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Bail-Out Brinksmanship

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Will credit markets get their bail-out? Will they even want the bail-out they might get?

As of this writing Friday morning, Washington remains deadlocked over the proposed $700 billion authority for the Treasury to buy illiquid assets. We think there is a meritorious idea at the core the proposal (see "It's Not the RTC -- It's a $700 Billion LBO" September 22, 2008). And only a fool would say that there is no risk to the banking system here. But given the apparent lack of any idea at Treasury or the Fed of how the bail-out would actually work, the terrible track record of those same authorities whose bungling of the Fannie Mae, Freddie Mac and American International Group situations only accelerated the crisis (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), and the onerous capital-punishing provisions being forced into the plan by Congress, at this point we are tempted to think that the world might be a better place without this particular bail-out. At this point, no bail-out will be a tough pill for markets to swallow, especially considering the extraordinarily alarmist rhetoric being employed on all sides of the debate. Today might be especially difficult if the collective mind of the market decides to engineer a speculative attack on Congress, as it were, by dropping precipitously in order to create a mood of panic that will force some kind of resolution over the weekend. But we're not convinced that the ongoing difficulties in credit markets can't be handled one local crisis at a time and, generally, with continuing ultra-liberal application of liquidity from the Fed. And even if we grant that the crisis is as threatening as the politicians say, the bail-out in the form represented in a bipartisan Agreement on Principles released by negotiators yesterday morning would make matters worse anyway.

Update to strategic view

US STOCKS, US FINANCIAL STOCKS: The proposed $700 billion bail-out has been derailed, but the climate of fear in Washington could easily still force a deal in very short order. No deal would be a shock to markets at first, and it would be a shame to lose what was good about the proposed program. But if it's loaded up with mortgage forbearance mandates and punitive equity grabs, then markets will be far worse with a deal than without one.

[see Investment Strategy Dashboard]

Key documents

Leaked initial legislative proposal
Official Treasury Fact Sheet
Leaked revised legislative proposal
Senate legislative proposal
House legislative proposal
Agreement on Principles
Conservatives' rescue principles

From our Client Resources page

Let's go back to basics and look at the good idea at the core of the Treasury's proposed bailout. In a nutshell, it

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is that the credit crisis can be alleviated in a win-win manner, by exploiting the arbitrage between the low value of mortgage-backed securities in the weak hands of banks, and the high value of MBS in the strong hands of the federal government.

- Banks need to deleverage by selling assets, and are frozen in their capacity as credit intermediaries until they can do so. They would prefer to deleverage by selling underperforming, risky, opaque and out-of-favor assets -- mortgage-backed securities.
- The prices of MBS are already depressed, possibly below their intrinsic value, by forced liquidation that has already occurred. They would be depressed further to ruinous fire-sale prices if there were more liquidation. So the banks can't sell.
- The government can help the banks by buying these assets, because it can exploit an arbitrage opportunity arising from its unique attributes as an investor.
- The government enjoys the market's lowest cost of capital (the Treasury rate), and is endowed with the largest, deepest and most diversified income stream and asset portfolio. So it is the most "efficient" buyer in the market (in the Modern Portfolio Theory sense of the word). To put it another way, any given security is more valuable and less risky from the government's point of view than from that of any other market participant. This is fundamentally true, without having to rely at all upon the exaggerated claims of potential profits for the government that have been bruited about this week.
- If the government is intrinsically the highest bid in the market for illiquid MBS, that means it would not be a hand-out to the banks for the government to make a bid above the current market price -- any more than it would be for any investor attracted to an opportunity to bid up a security that looks attractive from his unique point of view. It could even be argued that if the government were to pay fire-sale prices, it would be a hand-out to the government.

But the Treasury and the Fed have been unable to articulate a process that would capture the gains from this arbitrage. The original idea of a "reverse auction" would not capture them at all, because in that setting the price would be determined entirely by the sellers. Ben Bernanke was closer to the mark when he said on Tuesday, "If the Treasury bids for and then buys assets at a price close to the hold-to-maturity price, there will be substantial benefits." But Bernanke failed to say how such a price would be determined, or how an auction would be structured to introduce a bid at that price. So his remark has been repeated endlessly as proof that the Treasury intends a hand-out to Wall Street by paying above-market prices.

