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## Key Issues Facing U.S. Stabilization Plan

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We're pleased with the evolution of the global stabilization plan. Treasury, the Fed and other central bank have massive powers to protect the financial system and are now proposing more effective steps.

On October 14, Treasury is expected to announce a broad U.S. stabilization plan. It will likely:

- commit some of the new Treasury facility to preferred stock purchases; we think this is a very positive development -- see our October 8 piece and conference call with Prof. Charles Calomiris;
- give details on the facility's plans to purchase debt instruments and preferred stock;
- provide a guarantee for interbank loans;
- possibly provide more protection for bank deposits above the current \$250,000 FDIC insurance ceiling.
- In addition, Federal officials reportedly gave Mitsubishi UFJ some assurance that its investment in Morgan Stanley would be protected.

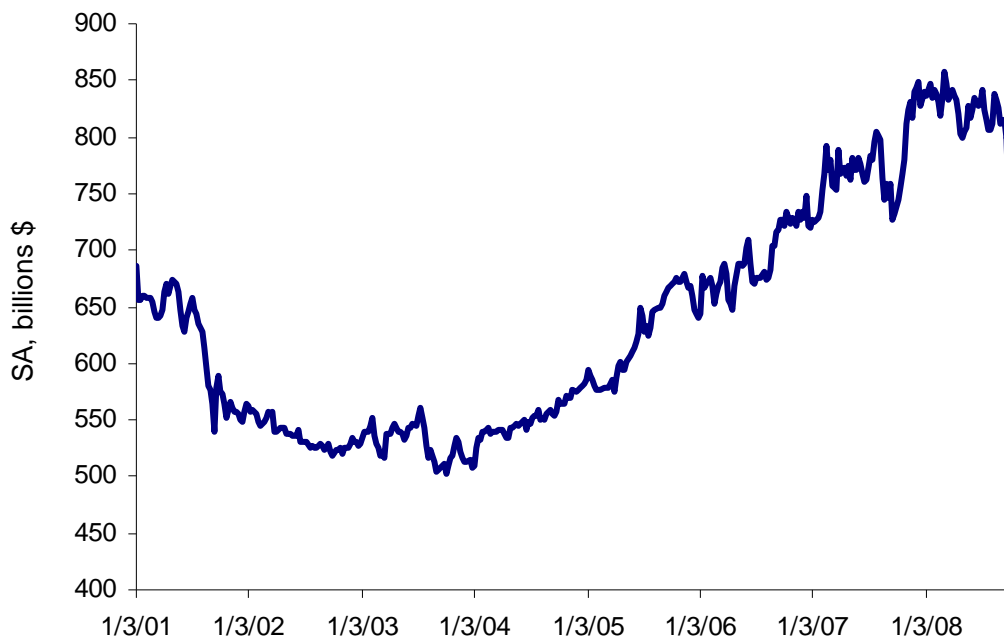
Each of these is a strong step in the right direction. In combination, they should be enough to stabilize financial markets. If so, this would allow the market's focus to gradually shift to judging the depth and length of the recession. Some observations:

- The reported assurances relating to Mitsubishi's Morgan Stanley investment may finally end the Treasury catch-22 that had destabilized financial markets over the last six months. The catch-22 was that financial institutions must raise large amounts of equity capital but that equity shareholders must be nearly wiped out to avoid the perception of a bailout. This was causing a sequential collapse of major financial institutions, with selling pressure shifting from each failed institutions to the next likely candidate.

