**Interventions by the Federal Reserve to Bail out Investment Firms and**

**Mortgage Companies**

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# Introduction

The Great Recession started in December of 2007 which lasted more than 20 months into 2009. It was a time of severe economic distress, marked by decline in home prices, foreclosures and delinquencies. The value of mortgage-backed securities and other related instruments dropped. The Gross Domestic Product growth rate suffered a decline to as low as negative 8.9 percent and unemployment rate peaked as high as 10.0 percent. Foreclosures increased in 2006, following a home-buying wave built, in part, on loose lending exotic mortgages and rampant speculation. The bubble bursts and the market failed because of the bad loans and excessive risks taken on by banks in the quest to expand their profits. The Federal Reserve also contributed to the prolonged crisis by keeping interest rates low leading up to the recession. Fannie Mae and Freddie Mac used strong backing from influential members of Congress to encourage irresponsible mortgages that required little down payment, as well as low interest rates for households with poor credit and low incomes. The widespread market failure led congressional leaders to propose radical changes in financial institutions, wider regulation and government control of companies. The radical changes or interventions involving financial institutions and mortgage companies were the bailout of AIG and Citigroup and the conservatorship of Freddie Mac and Fannie Mae. The financial institutions that were left out of the bailout by the Federal Reserve were commercial banks due to the Fed’s Regulatory governance authority.

# Fed Intervention on AIG

During the Great Recession of 2007 to 2009 and the financial crisis in 2008, the Federal Reserve offered bailout money from its Troubled Asset Relief Program (TARP) to investment firms who were in dire financial trouble facing bankruptcy. Of those investment firms, AIG was one firm the Federal Reserve bailed out. AIG, the world’s largest insurance company and a major participant in the global trade of derivatives and other financial instruments, was encountering severe liquidity problems, primarily as a result of losses on its mortgage-related investment portfolio and collateral calls on credit default swaps (CDS) and other financial contracts.  By mid-September 2008, these liquidity pressures brought the firm to the brink of collapse.  On September 15, 2008, certain credit rating agencies downgraded AIG’s ratings which triggered CDS-related collateral calls that the company could not meet. To prevent the collapse of AIG, the New York Fed and the Board of Governors of the Federal Reserve System with cooperation from the U.S. Department of the Treasury made the decision to intervene. The decision to lend to AIG was motivated by a single goal: to protect the U.S. and global economies and the American people from the devastating effects that its disorderly failure would have caused. At the time of AIG’s liquidity crisis, AIG had no effective bankruptcy framework in placed especially for its type and size. The company had no single regulator to step in and manage the company’s failure, and demands from creditors and shareholders were too much for a single court to sort through. The absence of a resolution authority, combined with the size and scope of AIG’s businesses and the existing stress on the economy, would have made the consequences of its failure potentially catastrophic (Reserve Federal Bank of New York, 2012). AIG had more than 76 million customers in approximately 140 countries, its failure would posed a direct threat to millions of policyholders, state and local government agencies, 401(k) participants, banks and other financial institutions in the United States and abroad; thus the company needed immediate action. The Board of Governors of the Federal Reserve System authorized the New York Fed to extend a secured revolving credit or loan of up to $85 billion to AIG and in return, the company agreed to transfer a controlling stake of 79.9 percent of company equity in the form of warrants called equity participation notes. The two year loan carried a rate of LIBOR plus 8.5 percentage points (Karnitschnig, 2008). Recently, the Fed had made a profit of $18 billion by selling mortgaged-backed securities it had acquired from AIG through the bailout and $8.2 billion in interest and fees (Fed Turns Bailout into $18 billion Profit, www.money.cnn.com).

# Fed Intervention on Mortgage Companies

The U.S. government seized Freddie Mac and Fannie Mae; the two mortgage companies affected by the bailout. It was important to rescue these two failed companies because their failures meant household wealth would be impacted; inabilities of households to get home loans, auto loans, and other consumer finance. Fannie Mae, a Fortune 500 company, does not lend money directly to home buyers. The company ensures that mortgage funds are available and affordable by buying mortgages from a variety of institutions that do lend money directly to home buyers. When lenders sell their mortgages, lenders replenish their funds; they turn around and lend more money to home buyers. Freddie Mac purchases mortgages from lenders and packages them into securities and then sell those securities to investors (Fannie and Freddie, 2012). Both companies own or back $5.4 trillion worth of home debt-half the mortgage debt in U.S. The sharp decline in home prices and increased foreclosures and delinquencies caused the two company’s shares to fall more than 80 percent in the market place. The seizing of Freddie and Fannie would extend as much as $200 billion in Treasury support, $100 billion per company and places Freddie and Fannie under a “conservatorship” to be run by the Federal Housing Finance Agency until the two companies are on stronger footing. The trade-off of the government agreeing to backstop the firms, the government would receive $1 billion in each company’s senior preferred stock, and a quarterly dividend payment and the right to own 79.9 percent of each company. Both firms lobbying and political activities were halted and both dividends and preferred shares were eliminated to conserve $2 billion annually (Ellis, 2008). As of May 2012, Fannie Mae announced the company made profit and that it didn’t need additional bailout money where previously Fannie Mae received $116 billion from the Treasury and paid back 23 billion in dividends. Freddie Mac received $72 billion and paid back $18 billion (Federal Mortgage Association, 2012).

