

From: Tonucci, Paolo [paolo.tonucci@lehman.com]
Sent: Wednesday, July 2, 2008 12:36 PM (GMT)
To: Felder, Eric [efelder@lehman.com]; Lowitt, Ian T [ilowitt@lehman.com];
Humphrey, Thomas P [THumphre@lehman.com]; Morton, Andrew J
[amorton@lehman.com]; Gelband, Michael [mgelband@lehman.com]
Subject: Re:

What is the sense of the group in terms of risks this creates?

----- Original Message -----

From: Felder, Eric
To: Lowitt, Ian T; Tonucci, Paolo; Humphrey, Thomas P; Morton, Andrew J; Gelband, Michael
Sent: Wed Jul 02 08:27:59 2008
Subject:

Accounts talking about this today ... feels like Paulson trying to set the stage for potentially getting rid of the dealer facility but have a plan in place in case there is an investment bank that fails once that happens.....

July 2 (Bloomberg) -- U.S. Treasury Secretary Henry Paulson called for regulatory changes that would allow financial firms to fail without threatening broader market stability.

The Treasury chief also proposed steps providing for the president to approve of any use of taxpayer funds to aid a financial company. In excerpts of a speech for delivery in London today, Paulson identified a legal gap that has left unspecified how to deal with the failure of a financier that doesn't take deposits, such as investment banks.

Paulson's proposals aim to tighten supervisors' oversight of lenders and dealers while at the same time discourage companies from depending on a government rescue if their bets go wrong. His speech comes a week before a congressional hearing to debate a regulatory overhaul in the wake of the credit crisis that caused the near-bankruptcy of Bear Stearns Cos.

"We need to create a resolution process that ensures the financial system can withstand the failure of a large complex financial firm," Paulson said in the speech excerpts distributed by the Treasury to reporters traveling with him in London.

The Treasury chief noted while there is a resolution mechanism for commercial banks, there is no such process for securities firms. Federal Deposit Insurance Corp. Chairman Sheila Bair has also urged that an agency be given power to take over and liquidate investment banks in an orderly manner. The FDIC has that power over lenders whose deposits it insures.

White House Input

"We will need to give our regulators additional emergency authority to limit temporary disruptions," Paulson said in the remarks planned for delivery at Chatham House, an international affairs research organization. "Any commitment of government

support should be an extraordinary event that requires the engagement of the Executive Branch."

The Fed invoked emergency powers as lender of last resort to give Bear Stearns a temporary loan in March and then to agree to take on \$30 billion of the company's assets to secure its takeover by JPMorgan Chase & Co.

Some central bankers and former officials have said those actions, and the Fed's opening of direct loans to primary U.S. government bond dealers, created the danger of spurring more reckless lending by providing a backstop.

"Two concerns underpin expectations of regulatory intervention to prevent a failure," Paulson said. "They are that an institution may be too interconnected to fail or too big to fail. We must take steps to reduce the perception that this is so -- and that requires that we reduce the likelihood that it is so."

First Task

The Treasury chief stressed that officials' first task "clearly" is ensuring market stability. Analysts see little chance of a regulatory overhaul being enacted by Congress this year, before a new administration takes office in January.

Regulators and legislators are struggling with how to alleviate the yearlong credit crisis that has caused about \$400 billion of writedowns and credit losses worldwide.

Paulson said the threshold for invoking emergency authority to limit turmoil "should be very high, such as a bankruptcy filing" to reinforce "discipline" among investors and dealers.

"For market discipline to be effective, it is imperative that market participants not have the expectation that lending from the Fed, or any other government support, is readily available," Paulson said.

Fed Loans

Fed officials are debating whether to extend their Primary Dealer Credit Facility, which allows securities firms to borrow from the central bank at the same rate as commercial banks. The Fed said in March the PDCF would last for "at least" six months.

The Fed and Securities and Exchange Commission are working on a "memorandum of understanding" to share information on investment banks to address issues raised by the PDCF. The SEC has a voluntary agreement with a group of investment banks through which it gets their capital and liquidity positions.

Paulson said that the Bear Stearns episode demonstrated the need for the Fed and SEC to cooperate and that the memorandum of understanding "should be helpful and inform future decisions as our Congress considers how to modernize and improve our regulatory structure."

The Senate Banking Committee's top Democrat and Republican last week demanded a halt to implementing any memorandum before Congress can weigh in.

House Hearing

Paulson and Fed Chairman Ben S. Bernanke are scheduled to testify July 10 to the House Financial Services Committee on financial markets and regulation. Massachusetts Representative

Barney Frank, who chairs the panel, said in a statement yesterday that it will explore investment banks' access to Fed loans, proposals to protect the financial system and "the adequacy of current powers of the Federal Reserve."

The Treasury chief in today's remarks also reprises his proposal for a broader market supervisor role for the Fed, which he first laid out in his "blueprint" for changes in March.

The central bank should expand to become a "market stability regulator" and needs the authority to get information from firms, "whether it is a commercial bank, an investment bank, a hedge fund, or another type of financial institution," Paulson said.