

# Research

February 10, 2009

Signe Roed-Frederiksen, Senior Analyst, +45 45 12 82 29, sroe@danskebank.dk

Peter Passing Andersen, Senior Analyst, +45 45 13 70 19, pa@danskebank.dk

## US: A united rescue effort, but short on detail

- Bank losses and write-downs continue to mount and with unemployment on the rise, loan losses are likely to increase further. The IMF has estimated that total losses in the banking system could amount to USD2,200bn, implying that only half of the forecast losses have surfaced so far. While losses in themselves are hampering the banks' capital cushion, uncertainty regarding the size and distribution of such losses works as a roadblock to the normal functioning of credit markets. Government intervention should therefore be aimed not only at recapitalizing the banks but also at removing uncertainty from banks' balance sheets.
- The Financial Stability Plan (FSP) announced by US Treasury Secretary, Timothy Geithner on 10 February addresses these issues by setting up a USD500bn Private-Public Investment Fund, which should catalyze private sector investments in distressed assets, combined with a Financial Stability Trust, which will receive convertible preferred shares from banks that receive new capital injections. However, the measures will take time to implement as the banking system will first have to undergo thorough stress tests to assess the health of individual banks. In addition, the terms on which new capital injections are made will be stricter than under the TARP.
- Furthermore, the plan includes an expansion of the Fed's TALF program to revive consumer credit. The program has been expanded to include commercial mortgage-backed securities, private label residential mortgage-backed securities and other asset-backed securities. The size of the program could be increased from the current USD200bn to as much as USD1,000bn.
- So far, the plan is short on detail, especially on the Private-Public Investment Fund, and it remains to be seen whether the announced measures will be enough to restore confidence and lending in the banking system. So far equity markets have been doubtful about the plan, with financials knocked back to last week's levels. In our view, the main drawback of the plan is that, apart from the expansion of the TALF, it will take time to implement. However, once it is effectuated, it could remove a great deal of uncertainty about the health of individual banks.

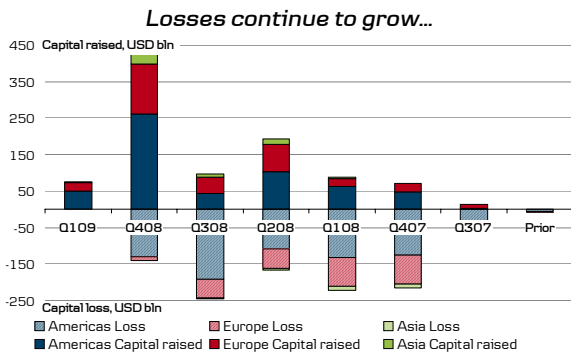
More capital, less uncertainty

### *Continued losses require more capital*

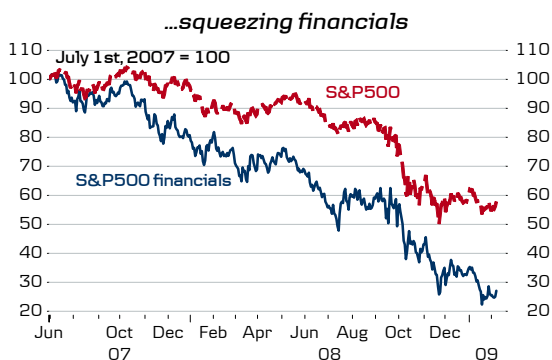
The global banking system is still struggling with major problems related to losses on toxic assets, primarily connected with housing and property

loans. The losses have cut the capital bases of the banks, and this has led to a credit squeeze in the global economy. This is preventing monetary policy mechanisms from functioning normally, which in turn means the recession looks set to be unusually long and deep. So far, the banks have reported write-downs and losses of a little more than

USD1,000bn, but there could be much more to come, according to the IMF. In the *World Economic Outlook Update*, which was published on 28 January, the IMF upgraded its estimate of total losses in the banking system to USD2,200bn from its previous estimate of USD1,400bn. In other words, only half of the forecast losses have surfaced so far.



Source: Bloomberg, Danske Bank



Source: EcoWin, Danske Bank

### A public-private partnership

The Treasury's Financial Stability Plan is founded on the basis of the already existing TARP funds, of which USD350bn remains, and consists of two different measures.

First, a Private-Public Investment Fund will be set up in order to catalyze private sector investments in distressed assets. The fund will start at a scale of USD500bn but "should ultimately provide up to USD1,000bn in financing capacity" according to Geithner. There are no details about the terms of asset purchases but apparently the pricing should be undertaken by private asset managers. How to attract private capital into the fund remains to be answered, but a potential way could be for the government to provide cheap financing or partial loss protection.

