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Sent: 1/23/2009 2:31:23 PM
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Fyi

▼ Jes Staley

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

From: Jes Staley
Sent: 01/23/2009 08:40 AM EST
To: Peter Scher
Cc: Jay Mandelbaum

While the challenges facing our economy are extraordinarily complex and global in scope, and while there is no single answer to many of the questions we are facing, here are a few of my thoughts on the economic issues we are facing, as well as what the government could do, even if difficult, to foster real recovery.

The primary issue we face is one of perception. While we all agree that we would like to have the banks start lending again, we need to understand that this needs to be the result of our collective actions, not the premise of our actions. In other words, the lack of lending in the current economy is not a cause of our problems, it is a result of our problems, and we need to fix the problem, not the symptom. The single best way to get banks to start lending again is to allow them to rebuild their capital levels, which perversely, in the short term, could actually lead to less lending. The Fed has done its part and steepened the yield curve, and this is a good starting point, along with the initial TARP infusions, to allow banks to begin building their balance sheets again, but it may not be enough. This is why we have to be wary of solutions that require the government to buy assets from banks at 'distressed' prices, as this could upset the process underway now of allowing banks to return to health. If our central goal is to drive lending, and our agreed upon premise is that the road to this goal is helping the banks regain financial strength, the selling of assets at current prices will be counterproductive, and should be avoided. There is a path to financial health that can come from asset purchases, but it is one that requires a different political dialogue.

So what should the government do? First the government should formally nationalize Fanny and Freddy and start a massive refinancing of the US mortgage market. Ultimately what we have, and specifically what the banks have, is a collateral problem, and the biggest factor in our collateral problem is US housing. Resetting mortgage rates would go a long way in stabilizing this part of the economy. This would be a proposal along the lines of the one put forth by Larry Lindsey and would allow the agencies to refinance all existing mortgages at 4% (or less) for 30 years. The tough political challenge in this solution is that the mortgage obligations have to be the equivalent of a tax obligation. This will settle the housing market and would most likely settle the asset backed market helping bank balance sheets. Moreover, this could also be better for the deficit than it might appear as at least one calculation has it raising the net worth of US households by some \$1.5 trillion

Secondly, Washington needs to decide that if they really want banks that are capable of lending, than they need banks that are healthy enough to lend. For this reason, the remaining part of the TARP, and perhaps a third TARP should be used to buy assets from the banks, but not at distressed prices. The government should buy these assets (subprime mortgages etc) at levels above distressed pricing, with the express purpose of helping rebuild bank balances sheets, with an eye to restoring credit growth.

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We need to have the political courage to stabilize the housing market with low fixed rate mortgages, while keeping the re-payment obligation real, and to assist the banks in returning their balance sheets to health by buying troubled assets at non-troubled prices. It is by following this plan that we can achieve the objective that is best for our economy, repairing bank balance sheets, and allowing banks to get back to what they are supposed to be doing... lending.

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