Economic Theme

Uncharted Territory: Take 13
Government intervention gains traction

At a glance

What happened

- Today, US authorities followed the lead of their European counterparts and announced plans for a comprehensive financial sector bailout.
- The measures include 1) using the Troubles Asset Relief Program to inject capital into US financial institutions, 2) a temporary FDIC guarantee on newly issued bank debt and deposits in non-interest bearing deposit transaction accounts, and 3) more details on the creation of the Commercial Paper Funding Facility.
- As the first and second points are entirely in line with measures previously announced by the European Union, there is now a clear sense that governments are acting in a determined and concerted manner to tackle the financial crisis.

Our assessment

- We believe these measures are key to unlocking the credit markets and should help avert a financial meltdown.
- However, they will not prevent a recession in the main economies, nor a protracted period of slow growth.
- These events confirm our move on Monday to moderate somewhat the defensive portfolio stance that we had been recommending over the past months.
- For bond holders and preferred security holders of US financial institutions, we view these measures as unambiguously positive, as they markedly reduce the risk of bankruptcy and default.
- For equity holders of US financial institutions, the outlook is less clear. While the measures reduce systemic risk, the capital injection will be dilutive to existing shareholders. Moreover, credit losses will continue to eat into the earnings of financial institutions.

Fleshing out the details of the US bailout

Treasury Secretary Henry Paulson, Fed Chairman Ben Bernanke and FDIC Chairman Sheila Bair announced a comprehensive plan to strengthen financial markets. The plan is consistent with the actions announced by the G7 countries on 10 October, indicating that the world’s leading economies are finally acting in a forceful and coordinated manner. As discussed below, the US government plan contains three elements:

1. The voluntary capital purchase program
   - The Treasury will use USD 250bn of the funds allocated to it through the Troubled Asset Relief Program (TARP) to buy equity in eligible financial institutions.
   - Eligible institutions that elect to participate will have to do so by 14 November.
   - The capital injection will be in the form of senior preferred shares.
• The purchase price of the preferred shares will be the market price of the common stock at the time of purchase.
• The preferred shares will pay a dividend of 5% for the first five years, and 9% thereafter. They are callable at par after three years.
• Participating financial institutions will have to issue warrants to the Treasury allowing it to buy common stock with an aggregate market price equal to 15% of the preferred share investment. The strike price will be set at the market price of the common stock at the time of issuance.
• Several large financial institutions have already agreed to participate in the program.

2. The Temporary Liquidity Guarantee Program
• The Federal Deposit Insurance Company (FDIC) guarantees certain newly issued senior unsecured debt issued on or before 30 June 2009. The guarantee means that the debt in question is fully protected in the event of bankruptcy of the issuing institution or its holding company.
• The guaranteed new debt includes promissory notes, commercial paper, inter-bank funding, and any unsecured portion of secured debt.
• Coverage will be limited to 30 June 2012, even if the maturity of the newly issued debt exceeds that date.
• Participating depository institutions will get full deposit insurance coverage for non-interest bearing deposit transaction accounts, regardless of the US dollar amount. This temporary guarantee expires at the end of 2009.
• The program will be funded through special fees and does not rely on taxpayer funding.
• All eligible financial institutions will be covered for a period of 30 days. After that they can opt-out of the program.

3. The Commercial Paper Funding Facility (CPFF)
• The creation of the CPFF was previously announced on Tuesday, 7 October. However, today Bernanke stated that it would start operating on 27 October.
• The CPFF will be structured as a credit facility to a special purpose vehicle (SPV).
• The SPV will receive funding at the fed funds rate, currently at 1.5%.
• The SPV will buy unsecured and asset-backed commercial paper. The commercial paper must be rated A1/P1/F1 by a major NRSRO and not rated below A1/P1/F1 by any major NRSRO.
• It will only buy commercial paper issued by US issuers, including US issuers with a foreign parent.
• The unsecured commercial paper may be secured by the seller in several ways, including an upfront fee or any collateral deemed sufficient by the Fed.
• The CPFF will cease to exist on 30 April 2009, unless the Federal Reserve Board agrees to extend the facility.

