

# Email from a senior adviser at the Federal Reserve, December 12, 2008

From: Tim J. Clark  
To: Rick E. Frazier, Donald L. Miller, Kenneth J. Hines, David Cook, Carolyn L. Johnson, William  
H. Johnson, Arthur Adams, Brian Bantz, Jordan Barua, Marc Ashford, Randall S. Stroub, Scott Alvarez  
Subject: Update on ML - ML  
Date: 12/10/2008 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 our 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/ on stand-alone basis and as a combined entity decline in BAC's projected year-end 2008 start be driving as much of the decline in the combined losses at ML, even as they are portraying the issue here. This is largely the result of decline and the fact that most capital in the combined BAC.

The preliminary assessment on the ML loss numbers is being overly aggressive in some of its larger market say that with certainty and for all positions -- so the situation may not 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

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# Restricted Federal Reserve Analysis of Bank of America & Merrill Lynch Merger, December 21, 2008

- 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**
  - o 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.

- o Having done a quick analysis on the specific positions/exposures at MER that generated the largest losses for MER in Q4, FRB 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.**

**BAC management's contention that the severity of MER's losses only came to light is problematic and implies substantial deficiencies in the diligence carried out in advance of and subsequent to the acquisition.**

**These were clearly shown in Merrill Lynch's internal risk management reports that BAC reviewed during their due diligence**

# Email from General Counsel to Chairman Bernanke on December 23, 2008

From: Scott Asher  
To: [REDACTED]  
Subject: [REDACTED]  
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 fact.

Scott

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• Staff at the Federal Reserve

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Email from General Counsel to Chairman Bernanke, December 23, 2008

From: Scott Alvarez  
To: Scott Alvarez  
Subject: Re: Fw: BAC  
Date: 12/23/2008 11:08 AM  
Encrypted

Thanks, Scott. Just to be clear, though we did not indicate that we believed that going forward we (safety and soundness) of his company. I think it may be just academic, but anyway. What would be the advance of a litigation but if requested by the defense that our analysis supported the safety and soundness merger and that we communicated that to Lewis?

▼ Scott Alvarez address deleted

Scott Alvarez address deleted

address deleted

12/23/2008 10:18 AM Subject: Re: Fw: BAC

Mr. chairman,

Shareholder suits against management for decisions like this are more than successful. Courts will apply a "business judgment" rule that gives management wide discretion to make reasonable business judgments. Management is liable for decisions that go bad. Witness Bear Stearns. A different question that doesn't seem to be the one Lewis is focusing on is disclosure. Management may be exposed if it doesn't properly disclose that is material to investors. There are also Sarbanes-Oxley requirements that management certify the accuracy of various financial reports. Lewis is to comply with all those reporting and certification requirements in completing this deal. His potential liability will be whether or not he reasonably should have known the magnitude of the ML losses. Lewis' disclosures to get the shareholder vote on the ML deal in early December. His lawyers were much involved in that set of disclosures and Lewis was clear to us that he didn't hear about the increase in losses till recently.

All that said, I don't think it's necessary or appropriate for us to give Lewis a letter along the lines he asked. First, we didn't order him to go forward—we simply explained our views on what the market reaction would be and left the decision to him. Second, making hard decisions is what he gets paid for and only he has the

A different question that doesn't seem to be the one Lewis is focused on is related to disclosure. Management may be exposed if it doesn't properly disclose information that is material to investors.

His potential liability here will be whether he knew (or reasonably should have known) the magnitude of the ML losses when BA made its disclosures to get the shareholder vote on the ML deal in early December.

Email from official at the Richmond Fed, December 23, 2008

I think he is worried about stockholder lawsuits; knows they did not do a good job of due diligence and the issues facing the company are finally hitting home and he is worried about his own job after cutting loose lots of very good people.

From: Marc Alfrind  
Sent: 12/23/2008 05:44 PM EST  
To: Jeffrey Lasker  
Cc: Jennifer Burns  
Subject: Re: Color from Iac Chairman

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Marc Alfrind  
Senior Vice President, External Supervision and Regulation  
The Federal Reserve Bank of Richmond  
Chesapeake, VA 23061-0411 | Cell: 800.572.4106  
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THE FEDERAL RESERVE BANK OF RICHMOND  
SERVING A BUSINESS COMMUNITY

Email from Chairman Bernanke to the Fed's General Counsel, December 23, 2008

He said he now fears lawsuits from shareholders for NOT invoking the MAC, given the deterioration at ML.

[H]e still asked whether he could use as a defense that the govt ordered him to proceed for systemic reasons. I said no.

address deleted  
12/23/2008 02:14 PM  
To: Scott Alvarez/primary contact  
cc: Kevin Warsh/  
Kroszner/primary deleted  
Kohn/  
Bibby/  
Subject: MAC  
Randal S.  
Donald L.  
Deborah P.

