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Broader Lessons From Lehman Brothers' Bankruptcy

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The events of the past two weeks led to three outcomes for troubled financial institutions in the U.S.: regulatory intervention (Fannie Mae and Freddie Mac); merger (Merrill Lynch & Co. Inc.); or bankruptcy (Lehman). The markets have yet to see a fourth outcome in this cycle: recovery. After all, as in previous cycles, we believe some of the strongest and best-positioned institutions will recover and eventually thrive once again.

The bankruptcy filing by Lehman Brothers Holdings Inc. (LBHI), the largest among financial institutions in U.S. history, has led us to three major conclusions:

- Some companies are indeed not too big to fail;
- While the availability of liquidity can provide some form of short-term life support to an institution under severe stress, it is either real or perceived capital inadequacy that can precipitate a company's failure; and
- The impact from a regulatory action or inaction can have unintended consequences through indirect exposures and linkages that sometimes are only known to direct market participants. Moreover, the current instability in the financial system is coming at a time when the U.S. economy is already weak and continues to deteriorate.

In the wake of Lehman's bankruptcy filing, Standard & Poor's Ratings Services lowered the ratings on the debt of Lehman's U.S. broker-dealer subsidiary to 'BB-/CreditWatch Developing' and its holding company ratings to 'D'. It is the trading operations embedded in the U.S. broker-dealer subsidiary that Barclays has announced it plans to buy for \$1.75 billion. We understand that the transaction will be structured as an asset purchase (versus legal entity) and will include Lehman's trading positions and any contracts that come with the business. It also includes the operational infrastructure supporting it and Lehman's corporate headquarters in New York. Barclays seems open to buying other assets as well.

Negative rating actions are likely on other financial institutions as we reassess the evolution of risk in these markets, the market's loss of confidence in their capital-raising abilities if investors question capital adequacy, and the longer-term reassessment of the impact on a changing business model as a new paradigm seems to emerge. We also anticipate negative rating actions on related structured finance transactions.

The Immediate Impacts Of Lehman's Failure

The unwinding of market positions and exposures to Lehman began on Sunday, Sept. 14, during a preemptive "netting trading session" opened by the International Swaps & Derivatives Assn. (ISDA) that took place from 2 p.m. to 6 p.m. This session was to allow firms to unwind derivatives transactions with Lehman by finding other parties to step in. According to press reports, very few Lehman trades were in fact offset because of different terms and maturity dates in those derivatives contracts as well as higher pricing. Still, our understanding is that the operational difficulties have been slowly overcome and the unwinding has progressed in an orderly fashion.

To reduce liquidity risk in the markets, the Federal Reserve Bank also expanded its lending facilities beyond the scope established last March. The Fed is now taking a wider array of securities as collateral for its loans, including equities and speculative-grade debt. While these are indeed positive steps, what's rattling the financial system now, in our opinion, is the fact that new capital raising has not kept up with growing write-offs, and the system clearly

needs capital, not liquidity. Still, both the early action by the ISDA and the extra liquidity support the Fed is providing should, in our view, aid an orderly liquidation of Lehman, with contained disruption to the rest of the system.

LBHI filed for Chapter 11 bankruptcy protection early on Sept. 15. Although the parent company did the filing, in practice, many trades between Lehman's broker-dealer subsidiaries and its counterparties are considered to be in default because of the ultimate parent's Chapter 11 filing, even though the subsidiary itself may remain solvent, liquid, and functioning. Also, some European and Asian regulators have taken preemptive steps against some Lehman subsidiaries (Lehman Bros. Bankhaus AG in Germany and Lehman Brothers Holdings PLC in the U.K., for example) to ensure or facilitate orderly liquidations.

Looking beyond just the Lehman failure, during the past few decades, the financial system has become more concentrated, and, in our opinion, risk at financial institutions has grown with a mix of riskier assets that are common across a larger number of institutions. While mitigation efforts, such as securitizations and credit insurance, attempted to lower financial institutions' risk exposure, the ultimate result in many cases has been quite the opposite. It now has become clearer that the specific structure of these instruments and their "interconnectedness" many times negate any expected benefits. From this perspective, systemic risk has risen.

