

Bailouts

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- A bailout need not benefit the owners of a firm much or even at all. Much of the benefit may flow to holders of the firm's debt.
- The bailouts of Fannie Mae and Freddie Mac provide an excellent case study for learning about bailouts.
- The biggest cost of an expected bailout can be distortion of investment toward firms with a bailout guarantee and encouragement of riskier activities, because the government and ultimately taxpayers bear the risk normally borne by holders of the firms' debt.

The term “bailout” is thrown around a lot these days. Nobody likes a bailout, and nobody wants to admit to receiving one. So, what is a bailout and why should anyone care?

What is a bailout?

Most people these days when they use the term “bailout” seem to have in mind a definition that differs from the formal, dictionary definition. A definition consistent with current usage is:

A bailout is financial assistance provided by a government to a person, firm, or any other entity because of financial distress.¹

On the other hand, the *Oxford English Dictionary (OED)* defines a bailout as

A (means of) release or rescue from difficulty or crisis; *spec.* an act of giving financial assistance to a failing business, etc; money given as such assistance.



Compared to current usage, the *OED*'s definition of the word is both too narrow, because it limits the recipients of bailouts to the entities receiving funds, and too broad, because it suggests that anyone can provide bailouts. While bailouts can be given to anyone, they are made by the government. More importantly, bailouts can be received by people who are not themselves in financial distress but are adversely affected by another's financial distress. For example, lenders to a borrower in distress can receive payments. These payments are important for understanding some of the effects of bailouts, as Fannie Mae and Freddie Mac illustrate.

¹ It might seem that a central bank providing funds to a firm with liquidity difficulties is a bailout by this definition, but it is not. According to the usual prescriptions for central banks, a central bank is supposed to lend to solvent banks with liquidity difficulties and not lend to insolvent banks. This distinction is clearer in principle than it is in practice.

The bailouts of Fannie and Freddie

The resolutions of the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac are much in the news these days.² These examples of bailouts provide some important object lessons. Shareholders are receiving little of the funds being spent on resolving Fannie and Freddie. Between June 30, 2007, and April 27, 2010, Fannie Mae's stock price fell from \$65.33 to \$1.21, and Freddie Mac's stock price fell from \$60.70 to \$1.47. Shareholders have suffered large losses. While the shares are not worthless, the government's cost of resolving Fannie and Freddie is estimated to be on the order of \$400 billion. The stock prices suggest that stockholders' positions in Fannie and Freddie are worth about \$1.4 and \$1 billion.³ Even if the only reason that the firms' stock has any value at all is due to the government's resolution of the firms, these shareholders are receiving little benefit from the \$400 billion.⁴ Where did the rest of the funds go?

The bulk of the \$400 billion represents payments by the U.S. government to holders of debt issued by Fannie Mae and Freddie Mac. These debt holders are receiving the major benefits from the bailout. Ironically, the perception that the government would make these payments contributed to actions that ultimately brought about the payments (Eisenbeis, Frame, and Wall 2007).

The expectation that the government will bail out a firm creates additional costs even when the firm is successful.

It was profitable for Fannie and Freddie to buy subprime mortgages and hold them because of a perceived government guarantee of their debt, and losses on those risky mortgages played a large role in their insolvencies. Fannie and Freddie originally facilitated securitization of mortgages, thereby increasing the efficiency of the market for mortgages. Another way these firms generated profits, though, was by holding securitized mortgages and financing them by issuing debt. Both firms' debt had low risk spreads over U.S. securities because of a widespread perception that the U.S. government would make good on the debt if the firms were unable to pay.⁵ Both Fannie and Freddie could generate higher returns than other firms from holding risky subprime mortgages because of the artificially low risk spreads for their debt. Ultimately, losses on those subprime mortgages were a primary cause of their failures.

Fannie and Freddie were not bailed out in one sense: shareholders lost substantially. In another sense, however, investors in the firms' debts turned out to be right in the end—they received a bailout. Interestingly, the investors received a slightly higher return than they would have received from Treasury securities when things went well. Now they are receiving a similar return even though the firms are unable to pay them.

² The more formal names of Fannie and Freddie are Federal National Mortgage Association and Federal Home Loan Mortgage Corporation.

³ The estimate of \$400 billion is by Peter Wallison (Liu and Long 2009). Other estimates would be more or less, but the magnitude still would be a hundred or more times the value of shares in the firms.

⁴ Shareholders in firms emerging from bankruptcy often receive a small sum and not zero.

⁵ This implicit guarantee was explicitly disavowed in the debt offerings of both firms. Nevertheless, the implicit guarantee has been realized, and the disavowals that were ignored were rightly ignored.

Cost of bailouts

Expenditures associated with a bailout are not the only costs, and the expenditures may not even be a large part of the total cost of a bailout. The expectation that the government will bail out a firm creates additional costs even when the firm is successful. The ability to issue debt with lower risk spreads means that firms with such guarantees attract more investment than they would otherwise. On the flip side, firms that do not have government guarantees of their debt attract less investment than they would otherwise. In other words, the allocation of investment is distorted toward firms whose debt holders will be bailed out.

Furthermore, financial activities unattractive to other private entities on the same scale can be attractive to firms whose debt is guaranteed—which is what happened with the GSEs. Firms with a guarantee can undertake riskier activities because the holders of the firms' debt are not concerned about the risks. Even when the activities are successful, those investments are a distortion of capital investment—and those risky positions can come to grief.

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References

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