The second leg of the plan is a fresh round of capital injections, combined with stress tests for all banks with assets above USD100bn. These tests

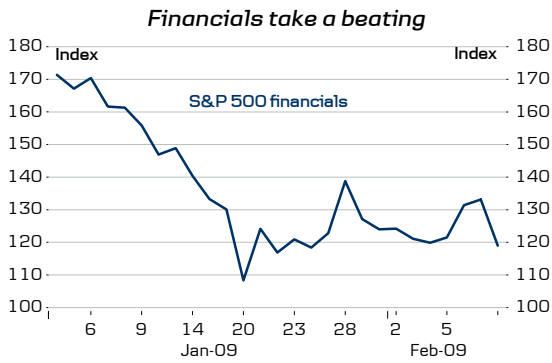
will be used to determine which banks need to be recapitalized or shut down. The Treasury will purchase convertible preferred shares in the banks in need of capital and the financing will come from the remaining TARP funds. The main drawback of this plan is that stress tests of all major banks will take time to implement and any capital injections will thus have to wait until after the tests. In addition, the terms of recapitalisation remain unclear, but any restrictions will be aimed at "ensuring that every dollar of assistance is used to generate a level of lending higher than what would have been possible in the absence of government support". As such, the plan is low on details and much of the program clearly needs to be worked out over the coming weeks and months.

### Transparency and accountability

Geithner went to great lengths to assure the public that the remaining TARP funds will be spent in a more accountable manner than the first part was. This includes putting restrictions on institutions that accept aid; however these do not apply retroactively. The restrictions include: a maximum payment of USD0.01 in dividends per quarter, refraining from purchasing shares and making new acquisitions and a limit on executives' compensation. In addition, Geithner also outlined a number of additional reporting requirements, which are intended to keep the pressure on institutions to make new loans.

### More details needed to judge final impact

The crisis requires a watertight and sustainable solution to the problems in the banking sector, making it easier to persuade private investors to place capital in the banks. The plan is so far short of detail, especially on the Private-Public Investment Fund, and it remains to be seen whether the announced measures will be enough to restore confidence and increase lending in the banking system. So far, equity markets have been doubtful about the plan with financials knocked back to last week's levels.



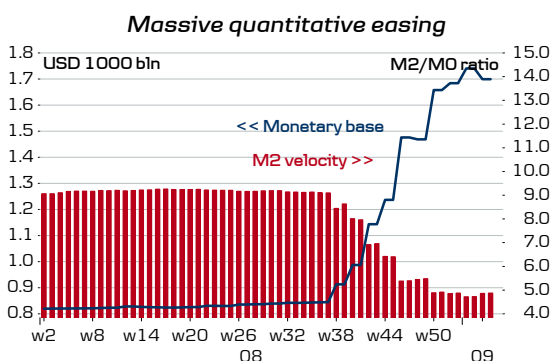
Source: EcoWin, Danske Bank

Much of the program clearly remains to be worked out over the coming weeks and months and, in our view, its main drawback is that it will take time to implement. However, once it is effectuated it could remove a great deal of uncertainty about the health of individual banks.

### Reviving consumer and business credit

#### Fed's balance sheet is skyrocketing

The Fed has taken an unprecedented range of measures in its efforts to counter the current financial and economic crisis. The focus has turned from providing liquidity to depository institutions to targeting the money market more broadly; following the collapse of Lehman the initiatives have been directed more broadly towards easing general credit market conditions and towards the mortgage market.



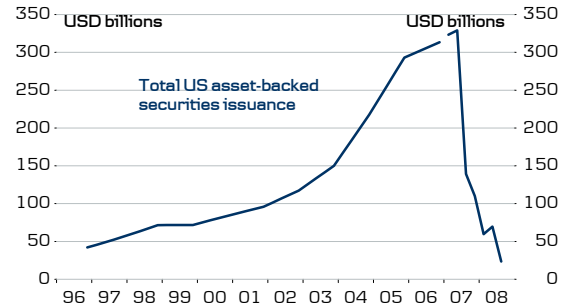
Source: EcoWin, Danske Bank

The Financial Stability Plan included more credit easing in the form of an expansion of the TALF program, designed to revive the asset-backed securities market and promote lending to households and businesses.

