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Peeking Under the TARP

Monday, September 29, 2008

Donald Luskin

Now a bill, but still no details. First take: it could have been worse, and it might work.

Where's the celebration? When the putatively final form of the Emergency Economic Stabilization Act of 2008 was announced Sunday afternoon, electronic markets in stock index futures barely reacted. As of this writing early Monday morning, they are trading lower. The first problem is that the banking bail-out bill isn't law yet -- and as President Bush said this morning, "it will be a difficult vote." Then when and if it becomes law, we still won't know for a while how its Troubled Asset Relief Program (TARP) will actually work -- especially how asset purchases and guaranties will be priced. So markets need to wait and see. And in the meantime they are processing on the absorption of Wachovia by Citigroup -- another over-the-weekend government-assisted wipe-out of shareholder equity -- and the rescues of Fortis and Hypo in Europe, and Bradford & Bingley in the UK.

Or are dour markets fixing on the view of the bail-out that we articulated Friday -- we said, "We're more bullish on no deal than on a bad deal" -- and determining this may, indeed, be a bad deal (see "Bail-Out Brinksmanship" September 26, 2008)? We're still not convinced that any comprehensive bail-out is necessary in the first place. But since we've got one, we're happy to be able to say that in our judgment, it could have been far worse, and might even end up doing some good.

Useful new elements have been added, and some of the worst elements that had been proposed by Chris Dodd and heavily promoted by Democrats have been stripped from the final bill or watered down -- ironically, thanks to Nancy

Update to strategic view

US STOCKS, US FINANCIAL STOCKS: We now have putatively final language for the banking bail-out: the Emergency Economic Stabilization Act of 2008, though it's not law yet, and markets still have no idea how its complex Troubled Asset Relief Program (TARP) will really work. The most pernicious elements considered last week are either gone or watered down, and useful new features -- such as Treasury insurance for illiquid securities, and Fed authority to pay interest on reserves -- have been added. We remain on alert for unintended consequences, especially in the form of incentives for speculative attacks. But at first blush, and acknowledging our basic aversion to government interventions, especially of this scope, we think this bill may end up being generally effective.

[see Investment Strategy Dashboard]

Key documents

Senate legislative proposal
Conservatives' rescue principles
Final bill
Summary
Analysis

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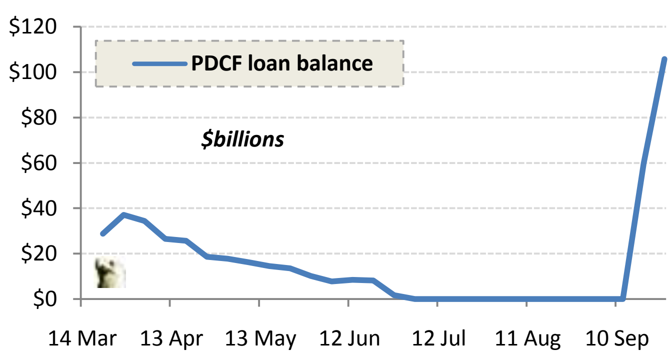
Pelosi. When Pelosi said last week she would block passage of any bill not supported by a majority of House Republicans, she gave a handful of conservatives a great deal of leverage over the bill's content. So gone is Chris Dodd's initiative for a fraction of profits (but not of losses) to go into housing assistance programs administered by political influence groups; gone is the power for bankruptcy judges to "cram down" debt forgiveness by mortgage lenders; gone are punitive "clawbacks" of prior executive compensation; and gone is the ruinous requirement that a bank selling assets to the Treasury cover 125% of eventual losses, if any, by issuing warrants.

It is that last provision -- concerning warrants -- that made the deal on the table last week a non-starter from our point of view. It is the logical equivalent of a bank writing a credit default swap to the government, payable in equity, and thus assuming the downside risk of the very same illiquid asset it is trying to get off its books. And how would banks have had to treat an event-contingent equity arrangement such as that under GAAP? But now, under Section 113(d) the version of the bill released Sunday afternoon, the Treasury secretary has broad discretion as to the amount and structure of warrants a bank must grant as part of any asset purchase. This discretion is *absolutely essential* -- not only because Dodd's punitive version effectively undid any benefit to banks of the Treasury's purchase of illiquid assets, but also because as matters stand now, nobody knows what market mechanism or pricing concept will be used in the Treasury's purchases -- so *no* rigidly pre-set warrant requirement is likely to be appropriate to whatever finally evolves.

