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It's Not the RTC -- It's a $700 Billion LBO

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Treasury's bail-out is broader than the market now sees, and so will be the regulations.

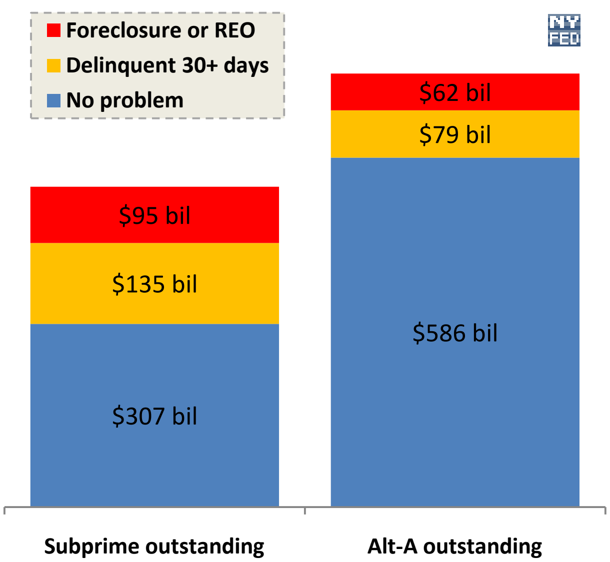
Update to strategic view

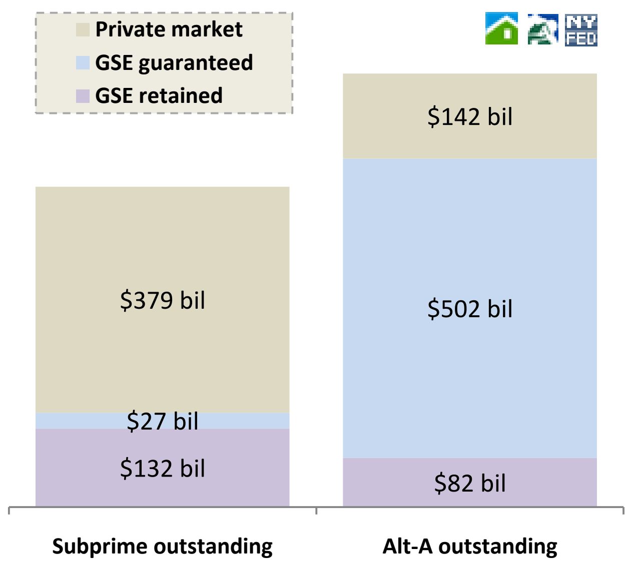
US STOCKS, US FINANCIAL STOCKS: The Treasury's massive bail-out of illiquid assets will extend beyond mortgages, and is probably the solution to the markets' paralysis at a time of unsustainably extreme fear. But we don't know how asset purchases will be priced, what regulatory costs will be imposed, nor whether a new type of speculative attack will be unwittingly released.

[see Investment Strategy Dashboard]

The proposed $700 billion purchase authority for the Treasury is a far more sweeping and comprehensive program than the market may appreciate, and by the end of the week financial industry lobbyists will try to make it more so. We learned Saturday from sources at Treasury that it is already intended to include not just mortgages and mortgage-backed securities, but also leveraged loans and other private equity deal-linked securities that haunt bank balance sheets. This intention hides in plain sight, in a footnote in a leaked copy of the latest revision of the legislative proposal put forth by Treasury, defining "troubled assets" to include "any" that the Treasury secretary "determines necessary to promote financial market stability."

This broad definition explains the enormity of the $700 billion figure that Treasury has been asking for since late Friday -- several times what it would take to buy the entire market for illiquid





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mortgage-backed securities at their current depressed prices. Just $327 billion would be enough to buy -- at 100 cents on the dollar -- every subprime and Alt-A mortgage in delinquency or foreclosure. For that matter, $521 billion would be enough to buy -- again, at 100 cents on the dollar -- *every* subprime and Alt-A mortgage that is not already owned or guaranteed by the federal government via Fannie Mae and Freddie Mac.

Sheer fear is driving everything here. Having seen the unintended consequences of their previous *ad hoc* bail-out attempts not only fail but actually make matters worse, Henry Paulson and Ben Bernanke are determined to throw enough money at the credit crisis to end it once and for all. To this end, they've effectively painted a doomsday scenario for Congress, leaving legislators little choice but to acquiesce in granting Paulson truly extraordinary personal powers, lest they be seen as failing to act after they had been warned. Senate Banking Committee Chair Christopher Dodd (D-CT) described Sunday morning -- on ABC's "This Week" with George Stephanopoulos -- a briefing late last week by Bernanke, in which the Fed chair's characterization of the present risk to the financial system was so catastrophic and so immediate as to leave the hearing room in stunned silence. Many investors we talked to last week were no less terrified. These seasoned, thoughtful professionals spoke to us, without a trace of irony, about the real possibility of an imminent "bank holiday," and a world in which by the end of the week ATMs would go dark and credit cards could not be used in commerce. Sophisticated investors -- and canny politicians -- don't experience such fears for no reason. But on the other hand, it has to be said that this is exactly what one feels at significant market bottoms.

