemented. Any savings from such legislation would be estimated when the proposal is considered and would be credited to that legislation for Congressional scorekeeping purposes.

- **Administrative costs.** Beyond the effect of any gains or losses on the transactions under the TARP and the recoupment mechanism, the

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3. The warrants would give the Treasury the right to buy stock in the future at a fixed price.

4. In other words, the price offered to the government for the troubled asset and the warrant or debt instrument together would be higher than the price offered for the troubled asset itself. Especially in current market conditions, it is possible that the price charged by firms for including the warrant or debt instrument would not fully reflect its value to the government.

programs authorized by this bill would involve administrative costs. For example, the government would have to compensate the private asset managers hired by the Treasury. Those administrative costs are not included in the $700 billion limit on asset purchases. Even if the transactions and the recoupment mechanism combined resulted in neither a gain nor a loss for the government, the administrative costs would expand the budget deficit.

The legislation includes a variety of other provisions that would, on net, add to the budget deficit. A number of those provisions are discussed below.

Other Major Provisions of Division A

In addition to the expansion in FDIC insurance limits and the provisions of the TARP discussed above, Division A also contains provisions that would:

- Change the tax treatment of certain types of income, losses, or deductions of corporations or individuals;

- Require that certain financial institutions seeking to sell assets through the TARP meet appropriate standards for senior executive officers' compensation, as determined by the Secretary of the Treasury;

- Require the Secretary of the Treasury to take steps to maximize assistance for homeowners, including encouraging servicers of the underlying mortgages to take advantage of the Hope for Homeowners Program under section 257 of the National Housing Act;

- Allow the Federal Reserve System to pay interest on certain reserves of depository institutions that are held on deposit at the Federal Reserve, starting on October 1, 2008;

- Direct the Federal Housing Finance Agency, the Federal Deposit Insurance Corporation, and the Federal Reserve Board to implement various measures with regard to residential loans and securities under their control in order to reduce the number of foreclosures, which could include modifying the terms of such loans; and

- Establish Congressional oversight and reporting requirements related to implementation of the legislation, along with a Financial Stability Oversight Board with responsibility for overseeing operations of the program.

The bill would require that the federal budget display the costs of purchasing or insuring troubled assets using procedures similar to those specified in the Federal Credit Reform Act, but adjusting for market risk (in a manner not reflected in that law). In particular, the federal budget would not record the gross cash disbursements for purchases of troubled assets (or cash receipts for their eventual sale), but instead would reflect the estimated net cost to the government of such purchases (broadly speaking, the purchase cost minus the present value, adjusted for market risk, of any estimated future earnings from holding those assets and the proceeds from the eventual sale of them).

Impact on Federal Finances

CBO expects that the Treasury would use most or all of the $700 billion in purchase authority within two years (after which the authority to enter into agreements to purchase various troubled assets would expire). To finance those purchases, the Treasury would have to sell debt to the public. Federal debt held by the public would therefore rise by about $700 billion, although the government would also acquire valuable financial assets in the process. As noted above, CBO expects that since the acquired assets would have some value, the net budget impact would be substantially less than $700 billion; similarly, net cash disbursements under the program would also be substantially less than $700 billion over time because, ultimately, the government would sell the acquired assets and thus generate income that would offset much of the initial expenditures.

In addition to any net gain or loss on the purchase of $700 billion or more in assets, the government also would incur administrative costs for the proposed program. Those costs would depend on the kinds of assets purchased or insured. On the basis of the costs incurred by private investment firms that acquire, manage, and sell similar assets, CBO expects that the administrative costs of operating the program could amount to a few billion dollars per year, as long as the government held all or most of the purchased assets.

Other provisions in Division A would on net increase the budget deficit. For example, the legislation would allow the Federal Reserve to pay interest immediately on certain reserve balances of depository institutions, rather than starting on October 1, 2011, as allowed under current law. CBO estimates that, over the next three years, the provision would reduce the Federal Reserve's payments of its profits to the Treasury, which are classified as revenue in the federal budget.