Putting the framework in place to avert the worst
The US government stepped up the efficacy of the bailout by announcing today that it will guarantee newly issued bank debt and also buy equity stakes in financial institutions. The steps announced mimic those previously announced by the UK and Continental European governments. Just one week ago, the US solution only envisaged buying troubled assets and in so doing, supporting the banking system. Direct

### Participating financial institutions (USD bn)

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<th>Institution</th>
<th>Participation</th>
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<td>Bank of America</td>
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<td>Citigroup</td>
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<td>JPMorgan Chase</td>
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<td>Goldman Sachs</td>
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<td>Morgan Stanley</td>
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<td>Bank of New York</td>
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<td>State Street</td>
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Source: Bloomberg, UBS WMR, as of 14 October 2008
equity capital injections will be more effective, as the banking system is levered. They will better address solvency concerns. Commercial banks in the US are levered about 10 to 1. So, each equity dollar amounts to securing 10 dollars in troubled assets. Furthermore, the bank debt guarantee should help to reignite the confidence among banks and restore normal lending practices. The protection includes unsecured inter-bank funding, which means that LIBOR interest rates should come down visibly in the coming weeks. In our view, the steps taken establish a framework to avert a broad-based financial meltdown. However, some companies will still be under a lot of pressure.

**Downbeat economic outlook remains**

Moreover, it also does not mean that the economy will rebound. The US economy likely contracted in 3Q08; we expect a drop in real GDP of 1% q/q annualized. Before the recent credit market dislocations, US consumers were already retrenching their spending. The credit crisis and the related drop in equity prices will only exacerbate that trend. With the unemployment rate rising, asset prices falling and little or no availability of credit, the consumer recession will last at least two quarters, in our view. We are in the process of revising our global economic forecasts. But what is already clear is that the recent credit crisis will adversely affect growth in the next few quarters, irrespective of the positive actions by governments. The financial system as a whole still has to delever and this will take more time. Therefore, credit availability will continue to dwindle going forward, although now it will happen in a more orderly fashion.

**Asset allocation implications**

We view these events as a significant milestone in the financial crisis. They are significant enough to avert the risk of a financial meltdown, in our view. We also have to acknowledge that following the abrupt correction of the past weeks, equity markets have become very attractively valued. Therefore, we believe that we have reached an interesting entry point to moderate somewhat the defensive portfolio stance that we had been recommending over the past months. Hence, we upgraded equities to a neutral tactical stance and downgraded fixed income on Monday. We suggest that investors who are currently underinvested in equities can start considering a progressive reentry back toward their long-term allocation. We also reduced the defensiveness in our US Equity sector strategy by trimming overweights in Health Care and Consumer Staples and reducing our underweight in Consumer Discretionary. Additionally, we upgraded Insurance to moderate overweight.

**Government plan positive for bond and preferred holders**

The implications are many for the bond market. To begin, default risk for participating financial institutions will seemingly drop dramatically, over the next three to five years. This would appear to be ample time for management teams to reconstitute their businesses, changing the business mix to adapt to an evolving landscape for the banking system. In addition, we have confidence that financial markets should normalize within this time frame, as some recovery to housing and more broadly, the economy in general should allow these companies to return to profitability. As a result, there is good reason to believe that principal and interest should be secure for all debt securities of participating entities.

Besides, this can be considered another important step towards order being restored in the credit markets. With government involvement, we believe counterparty risk is greatly reduced, meaning market par-
Participants will feel more secure in dealing with each other. Further, given Secretary Paulson’s mandate that new capital should be deployed rather than hoarded, we expect banks will resume lending activities to some extent in the near term. Overall, we anticipate that currently heightened risk premiums will begin to recede, lowering the cost of capital, and jumpstarting the market for a variety of products including corporate bonds and loans, mortgages and consumer loans.

For creditors of participating financial institutions, the plan is an unambiguous positive. New capital will enhance the balance sheets of these entities, allowing these companies to operate more freely and withstand further credit losses. Presumably, additional capital would be made available by Treasury if needed. As the new capital is in the form of senior preferred equity, the structure of these transactions favor existing bondholders—both senior and subordinated. Both of these classes of creditors will rank ahead of the new capital, and therefore their standing in the capital structure is propped up by the new capital and promise of government involvement.

We view the plan as a net positive for preferred security holders as well. Existing senior preferreds will rank pari passu (equal to) these new preferreds, so holders of these securities more clearly enjoy the benefit of the recapitalization. The picture is less clear for junior preferred holders, who would be negatively affected as they would be structurally subordinated by the new preferred. Still, we believe that this move further down the capital structure is more than offset by the benefit of government involvement.

**Mixed outlook for equity holders**

For equity holders in US financial institutions, the outlook is less clear. The US bailout plan is beneficial to the extent that it reduces the risk of a systemic collapse and thereby raising the chance for survival for the main financial institutions. This factor likely drove the positive market reaction to the news. However, one also needs to consider that the capital injection will be dilutive to existing shareholders. Based on the institution, the dilution could range between 10 and 30%. Moreover, given the deteriorating economic environment, credit losses will continue to depress the earnings base of financial institutions. Therefore, we believe that investors should carefully discriminate between companies on the equity side.
Appendix

If the date of this report is not current, the investment opinion and contents may not reflect the analyst's current thinking.

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