# TURMOIL OF EPIC PROPORTIONS

by Steve Brown

This weekend was historic in so many ways, but it eventually led to Lehman's bankruptcy, Merrill Lynch being acquired by Bank of America, 10 large banks setting up $70B in a liquidity fund, the Federal Reserve launching emergency measures to calm financial markets and AIG (the biggest insurer in the world) to make an unprecedented move asking the FRB for $40B in a short-term loan.

Lehman. It is official - The 4th largest investment bank has filed for Chapter 11 bankruptcy protection. This is the largest bankruptcy in history and takes out a 158Y old firm that survived the railroad bankruptcies of the 1800's, the Civil War and the Great Depression. Lehman listed more than $613B of debt and had 25k employees worldwide. Of note, the filing did not include its broker-dealer operations or its asset management firm, which will be liquidated by Lehman. As the story goes, front-runner Barclays reportedly pulled out from the bidding on Sunday, after it could not get guarantees from anyone that would protect it against future losses. That led to a cascade of frenzied activity among those present at the FRB NY emergency weekend meeting that led to other consequences obviously.

Merrill Lynch. As the story continues, once front-runner Barclays pulled out of the Lehman bidding, the impending bankruptcy of Lehman left Merrill with little choice but to find a buyer. They did so with Bank of America. This surprising turn of events ended Merrill's 94Y run and combines the world's largest brokerage firm with the largest bank in the country. The acquisition will cost BofA $50B, but that is a 61% discount from Merrill's stock price of only a year ago. The combination adds 62k employees to Bank of America's existing 209k, brings in $1.6T in managed assets.

Federal Reserve. In addition to coordinating events, the FRB worked hard over the weekend with all players to increase global liquidity. It provided a leadership role in encouraging 10 large banks to create their own $70B liquidity facility each could tap in the future to solve their own liquidity problems. It also got central bankers across the world to flood in liquidity to keep market disruptions contained and widened the collateral it would accept on its auction facilities. It also boosted liquidity in the auction facilities by $50B and increased auction frequency. Finally, the FRB allowed equities to be pledged as collateral for the first time in its history and granted an exemption allowing banks to provide their securities subsidiaries with funding if required.

American International Group (AIG). This part of the story gets a bit strange, as AIG, the largest insurer in the country in terms of assets, took the unprecedented step and approached the FRB for a $40B bridge loan. Under extreme pressure to raise capital and worried that an impending ratings cut could have a material effect on its liquidity, AIG will most likely have to sell major business units.

Aftermath. For community banks, there are now fewer securities counterparties and the market is in extreme turmoil, so expect Wall Street dealers to quote wide bid-ask spreads. Less dealer capital and lower liquidity will be the norm for the near term. The flight to quality with lower yields overall has increased the probability of a Federal Reserve rate cut. Despite lower yields in Treasuries, don't look for that kind of move in CDs, since liquidity will remain an issue. Banks that can better differentiate themselves compared to problem institutions stand a much better chance of lowering their funding costs over time. Look for more consolidation to occur until a bottom is found in housing, as bad bets reshape our lending and credit environment. As an aside, we are not sure yet, but the FRB saying they will take equities may open up room for community banks to borrow against impaired FN/FH preferred stock.

The value of liquidity and capital has increased, risk management is more important than ever and planning for the unexpected should be expected. The landscape of financial services has forever changed.

## BANK NEWS

**Customer Acquisition**

Wachovia is reporting its Way2Save debit/savings product introduced in January has captured more than 1mm customers. Even more important for the bank, 30% of those were new customers.

**Spooky Times**

Washington Mutual was downgraded to "junk" status by Moody's, after the country's largest S&L said it expects a $4.5B increase in reserves for bad loans in the 3Q. Experts say WAMU may need to sell branches to raise capital.

**Discount Window**

FRB marketing to remove the stigma of borrowing at the Discount Window has worked, if borrowing levels are any indication. In 6 of the past 8 weeks, borrowing has hit record levels, reaching $23.5B this past Wednesday.

**Cuts Ahead**

A survey by the Business Roundtable finds roughly one-third of CEOs expects to cut jobs in coming months, up slightly from the prior month.

**Customer Selling**

New information from Wells Fargo indicates 80% of new product sales come from existing customers.