- The Tuesday announcements probably won't directly address two critical aspects of the financial crisis, the credit default swap market and the mark-to-market spiral in which accounting valuations, opaque and unregulated CDS markets, bond ratings and stock prices link in a downward spiral only loosely connected to actual or prospective cash flow. To an extent, a government purchase of preferred equity offsets a low-ball mark (it adds back the capital taken away by an arbitrary mark.) There is movement on several fronts relating to this set of problems – more focused discussions of a CDS clearinghouse, an SEC staff q&a repeating guidance against fire-sale prices, a FASB staff paper on October 10 that might allow use of cash flows to value an illiquid asset rather than distorted mark-to-market prices. We don't think any of these developments are far enough along to counteract Treasury resistance, so we think rising prices are the more likely solution for now.
- The Treasury details of the preferred stock program will be important. Most helpful to the stock market would be if Treasury makes clear it wants stock prices to go up substantially for institutions in which it invests, with the goal of restarting lending activity. To accomplish this, Treasury should need to charge low dividends in the early years, forego the warrants the Fed imposed on AIG ( to the detriment of its equity shareholders), and keep the government's influence on company decisions to a minimum. In contrast, the program would be disappointing if it limited a shareholder's upside opportunity, merely shoring up a weak bank without attracting piggy-back capital from the private sector.
- Also important in Treasury's announcement is the split of funds from the Treasury facility -- to debt purchases, preferred stock injections and other uses. We expect Treasury to leave its options open, in effect presenting a jump-ball in which the funds will be used for the programs that seem to be working best. This is a good development. We were not fans of the debt-purchase aspect of the Treasury facility. It's never been clear how this could function or how it would help. Congress's passage of the \$700 billion facility was probably constructive because it met the urgent world-will-end request from Treasury yet provided broad enough authority that the facility can evolve as it is implemented.

- We expect the Tuesday U.S. announcement to follow along with the international movement toward guaranteeing various parts of bank liabilities. We think these are effective ways of stabilizing the financial system with relatively low short-term costs (though more costly in the long-term by distorting the capital structure and risk taking). The plan may increase protection limits for depositors. It will probably provide some type of guarantee for interbank loans. But we don't think Treasury will go far at this time in the European direction of guaranteeing bank debt issuance. It has collapsed, but we think it will need to rebuild gradually from much lower levels.

### **Financial Companies Commercial Paper Outstanding (last obs. October 8, 2008)**

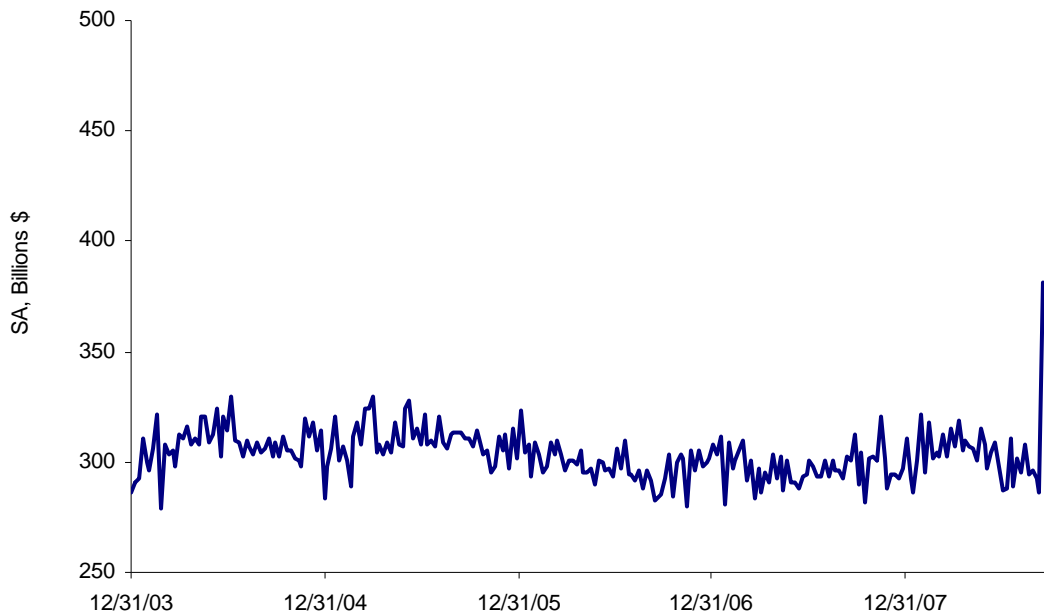


Source: Haver; Encima Global

- The ultimate test for the Treasury announcement is whether it incentivizes banks to lend their idle cash. This is partly rules, partly constructive after-tax greed (recall Wells Fargo's new tax benefits from Wachovia's loss carryforward). Cash assets at U.S. commercial banks have risen from a relatively stable \$300 billion prior to the Lehman bankruptcy to nearly \$500 billion.

### Cash Assets: All Commercial Banks (last obs. October 1, 2008)

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Source: Haver; Encima Global

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