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Tuesday, September 16th, 2008

## With Buyout of Merrill, Bankruptcy for Lehman, Wall Street Plays "Let's Make a Deal"

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**Money Morning/The Money Map Report**

In one of its wildest and weirdest stretches ever, Wall Street entered a weekend awaiting a government bailout of Lehman Brothers Holdings Inc. (LEH) and exited with Merrill Lynch & Co. Inc. (MER) agreeing to sell itself to Bank of America Corp. (BAC) for nearly $50 billion – and Lehman announcing it will seek bankruptcy in a bid to avoid a total liquidation after it was unable to find a buyer.

And this real-life version of the game show "Let's Make a Deal," is far from over: Like a once-great prizefighter who's clawing for the ropes after being staggered by a shot to the chin, U.S. insurance giant American International Group (AIG) is trying to keep from dropping to the canvas. AIG leaders begged the U.S. Federal Reserve for a $40 billion lifeline – without which the insurance giant probably won't last the week, ***The New York Times*** reported.

There's even conjecture that the beleaguered Washington Mutual Inc. (WM) – the nation's largest savings and loan – may get pulled down by this financial undertow.

"The tectonic plates beneath the world financial system are shifting, and there is going to be a new financial world order that will be born of this," Peter Kenny, managing director at Knight Capital Group Inc. (NITE), the New Jersey-based brokerage firm that handles $4 trillion in stock transactions a year, told ***Bloomberg News***. "It's an ugly and painful process."

With Wall Street's leaders huddled in meetings at the encouragement of the Bush Administration, yesterday's fourth-down wheeling and dealing capped a weekend of furious, round-the-clock negotiations that demonstrate one very critical point – the credit crisis isn't over.

In fact, it may actually be getting worse.

Many experts now worry that the U.S. financial sector faces a "crisis of confidence," a potentially devastating psychological impasse from which there's no easy escape. The stunning-and-sweeping moves, which are permanently reshaping the U.S. financial sector, are the latest chapter in a financial crisis that has resulted in hundreds of billions of dollars in losses – ostensibly due to bad real-estate loans, ***The Times*** reported.



"My goodness. I've been in the business 35 years, and these are the most extraordinary events I've ever seen," said Peter G. Peterson, co-founder of the private equity firm The Blackstone Group LP (BX), who was head of Lehman in the 1970s and a secretary of commerce in the Nixon administration – and whose new foundation is sponsoring the documentary, IOUSA, which warns of the looming U.S. government debt crisis.

In a move that mirrored the step taken by hedge fund Long-Term Capital Management 10 years ago this week, 10 major banks will create an emergency fund of $70 billion to $100 billion that financial institutions can use to protect themselves from the fallout of Lehman's collapse. And the Fed expanded the emergency loan program it created for Wall Street banks, a move that ***The Times*** and other media outlets concluded will increase what each U.S. taxpayer will owe as a result of this crisis.

But it remains to be seen whether the sale of Merrill Lynch, the "controlled demise" of Lehman and the intervention into the fate of other key U.S. financial giants will be enough to keep the broader U.S. economy from getting swept into a stagflationary recession.

## And Then There Were Two

The five New York-based securities firms that dominated Wall Street have been reduced to two: Goldman Sachs Group Inc. (GS) and Morgan Stanley (MS). Both firms will report a profit decline for the third quarter – but unlike Merrill Lynch and Lehman, Goldman and Morgan Stanley have remained profitable throughout the year.

"I think highly of Morgan Stanley and Goldman Sachs, so I expect them to ride this out," Roger Altman – the CEO of investment banker Evercore Partners Inc. (EVR) and a former deputy treasury secretary – said during an interview on ***CNBC***. "But as to whether we've seen the last of this crisis, I think the answer to that is clearly: ‘No.’ And exactly where it goes from here and how it unfolds, I’m unsure.”

But how did it get this far?

