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US Treasury Email from Matthew Rutherford to Jim Wilkinson Re Market Sentiment

Matthew Rutherford

Hayley Boesky

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From: Rutherford, Matthew
Sent: Friday, September 12, 2008 8:01 AM
To: Wilkinson, Jim
Subject: Market Sentiment

See the email below. I would be careful about any statement. Markets are incredibly nervous.

-----Original Message-----
From: Hayley.Boesky@ny.frb.org [mailto:Hayley.Boesky@ny.frb.org]
Sent: Thursday, September 11, 2008 11:58 PM
To: Hayley.Boesky@ny.frb.org
Cc: Brian.Peters@ny.frb.org; Debby.Perelmuter@ny.frb.org; James.Clark@ny.frb.org; Matthew.Lieber@ny.frb.org; Rutherford, Matthew; Meg.McConnell@ny.frb.org; Michael.Nelson@ny.frb.org; Schetzel, Michael; Patricia.Mosser@ny.frb.org; Steven.Friedman@ny.frb.org; William.Dudley@ny.frb.org
Subject: Panic

I have spent the past 3 hours receiving calls from HFs. On a scale of 1 to 10, where 10 is Bear-Stearns-week-panic, I would put sentiment today at a 12.

People are expecting full blown recession. There is full expectation that Leh goes, wamu and then ML. Worries about GS and reports of losses in their PB business. Apparently GS had a lot of commodity HFs who took big losses. ALL begging, pleading for a large scale solution which spans beyond just LEH. The two ideas which keep coming up are easing risk capital weights and a RTC type fund. Objective is to ease balance sheet pressures of the banks.

I am sure you have all heard lots of this but I felt I needed to relay the message given they all took the time to call and given the panic in their voices...

----- Original Message -----
From: Hayley Boesky
Sent: 09/11/2008 11:36 AM EDT
To: Hayley Boesky
Cc: Brian Peters; Debby Perelmuter; James Clark; Matthew Lieber; Matthew.Rutherford@do.treas.gov; Meg McConnell; Michael Nelson; Michael Schetzel; Patricia Mosser; Steven Friedman; William Dudley
Subject: Re: Fw: Options for short-circuiting the market nearly every large HF (Moore Cap, Tudor, Fortress, etc.) has called to tell me that others are refusing to take LEH's name

Hayley R. Boesky
Federal Reserve Bank of New York
33 Liberty Street
New York, NY 10045

Telephone: [redacted]
Mobile: [redacted]

Hayley
Boesky/NY/FRS

To

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09/11/2008 10:46 AM

Meg McConnell/NY/FRS, Bill Dudley, Patricia Mosser/NY/FRS, Brian Peters/NY/FRS, Michael Nelson/NY/FRS, Debby Perelmuter, Michael Schetzel/NY/FRS, Matthew.Rutherford@do.treas.gov

cc

steven.friedman@ny.frb.org, James G Clark/NY/FRS@FRS, Matthew Lieber/NY/FRS@FRS

Subject

Fw: Options for short-circuiting the market

some thots from Louis. I have bolded the relevant points.

Hayley R. Boesky
Federal Reserve Bank of New York
33 Liberty Street
New York, NY 10045

Telephone: [redacted]
Mobile: [redacted]

----- Forwarded by Hayley Boesky/NY/FRS on 09/11/2008 10:08 AM -----

"Louis Bacon"
[redacted]

09/11/2008 09:10 AM

To

<Hayley.Boesky@ny.frb.org>

cc

Subject

FW: Options for short-circuiting the market

Our thoughts as of earlier.

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On a day like this it make sense to make a quick list of what the Fed and/or Treasury can do tomorrow/at any point to try to short circuit what
is going on in the markets. To be clear - I do not have any specific intelligence on how any of these are being considered by policymakers.
This is only to lay out what is legally possible. All of the items on this first list are entirely achievable by either Treasury or the Fed without any need to consult with or seek authority from Congress

The Fed can cut rates - either on the 16th or intermeeting. They have at least 150bps of ease without getting us into Japan territory. FOMC as a group could not accept the tradeoff on inflation for a FF rate lower than 2.00%. The last cut was April 30th. Crude was at $113. In the interim, the markets and the economy got worse (worse than the Fed had expected), and crude went to $145. Crude is at $103. Going forward, inflation is only going to go one way - South. The Fed should seriously consider cutting.

