From:	Tim P Clark
To:	Rita C Proctor; Donald L Kohn; Kevin Warsh; Deborah P Bailey; Roger Cole; Coryann Stefansson; William Rutledge; Arthur Angulo; Brian Peters; Jennifer Burns; Mac Alfriend; Randall S Kroszner; Scott Alvarez
Subject:	Update on BAC_ML
Date:	12/19/2008 02:29 PM

The following is a quick update and some preliminary views in advance of the call at 3:30 today.

We (FRB Richmond, FRB NY and Board staff) are continuing to gather needed info for full assessment of ML through Bank of America (BAC) management, though much of what is needed for a good preliminary assessment on ML is in our possession and being analyzed. We also had a pretty good sense already of conditions at BAC, which have also deteriorated recently as evidenced by their own projection for Q4 having gotten significantly worse in the past week or two, and we are currently working to update are views on BAC as a stand alone entity. As they themselves noted the other night at our meeting, even on a stand alone basis, the firm is very thinly capitalized in terms of tangible common equity (TCE) relative to assets and exposures.

- It is notable that a quick analysis of the TCE/assets ratios of BAC and ML on stand-alone basis and as a combined entity implies that the recent decline in BAC's projected year-end 2008 stand alone number appears to be driving as much of the decline in the combined pro forma ratios as the losses at ML, even as they are portraying the losses at ML as being the key issue here. This is largely the result of declining ratio at BAC stand alone and the fact that most capital in the combined entity will be coming from BAC.

The preliminary assessment on the ML loss numbers is that ML does not appear to be being overly aggressive in some of its larger markdowns -- though we can't yet say that with certainty and for all positions -- so the size of the losses/write downs may <u>not</u> be over-stating the problems at ML to a large extent in an attempt to 'kitchen sink' the losses in advance of the acquisition date. Details on the sources of the 'new' $4 billion of losses are being sought right now and that will be included in the analysis once we get a bit more clarity.

General consensus forming among many of us working on this is that given market performance over past several months and the clear signs in the data we have that the deterioration at ML has been observably under way over the entire quarter -- albeit picking up significant around mid-November and carrying into December -- Ken Lewis' claim that they were surprised by the rapid growth of the losses seems somewhat suspect. At a minimum it calls into question the adequacy of the due diligence process BAC has been doing in preparation for the takeover. [As an aside, BAC management told us they could not provide electronic versions of ML files, and one wonders how that is possible since they have been doing the due diligence for months and having e-files would have made that much simpler and more effective for them. May have helped limit their current surprise.]

As per our meeting with management the other night, BAC management has identified a $78 billion portfolio of positions and exposures that are causing the problems at ML. Those are as follows:

Merrill Lynch 'Legacy Portfolio'

$ millions	
Leveraged Finance	7,309
CRE	5,013
ABS CDO (Super Senior)	776
Residential Mortgages, largely Non-US	4,008
Current Exposure to Financial Guarantors (net of CVA/reserve)	9,325
CPI/PCG	3,428
Investment Portfolio	20,968
Current Exposure to Credit Derivatives Product Companies	3,732
Private Equity ('net')	10,784
Asset Based Lending	13,170
Total	**78,513**

NY Fed is working today to analyze the key positions as well as others at ML to see how much further deterioration is likely or may be coming from this portfolio. The firm has substantial continuing notional hedges purchased from financial guarantors ($53 billion) and from credit derivative product companies ($18 billion) that could drive exposures to those sources higher and generate further associated write-downs in the value of the hedges if those entities deteriorate further.

Charlotte Fed folks have the lead in updating our analysis of BAC on a stand alone basis, both the current and projected condition of the firm. Notable issues are the thin level of tangible common equity relative to assets and exposures, the recent deteriorating condition noted above and what appear to be quite optimistic underlying assumptions for the economy and performance of assets and markets in 2009 that are driving a relatively positive projection for the firms' stand alone condition out through 2009. Even if the projections are an adequate reflection of expected losses from some portfolios going forward, they appear to clearly not be well prepared for any further deterioration in economic conditions and/or asset performance. Which is to say the firm is not well prepared to withstand substantial unexpected losses that would result from further economic deterioration and market disruptions. BAC has a number of sources of potential vulnerability in its own portfolios, including consumer loans, particularly credit cards and mortgage-related, as well as relatively large exposure to commercial real estate-related positions and a commercial lending portfolio (funded and commitments) with a very large share of the dollar value of exposures stemming from 'BB' and below-rated borrowers.