The financial-sector convulsions that started in the summer of 2007 already have eliminated The Bear Stearns Cos., which in March was forced into a government-supported, cut-price sale to JPMorgan Chase & Co. (JPM). Last weekend, the U.S. Treasury Department took control of mortgage giants Fannie Mae (FNM) and Freddie Mac (FRE) – placing them into a conservatorship – after concerns that foreign central banks would stop buying our bonds actually forced the government’s hand [For a full report on that dilemma, take a look at our report, Foreign Bondholders - and not the U.S. Mortgage Market - Drove the Fannie/Freddie Bailout].

Fed and U.S. Treasury officials met in an emergency session as Barclays PLC (ADR: BCS), the U.K.’s third-largest bank, and Bank of America abandoned talks to acquire Lehman after failing to win government guarantees against losses. The companies were considered leading candidates to acquire the 158-year-old investment bank after record losses erased 94% of its stock value this year.

The first in a series of weekend meetings began at 6 p.m. Friday at the Federal Reserve building in Lower Manhattan. The Fed called the emergency session. U.S. Treasury Secretary Henry M. “Hank” Paulson Jr. attended, as did key banking-industry executives.

Because the central bank and the Treasury had already intervened with the “shotgun” marriage of Bear Stearns and JPMorgan – underwriting $29 billion in assets as part of the deal – and with the conservatorship for Fannie and Freddie, most observers expected the financial sector’s dynamic duo to work their magic yet again.

But it was not to be.

News reports say that the bankers were told that – this time around – the government would not bail out Lehman and that Wall Street had to solve its own problems. Lehman’s stock plunged last week, as worries about its financial condition escalated. When counterparties became wary of doing business with Lehman, its ability to survive as a standalone company in that form was all but over.

Without the safety net of government backing, Lehman sought a buyer, focusing on Barclays and Bank of America. But Barclay’s abandoned talks to acquire Lehman after failing to win government guarantees against losses for the big British bank.

That’s where the takeover talks took an odd turn. Although Merrill and Lehman are both investment banks – Merrill focuses on the brokerage business while Lehman keys on the institutional portion of the market – both firms made an ill-fated foray into real-estate-related investments.

Understanding that global investors would lump Merrill in with the other troubled companies as the crisis worsened, new CEO John A. Thain began buyout talks with Bank of America CEO Kenneth D. Lewis, published reports state. One person briefed on the negotiations said Thain had rebuffed Bank of America when it approached Merrill earlier this summer. But understanding how a Lehman bankruptcy would whipsaw the markets, Thain realized a deal was the best answer this time around,

***The Times*** reported.

Bank of America will swap 0.8595 shares of its stock for each Merrill share. That works out to $29 a share, based on Bank of America's closing price of $33.74 on Friday.

"A merger between Merrill and Bank of America is a good idea," Richard Bove, an analyst at Ladenberg Thalmann & Co. in Lutz, Fla., told ***Bloomberg***. "If Lehman fails, the next bank to be attacked would be Merrill. They are attempting to forestall that attack by linking with Bank of America."

AIG, once the world's largest insurer, is struggling to raise cash to avoid a credit-rating downgrade that could cripple its business.

Early today (Monday), Lehman filed the biggest bankruptcy claim in history. The 158-year old firm filed a Chapter 11 petition with the U.S. Bankruptcy Court in Manhattan, listing more than $613 billion in debt.

That makes Lehman's failure the largest of any investment bank since the collapse of Drexel Burnham Lambert 18 years ago, ***The Associated Press*** reported. The credit crisis has forced the world's biggest banks to take more than $510 billion in write-downs, ***Bloomberg News*** reported.

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### There Is 1 Response So Far. »

1. *Comment by H. Craig Bradley* on 17 September 2008:

   Yes, indeed the financial landscape is changing. Realistically, I suspect these changes have been progressing along for some time before the current crisis.

   One thing is for certain, there will be fewer investment bankers employed in New York from now on. That means fewer Christmas Bonuses and fewer domestic penthouses buyers.

   The United States is no longer the top financial dog. Not only are manufacturing jobs being exported, but investment banking jobs in future years are moving offshore, as well. Asia (China, Singapore) and the Middle East (United Arab Emirates) are probably going to fulfill the investment banking role Wall Street once occupied. In a way this is predictable, as more and more dollars are exported to Asia and Middle East countries.

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