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Federal Reserve Bank Email from Rita C Proctor to Chairman Re AM Financial Markets Conference Call 9-11-08

Rita C. Proctor

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From: [Rita C Proctor](#)
To: Chairman
Subject: Fw: AMFinancial Markets Conference Call 9/11/08
Date: 09/11/2008 10:45 AM

RESTRICTED FOMC CLASS II

Overnight, sentiment towards risky assets remains decidedly negative as market participants continued to discuss the Lehman Brothers announcement yesterday. In particular, overseas equities, particularly in Asia, were off as much as 3 percent overnight, while U.S equity futures were down 1.4 percent. Again, financial sectors underperformed, with the Topix banking sector index 5 percent lower. In addition Treasury yields were 8 basis points lower and the dollar continued to appreciate against most major currencies. The yen also outperformed against against most higher yielding currencies.

For the most part, analyst have continued to express disappointment that Lehman Brothers has yet to make significant progress in actually obtaining additional capital. Some market participants have been comparing the "feeling" in the market with that just ahead of Bear Stearns in March.

Because of the ongoing focus on Lehman, there has been a great deal of focus on the potential implications of a downgrade (or worse) could have on financial markets.

Lehman's share price declined 45 percent to \$4 in the pre-open and its CDS price widened 200 basis points to 775 as market participants voiced concern over the viability of Lehman as an ongoing concern. Yesterday afternoon, Moody's held a conference call on this topic and stated that Lehman's plan for reorganization was insufficient for them to maintain their current 'A2' credit rating and -- without additional shoring up of their capital base, preferably by a strategic buyer with substantial capacity -- Moody's would likely downgrade Lehman's long-term credit rating. Moody's cited the market's "crisis of confidence" concern with Lehman to suggest that ratings downgrades could come quickly unless there was swift progress to shoring up Lehman's capital base. There are several possible implications of a Lehman downgrade:

1. Lehman would have to post collateral to many of its over-the-counter derivative counterparties, which could put further strain on its funding needs. One dealer estimates that a one notch downgrade of Lehman could require them to post \$2.9 billion of collateral, and a 2 notch downgrade could require \$4.4 billion of collateral.
2. In addition, funding from money funds are likely to be adversely impacted by a ratings downgrade. We've spoken with several large money funds since Lehman's preannouncement and have received somewhat mixed reports in terms of new shifts in providing funding to Lehman. Of the funds that we have spoken with thus far, all but one were continuing to roll overnight repo for steady amounts. One fund did not roll about \$1.5 billion in overnight positions for Treasury and agency-MBS repo. They stressed that they saw negligible risk in maintaining these positions, but found it easiest to eliminate the exposure in the face of inquiries from investors and senior management. Another fund, which had maintained small overnight unsecured positions did not roll these yesterday. Importantly, Fidelity, the largest fund

complex, stressed that while they hadn't made any significant shifts yet today, they were still in the process of making decisions and would follow up with us later.

As background, over recent months, funds have gradually reduced their exposures to Lehman, by reducing or eliminating unsecured positions, by reducing the tenors and amounts of secured positions, and in some cases narrowing the types of collateral accepted for secured lending. In many cases, the only remaining exposures were overnight repo for traditional (Fed OMO-eligible) collateral.

As such, some believe that Lehman is currently in a distressed sale situation, and it is not completely clear who would or could buy the firm. Some suggest that Lehman Brothers' most viable option is to find a highly rated, deep-pocketed buyer. Some suggest that this might mean it could be a large bank, though they note that two of the largest U.S. banks may not currently have the capacity to acquire Lehman and its assets. JPMorgan is still digesting Bear Stearns and Bank of America is still working through their Countrywide acquisition. Thus, some have suggested that a consortium of banks could take on this role. Other potential candidates are sovereign wealth funds or private equity firms. However, some suggest that the size of a potential capital injection may be large enough to require some type of federal approval for a sovereign fund to inject capital, which would lengthen the duration of the process and may deter some potential suitors.

In many ways, if Lehman were to fail, it would be a much more complex proposition to unwind their positions than it would have been to unwind the positions held by Bear Stearns. At the end of 2007, Lehman's net positions in derivatives measured approximately \$54 billion, or nearly twice the size of Bear Stearns at that time. While Lehman's management has taken significant steps to reduce these positions and de-risk Lehman's balance sheets, it is likely that a failure by Lehman would be significant. With sentiment towards Lehman appearing to shift, market participants have also started to discuss the implications for other broker dealers and the financial system as a whole. The CDS term structures of other broker dealers have inverted further. Assuming recovery values of 40%, the market is placing a 5% probability that Morgan Stanley defaults in the next year and a 7% probability that Merrill Lynch defaults.

In addition, some market participants suggest that a further deterioration in risk sentiment due to a worst-case scenario with Lehman Brothers could have an impact on the risk positions of hedge funds. As we noted yesterday, this may push more hedge funds towards their NAV triggers. Hedge funds' poor performance and investor redemptions are also behind some recent concerns regarding the strength of Goldman Sachs' prime brokerage business. Several market participants have speculated that the prime brokerage business may be suffering as a result of the closure of a significant number of clearing accounts, and that these accounts may be under-margined, requiring Goldman to make up the difference. Goldman's share price is 3 percent lower on the session and their CDS spreads have widened 10 basis points to a level of 182 basis points.

Pressures in the funding markets ~~Redacted Materials~~

markets to persist in coming months. Spreads 6-months forward and beyond have also risen notably over the intermeeting period.

Rates in collateralized funding markets Redacted Materials

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