Making matters worse, negotiations with Congress have added features to Paulson's original very simple proposal, some of which weaken its power to help the banking system and the economy, and which, on balance, probably render the plan counterproductive. On the plus side, negotiations have produced mechanisms to exercise congressional oversight in what was initially a unilaterally Treasury-driven program. And it's smart to not give Treasury the full $700 billion authority immediately, but rather to meter it over time as Treasury gains experience with the program.

But on the negative side, the mandate for Treasury to attempt to prevent foreclosures in the mortgages it acquires under the program is flatly counterproductive. The idea here is to move MBS from weak hands to strong hands -- yet if Treasury is required to handle the mortgages it acquires with any goal in mind other than financial maximization, its strong hands are weakened. Mitigating the counterproductive power of this element is the fact that many of the illiquid MBS the Treasury is likely to acquire -- the sorely distressed lower-rated CDO tranches suffering most from foreclosures and delinquencies -- won't give Treasury possession or control of the underlying mortgages, anyway.

The requirement that Treasury punish executives of banks that sell MBS under the program by limiting their compensation satisfies a political hunger for justice. But anything that inhibits banks from taking full advantage of the program limits the extent to which the gains from the underlying arbitrage can be exploited.

By far the worst feature -- which, if implemented, we think will have a strongly counterproductive effect -- is the requirement that the Treasury take some kind of equity stake in banks who participate in the program.

- If the Treasury pays a market-like price for a MBS -- or even if it pays somewhat above market, based on exploiting the arbitrage we have described -- then why should a bank have to give up equity? If it is going to give up equity, then wouldn't it be better off raising capital from public markets, even at dilutive prices? It knows it will get diluted either way, and at least if it goes the capital-raise route, it will get to keep the MBS.
- If the equity is contingent, in the form of warrants that would be exercisable in the event that the Treasury eventually shows a loss on the MBS it buys, then the bank doesn't truly get the MBS off its books when it sells. It is still fully liable for the loss, one way or the other. So how does that improve anything for anybody?
- By requiring equity, entities that have no equity to give -- such as bond mutual funds -- will be shut out of the program.
- And perhaps worst, the Treasury's taking equity perpetuates the deadly dynamic set in motion by the Bear Stearns, Fannie Mae, Freddie Mac and AIG rescues in which the Fed and the Treasury create incentives for speculative attacks on the very companies they are trying to save (again, see "AIG: Rescue or Bag Run?" *et al.*).

As to the alternative plan being put forward by conservative members of the House of Representatives -- which has been blamed for derailing the negotiation process -- we don't think that government-issued insurance for risky MBS is the optimal approach. It would be better than no deal at all, and far better than the equity-unfriendly bill outlined in the negotiators' Agreement On Principles. But its ultimate effectiveness would depend on whether banks need to deleverage, by actually getting illiquid MBS off their books, or simply to "de-risk," by limiting further downside from those securities. The availability of high-quality insurance for MBS would be good for "de-risking," but if the object is literal deleveraging, then insurance wouldn't accomplish it, as it would leave illiquid MBS on the banks' books.

Considering the enormous stakes involved -- $700 billion is a great deal of money, even in Washington, DC -- it's not surprising to see negotiations dragging on, and even appearing to come completely off the rails. But politicians on all sides of the issue have agreed that some kind of bail-out is of urgent importance -- which the Washington Mutual failure underscores -- so despite the brinksmanship we're seeing, it's still likely that a deal can get done. If there's no deal, brace for a bad shock in markets -- but we think the chances of the kind of total system meltdown being advertised by the politicians are quite small, and that markets are likely to be surprisingly resilient. If there *is* a deal, it will be all about the details. At this point, with so many failed rescues in the recent past, it's hard to believe that markets would react well for very long to a deal that's not a good one. We're more bullish on no deal than on a bad deal.

BOTTOM LINE: The proposed $700 billion bail-out has been derailed, but the climate of fear in Washington could easily still force a deal in very short order. No deal would be a shock to markets at first, and it would be a shame to lose what was good about the proposed program. But if it's loaded up with mortgage forbearance mandates and punitive equity grabs, then markets will be far worse with a deal than without one.