

# Irrational Exuberance Turns to Irrational Despair: Merrill Lynch and Lehman Brothers

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PERSPECTIVE	#
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## IN THIS PERSPECTIVE **FinSightsAdvisor**

This Financial Insights Perspective provides the FinSights Advisor's weekly perspective on the financial services industry. It provides financial institutions with timely guidance about maximizing one's technology investments. This week's issue looks at how Wall Street continues to witness the shocks from the credit crisis as Lehman Brothers filed for bankruptcy and Merrill Lynch agreed to be acquired by Bank of America. Furthermore, insurance giant AIG finds itself in a liquidity squeeze and Washington Mutual is being brought to its knees from exposure to mortgage products.

What seems to be a weekly occurrence, this news comes immediately on the tail of last week's federal bailout of Fannie and Freddie Mac. Gone are two more storied Wall Street firms and with it come more questions; what firm's will fall next and how, how does the industry landscape change, is the end in sight?

### Background

Questions and rumors had been swirling around the Street regarding Lehman's and Merrill Lynch's going concern for weeks and the shoe finally fell this weekend.

Lehman Brothers had been struggling to stay afloat since the subprime crisis started over a year ago. Last week the firm reported the largest loss in the firm's history and mentioned plans to sell off or spin out various assets to raise capital. As the situation quickly deteriorated, Barclays and Bank of America were considered potential acquirers, but both walked away from any potential deals this weekend after the Treasury abandoned commitment of additional taxpayer funds as it had done for JPMorgan Chase following Bear Stearns collapse.

While Lehman was forced into bankruptcy, Merrill Lynch was able to work out a rescue plan for itself – possibly getting in front of its own

future collapse. In frenzied negotiations over the weekend Merrill Lynch's John Thain was able to sell the firm to Bank of America in a \$50.3 billion stock deal based on prices at the time of announcement. Merrill Lynch, like Lehman, had made many efforts to remain in business, but the acquisition signals that things had become too severe for the firm to handle.

#### *The Treasury changes expectations*

The other story line is in the way the Fed and U.S Treasury dealt with the negotiations for these two firms. Officials were relieved that Merrill avoided a disaster but Henry Paulson took a decidedly harder line against Lehman Brothers, stating that Bear Stearns was very different from Lehman. Bear Stearns' collapse was unexpected and rapid, leaving little time to search for options. There was also hope in March that the Bear Stearns' deal could stop the hemorrhaging, which was not the outcome of that investment. Finally, financial institutions rallied to unwind their transactions over the weekend and dramatically reduce counter-party risk with Lehman, enabling a controlled failure. The public explanation was that the government wants to avoid any moral hazard; other banks will need to share in the risk by means of lending to other financial institutions. The Treasury is resetting the expectation that they will continue to bail-out Wall Street, forcing firms to pay for their sins and potentially leaving other banks in the cold.

It appears that future bail out from the Fed isn't going to happen. U.S. Treasury Secretary Paulson pointed out on Monday that the Fannie and Freddie bail-out was about the government living up to its responsibility that dates back to the original charter for these institutions. Paulson spoke also of a need to balance regulation and market discipline, re-enforcing his call for more regulation of the capital markets industry. This stance marks the new path that failing firms will need to take in order to remain afloat.

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#### Changing Landscape

Today's news results in profound changes and implications in financial services market. With Bears Stearns and Merrill Lynch now paired with commercial banks and Lehman Brothers in bankruptcy, the remaining stand alone investment banks are faced with a new competitive and market challenge.

While investment banks are notorious for taking riskier bets, they are forced to reconsider many large profit making investments that have evaporated or are now considered too risky, thus impacting the bottom line. Firms like Goldman Sachs and Morgan Stanly will need to consider ways to compete with the remaining goliath banks that have gained large interests in the investment banking world overnight and

are supported by core deposits and other business lines - making them more formidable competitors.

There are also many firms that relied on the capital from Lehman Brothers and Merrill Lynch themselves, such as hedge funds who are now further crippled from two departed backers. This has the potential to shutter even more funds during a year that has seen north of 700 hedge funds close and a historical low year for new launches.

