

What are the Best Solutions to Help End the Current Financial Crisis?

(The following document is three pages in length.)

1. Top priority should be to help save the banks.

- New Treasury Department program announced this week. It creates a Public-Private Investment Program to purchase “toxic assets” that are currently burdening the financial system.
 - Treasury Department [Fact Sheet](#).
 - Treasury Department [White Paper](#).
- Secretary Timothy Geithner’s op-ed in the *Wall Street Journal*, [My Plan for Bad Bank Assets](#).

2. Suspend “slavish adherence” to mark-to-market accounting rules.

- Current mark-to-market accounting rules require banks to revalue assets to current market prices, even if an asset is likely to recover its value over time. During an economic downturn, mark-to-market causes a real loss of capital for banks. This, in turn, can trigger increased capital requirements at a time when banks can least afford it, which increases the risk of bank failures.
- See the NCPA’s Brief Analysis on [mark-to-market](#).
- The Financial Accounting Standards Board (FASB) [proposed new guidance](#) to relieve some of the strict adherence to mark-to-market rules (although it doesn’t go as far as McTeer recommends).
 - Gives banks and other financial firms (together with investors and other interested parties) more flexibility to measure the fair value of their assets using a model that considers the current market value, as well as the potential *future* value of the asset – especially for assets

that are currently considered illiquid (so-called “toxic assets”).

- Allows banks and other financial firms to assess the likelihood of selling “toxic assets” after they recover their value. The overall financial balance sheet of the bank will take into consideration whether the bank has the intent and ability to hold a “toxic asset” until it recovers its value.

3. Enact real economic stimulus.

- Big stimulus package was a boondoggle, intended to fund a liberal wish list of government programs (backlogged for the last 8 years).
- NCPA: [Economic Stimulus the Right Way](#).
 - Allow businesses to immediately expense the costs of assets they purchase in the year that they buy such assets.
 - Allow the repatriation of foreign income at a reduced tax rate.
 - Cut the payroll tax in half.
 - Make the 2001/2003 tax cuts permanent.
- Stimulus policies, and other government economic policies, should be permanent and consistent. Confidence will grow as investors, businesses, and consumers sense certainty and stability in government policy. At present, many investors may be reluctant to inject capital into the economy when they perceive government economic policy as uncertain, unannounced, or likely to change from week to week.

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War on Capitalism and Contracts - AIG Bonus Taxes

Background:

In September 2008 the federal government made a large cash infusion of \$85 billion to AIG, which has increased the taxpayer's stake in the company to \$182 billion. Whether or not this large bailout was the proper role of government is still a matter of debate. Nevertheless, there is no debate that any use of taxpayer money should be carefully considered and deliberately implemented.

However, judicious stewardship of taxpayer resources is not a strong hallmark of federal bureaucracy. This weakness became apparent when everyone learned that AIG was honoring its contracts to pay \$165 million in bonuses to its employees. Although they didn't break any laws, AIG's decision to pay bonuses to its employees before repaying the taxpayer bailout loan has caused general outrage in the public. This outrage was reflected in Congress, where legislation to slap a 90% tax on employee bonuses has already passed in the House of Representatives and may be considered this week in the Senate.

This knee-jerk tax hike is an ominous and disturbing action by Congress. Whatever circumstances surround AIG's actions, Congress has provoked larger questions about whether contracts remain sacred and enforceable. And if Congress can selectively punish AIG for actions that may be distasteful (but weren't illegal), what kind of power will they wield in the future? It is as true today as it was in 1819 when Chief Justice John Marshall said, "the power to tax involves the power to destroy."

Following are some details of the legislation passed last week by the House of Representatives:

- Creates a new 90% income tax rate on bonuses.
- Applies to employees of companies receiving bailout funds in excess of \$5 billion
 - According to a tally by *The New York Times* of bailout recipients, employees at 11 institutions—including Goldman Sachs, Bank of America, Citigroup, Wells Fargo, and JPMorgan Chase—would face restrictions immediately.
- Applies to family income above \$250,000
 - The tax would be paid by any employee or former employee whose family income exceeds \$250,000. Therefore, if you are a receptionist at AIG and your husband or wife is a doctor, your \$5,000 bonus would be taxed.

The Senate may consider similar legislation this week. It differs somewhat from the bill passed by the House:

- Employees would pay the normal taxes on their bonuses, but the company and the employee would each pay an additional 35% excise tax.
- Applies to banks and other institutions that have received at least \$100 million in federal bailout assistance.
- Exempts the first \$50,000 of any bonuses (to protect lower-level employees). But all bonuses intended to retain an employee would face the new tax with no such exemption.