Had a good conversation with Levis just now. He confirms his willingness to do the MAC and to work with the government to develop whatever support package might be needed for earnings announcement dates around Jan 20. We discussed his common equity issue. We agreed that having a significant amount of TARP capital in the form of common was not an ideal solution, given the ownership implications. But we agreed both to think about possible solutions (eg, a govt backstop of a capital raise, govt common with limited control rights, etc.).

He had a question which I will address to Scott (also to Deborah). He said he now fears lawsuits from shareholders for NOT invoking the MAC, given the deterioration at ML. I don't think that's very likely and said so. However, he still asked whether he could use as a defense that the govt ordered him to proceed for systemic reasons. I said no. It is true, however, that we have done analyses that indicate that not going through with the merger would pose important risks to BAC itself. So here's my question. Can the supervisors formally advise him that a MAC is not in the best interest of his company? If we did, could he cite that in defense if he did get sued for not pursuing a MAC?

# Email from Chairman Bernanke, December 21, 2008

From: Jonathan F. Maher  
To: David L. Davis; Aaron M. Davis; Michael A. Fuchs; Randall S. Kinnear; Tom C. Thornton; Robert J. Viner; Scott Wallace  
Cc: [REDACTED]  
Subject: [REDACTED]  
Date: 12/21/2008 10:53 AM  
Encrypted

Thanks. I think the threat to use the MAC is a bargaining chip, and we do not see it as a very likely scenario at all. Nevertheless, we need some analysis of that scenario so that we can explain to BAC with some confidence why we think it would be a foolish move and why the regulators will not condone it.

My current thinking is that we should have a regulator call without treasury (including though occ and fdc) to work out our joint position. We then need a second call, perhaps with fewer staff than the first, to discuss the findings and implications with Treasury. That all has to happen today, so anything we can do to move the regulators call up a bit would probably be helpful. Depending on how that goes, it might be principals only calling Lewis tonight or tomorrow morning.

I talked to Lacker yesterday but have not spoken to Lewis since the call on Friday.

I think the threat to use the MAC is a bargaining chip, and we do not see it as a very likely scenario at all.



Email between officials at the New York Fed, December 18, 2008

Smoking gun... You're the man!

From: ARCEL ZAVADA  
To: BILLY THOMAS  
Subject: Re: Looking at the BAC BOB deck  
Date: 12/18/2008 06:05 PM

Smoking gun...You're the man!

✓ Brian Peters (address deleted)

Brian Peters (address deleted)

12/18/2008 05:35 PM

To: Arthur Alquist (address deleted), Christopher  
Cuban (address deleted), Tim P  
Coy (address deleted), Kevin Stroh (address deleted)

CC:

Subject: Looking at the BAC BOB deck

	Dec 9, 2008 BOD	12/17 phone call	Delta
BAC Only	2.61%	2.60%	(0.21)
BAC + ML Proforma	2.50%	2.20%	(0.30)
Delta	(0.31%)	(0.40%)	

If I look at pg 6, BAC capita is 78% of proforma combined capital. If we model what the proforma would have looked like if there had been no change at ML, I come up with a proforma of 2.34. So 16bp of the deterioration is due to BAC (2.50-2.34), and 14bp is due to ML (2.34-2.20).

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I don't think it's necessary or appropriate for us to give Lewis a letter along the lines he asked. First, we didn't order him to go forward.

Second, making hard decisions is what he gets paid for and only he has the full information needed to make the decision -- so we shouldn't take him off the hook by appearing to take the decision out of his hands.

From: Scott Alvarez  
Subject: FW: BAC  
Date: 12/23/2008 11:08 AM  
Encrypted

Thanks Scott. Just to be clear, though we did not order Lewis to indicate that we believed that going forward would be in the best interests of the company (safety and soundness) of his company. I think this is more of an academic question. What would be wrong with just saying that our analysis supported the safety and soundness case for the merger and that we communicated that to Lewis?

Scott Alvarez  
address deleted

Scott Alvarez  
address deleted  
12/23/2008 10:18 AM  
Subject: Re: FW: BAC

Mr. chairman,  
Shareholder suits against management for decisions like this are common. Courts will apply a "business judgment" rule that gives management wide discretion to make reasonable business decisions. Management is not liable for decisions that go bad. Witness the Enron case. Management may be exposed if it doesn't properly disclose material information. There are also Sarbanes-Oxley provisions that require management to certify the accuracy of various financial reports to comply with all those reporting and certification requirements. His potential liability here will be whether he should have known the magnitude of the ML loss. It is not clear from the disclosures to get the shareholder vote on the ML deal in California that his lawyers were much involved in that set of disclosures and that he didn't hear about the increase in losses till recently.

All that said, I don't think it's necessary or appropriate for us to give Lewis a letter along the lines he asked. First, we didn't order him to go forward--we simply explained our views on what the market reaction would be and left the decision to him. Second, making hard decisions is what he gets paid for and only he has the full information needed to make the decision--so we shouldn't take him off the hook by appearing to take the decision out of his hands.  
Let me know if you'd like any more info on this.  
Scott  
address deleted