Bank of America adds Merrill Lynch to its long list of recent acquisitions, which started with MBNA. The USTrust conversion is targeted for 4Q'08 completion; LaSalle integration is in progress; CountryWide will convert by late 2009; and following the Merrill Lynch transaction in early 2009, integration will progress through 2010. Although Bank of America currently has holdings in China Construction Bank and a legacy presence in Latin America, the Merrill Lynch acquisition catapults Bank of America's international presence to 40 countries, but with a much more retail focus than Citigroup and JPMorgan Chase. In addition, this acquisition allows Bank of America to circumvent a critical roadblock to growth – the deposit cap.

The continued formation of the large financial services conglomerates prompts the question; does continued diversification of commercial banks put those institutions at risk of failure at a later date? One could argue this either way. Bank of America could be viewed as expanding its existing competencies. Or Bank of America could find itself in a situation similar to AIG. There is no doubt that now Bank of America has greater exposure to world markets and economics, along with a diverse product set, which could either be a smart diversification strategy or risky endeavor.

There is no question that the U.S. banking landscape has changed dramatically. The top three players, Bank of America, Citigroup, and JPMorgan Chase, are now fully diversified financial services firms. Three of the top ten banks in the U.S. are Deutsche Bank, HSBC, and Barclays. Others in the top ten have their own struggles: Washington Mutual is actively seeking a buyer as it sits on the failure watch list, and Wachovia continues cost cutting and restructuring exercises. We've experienced 11 bank and thrift failures to date this year. Sentiment across the industry is that the worst is yet to come, and that "too big to fail" is no longer true. Quite positive to the U.S. economy, however, is that Bank of America, a U.S. entity, is purchasing Merrill Lynch. Had the latter been the case, yet another international player would have been added to the above list.

This altered landscape will bring a slew of implications. It is certain that the regulatory environment will change as the government provides funds to keep the U.S. financial market from further weakening, and lawmakers' labor to ease the impact on the economy and consumers, while looking to prevent further and future

deterioration. In this regulatory shift, it is likely we will see power shift from the OTS to the Federal Reserve. We also expect to see a more conservative approach towards investment banking, and to lending at all levels. This will translate to less competitive rates for all from the largest industry leaders to the small business and consumer as funds availability diminishes. Additionally, the conservative nature of commercial banks is likely to seep through to their investment arms. Investment firms have been innovative and leading edge in products, delivery and some technologies. Banks with investment arms are more likely to temper the highs and lows of stand-alone investment banks due to a more conservative corporate culture.

As for AIG, a truly global, diversified financial services firm, it finds itself in a precarious position needing to raise \$60 billion in capital. The complex nature of AIG means it is entwined in the subprime debacle, and also has clients who are struggling with exposure to recent Wall Street happenings.

The core AIG business model is business-to-business financing, leasing and insurance. Therefore, to raise capital, AIG will likely sell off many business-to-consumer lines including U.S. auto insurance (retaining international auto), annuity and leasing. These lines of businesses are going concerns in and of themselves and would be simple enough for AIG to sell, as easily as they were acquired – but can they do the deals quickly enough? Commercial property and casualty and other business-to-business lines are more integral to AIG's core business, and are not as easy to package for sale. AIG will refocus on these lines.

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## Assessing the Impact

We are entering a period of restructuring of the investment banking industry and how liquidity is generated for American consumer lending products. Credit standards for mortgages, auto loans, credit cards and student loans will continue to be tightened. Higher credit scores will be required, greater scrutiny of a consumer's debt ratios and past payment behavior will be a greater part of the loan origination process. Specifically lenders will be implementing “override” criteria that looks for specific negative events over and above a credit score - such as a historic major delinquency. Lenders will, either subjectively or through automated software, be analyzing how consumers respond under stress scenarios. These stress scenarios will include loss of income and further leveraging of individual and household balance sheets through subsequent borrowing. It may not be acceptable going forward for a borrower to take out a home equity loan if they have 10 credit cards with over \$100,000 in unused credit limits. The lending environment today has tightened significantly; various types of flexible mortgages have all but disappeared from the market along

stricter lender standards on real estate appraisals. Lenders are also re-examining credit criteria on pre-approved credit marketing campaigns.