Better yet, the House conservatives wrote into the final bill Section 102 -- the authority for Treasury to sell to banks insurance on their illiquid assets, as an alternative to selling those assets to the Treasury. And nothing in the bill requires that banks who buy the insurance issue warrants, or limit executive compensation in any way. We noted last week when the conservatives offered the insurance concept as the cornerstone of their alternative rescue principles that it doesn't facilitate a system-wide deleveraging as efficiently as outright Treasury purchases would (again, see "Bail-Out Brinksmanship"). But as one smart client pointed out to us, it would make otherwise uninsurable MBS more valuable, and bring liquidity to these gridlocked markets -- an indirect but nevertheless potentially very effective path to deleveraging -- especially since warrants won't be part of the deal. If nothing else, the insurance is a straightforward way for a bank to once and for all stop the bleeding from its MBS. If Treasury-issued insurance had been available in July, would Merrill Lynch have made a non-recourse loan to Lone Star Funds to buy, at fire-sale prices, Merrill's illiquid MBS portfolio (see "All Cross, No Current" August 1, 2008) -- thus locking in a huge write-off, yet doing nothing at all to stem further losses, and ending up in a shot-gun marriage with Bank of America?



Also, Section 128 of the final bill gives the Fed the ability to pay interest on reserve balances, starting on October 1. As with TARP, we don't know exactly how the Fed will actually implement this new power, or communicate to the market about it. But given the heavy burdens now being placed on the Fed's balance sheet -- for example, the Primary Dealer Credit Facility has grown from nothing to $106 billion in just two weeks -- it's absolutely essential that the Fed have this new power in order to grow its balance sheet without printing money to do it (see "The Fed's New New Facility" May 16, 2008).

We are also glad to see in the final bill Sections 104 and 125 mandating oversight of the Treasury's execution of TARP, and Section 115 setting forth a schedule for building up in steps to the full $700 billion authority, as experience with the program is acquired. We also note that the definition of "Troubled Asset" in Section 3(1)(9)(b) remains, as we pointed out initially, broad enough to include the leveraged loans -- which may become the next focus of the credit crisis (see "It's Not the RTC -- It's a $700 Billion LBO" September 22, 2008).

The most troubling element of the final bill is Section 134: "Recoupment," included at the insistence of Democratic representative John Tanner. The section consists of only a single paragraph of just 102 words, but it's potentially a very strong poison pill. It provides that if, after five years, the government shows a net loss on the transactions it makes under TARP, then

> …the President shall submit a legislative proposal that recoups from the financial industry an amount equal to the shortfall…

In other words, if TARP loses money -- regardless of whose responsibility that is -- then the entire financial sector -- including firms that didn't even participate in TARP -- will somehow be expropriated to make up for the loss. If taken at face value, this paragraph renders the bail-out not a bail-out at all -- but rather the opportunity for the government to make a $700 billion investment with borrowed money, and get 100% of the upside and none of the downside. The language is soft and unspecific, suggesting that it is intended mostly as a face-saving device for congressmen who don't want to be blamed for bailing out "fat cats" (and as a campaign contribution extraction device when five years rolls around).

BOTTOM LINE: We now have putatively final language for the banking bail-out: the Emergency Economic Stabilization Act of 2008, though it's not law yet, and markets still have no idea how its complex Troubled Asset Relief Program (TARP) will really work. The most pernicious elements considered last week are either gone or watered down, and useful new features -- such as Treasury insurance for illiquid securities, and Fed authority to pay interest on reserves -- have been added. We remain on alert for unintended consequences, especially in the form of incentives for speculative attacks. But at first blush, and acknowledging our basic aversion to government interventions, especially of this scope, we think this bill may end up being generally effective.