RATELAB
MERRILL LYNCH US RATES STRATEGY

Value Concepts from the ML Trading Desk

"The GSE Solution"

Full disclosure, ex ante: This is the personal view of the writer and NOT an opinion or trading recommendation from the firm.

The core issue for this entire financial debacle has been the **Bifurcation of Risk and Return**. This has occurred along the entire food chain of structured finance. What do I mean by Bifurcation of Risk and Return; It means that those who stand to benefit from some sort of financial (or any business) activity are not the ones who will absorb a commensurate portion of the risk. A variant of this is known as Moral Hazard.

The most basic example was the ability of Residential Mortgage borrowers to finance nearly 100% of the purchase price of a home, a.k.a., 100% Loan-to-Value (LTV). With almost no "skin in the game", borrowers owned all the upside if the value of their house rose but little of the downside if the price declined. Moreover, the willingness to "mail in the keys" was increased since the borrower was no longer leaving the down-payment on the table if he walked away. When a homeowner has the standard 20% invested in the house, unless he becomes so financially impaired that he can no longer make the mortgage payment, he will likely stay in the home even if the house is "mark to market" under the mortgage balance. This is why foreclosures will most likely exceed the last Real Estate bust of the early 1990s where loan standards did not become so lax.

Why were lending standards allowed to diminish so greatly? Because further up the Financial food chain, the lenders were no longer holding the loans on their books but rather selling them into the capital markets.

Now let's examine the GSEs. Let me state foremost that their basic mandate of wrapping and standardizing MBS to stimulate and liquefy the transmission of Capital into the US Mortgage market is a vital public policy venture and must be maintained. That said, there has always been the potential for a Moral Hazard induced problem because of the **Bifurcation of Risk** underlying the GSE structure. The "Implicit USGoverment Guarantee" of a privately held company created the potential for the equity shareholders to have a proportionally greater share of the gains than the losses, and as such, to take on greater risk than a purely privately held company might. This may have been a contributing factor to their current situation and is at the core of the solution.

The Solution

Most Financial participants have their view of an efficient strategy, but the only truly effective long-term solution must somehow **remove the Bifurcation of Risk**. This ultimately means either full nationalization or privatization over some reasonable course of time. Once those who stand to gain also own a market valued proportional share of the risk, these entities will be managed in the most efficient manner and will once again add stability to the business of Mortgage Finance.

My best guess of what happens:

1) The common equity is eliminated at some price near epsilon. Similar to the Bear Stearns "take down", this will be the USGovernment's admonition against Moral Hazard.

2) The Preferred and Subordinated Debt will have some sort of "hair-cut", but will not be wiped out. This hair cut could include a reduction in coupon, a lengthening in maturity, a reduction in principal, a change in its priority placement in the capital structure or any combination of these. The buyers of these bonds agreed to take a larger coupon than the "Risk Free Rate", as such; they should not receive a "Risk Free" return. That said, since so many mid-size Banks own the Preferred shares in their "held to maturity" accounts, creating any circumstance that would require a mark-to-market impairment reducing their capital ratios would defeat the purpose of the solution. Consequently, the solution must be "accounting friendly". **Since current market prices already reflect this risk, it is likely that these bonds actually rally after the plan is enacted.**

3) The USGovernment will sufficiently recapitalize at the equity level and keep a controlling interest. This way the Taxpayers will enjoy the long-term upside after paying for the short-term downside. This hopefully reinforces the message that the USGovernment will backstop the MBS and Senior Debt without having to take these obligations directly onto their balance sheet.

4) The USGovernment will in short order remove the bad loans from the GSE's books in a method similar to the 1990s Resolution Trust Corporation (RTC).

5) In two to four years, the newly cleansed GSEs will be privatized with no Government backing.

The Timing

As they say, timing is everything. The markets, particularly the Equity Markets, want this deal done this Sunday night, ala Bear Strearns. This will NOT happen.

Aside from the fact that the Treasury Department is likely not ready yet (they had hoped Plan "A" would work), the political conventions start next week and this issue would be problematic for the political process. At the back end, next year is probably too late for the markets to tolerate. Consequently, the right time will probably be sometime in late September, after the conventions but before the start of the new US fiscal year on October 1.

Support for this idea can be found in the fact that the Treasury seems to be on pace to fund about $40bn more than the $171bn they suggested for the quarter. Although this could simply mean they got their estimates wrong, it could also mean that they think it's prudent to have additional cash right now.

The Reaction

The above actions would accomplish many of the main goals of the FED/Treasury Department.

1) Substantial action would <u>increase demand and tighten spreads</u> for Senior GSE Debt as well as eliminate the press headlines of "funding risk". This will stabilize the key players in the MBS market.

2) This stabilization will <u>flash the "green light" to buy MBS passthroughs</u> again. Liquid USGovernment supported bonds at T10yr +207bp will find a huge support group.

3) Obviously <u>negative for USTreasuries</u> as investors swap into MBS and increased RTC-style supply is introduced.

4) A <u>short-term increase in volatility followed by a slow decline</u> caused by less uncertainty and reduced GSE hedging.

Ancillary Benefits

Aside from the direct benefit of the immediate removal of uncertainty, this solution promotes good public policy in other ways. One could expect the Secondary MBS rate to decline by 30bp to 50bp over the course of a few months. Over time, a similar reduction in the Primary rate will also occur. What would a 50bp reduction in MBS rates do:

1) Nobody "buys a house"; they buy a stream of mortgage payments. As such, lower rates create the ability to buy a more costly home. For example: A median $240k home might require a $40k down payment and produce a $200k principal loan. At 6.5%, the monthly payment would be about $1,265. At a 6% rate, the payment would be $1,199. But if a home buyer can afford $1,265, at a 6% rate she could now borrow $211k and buy a $251k house. If Government action can reduce the MBS rate by 50bp, that effectively raises home prices (or reduces their decline) by almost 6% !!!

2) US Banks own about $750bn in FN/FH MBS bonds. A 50bp reduction in the Secondary MBS rate would boost their value by about 2 ½ points or almost $20bn. Moreover, one would expect an even greater increase in value in their non-credit impaired whole loans. This would substantially improve the perception of stability for the banking sector.

3) A substantial proportion of Prime borrowers will be able to ReFinance and reduce their monthly payments. These dollars can then either be spent to support GDP growth or saved to increase our national capital base.

4) Strong positive action will most likely "green light" outside investors such as Domestic Private Equity or Foreign SWFs to invest in the Financial sector. Great fortunes were made by investors who bought distressed assets during the 1990s S&L debacle. The desire to capture this potential windfall will bring in enough money to fully recapitalize the US banking sector.

Conclusion:

As stated at the outset, this is a sensitive topic and the above is solely the author's opinion. Nonetheless, it does seem to be the most reasonable manner to accomplish the larger public policy goals without setting negative precedents.

We will offer TRADE IDEAS in a later RateLab.

ML US Rates Strategy
August 22, 2008