The Treasury can announce a large GSE MBS purchase program under their GSE support package from this weekend. They were hoping for a big positive bounce from the GSE package and announcement and I suspect they were waiting to see if they could get away with something small. If it made sense to cross the threshold to have the US purchase GSE MBS in the first place, then the Treasury should announce a big number that will make the market think again (positively) about the value of any GSE MBS banks hold. All the critiques of this weekend's GSE plan will still apply (it doesn't fix the problems with the bad assets/private-label MBS, HELOCS, underwater borrowers, unemployment), but this is a step that Treasury has all the authority it needs to take immediately and which they should take in conjunction with a Fed move.

The Treasury can announce a major expansion of funding to the Federal Home Loan Bank system. This would be passed on to banks via a major expansion of advances from the Federal Home Loan Banks against mortgage-related collateral, including term advances of up to three years. This would be out of left field, but Treasury already has all the legal authority and all the budget authority it would need to do this. (Treasury somewhat-unexpectedly asked for the authority to support the FHLBs, along with the authorities they used in this weekend's GSE package, in the July legislation.) Treasury may be positioning for something of the sort - this weekend, when they announced the new Treasury credit facility for the GSEs (Government Sponsored Enterprise Credit Facility), they opened the credit facility to the FHLBs as well as to Fannie & Freddie. The FHLBs can borrow from this new Treasury credit facility at Libor+50 by pledging advances that the FHLBs make to banks. This is intended to be short term credit facility, with loan terms from one week to one month, renewable. But if Treasury wanted to crank up a major Treasury lending program for the FHLBs and make the loans long-term, it could allow the FHLBs to provide even more significant term funding at predictable rates to banks for their mortgage-related assets including HELOCS, whole loans, etc.

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Bank regulators can cut risk weightings on GSE-issued MBS and debt on the basis that the government has backstopped the Agencies. This would free up balance sheet and help with the capital problems at banks. The one stumbling block to this is that the Treasury included an explicit "Disclaimer of Guarantee" in their $100B backstop agreement with the GSEs this weekend. This states clearly that Treasury's commitment "shall not be deemed to constitute a guarantee" by the United States of the payment or performance of any debt security of the GSEs. So, Treasury converted the implicit guarantee into an explicit contingent liability of the USG for the express benefit of the GSE debtholders, but Treasury also limited the size of this contingent liability of the USG to $100B. It would seem to be a difficult to justify treating GSE debt exactly the same as government debt from a regulatory capital perspective on this basis.

Those are the bold things Treasury and the Fed can do. The FRBNY may also attempt to stabilize or support the LEH situation by lending to LEH through the PDCF as a backstop until LEH works out its situation or to LEH's newco/spinco (with no other BSC-type intervention) - or they could facilitate a transaction by using the Maiden Lane structure that was set up for JPM/BSC in some way. Some or all of this may well prove necessary, but I personally doubt that it will make the market feel better. Perhaps I am wrong.

The Fed could also make another innovation it its liquidity facilities - perhaps a major extension in the term, say to three years (something like what the BOE has done). It is not clear why the Fed should do this when Treasury has created its own credit facility for the FHLBs. But there may be other assets that might benefit from longer term stable financing from the Fed.

Certainly the market does not expect many of these steps, and some of them would be a shot of cold water in the face. Some combination of the above might stabilize the situation for a time. We should be aware that any of the above are possible since all of them are entirely achievable by either Treasury or the Fed without any need to consult with or seek authority from Congress.

However, none of the above will fix the fundamental problem, which is too many bad assets that need to get off of too many balance sheets. This has always been the fundamental problem. Erin's report that all of the banks at Lehman's Financial Conference today laid out their plans for asset sales (HELOCs, construction loans, development books) as their main strategy for rehabilitating their balance sheets has very sobering implications for asset prices and the viability of this strategy, as she has pointed out.
Her takeaway of the fierce competition from the largest banks for deposits also must be worrisome to policymakers. To me this says that it is time for the government to start seriously considering an RTC2.

By RTC2 I mean some sort of vehicle, either pre-funded by the government or backstopped with government money, that would purchase assets for once & for all off bank balance sheets, giving in their place a government recap bond of some sort. This should have a fairly aggressive conversion feature that would allows the government to dilute existing shareholders if the par amount are not repaid within some time period.

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