

Flash Comment

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USA: Lehman files for bankruptcy

Overview: It has been a hectic weekend on Wall Street as banks have worked together with the Fed and US Treasury to find a buyer for Lehman Brothers. Over the weekend, though, it became apparent that no buyers could be found and according to news wires Lehman is filing for bankruptcy. Merrill Lynch – another battered investment bank – has been sold to Bank of America and the Fed has expanded liquidity facilities.

Details: Below we provide an overview of the events of the weekend.

Lehman Brothers buyers walk away: The two potential buyers for Lehman Brothers – Bank of America and Barclays – both walked away from talks about taking over the ailing investment bank. Apparently the talks stranded because the US government refused to provide a financial backstop to potential buyers and thus seems to have drawn a line in the sand as to how far it will go to bail out investment banks.

Banks set up USD 70bn fund for liquidity: Over the weekend the news that no one would save Lehman Brothers created worries across Wall Street as financial companies worked to disentangle themselves from trades with Lehman Brothers. Trading of OTC contracts involving Lehman Brothers was opened on Sunday. The final outcome is still very uncertain and different solutions are apparently still being worked on. According to Bloomberg a group of banks including Bank of America, Citigroup and JPMorgan Chase & Co. are setting up a fund of USD 70bn aimed at providing liquidity. This is to supplement the expansion of Fed liquidity facilities (see below). Each participating financial firm will provide USD 7bn to establish a fund and have the ability to borrow up to a third of the total.

Merrill Lynch sold to Bank of America: On late Sunday, Merrill Lynch agreed to sell itself to Bank of America for roughly USD 44bn (around USD 29 per share). Bank of America once again came to the rescue as it has already made several acquisitions including the purchase of ailing mortgage lender Countrywide Financial Corp earlier this year. By adding Merrill Lynch, it will be the nation's largest stockbroker as well as a well-regarded investment bank. It is already one of the largest depository institutions. With Bears Stearns being sold earlier this year, Merrill Lynch now sold and Lehman Brothers going into bankruptcy, the previous five independent brokers have now been reduced to two with Goldman Sachs and Morgan Stanley the ones left.

New Fed facilities: The Federal Reserve Board on Sunday announced several initiatives to provide additional support to financial markets, including enhancements to its existing liquidity facilities. According to the Fed, these changes represent a significant broadening in the collateral accepted under both programmes and should enhance the effectiveness of these facilities in supporting the liquidity of primary dealers and financial markets more generally.

- **Collateral expansion for PDCF:** The collateral eligible to be pledged at the Primary Dealer Credit Fa-

cility (PDCF) has been broadened to closely match the types of collateral that can be pledged in the tri-party repo systems of the two major clearing banks. Previously, PDCF collateral had been limited to investment-grade debt securities.

- Collateral expansion for TSLF: The collateral for the Term Securities Lending Facility (TSLF) has also been expanded; eligible collateral for Schedule 2 auctions will now include all investment-grade debt securities. Previously, only Treasury securities, agency securities, and AAA-rated mortgage-backed and asset-backed securities could be pledged.
- TSLF Schedule 2 auctions expanded to every week: Previously, Schedule 2 auctions had been conducted every two weeks.
- TSLF Schedule 2 auction amount increased: The amount offered under the Schedule 2 auction will be increased to a total of USD 150bn from a total of USD 125bn. Amounts offered under Schedule 1 will remain at a total of USD 50bn.
- Depository institutions liquidity: The board also adopted an interim final rule that provides a temporary exception to the limitations in Section 23A of the Federal Reserve Act. It allows all insured depository institutions to provide liquidity to their affiliates for assets typically funded in the tri-party repo market. This exception expires on January 30, 2009, unless extended by the board, and is subject to various conditions to promote safety and soundness.

For an overview of the different facilities from the Fed see "[Research US: Monetary Policy and Liquidity Effects](#)"

Assessment and outlook: The events over the weekend mark yet another point in the financial crisis and leave the outlook very uncertain. One of the issues is the liquidation of Lehman's assets. At the end of August Lehman owed USD 33bn of commercial real-estate assets and USD 13bn of residential mortgages and markets fear a fire sale could add to losses in these markets. The financial system in the US has been brought to its knees and with the US Treasury apparently stepping away from bailing out more companies the solutions are left for the financial companies themselves, although in co-operation with the Fed and US Treasury.

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