The Government Steps in to Stabilize Financial Markets

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Turmoil in the Capital Markets Requires Government Intervention

The U.S. Treasury is seeking authority from Congress to purchase up to $700 billion in troubled mortgage assets.

The U.S. Treasury asked Congress this weekend for authority to purchase as much as $700 billion in impaired illiquid mortgage related assets (and later revised to include other troubled assets). This initiative treats the disease that is impacting our capital markets, no longer the symptoms. The proposed legislation, the most significant fiscal policy initiative aimed at the financial markets since the 1930s, gives the Treasury Secretary sweeping power to address the purchase of these troubled assets. In effect, the U.S. government is becoming the buyer of last resort for mortgage assets that no other financial institution wants to buy.

The foundation of capitalism in a democratic society is the existence of a free market with minimal involvement by the government. Our financial system allows for the exchange of risk within boundaries and regulations, only some of which are set by the government (such as filing requirements with the SEC). However, our capital markets have ground to a halt and the U.S. Financial system is on the brink of collapsing under its own leverage. The free exchange of credit, which is the life blood of our capital markets, is non existent. Without the ability to access credit, our economy stops working. As a result, the basic elements of our economy would quit functioning, manufacturing plants shut down, retail stores can't purchase inventory, and jobs are lost. This government initiative is historic.

Up until this point, the U.S. government has treated the symptoms of the financial crisis. By literally addressing the crisis of the moment, the government has attempted to keep the capital markets working with the hope that an orderly deleveraging over time would not be disruptive to our markets. As a result, the government has assisted in the merger of Bear Stearns, the takeover of Fannie Mae and Freddie Mac, the bridge loan to AIG and emergency insurance program to guarantee Money Market Mutual Funds. However, market turmoil this past week underscored the lack of investor confidence in the U.S. Financial system. The disease that needs to be treated is eradicating the toxic assets that are sitting on the balance sheets of financial companies. If banks and broker dealers are allowed to off-load the illiquid toxic mortgage backed securities, then they should have the financial strength to raise additional capital.

How Will the Plan Work?

The short answer is: we don't know but, we think it will.

The request from the U.S. Treasury to Congress was only two-and-a-half pages long and provided very little detail on how the plan would work. As complicated as this problem is, we found it somewhat ironic that one of the most important initiatives in the modern history of our capital markets could be summarized in less than three pages. The government wants to keep the plan simple.

The government is asking for the unchecked authority, under the Secretary of the Treasury, to hire asset managers to oversee the purchase of specific mortgage related assets. Democrats will push for better oversight of the program than what's been proposed. The proposal allows the Treasury Secretary discretion in the purchase, sale and management of residential or commercial mortgage securities, as well as any similar obligation or instrument that are based on or related to mortgages. Politically, we expect a backlash from democrats given the request for such broad powers. However, we also expect a bipartisan sense of urgency to pass meaningful legislation in the spirit of what is being requested very quickly.

Probably the closest comparison to the organization that the U.S. Treasury is attempting to set up is the Resolution Trust Corporation (RTC) that was initiated in 1989 to liquidate the assets of troubled savings & loan institutions. The assets that the government is willing to purchase are illiquid and price discovery will be a problem. While it appears to give the Secretary of the Treasury the authority to hire firms as agents of the government, it is not clear how prices will be determined for such illiquid assets. Funding of the program may take the form of specific debt offerings from the U.S. Treasury.

What can we Expect?

This proposed legislation is only one more step in the process of deleveraging of our markets, a process which started a year ago. We are not through the woods and we expect that volatility in the markets will continue although not to the extent that we've experienced. However, we think this will provide an important mechanism to allow liquidity to flow back into the capital markets.

Focusing just on banks, we expect management to act to sell assets and purge their balance sheets fairly quickly. The winners are those banks that have strong enough capital positions to weather the sale of mortgage related securities where a market for those assets didn't exist before. This would include such banks as Fifth Third, Wachovia, National City, SunTrust, Key Bank, Wells Fargo, and Regions Bank. The money center banks, including Citigroup, JPMorgan and Bank of America, have more complex mortgage related assets on their balance sheet and it is unclear at this point how they will be affected.

For investment banking firms such as Goldman Sachs and Morgan Stanley, this should also have a positive impact. We believe if this had been initiated two weeks ago, Lehman Brothers would not have filed for bankruptcy and Merrill Lynch would still be independent. It would not surprise us to see a rethinking of the BankAmerica/Merrill Lynch deal in light of this legislation.

Problems still remain. Continued deterioration in housing prices across the country will further impair mortgage related assets on bank balance sheets. The deterioration in the residential mortgage sector is bleeding into the commercial mortgage area. However, by cleaning up the balance sheets of these financial institutions, they will have the ability to raise additional capital and strengthen their balance sheets. The landscape of our financial system will continue to change as more legislation is enacted down the road.

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