#### Expanding the TALF

The Fed's Term Asset-Backed Securities Lending Facility will be increased by a factor of five to as much as USD1,000bn and expanded to include 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. So far the facility has only covered asset-backed securities backed by newly and recently originated auto loans, credit card loans, student loans, and SBA-guaranteed small business loans

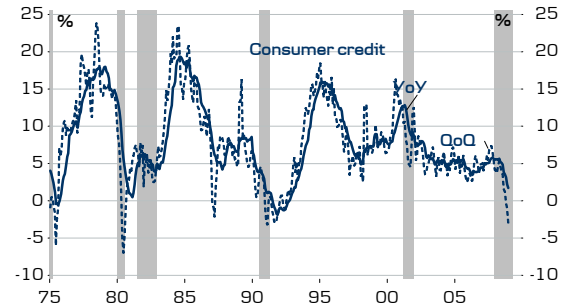
#### Asset-backed security issuance has plunged



Source: SIFMA, Danske Bank

The securitization of such loans has become extremely difficult and the issuance of asset-backed securities has plunged. This is one factor behind the banks reluctance to provide credit to households and businesses as evident in the latest Senior Loan Officer Survey.

#### Consumer credit growth in negative

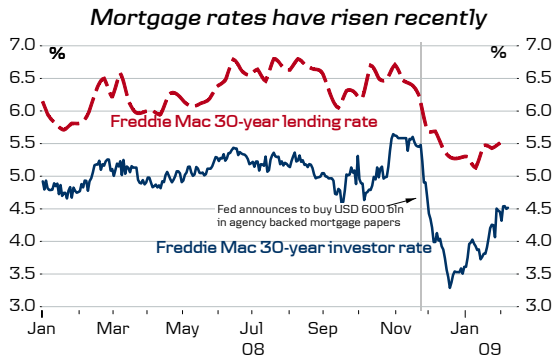


Source: EcoWin, Danske Bank

The expansion of the TALF would be supported by the provision by the Treasury of additional funds from the Troubled Asset Relief Program of up to USD100bn rather than the USD20bn currently earmarked. The Fed has yet to start up the TALF but it is intended to be under way this month. Fed Chairman Bernanke in his testimony said that it should be "operational shortly."

### Targeting the housing market

In his speech, Geithner also announced that the President has asked his economic team to come up with a “comprehensive plan to address the housing crisis”. The details of the plan will be announced in the next few weeks and the focus will be on “bringing down mortgage payments and reducing mortgage interest rates”.



Source: EcoWin, Danske Bank

Despite the Fed's MBS purchase program, mortgage rates have crept higher again in recent weeks, pushed upwards by the surge in longer-term US treasury yields. The Fed could still announce increased purchases of MBS or direct buying of Treasury securities, but such announcements are likely to be made in the context of the President's housing plan or at least will have to await such a plan.

#### Box: relevant links

Fed's press release on the expanded TALF program:

<http://www.federalreserve.gov/newsevents/press/monetary/20090210b.htm>

Treasury Secretary Geithner's speech:

<http://www.treasury.gov/press/releases/tg18.htm>

Financial Stability Plan Fact Sheet:

<http://www.financialstability.gov/docs/fact-sheet.pdf>

*This report has been prepared by Danske Research, which is part of Danske Markets, a division of Danske Bank. Danske Bank is under supervision by the Danish Financial Supervisory Authority. .*

*Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high quality research based on research objectivity and independence. These procedures are documented in the Danske Bank Research Policy. Employees within the Danske Bank Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and to the Compliance Officer. Danske Bank Research departments are organised independently from and do not report to other Danske Bank business areas. Research analysts are remunerated in part based on the over-all profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.*

*Danske Bank research reports are prepared in accordance with the Danish Society of Investment Professionals' Ethical rules and the Recommendations of the Danish Securities Dealers Association.*

**Risk warning**

*Major risks connected with recommendations or opinions in this report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.*

**First date of publication**

*Please see the front page of this research report for the first date of publication.*

**Disclaimer**

*This publication has been prepared by Danske Markets for information purposes only. It has been prepared independently, solely from publicly available information and does not take into account the views of Danske Bank's internal credit department. It is not an offer or solicitation of any offer to purchase or sell any financial instrument. Whilst reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation is made as to its accuracy or completeness and no liability is accepted for any loss arising from reliance on it. Danske Bank, its affiliates or staff, may perform services for, solicit business from, hold long or short positions in, or otherwise be interested in the investments (including derivatives), of any issuer mentioned herein. The Equity and Corporate Bonds analysts are not permitted to invest in securities under coverage in their research sector. This publication is not intended for retail customers in the UK or any person in the US. Danske Markets is a division of Danske Bank A/S. Danske Bank A/S is authorized by the Danish Financial Supervisory Authority and subject to limited regulation by the Financial Services Authority (UK). Details on the extent of our regulation by the Financial Services Authority are available from us on request. Copyright © Danske Bank A/S. All rights reserved. This publication is protected by copyright and may not be reproduced in whole or in part without permission.*