Steve,

See below. We keep coming up against the same quandary that we have discussed previously. I still think it is worth engaging the industry group, even though that is not without risks. We could cast it simply as CRMPG III follow-up on issues of long-standing interest to public sector as well as the private sector. At the same time, we could quietly drill down deeper at LB and perhaps at some other dealer that is not under a cloud, both to see the extent to which different business models present different problems and to be able to truthfully tell LB that they are not the sole source of concern, as they shouldn't be.

On the substance, the interesting question is whether it would be possible to stabilize the legal entity where most of an IB's OTC derivatives trades are booked. One potential problem is that defaults by affiliates would allow counterparties to terminate trades with the legal entity that we seek to stabilize. Cross default provisions presumably could allow counterparties to terminate trades with the legal entity. If so, how readily could the legal entity reestablish its hedges, even if the government recapitalized it or guaranteed its obligations? Another potential problem is that the legal entity may have large exposures to affiliates that are going under. Notwithstanding these potential problems, I think the place to start is with an understanding of the legal entities positions, hedges, and counterparty exposures.

As to timing, both Bill and I (and many others) are on vacation this week.

Reactions?

Pat

----- Forwarded by Patrick M Parkinson/BOARD/FRS on 08/19/2008 11:56 AM 
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Pat—we met with Lehman two days ago and have a draft of notes that have not been agreed upon. In any event, I don’t think we really got much new information that will push the agenda forward. My initial takeaway is that legal entity will drive the analysis and that aggregation of counterparties across legal entities will be the next level of analysis. As HaeRan indicated, to really get into possibilities, you would need to request master agreements which I believe would be a huge negative signal, and I would be very reluctant to take that step. In this connection, merely having the meeting with Lehman caused a stir in Lehman and we had to assure them that our questions were not institution specific, even as I noted that we did not have any other meetings yet scheduled with other institutions. Fortunately, there was an industry meeting on the subject the next day that indicated a broad interest in the subject. We were very careful to limit the meeting to 60 minutes. I would be very reluctant to drill deeper at Lehman at this point without a clear signal that our work involved other institutions in some way. Asking for the industry group (your suggestion) would seem to me to be less provocative than gathering info from a single firm. However, I certainly can see the point that asking for the industry group could spook the market, but going to a single firm is even less desirable in my view. Sorry I can’t be more helpful than this. Going on vacation next week, but will check for your emails. Cheers.

Patrick M
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08/15/2008 02:02
PM

To
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cc

Subject
Fw: Gameplan and Status to Date

See below. I worry that without gathering more info we will not come up with a sensible gameplan.

How are you coming with info gathering from Lehman?

Pat
----- Forwarded by Patrick M Parkinson/BOARD/FRS on 08/15/2008 01:56 PM
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Steven.Shafran@do
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My worry is that while this would make sense in a less stressed market, that the timing right now is problematic. If we ask, will we see anything in time to deal with some of the immediate issues that concern us? And by asking, are we signaling concerns that only exacerbate the issues?

My concern is we need a gameplan for a specific problem that we could be confronted with at any time.

steve

-----Original Message-----
From: Patrick.M.Parkinson@frb.gov [mailto:Patrick.M.Parkinson@frb.gov]
Sent: Friday, August 08, 2008 4:02 PM
To: Shafran, Steven
Cc: Arthur.Angulo@ny.frb.org; haeran.kim@ny.frb.org; Schaffer, Laurie; lucinda.brickler@ny.frb.org; Broome, Meredith; Theodore.Lubke@ny.frb.org; Til.Schuermann@ny.frb.org; William.BRODOW@ny.frb.org; Patrick.M.Parkinson@frb.gov
Subject: Re: Gameplan and Status to Date

I have been plowing through the CRMPG III (Corrigan III) report. Recommendation V-22 (p. 125) states that the industry should consider formation of a "default management group", composed of senior business representatives of major market participants (from the buyside as well as the sell-side) to work with regulatory authorities on an ongoing basis to consider and anticipate issues likely to arise in the event of a default of a major counterparty.

Would it be worth asking Corrigan to accelerate formation of this group and ask them what they see as the issues? We would of course need to be careful not to suggest concerns about any particular market participant, although they no doubt would draw their own conclusions.

Pat

Patrick M
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To                    RC 
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08/08/2008 09:47

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AM

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Subject

Gameplan and Status to Date
(Document link: Patrick M Parkinson)

Here is how I see the gameplan. Comments are welcome.

1. Identify activities of the firm whose liquidation under Chapter 11 could have a significant adverse effect on financial markets and the economy.

2. Gather additional information about those activities so as to assess more accurately the potential for liquidation to have such an effect.

3. Where we conclude the potential is serious, identify actions that the firm, its counterparties or the government could take to mitigate the risk.
With respect to government actions, consider both actions that could be taken under existing authority as well actions that would require legislative authorization.

4. Our preliminary view is that the principal investment bank activities that could entail systemic risk are tri-party repo borrowings and OTC derivatives activities. But we need to ask again whether they may be other such activities, including sec borrow/loan.

5. We have given considerable thought to what might be done to avoid a fire sale of tri-party repo collateral. (That said, the options under existing authority are not very attractive--lots of risk to Fed/taxpayer, lots of moral hazard.) We still are at the early stages of assessing the potential systemic risk from close-out of OTC derivatives transactions by an investment bank’s counterparties and identifying potential mitigants.

Pat

Patrick M
Parkinson/BOARD/F
RS
To
08/08/2008 09:15 AM

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Subject

Conference Call Participants
Are copied on this message.

Pat