Timothy Geithner /NY/FRS
07/15/2008 08:22 AM

To William Dudley/NY/FRS@FRS, Chris McCurdy/NY/FRS@FRS, Donald L Kohn/BOARD/FRS@BOARD, Kevin
cc Michael Schetzel/NY/FRS@FRS
bcc
Subject Re: Lehman Good Bank/Bad Bank idea discussed last night

History: This message has been forwarded.

Pls add something on how we decide what assets to take.

And we need a broader framework in which to place this, with high procedural hurdles.

From: William Dudley
Sent: 07/15/2008 08:17 AM EDT
To: Chris McCurdy; Donald Kohn; Kevin Warsh; Lucinda Brickler; Meg McConnell; Terrence Checki; Timothy Geithner; Patrick Parkinson
Cc: Michael Schetzel
Subject: Lehman Good Bank/Bad Bank idea discussed last night

Just to put some words to what I was proposing last night. Very much in the spirit of what we did with Bear...but better because less damage to franchise, no forced sale.

Lehman Good Bank/Bad Bank proposal

All the numbers are rough guesses, but I want to give you an explicit example to think about.

Separate into two parts:

Maiden Lane type vehicle: $60 billion of illiquid assets backstopped by $5 billion of Lehman equity. Fed guarantees financing or finances the $55 billion. Lehman owns this vehicle, so if assets > liabilities upon windup, accrue to Lehman shareholders.

Clean Lehman left. $600 billion of assets, $23 billion of equity. Much less risk, greater liquidity cushion (don't have to finance illiquid assets).

Fed gets equity in clean Lehman (whether warrants or some other form of equity TBD in compensation for backstop financing in SPV).

Protections to the Fed. First loss piece, net interest margin on SPV, and equity in clean Lehman.

Why we want to do this. Takes illiquid assets off the market, reduces risk that forced sale of assets will generate losses that make Lehman insolvent. Preserve Lehman franchise value as a going concern. No negative externality to rest of financial system. Moral hazard considerations low given equity dilution. Clean Lehman can be sold or remain a viable concern.

Risks:

Other firms will want to do the same thing.

Response: Can set the level of dilution high to make this less attractive. For example, if the Fed was given warrants giving it effectively 50% or more of the upside in Lehman going forward, this would deter others from pursuing this unless in extremis.

Why would Lehman do this?

Better than forced asset sales. Preserves franchise. No need for distressed sale of the entire company. Can find a medium-term solution.

If Lehman is solvent now, this preserve solvency. If Lehman is, in fact, insolvent now--even in the absence of forced asset sales--this limits degree of insolvency. Risk of not intervening early, Lehman is solvent now, becomes insolvent due to forced asset sales. Benefits of forced sale of firm under duress accrue to buyer, and large negative externalities to the broader market.

We could propose it to Lehman as a choice. Does not have to be coercive. If slide were to continue, what might have looked unattractive might increasing look attractive relative to the alternatives.

Best,
Bill