We plan to finalize the analyses described in this note today/tonight and work this weekend to create a forward-looking view of the extent of the vulnerabilities for the combined entity, which we will shoot to wrap up by Sunday night and provide the full analysis Monday morning.

please forward to any relevant parties I may have accidentally left of the distribution and let me know if you have any questions
tim

Tim P. Clark
Senior Advisor
Banking Supervision & Regulation
Federal Reserve, Board of Governors

Analysis of Bank of America & Merrill Lynch Merger

Restricted FR
(Second Draft)
December 21, 2008

I. Summary Overview

Bank of America (BAC) has sufficient resources to consummate the merger with Merrill Lynch (MER).

- Upon consummation of the merger, based on current projections for both firms, the combined entity would have an 8.6% Tier I risk based capital ratio and a Tier 1 leverage ratio of 5.2%. However, the amount of tangible common equity at the combined firms will be among the lowest of the large BHC at 2.2% on day one of the acquisition.
- An immediate vulnerability would be BAC's access to market funding. On a stand alone basis, BAC has a significant short term funding dependence. MER has significant dependence on the government funding programs, and will likely increase the short term funding pressure on the combined firm.
- The principal vulnerability of the combined firm, similarly to other large BHCs, would be:
  - Potential losses from BAC's consumer and commercial credit portfolios, which will be contingent upon the economic environment going forward and will be realized over time.
  - MER has the largest exposure to financial guarantors across US financial institutions. Unlike the timing of loss recognition in the loan portfolios, losses associated with financial guarantor exposures could be realized in a more compressed timeframe. Moreover, the timing of potential losses from these exposures is highly uncertain.

From the perspective of regulatory capital, Bank of America ("BAC") currently exceeds regulatory minima for well-capitalized on a stand-alone basis, with an expected Tier I capital ratio of 9.2% at year-end 2008. However, only about one third of the firm's Tier I capital is in the form of tangible common equity.

- When viewed from the standpoint of tangible common equity to total assets (the TCE ratio) the firm is among the more thinly capitalized of the five largest domestic BHCs. This ratio is closely watched by analysts and investors and further deterioration of the firm's TCE ratio would likely cause increased uncertainty among market participants about the firm's prospects.

Since September, continued economic deterioration and substantial market disruptions have weakened the condition of both firms.

- MER's deterioration has been substantially worse than BAC's and all but ensures that the firm could not survive as a stand-alone entity without raising substantial new capital (and\or government support) that is unlikely to be available given the uncertainty about its prospects and further future losses.

- Management now projects Q4 after-tax losses of roughly $14 billion for MER, and approximately a $1.4 billion after-tax quarterly net loss for BAC, which for BAC represents more than four times management's projected losses from just two weeks ago. The losses at MER will erode over 50% of MER's tangible common equity.

While the extent of the market disruptions that have occurred since mid-September were not necessarily predictable, BAC management's contention that the severity of MER's losses only came to light in recent days is problematic and implies substantial deficiencies in the due diligence carried out in advance of and subsequent to the acquisition.

- In the merger proxy statement and investor presentations the firm explicitly asserts that it has an understanding of MER's business activities, financial condition and prospects as well as an understanding of the outlook for the firm based on prospective economic and market conditions.
- Staff at the Federal Reserve has been aware of the firm's potentially large losses stemming from exposures to financial guarantors, which is the single largest area of risk exposure and driver of recent losses that have been identified by management. These were clearly shown in Merrill Lynch's internal risk management reports that BAC reviewed during their due diligence.

    - The potential for losses from other risk exposures cited by management, including those coming from leveraged loans and trading in complex structured credit derivatives products ('correlation trading') should also have been reasonably well understood, particularly as BAC itself is also active in both these products.

    - Having done a quick analysis on the specific positions/exposures at MER that generated the largest losses for MER in Q4, FRS staff see no clear indication that they were driven by overly aggressive marking down of positions in advance of the acquisition. This general conclusion notwithstanding, some of the marks do appear somewhat conservative and the appropriateness of the timing of the impairment charge taken against goodwill is hard to assess. On the other hand, credit valuation adjustments against financial guarantors are not particularly aggressive relative to those staff has observed at other firms.

The combined firm remains vulnerable to a continuing downturn.

- At the time of the completion of the merger, based on current projections for both firms, the combined entity would have an 8.6% Tier 1 capital ratio, and a TCE ratio

BOG-BAC-ML-COGR-00037

of less than 2.2%. This is in relation to BAC's stand-alone ratios of 9.2% and 2.6%, respectively.

- Based on stress analysis performed by staff, under moderate and severe stress scenarios the combined BAC-MER firm would be among the most vulnerable of the largest domestic BHCs, but not substantially more vulnerable than many others.

- In the event that actual losses were in line with stress projections, TCE and Tier I capital would be substantially eroded, with Tier I risk based capital ratios of 6.4% and 4.0%, respectively, under the moderate and severe stress tests.

- Resulting from the impacts of a moderate or severe recession, our scenario analysis suggests that the combined entity would need to raise roughly $21 billion and $67 billion of Tier I capital, achieve a Tier I risk-based capital ratio of 7.5% at year-end 2009.