For example, whereas direct exposure to Lehman is small at many larger institutions, cross-industry correlations could be high, and indirect exposures are still being sorted out. We expect financial institution announcements to trickle out with charges in the third quarter not only for Lehman exposure but also related to the government-sponsored entities (GSEs) Fannie Mae and Freddie Mac.

The Lehman fallout is likely to have a significant direct and indirect impact on a number of large banks globally. Here are three areas worth mentioning:

- Exposure to debt in (selective) default. LBHI had outstanding long-term debt of approximately \$110 billion as of Aug. 30, 2008. Short-term commercial paper outstanding was around \$8 billion at the end of May, but has likely been reduced significantly since that time. The fact that trustees hold a majority of this debt means the bankruptcy petition sheds little light on the economic ownership of Lehman's obligations. We believe, though, that a broad range of institutions, not just large capital market players, are likely to hold some of this paper. Managed conduits, which are typically subject to available-for-sale (AFS) accounting, could also contain meaningful amounts of Lehman debt where the risk ultimately lies with the managing bank. Money market funds managed by banks could also be holding some Lehman debt, leading to potential compensation to clients. This has already happened with some structured credit exposure that such funds held. So far, we have not yet identified particular concentrations that would threaten a rating, but some exposures are material. It will take some time to get the full picture, including among smaller players. LBHI also has some \$8 billion of hybrid capital outstanding. It is possible that some of this could be held by collateralized debt obligations (CDOs) of trust-preferred securities, some of which may have been distributed widely.
- Counterparty exposure. Likely to be more significant is counterparty exposure to the various companies within the Lehman Bros. group. These exposures should be largely confined to the biggest banks and broker-dealers, but smaller institutions could have some as well. These exposures are likely to be large in gross terms (mostly via repurchase agreements and securities lending transactions) and to vary considerably among institutions. Again, so far, we believe that such exposures are manageable for the institutions involved. Given the probable movements in the value of the collateral, potential future exposure could yet rise materially and be subject to considerable

volatility, although we would expect these exposures to have largely crystallized into current exposures by now. Furthermore, given possible differences in the treatment of the various Lehman entities, it is not yet clear whether positive and negative exposures across the group can be netted. As noted above, although the main U.S. broker-dealer subsidiaries remain operational, the German bank subsidiary is effectively frozen, and the primary U.K. subsidiary, which conducts a majority of the group's derivative exposures, has been placed in administration.

- **Market price impact.** Even entities active in the capital markets that have negligible direct exposure to Lehman will likely suffer, in our view--and to a potentially greater extent. This is because we expect the parent company's Chapter 11 filing to intensify pressure on the group to shrink its balance sheet. Indeed, we believe that the secured nature of the bulk of the exposures to Lehman enables banks to seize the group's collateral and attempt to liquidate it. This will likely result in further downward pressure on a wide range of assets. That could, in turn, force highly leveraged institutions to liquidate to meet margin calls, putting further pressure on assets. It is too early to gauge the likely impact of this, but it seems probable that third-quarter 2008--already shaping up to be weak--can only worsen as a result of Lehman's Chapter 11 filing and lead to still more disadvantageous market prices at the end-of-September balance-sheet date. In addition, the precedent that would be set concerning the valuation of assets in the Lehman portfolios could, in our opinion, become a benchmark for marks to market of real estate-related assets as well as other asset classes to which these institutions are exposed. It is important to note that asset liquidations are coming from all corners, either to cover losses or because the global economy is slowing.

This Was About Capital Adequacy, Not Liquidity

One distinguishing factor between the collapse of Bear Stearns last March and Lehman six months later was that of perception: Market confidence was lost in both cases but we think for different reasons. In the case of Bear Stearns, solvency at the time was not being questioned--liquidity was. However, with Lehman, the issue was capital adequacy, considering its large book of risky assets, including \$12 billion in residential mortgages and \$33 billion in commercial real estate loans that the firm was trying to offload for several weeks. Potential write-downs and marks on these assets for any purchaser would have proven difficult. In fact, liquidity risk was partly contained thanks to the Fed's supportive programs established last March in the wake of the Bear debacle. These programs have now been expanded in the wake of the Lehman bankruptcy.