In addition, a number of provisions Division A would affect federal revenues by changing tax law, including provisions that would limit the deductibility of executive compensation for certain firms selling assets; allow losses incurred by certain taxpayers on preferred stock in Fannie Mae and Freddie Mac to be treated as ordinary rather than capital losses; and exclude from income amounts attributable to the cancellation of mortgage debt of individuals in certain circumstances. The Joint Committee on Taxation estimates that, on net, these provisions in Division A would reduce federal revenues.

Enacting Division A could also affect other federal spending—including, for example, outlays from the operations of Fannie Mae, Freddie Mac, federal housing programs, and deposit insurance. Some of those effects would be related to how TARP would be used to purchase assets (including what kinds of assets would be acquired and from what types of institutions), and how successful the program would be in restoring liquidity to the nation's financial markets.

Division B – Energy Improvement and Extension Act of 2008

Division B of the bill would provide a number of tax incentives related to energy and fuel production and energy conservation. It also includes several provisions that would raise revenue, with the largest effect from a modification of the requirements imposed on brokers for the reporting of their customers' basis in securities transactions. CBO and the Joint Committee on Taxation (JCT) estimate that, over the 2009-2013 period, Division B would reduce revenues by $6.8 billion, increase outlays by about $0.2 billion, and increase projected deficits by about $7 billion. CBO and JCT estimate that, over the 2009-2018 period, Division B would increase revenues by about $0.3 billion, increase outlays by about $0.2 billion, and reduce projected deficits by less than $0.1 billion.

Division C – Tax Extensions and Alternative Minimum Tax Relief

Division C would extend relief from the alternative minimum tax for 2008, extend and modify a number of other expiring tax provisions, provide tax relief for regions of the country affected by severe storms earlier this year, make other changes to tax law, and provide payments to state and local governments for support to rural schools and other county programs. It also would modify the tax treatment of deferred compensation paid by certain foreign entities. CBO and JCT estimate that, over the 2009-2013 period, Division C would reduce revenues by about $105.2 billion, increase outlays by $7.1 billion, and increase projected deficits by about $112.3 billion. CBO and JCT estimate that, over the 2009-2018 period, Division C would reduce revenues by about $99.5 billion, increase outlays by about $7.5 billion, and increase projected deficits by about $107.1 billion.

Intergovernmental and Private-Sector Mandates

The non-tax provisions of the legislation contain no intergovernmental mandates as defined in the Unfunded Mandates Reform Act (UMRA).

The non-tax provisions do, however, contain private-sector mandates as defined in UMRA, and CBO estimates that the aggregate cost of those mandates would exceed the annual threshold established in UMRA ($136 million in 2008, adjusted annually for inflation).

Division C, section 512 would impose a private-sector mandate on group health plans and issuers of group health insurance by prohibiting them from imposing treatment limitations or financial requirements for mental health benefits that differ from those placed on medical and surgical benefits. CBO estimates that the direct costs of the private-sector mandate would significantly exceed the annual threshold established in UMRA in each of the first five years that the mandate would be in effect.

Division A, section 136 could impose a private-sector mandate to the extent that deposit insurance premiums are higher than they would be in the absence of this bill. Most depository institutions (commercial banks, savings associations, and credit unions) are required by law to have federal deposit insurance. CBO, therefore, considers changes in the federal deposit insurance system that increase requirements on those institutions to be private-sector mandates under UMRA. The cost of the mandate would be the additional premiums assessed during each of the first five years the mandate is in effect. While CBO expects that any additional losses from the temporary expansion in coverage would gradually be offset by higher future premiums, we cannot estimate the cost of the mandate because of uncertainty about the timing of the losses and whether or by how much premiums would increase during those first five years.

I hope this information is helpful to you. If you have further questions about CBO's analysis, do not hesitate to contact me.

Sincerely,

Peter R. Orszag
Director

cc: Honorable Richard C. Shelby
Ranking Member

Honorable Kent Conrad
Chairman
Committee on the Budget

Honorable Judd Gregg
Ranking Member

Honorable Max Baucus
Chairman
Committee on Finance

Honorable Charles E. Grassley
Ranking Member