From: Scott Alvarez
To:
Subject: Re: Fw: BAC
Date: 12/23/2008 11:23 AM
Encrypted

I agree we and Treasury gave our views on what we thought the likely effects would be of not proceeding, but that's different than ordering Lewis to proceed. We didn't take the decision out of his hands or threaten punitive supervisory action if he didn't proceed. I want to avoid the Fed being the centerpiece of the litigation. Lewis needs to have every incentive to analyze the facts and document and justify his decision. If he thinks he can rely on us, he'll assert there was nothing he could do and he can be reckless--not the right incentive. Moreover, once we're in the litigation, all our documents become subject to discovery and, as you'll remember from Deborah's presentation, some of our analysis suggests that Lewis should have been aware of the problems at ML earlier (perhaps as early as mid-November) and not caught by surprise. That could cause other problems for him around the disclosures BA made for the shareholder vote. In any event, we can always decide at the time of litigation whether to help even if now we hold fast.

Scott

Kevin Warsh/BOARD/FRS

12/29/2008 12:58 PM

To Chairman's Email Address Redacted

cc Donald L Kohn/BOARD/FRS@BOARD, Michelle A Smith/BOARD/FRS@BOARD, Scott Alvarez/BOARD/FRS@BOARD

Subject BofA

Ben:

Spoke with BoA folks this morning, mostly Joe Price (CFO) They seem to have taken on board some of the ideas we discussed with them last week, but did not instill a ton of confidence that they have got a comprehensive handle on the situation. Their views, however, are evolving towards asking for some relief to parent co in addition to ML.

ML: They proposed mix of government capital (common-like, non-voting equity) plus asset wrap ($140Bn) with "fill the whole" at ML for the "good of the system". Cost of government support here will need to be negotiated here, but they think they are entitled to some favorable terms because they have agreed to go forward to closing. I reminded them that they are the ones who would look equally bad in eyes of market and regulators if they chose to terminate transaction. T

Parent: With respect to BoA, they now propose reducing dividend payout to "nominal" amount.. With respect to capital raise, they want to target all-in-capital raise that takes TCE ration to 3 to 3.5%, which seems like a total capital raise of $12-15 Bn, with government serving as backstop in event they couldn't raise capital themselves. They'd also like asset wrap of about $50 Bn for BoA assets "that are comparable to" ML. On BoA pieces, recognize that terms of government support would be more expensive.

They would hope to announce comprehensive package with our support on Jan 20 (happy inauguration day, mr. president).

Don and I are talking with Fed staff plus OCC plus Treas tomorrow afternoon, and should have better view of way forward after that. BoA is going to talk with Exec Committee of its Board on Wednesday, and I told Price I'd give him some preliminary guidance by then

Thanks

From:	Deborah P Bailey
To:	Mac Alfriend; Roger Cole
Subject:	Re: BAC
Date:	12/20/2008 01:32 PM

Mac, if we need to do something I think we will look at doing it in January. I also think that it would be done with a series of actions including cutting drastically the dividend, some supervisory action (MOU) that covers management. Personally I think management should be downgraded, no more acquisitions, raise some "real" capital, frequent meetings with the Board,etc. It will definitely a price to pay. I always had my doubts about the quality of the due diligence they did on the ML deal. Don't forget they paid a premium. How do you pay a premium and now ask for help? This will not go over well at all.

Let's keep talking on these points.

Sent from the Blackberry of Deborah Bailey

▼ Mac Alfriend

----- Original Message -----
From: Mac Alfriend
Sent: 12/20/2008 12:34 PM EST
To: Deborah Bailey; Roger Cole
Subject: BAC

Some very preliminary thoughts on getting a pound of flesh out of Lewis. Should we do this as part of the agreement to bail them out or just let them know that we will be contacting them with a board resolution/mou in January. Your thoughts

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----- Forwarded by Mac Alfriend/RICH/FRS on 12/20/2008 12:31 PM -----

Mac Alfriend/RICH/FRS

12/20/2008 12:25 PM

To	Jeffrey Lacker/RICH/FRS
cc	James McAfee/RICH/FRS@FRS, Jennifer Burns/RICH/FRS@FRS, Lisa A White/RICH/FRS@FRS, Sally Green/RICH/FRS@FRS, Stacy L Coleman/RICH/FRS@FRS, Trish Nunley/RICH/FRS@FRS
Subject	Re: The ChairMan

good point I forgot about over reliance on overnight funds (short term profit mentality)

December 21, 2008

Talking points for BankAmerica Discussion

[Bracketed language below is for further internal discussion purposes and subject to revision based upon briefing by Staff this afternoon]

1. Abandonment of the transaction on the eve of consummation, especially after the extensive preparations that BA has already taken, would surprise the market and have serious adverse effects not only for ML, but also for BA. Of course, it would have negative implications for the System.