One quick way of raising capital would be through preferred stock issuance. But this market closed even before the conservatorship of the GSEs last week. The fact that the conservator intends to stop dividend payments on the preferred stock of both Fannie and Freddie has, in our opinion, only dislocated the market further and significantly reduced investor appetite for such instruments. Therefore, we believe preferred stock issuance has become less palatable. But, at the same time, the depressed equity markets are indicating that raising common equity may not be a viable option either. Clearly, given limited capital-raising opportunities, private equity investors may likely participate more actively in the industry's recapitalization.

"Too Big To Fail" Can Be Selective

In May 1984, the federal government contributed roughly \$1 billion to save Continental Illinois Bank from default. Then the seventh-largest U.S. bank, Continental was also a money-center bank holding large deposits of hundreds of

smaller banks throughout the Midwest. The failure of such a bank might have tipped many smaller institutions into default, so the Fed and the primary regulator, the Comptroller of the Currency, engineered a rescue that saved Continental depositors and stock and bond investors in the holding company. Because of the controversy that arose, when the Comptroller testified in Congress he coined the phrase: "too big to fail." The subsequent furor ensured that this was the last time investors were bailed out in this way. Subsequent failures, in the absence of a purchaser being found for the whole balance sheet, left holding company creditors with little other than a residual claim on operating company assets.

To be sure, the government has supported financial institutions for many years in a variety of ways. The bailout last March of Bear Stearns contributed to this view, especially as the Federal Reserve Board put in place liquidity facilities for broker-dealers not invoked since the 1930s. Indeed, we factored this type of liquidity support as part of our ratings for broker-dealers this year. By also brokering the JPMorganChase takeover of Bear Stearns to avoid the latter's collapse, the government showed extreme support to limit systemic risk.

The government provided such support again with its intervention via conservatorship of Fannie and Freddie this month. Some could argue that the GSEs' conservatorship is a special case of extraordinary intervention because of the GSEs' status as institutions with implicit government support. Still, market expectations that the government would stand by and support failing financial institutions were reinforced, thus creating moral hazard as an unintended consequence of the Bear and GSE bailouts. Nevertheless, one week after taking over the GSEs, the government made it clear that market discipline should take its course and that perhaps very few financial institutions would indeed be "too big to fail."

In our view, the political will for supporting financial institutions is dwindling, unless there is a clear sense that systemic risks are so high that only regulatory or government support will stave off a more widespread financial crisis. Such was the rationale behind the most recent support of AIG. With AIG, the government has made clear it will be willing to provide extraordinary support only in rare instances for institutions of high systemic importance (see "How Systemic Importance Plays A Significant Role In Bank Ratings," published July 3, 2007, on RatingsDirect). Another interpretation of the lack of support for Lehman could be that banking regulators had learned enough from the Bear Stearns debacle so that they were more prepared to deal with the failure of Lehman Bros.

Putting The Current Turmoil In Perspective

Indeed, many lessons can be learned from the seismic events that have unfolded this year in the U.S. financial services industry. In today's world, market events can easily overwhelm financial fundamentals in a speedy manner, and short-selling by hedge funds and other investors can lead to confidence loss and crimp a firm's financial flexibility. The precipitous failures of Bear Stearns, Fannie and Freddie, and Lehman Bros. have been unprecedented, as has the announcement of Merrill Lynch's acquisition by Bank of America.

For now, Lehman's orderly resolution will take some time, and it is unclear who the real losers are and how much will be lost. But from an industrywide perspective, the loss of an important player could offer franchise-enhancing and profitable opportunities to those that survive.

Standard & Poor's has recorded a podcast on these topics, which is currently available for download for those who register through www.standardandpoors.com.

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