No one knows yet exactly what the Treasury's program will turn out to be. Even when the terms of legislation are known, we won't know exactly how Paulson will use his new powers -- or how his successor will. While a very simple plan is being hurried through Congress in an atmosphere of fear, every day that the stock market doesn't collapse this week will take some of the edge of panic off and increase the chances that the final legislation will be complicated by features currently not in the picture. It seems unlikely that legislation will emerge by the end of the week that gives the Treasury everything it wants -- unfettered authority -- and nothing that it doesn't want -- such as increased duties to aid homeowners in foreclosure or a mandate to rein in executive compensation. So it's too early to hold a definitive opinion about whether it will, in fact, finally end the credit crisis. For what it's worth, this would seem to be exactly what the most extremely pessimistic commentators such as Bill Gross have long said is the only thing that will do the trick, and it will be interesting now to see if they concede that it actually will. On the face of it, in our view is that it *should* work, and our best guess is that it probably will. From our standpoint, the worst risk is that it is overkill -- indeed, that the crisis may well have solved itself already had it not been for the government's previous ham-handed attempts to intervene.

Certainly if the program could be implemented by the wave of a wand, instantly moving unwanted illiquid assets from the weak hands of the financial sector to the strong hands of the government at a fair price, to be carefully reintroduced to the market at some propitious time in the future, then what's not to like? The spasm of risk aversion paralyzing the markets would thereby be eased, by the simple excision of the risk to which the markets are averse. But there is no magic wand. The Treasury's program will have to be implemented in the presence of competitive forces that have already swamped the government's previous bail-out attempts with unintended consequences. The expectation that the government would be a bid under such firms as Fannie Mae, Freddie Mac, Lehman Brothers, Merrill Lynch and AIG -- whether or not the bid ultimately was there -- served to unleash speculative attacks against those firms, destroying them rather than saving them (see "Fannie/Freddie Fallout" September 8, 2008; "Your Speculative Attacks Dollars At Work" September 11, 2008; and "AIG: Rescue or Bag Run?" September 17, 2008). We think the type of speculative attack that felled those firms has been effectively muzzled with last week's ban on short-selling (see "If You're Short, Abort" September 19, 2008). But we're not certain that some new attack mechanism won't arise now, designed to exploit the Treasury's stop-loss order under mortgage-backed securities and other illiquid assets.

Even abstracting from such concerns, straightforward issues of portfolio selection, pricing and valuation will be a devil in the details of the Treasury's new program. Exactly which issues will the Treasury purchase? We can be sure that the banks and brokers with illiquid securities to sell will seek to offload the worst. How will the purchases be priced? The Treasury is talking about a "reverse auction," but who's expert enough to conduct the auction who won't also want to participate in it as a seller? Could sellers of illiquid assets mount a "reverse speculative attack" designed to increase the price of those assets ahead of an auction? Will banks have to mark their positions in assets not sold at auction to the auction price?

Such questions make it plain that the proposed $700 billion Treasury bail-out is much more than a repeat of the Resolution Trust Corporation, the S&L crisis-era program to which it is being frequently compared. RTC was a program for the orderly liquidation of mortgages and real estate that the federal government had *already* acquired by virtue FDIC and FSLIC insurance covering thousands of bank and S&L failures. Today's proposed bail-out, on the other hand, is focused on acquiring distressed assets, with the process of liquidating them only a distant consideration for the far future. It amounts to a vast LBO by the Treasury -- the debt-financed acquisition of assets for rehabilitation and ultimate reintroduction in the public markets. With the Treasury's ultra low cost of financing at current yields, and the extraordinary credit spreads available in illiquid mortgage-related securities and leveraged loans, arguably the Treasury is starting out in the LBO business with a significant leg up.

With the LBO model in mind, we caution against taking seriously the repeated claims in the media that the Treasury's program amounts to a vast increase in government spending. It does not. It is, however, a vast increase in government *investment*. And it will not be without cost even if the government ultimately turns a large profit. There will be regulatory strings attached to this investment, even if the legislation enabling Treasury's authority is rushed through in its simplest possible form. It is inevitable that, after this, we will see onerous new regulations restricting the scope of operation of financial intermediation. Worst case, we'll see the equivalent of Sarbanes Oxley applied to the entire financial sector. In SarBox, the firms whose negligence permitted the Enron/Worldcom accounting scandals to happen in the first place -- the auditors -- were given vast new powers to regulate corporate behavior. In the post-subprime world of aversion to credit risk, who'll end up calling the shots in lending decisions? Probably the ratings agencies.

The regulation has already begun. We have last night's announcement that the Fed has "accepted" Goldman Sachs' and Morgan Stanley's "application" to become bank holding companies -- that is, to be regulated by the Fed. It's a fair guess that this "application" was a *quid pro quo* for access to Fed liquidity, and lots of it. Last week the balance of outstanding loans from the Fed through the Primary Dealer Credit Facility went from zero to $60 billion, and it's not hard to guess who did the borrowing, since there aren't many non-bank primary dealers left. So it's not hard to imagine the New York Fed's Timothy Geithner explaining to the CEOs of Goldman and Morgan that, in the future, they would be more welcome at the discount window -- as banks -- and with bank capital requirements.

BOTTOM LINE: The Treasury's massive bail-out of illiquid assets will extend beyond mortgages, and is probably the solution to the markets' paralysis at a time of unsustainably extreme fear. But we don't know how asset purchases will be priced, what regulatory costs will be imposed, nor whether a new type of speculative attack will be unwittingly released.