

Blake Christian

From: Woo, Vincent [Vincent.Woo@opco.com]
Sent: Tuesday, February 10, 2009 11:47 AM
Subject: Another Perspective

(RBS GREENWICH CAPITA)
At: 2/10 14:32:34

The Obama Administration's financial rescue package has a nifty name "Financial Stability Plan" but not much else. It is difficult to remember when there's ever been a bigger effort to build up expectations followed by such a disappointing absence of a plan. After literally weeks of leaked trial balloons and extensive discussion, Secretary Geithner gave us a lot of populist hot air blaming everyone else for our current situation, told us that "the policy response has to be comprehensive and forceful" and then offered up warmed-over incremental changes to existing programs and a promise to "explore" possibilities for a public-private investment fund to lift bad assets off of bank balance sheets. Not good enough. Clearly, the financial markets agree.

Before discussing the details of the plan, there are two points that Secretary Geithner made in the first half of his speech that I'd like to highlight.

-- "Governments and central banks around the world pursued policies that, with the benefit of hindsight, caused a huge global boom in credit, pushing up housing prices and financial markets to levels that defied gravity." This is probably the piece of Geithner's speech that I most agree with. But it's a little hard to accept from the man who was President of the New York Fed from October 2003 until late last year. Forgetting about the botched bailouts last year, Secretary Geithner was uniquely positioned at the center of both the failed monetary policy of the Fed in the 2004-2006 period that he rightly notes was the primary cause of this mess, and the egregious failure of the Federal Reserve and other regulators to properly govern the banking system, especially the moneycenter banks that are responsible for the bulk of the problems that the Administration is currently supposed to be addressing.

-- "We believe that action has to be sustained until recovery is firmly established. In the United States in the 30s, Japan in the 90s, and in other cases around the world, previous crises lasted longer and caused greater damage because governments applied the brakes too early. We cannot make that mistake."
This is the second time in a week that Geithner has made this point. Unfortunately, this sounds an awful lot to me like the kind of thinking that got us here in the first place. The right answer is to be aggressive in addressing the crisis and then to be aggressive in normalizing policy, lest excessive liquidity leads to a bubble (makes you wonder if Geithner actually believes the first statement he made about how the bubble started). More importantly, it smells an awful lot to me like the government is already beginning to jawbone Fed policy. Having the Treasury work so closely with the Fed on crisis response is the right thing, but it puts the Fed at risk of losing some of its independence. If press reports from late last year that Larry Summers will be named Fed Chairman when Bernanke's term expires (Jan. 2010) are true, then the stage is set for the Fed to become a wholly-owned subsidiary of the Obama Administration, and, if Geithner's thinking is any indication, I suspect we should probably be pushing off our forecast for the timing of the normalization of monetary policy and buying lots of TIPS.

On the plan, or more accurately the concepts:

1. Require banks to go through examinations. The idea here is to create a uniform and comprehensive forward-looking stress test to really figure out what banks' balance sheets look like. This is a fine idea, but it makes you wonder what the Fed, FDIC, OCC, et al. have been doing over the past 5 years.

All banks with over \$100 billion in assets will be required to take the stress test. Smaller banks will no doubt be encouraged to do so as well. Any institution that needs added capital based on the stress test results will get it, but the conditions are going to be onerous. Lending quotas, no dividends, no acquisitions, executive comp limits, etc. The capital will come in the form of preferred securities that would be convertible to common equity.

2. Public-Private Investment Fund. The debate over the past month has been over whether the government would opt for a bad bank or an asset guarantee program. The final result is pretty much neither. Instead, the government is going to provide private players with the privilege of buying the assets themselves. We can presume that the government is going to have to offer some combination of downside protection, cheap financing, and/or price breaks to make this happen, but all of that will have to wait until the Administration has an actual plan!

3. Expanded TALF. This one is a great illustration of the lack of substance to today's announcement. The Geithner speech talks grandly about a major expansion of lending support that builds on the TALF program. However, if we look at the Federal Reserve Board's press release, the picture becomes more clear.

"The Federal Reserve Board on Tuesday announced that it is prepared to undertake a substantial expansion of the Term Asset-Backed Securities Loan Facility (TALF). The expansion could increase the size of the TALF to as much as \$1 trillion and could broaden the eligible collateral to encompass other types of newly issued AAA-rated asset-backed securities, such as commercial mortgage-backed securities, private-label residential mortgage-backed securities, and other asset-backed securities. An expansion of the TALF would be supported by the provision by the Treasury of additional funds from the Troubled Asset Relief Program.

The Board's objective in expanding the TALF would be to provide additional assistance to financial markets and institutions in meeting the credit needs of households and businesses and thus to support overall economic growth in the current period of severe financial strains. Decisions concerning the expansion of the TALF, which will be made in consultation with the Treasury Department, will draw on initial experience in administering the program and the Board's assessment of the likely effectiveness of possible enhancements to the program in advancing its broad economic goals."

In other words, the Fed is not committing itself to anything more than it said back in November. If the first round of TALF works, then the Fed is prepared to expand it to other markets, such as CMBS and non-agency MBS. Still no timeframe (other than "later this month") on the first TALF operation, much less the expansion. So much for forceful!

4. Finally, a "comprehensive" housing program. If you are making your mortgage payments, this amounts to giving the Fed a pat on the back for their purchases of agencies and MBS. Elsewhere, the Treasury is going to commit \$50 billion of TARP (sorry, FSP) money to foreclosure prevention. Secretary Geithner will "announce the details of this plan in the next few weeks," but it seems clear that the government is going to share in the losses created by loan modifications. I doubt that loan modifications are going to play a significant role in resolving the housing crisis (an increasing proportion of delinquent loans are beyond reasonable repair). Rather, I think that this element of the plan has become the pound of flesh demanded by an angry public for the cost of the bailout of the financial system. It will make Democratic Congressional leaders happy and pave the way for more public funds if they become necessary down the road, so it has to be done. But at some point, the average middle to upper-middle class taxpayer, who is dutifully making his/her mortgage payment every month, is going to wake up and realize that he/she is getting nothing for seeing his taxpayer dollars put to work bailing out Wall Street. Hard to say whether that means another round of backlash against Wall Street or whether homeowners are just going to figure out what's going on and stop paying their mortgages.

As I wrote yesterday, the dithering and conflicting leaks over the past few weeks had given me a sneaking suspicion that today's announcement was going to be a big disappointment. Indeed. Is it too late for Geithner to call "mulligan" and schedule another press conference? On second thought, maybe he should just wait until he actually has something to say.

Vincent Woo

Managing Director - Investments
Cash Management Group
Oppenheimer & Co. Inc.
10880 Wilshire Boulevard
Los Angeles, CA 90024
800-421-4314

Phone: 310-446-7177
Fax : 310-446-7371
vincent.woo@opco.com

For more information about Oppenheimer's products and services, visit our website at <http://www.opco.com>
This communication is for informational purposes only and nothing herein should be construed as a solicitation, recommendation or an offer to buy or sell any securities or product. The information contained herein has been obtained from sources believed to be reliable but we do not guarantee accuracy or completeness. Oppenheimer & Co. Inc and its affiliated companies, their officers, directors and employees may have a position in or, make a market in any securities mentioned above and, may act as an investment banker or advisor to such companies. Client account information or transaction details do not supersede mailed confirmations or account statements which are the only official records containing this information. As a matter of policy, orders are not accepted via e-mail or voice mail and no responsibility shall accrue relating to any orders placed in this manner. If this communication has been received in error, please delete or destroy immediately.