* The market would doubt the judgment of BA's management and its ability to perform adequate due diligence and manage risks. It would call into question the risks inherent BA's existing footprint, including Countrywide.

* Abandoning the transaction would expose the weaknesses in BA's capital and asset quality, as analysts attempt to determine why BA did not believe it had the resources to acquire ML.

* The market would conclude that BA was too weak to address the problems at ML, particularly because ML brings with it $10 billion in Government TARP capital in addition to its own capital.

2. BA's assertion that it would successfully exercise the material adverse effects clause is not credible, according to Fed and other key US Government (USG) attorneys.

*The public assertion of the claim, however, would likely cause the demise of ML in much the same fashion as the collapse of Lehman.

*This would cause significant reputational consequences for BA, in the markets, with the public and with the regulators.

3. If USG were to provide aid to BA in connection with the acquisition of ML, BA would look very weak in the eyes of the market (e.g., look more like Citi and less like JPM)

* Except for the CPP (which has already provided BA with $15 billion and promised BA another $10 billion upon completion of the ML transaction), the Fed and Treasury have established a policy on assisting only troubled companies in time-constrained, emergency situations.

* The ML deal has taken place in full view of the market over an extended period of time and without any indication of extraordinary weakness. Markets will be focused on the 2009 pro forma financials, not the 4Q ML write-downs.

*Were the US Government to provide aid at this point, it would appear that BA was itself too weak to acquire ML and had poor leadership and inadequate risk-management systems in place across its entire footprint.

4. In spite of all of this, if BA believes that aid from USG is essential, and the USG chooses to provide aid to BA, it will come at a price – both economically and reputationally. Assistance, generally, has taken any/all of three forms – regulatory, capital, or with respect to distressed assets. [We may need to revise this judgment later today]

*Regulatory: Relief takes various forms [but we must be alert here that extraordinary relief might smack of forebearance and markets and ratings agencies may not be as tolerant as regulators]

*Capital: [The central problem here is likely to be insufficient capital in a fast deteriorating economic environment. The solution, thus, may well be a new capital raise, which could include a mix of private and public capital as USG could provide backstop in various forms].

*Distressed Assets: [The pool of "distressed assets" at ML have already undergone massive write-downs, so tail-risk looks smaller than in other situations. Also, the size of the distressed pool looks relatively small compared to size of pro forma BA balance sheet]

5. If, however, BA maintains that the distressed assets are the central cause of the expected pro forma weakeness, and USG more clearly understands BA's rationale, then BA should be expect to be required to —

* take all the expected losses from any designated portfolio plus provide an additional cushion for extraordinary losses;

* pay rates for any aid it receives significantly in excess of the CPP ; and

* provide some measure of upside compensation to the US Government.

Moreover, BA will be subject to restrictions on its business activities that, at a minimum, will include—

* a ban on dividends without US Government approval,

* more severe executive compensation limitations than those from the CPP,

* limitations on various types of corporate expenses,

* a government foreclosure prevention policy,

* restrictions on further acquisitions/transactions,

* requirements to raise additional capital in agreed time-frame, and

* more intrusive review and involvement by the US Government in the selection of management of BA, including the board of directors.

6. [BA has made clear previously to the regulators and to the marketplace that it believes this deal is strategically and financially good for BA in the medium-term. BA has said that the franchise value of ML is very strong and its long-term prospects appear good. BA should proceed with the deal and manage the deal as capably as possible, including consideration of announcing a capital raise]

*[BA should consider the following contingent support of USG. That is, if unforeseen market events threaten the viability of BA, the Federal Reserve and the other Federal Government agencies will consider and use all options available to address the situation at that time.]

BOG-BAC-ML-COGR-00029

Eric Rosengren/BOS/FRS

01/16/2009 03:29 PM

To Rita C Proctor/BOARD/FRS

cc Donald L Kohn/BOARD/FRS@BOARD, Elizabeth A Duke/BOARD/FRS@BOARD

Subject ring fencing

Dear Ben:

I wanted to follow up on my question this morning. Going forward I am concerned if we too quickly move to a ring fence strategy. Particularly if we believe that existing management is a significant source of the problem and that they do not have a good grasp of the extent of their problems and appropriate strategies to resolve them. I think it is instructive to look at the example of the Royal Bank of Scotland. They have consolidated assets of $3.8 trillion. The UK

replaced senior management and currently owns 58% of the bank. The bank is maintaining operations without significant disruptions. Should problems get worse, the government may need to increase their stake. However, management has been changed, shareholders have been diluted to the extent of the losses realized to date required additional capital, and new outside directors are being selected. Such a strategy obviously has pitfalls, but I would not want to discard this option prematurely.

Eric

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