Over the past few years credit standards have been steadily lowered to attract greater levels of loan volume. This volume was enabled by a capital markets system that provided vast liquidity through the creation of ABS investment vehicles. The present and continuing consumer credit constriction is a function of capital markets liquidity, but also and as importantly, fundamental underwriting revisions. While consumers may be willing to repay their mortgages, due to a slower economy, their ability to pay is severely hampered. The dramatic expansion of the mortgage industry has benefited consumers in the respect that many mortgages were enabled by a system of lower credit standards and excessive liquidity. As consumers have become stressed from a payment perspective, a more liberal credit environment was a set up for failure across an entire class of borrowers. The pendulum that represents financial services balance between benefiting consumers with wider, more available consumer credit and protecting the institution's risk interest has begun to swing towards a general credit tightening. For the foreseeable future, 2-5 years, we can expect a tighter, more constrained lending paradigm for consumers. With a tighter lending environment, carry-over effects will impact the housing, auto and durable goods industries that have built growth on the consumers' ability to finance purchases. A decreased ability on the part of consumers to finance durable goods will result in softer demand or at the very least stable demand with financial barriers to growth. Without a doubt the financial markets are in for continued punishment.

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#### Some IT Budget Points

- Lehman Brothers represented approximately 3.1% of the overall IT spending (HW, SW, Services) in the U.S. Securities and Investment Services industry. Merrill Lynch represented approximately 2.9% of the IT spending in the industry. With its acquisition by Bank of America, the securities industry from a IT budget perspective, seems to have shrunk by almost 6% over the weekend.
- For IT vendors considering sales strategies, the former top 10 securities firms in the U.S. have become a much smaller opportunity (top 10 firms based on revenue). Lehman represented approximately 17.5% of the spending among the top 10 securities firms.
- Merrill Lynch represented approximately 18% of the spend among the top 10 securities firms. Once the acquisition by Bank of America is underway, significant long-term synergies will greatly reduce the opportunities here, but in the short-term there will be

significant efforts required that will lead to investment in services and IT management tools.

- Add the impact with Bear Sterns collapse, which was around 7% of the top 10 firm's spend, then the selling opportunity to the top has shrunk by 1/3 (32.8% - estimated that IT Spending directly related to the Merrill book of business reduces by half with long-term synergies). This shifts spending to commercial banks, but many of the underlying software application spending for specialized capital markets applications will continue – but with a different buyer on the contract.

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## Guidance

### ***Advice for Banks***

- Regional and community banks and credit unions will need to keep a watchful eye on the industry, gauge the reaction of consumers, and act accordingly to increase market share. Will consumers be concerned with their bank's future? Deteriorating customer service? Focus, or lack thereof, on banking? These concerns will be opportunities for this institution segment as the tier 1 banks are focused on consuming acquisitions or remaining independent themselves.
- Bank of America may stumble through its lengthy integrations and present opportunities for other institutions. However, Bank of America may pull it off and become the Google or Microsoft of the financial services industry.

### ***For IT Vendors***

- The number of potential customers continues to shrink, while institutions themselves become more complex. Expect continued difficult market conditions and consolidation.
- Know that the sales cycle for banks is much longer and complex than for capital markets firms – IT vendors to the largest banks will need to align to their client's new structure and willingness to make investments in smaller firms that are embraced by capital markets firms.
- IT vendors in analytics, compliance and risk management should be jockeying to assist these firms where there are obvious gaps.
- Bank of America will be well positioned to white label and provide wealth management services to smaller banks, such as M&I Bank did in creating Metavante. However, with bank of America

competing in almost every U.S. market – are smaller institutions interested in such an alliance?

- Vendors of risk oriented intellectual property and decision support technologies will see demand for data to originate loans will decline over the next year due to lower overall demand. Vendors of risk intellectual property and software tied to analytics should see stability and some growth due to the industry's need to increase knowledge of existing portfolios and better manage existing account relationships for risk, growth and profitability.

## LEARN MORE

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### Related Reading

- *Fannie Mae and Freddie Mac Takeover: A Short Term Solution in an Industry With Longer Term Issues* (Financial Insights #FIN, September 2008)
- *Fannie Mae, Freddie Mac, and the Feds: What's Next for Mortgage Market Players?* (Financial Insights #FIN213521, July 2008)
- *The Bear Stearns Collapse and Implications in the U.S. Financial Services Industry* (Financial Insights #FIN211487, March 2008)
- *Worldwide Financial Services 2008 Top 10 Predictions* (Financial Insights #FIN211197, February 2008)
- *The Subprime Lending Debacle: The Mistakes Were in Market Risk Analysis Involving CDOs, not the Credit Risk Analysis of Those Applying for Mortgages* (Financial Insights #FIN206063, March 2007)
- *Combating Fraud in Home Equity Lending: The Enemy of My Enemy Is My Friend* (Financial Insights #FIN204930, December 2006)

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