Problems:

- The Constitution prohibits bills of attainder that declare someone guilty of a crime without the benefit of a trial. Furthermore, the Constitution prohibits ex post facto laws that apply retroactively. The various AIG bonus agreements were struck throughout 2008, when the company wasn't under government control.
 - According to Charles Krauthammer, this legislation amounts to overturning the Constitution for about \$165 million, which amounts to less than 1/18,500 of the \$3.1 trillion federal budget.
 - Sen. Judd Gregg: "It's a bill of attainder, it's blatantly unconstitutional, and it sets a precedent just if it even gets to the Senate of pettiness that's hard to equal"
- Is it the rule now that when the public anger is kindled, Congress will summarily cancel contracts? - Charles Krauthammer
- If the government views the bailout as taxable at the 90% rate, what is to stop them from regulating and controlling our nation's small businesses that contract with the federal government?
- Why 90%, who judged that they could keep 10%? In fact, asked why the rate was 90% and not 100%, Ways and Means Chairman Charlie Rangel recently stated that "state and local governments will take the extra 10%."

War on Contracts II – Mortgage Cramdown

The “Helping Families Save Their Homes Act of 2009,” sponsored by Rep. John Conyers, passed the House of Representatives on March 5 and is currently before the Senate. Some of the provisions discussed below were modified, and included “stronger requirements that homeowners make systematic -- and verifiable -- attempts to modify loans before resorting to bankruptcy.” However, even as modified, the contract modification provisions of the bill are controversial, and any of the original provisions could be restored.

Higher Interest Rates and Higher Down Payments

- The cram-down provisions of the legislation will result in increased risk for lenders, leading to higher interest rates and higher down payment requirements throughout the mortgage market. For example, the Mortgage Bankers Association estimates that the interest rate for a 6 percent, 30-year, \$300,000 fixed-rate mortgage could go up to 8 percent. That translates into an annual increase of \$4,824, and more than \$144,000 in higher costs over the life of the loan.
- According to a [2008 New York Federal Reserve report](#), after Congress ended bankruptcy modification (cram-down) for auto loans in 2005, auto loan terms on average decreased by 2.65 percent (265 basis points). See [Don't Let Judges Tear Up Mortgage Contracts](#) by Todd J. Zywicki (Wall Street Journal)
- Tighter credit will hurt all future borrowers, and this legislation will only shift the cost of saving today's troubled loans to borrowers who were more responsible.

Redistribution of Taxpayers' Wealth

- The “cram down” provisions will leave taxpayers vulnerable to liabilities through federal mortgage guarantees.
- Outstanding mortgage and debt guarantees from Freddie Mac and Fannie Mae alone amount to more than \$5 trillion, and the government is also exposed for guarantees of Citigroup, Bank of America, Indy Mac, Washington Mutual, Federal Housing Administration, Veterans Administration, and Rural Housing Service mortgages.
- Bankruptcy “cram down” provisions will not simply redistribute losses from *borrowers to*

lenders as some contend. It will also redistribute losses in turn from *lenders to taxpayers*, producing a massive redistribution of wealth from responsible, accountable taxpayers to borrowers and irresponsible lenders who will not be held accountable.

Moral Hazard and Destabilization of Existing Mortgages

- Because this legislation makes bankruptcy “cram down” available to all existing mortgages, it will reduce the incentives for approximately 50 million solvent home borrowers to keep making payments on their mortgages.
- Congress can expect many borrowers to stop paying their mortgages, trigger foreclosure notices, and petition for bankruptcy to restructure their mortgages and restructure or eliminate all of their other debts – including credit card purchases, auto purchases, and other consumer credit transactions essential to struggling sectors of our economy.
- This bill would create a disincentive for efforts to work out or modify troubled loans. It is unclear how the credit system will react if most borrowers think they can play this game, although it is clear the bankruptcy system would face an overwhelming avalanche of cases.

A Return to the Financial Meltdown

- The “cram down” provisions will force ratings downgrades for broad classes of mortgage-backed securities – requiring banks and insurance companies to increase capital reserves by up to *hundreds of billions of dollars*.
- This is because many mortgage-backed securities include contractual agreements that require sharing of losses between highly rated and lower rated tranches (mortgage-backed securities).
- The legislation attempts to get around this problem by including a provision that declares these lawful, pre-existing contract clauses are “contrary to public policy” and unenforceable.
- This legislative “fix” will likely either be invalidated by the courts or lead directly to massive federal takings liabilities.