# Fed Intervention on Financial Institutions

The financial institution that exposed the federal government to the greatest potential loss during the bailout was Citigroup. Citigroup showed fourth quarter losses in 2007 of $10 billion that were linked to sub-prime mortgage crisis and the government identified a pool of more than $306 billion in troubled assets on Citigroup’s balance sheet. Then it reported $2.8 billion in losses in the third quarter of 2008. The company’s share prices continued to fall. In order for the government to help bring stability to the entire financial system, concessions were made in return for the U.S. governments’ direct investment of about $20 billion in the bank and an agreement to back around $306 billion in loans and securities. Citigroup shouldered losses on the first $29 billion from that portfolio. Other remaining losses were split between Citigroup and the government, with the bank absorbing 10 percent and the government absorbing 90 percent. In exchange, Citigroup issued $7 billion of preferred stock to government regulators, and in addition, the government also purchased $20 billion of preferred stock. The preferred stock would pay an 8 percent dividend and slightly eroded the shares held by investors (Rosenberg, p. 71).

# Top Ten Bailout Recipients

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Name | Type | State | Total Disbursed | Profit / Net Outstanding |
| [Fannie Mae](http://projects.propublica.org/bailout/entities/158-fannie-mae) | [Government-Sponsored Enterprise](http://projects.propublica.org/bailout/list/category/Government-Sponsored%20Enterprise) | [D.C.](http://projects.propublica.org/bailout/list/state/DC) | $116,149,000,000 | -$90,617,000,000 |
| [Freddie Mac](http://projects.propublica.org/bailout/entities/230-freddie-mac) | [Government-Sponsored Enterprise](http://projects.propublica.org/bailout/list/category/Government-Sponsored%20Enterprise) | [Va.](http://projects.propublica.org/bailout/list/state/VA) | $71,336,000,000 | -$51,199,000,000 |
| [AIG](http://projects.propublica.org/bailout/entities/8-aig) | [Insurance Company](http://projects.propublica.org/bailout/list/category/Insurance%20Company) | [N.Y.](http://projects.propublica.org/bailout/list/state/NY) | $67,835,000,000 | -$2,609,686,768 |
| [General Motors](http://projects.propublica.org/bailout/entities/233-general-motors) | [Auto Company](http://projects.propublica.org/bailout/list/category/Auto%20Company) | [Mich.](http://projects.propublica.org/bailout/list/state/MI) | $50,744,648,329 | -$27,197,156,843 |
| [Bank of America](http://projects.propublica.org/bailout/entities/27-bank-of-america) | [Bank](http://projects.propublica.org/bailout/list/category/Bank) | [N.C.](http://projects.propublica.org/bailout/list/state/NC) | $45,000,000,000 | $4,566,857,694 |
| [Citigroup](http://projects.propublica.org/bailout/entities/96-citigroup) | [Bank](http://projects.propublica.org/bailout/list/category/Bank) | [N.Y.](http://projects.propublica.org/bailout/list/state/NY) | $45,000,000,000 | $12,354,705,112 |
| [JPMorgan Chase](http://projects.propublica.org/bailout/entities/282-jpmorgan-chase) | [Bank](http://projects.propublica.org/bailout/list/category/Bank) | [N.Y.](http://projects.propublica.org/bailout/list/state/NY) | $25,000,000,000 | $1,731,202,357 |
| [Wells Fargo](http://projects.propublica.org/bailout/entities/518-wells-fargo) | [Bank](http://projects.propublica.org/bailout/list/category/Bank) | [Calif.](http://projects.propublica.org/bailout/list/state/CA) | $25,000,000,000 | $2,281,347,113 |
| [GMAC (now Ally Financial)](http://projects.propublica.org/bailout/entities/236-gmac-now-ally-financial) | [Financial Services Company](http://projects.propublica.org/bailout/list/category/Financial%20Services%20Company) | [Mich.](http://projects.propublica.org/bailout/list/state/MI) | $16,290,000,000 | -$10,752,090,618 |
| [Chrysler](http://projects.propublica.org/bailout/entities/93-chrysler) | [Auto Company](http://projects.propublica.org/bailout/list/category/Auto%20Company) | [Mich.](http://projects.propublica.org/bailout/list/state/MI) | $10,748,284,222 | -$1,315,061,737 |

(Bailout Recipients, 2012)

# The Fed says No to Commercial Banks

The Federal Reserve ruled out a bailout of central bank for state and local governments. The Fed had no intention of getting involved in state and local finance. When the Fed engages in ‘quantitative easing,” it is not printing money and giving it away for it is actually extending credit, creating an overdraft on the account of the borrower to be paid back later. The Fed is limited by statute to buying municipal government debt with maturities of six months or less that is backed by tax or other assured revenue. Bailing out state and local governments is out of the Fed’s mandate (Hilsenrath, 2011).

# Conclusion

The single goal of the Fed is to protect the U.S. and global economies and the American people from the devastating effects of failed companies. The failures of AIG would posed a direct threat to millions of policyholders, state and local government agencies, 401(k) participants, banks and other financial institutions in the United States and abroad. The Fed also intervened in saving the mortgage giants Freddie and Fannie. Both companies own or back $5.4 trillion worth of home debt-half the mortgage debt in U.S. Home prices and foreclosures and delinquencies increased, causing the two company’s shares to fall more than 80 percent in the market place. The Fed rescued these two failed companies because their failures meant household wealth would be impacted; inabilities of households to get home loans, auto loans, and other consumer finance. Also, in order for the government to help bring stability to the entire financial system, the Fed bailed out Citigroup. All bailouts had many price tags; stocks, dividends, takeovers, and restructuring.

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