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From: Wilkinson, Jim
Sent: Friday, September 12, 2008 3:35 PM
To: 'coxc@sec.gov'
Subject: Fw: FT - No Fed bail-out this time round

From: McLaughlin, Brookly
To: _DL_FYI
Sent: Fri Sep 12 15:21:33 2008
Subject: FT - No Fed bail-out this time round

FT - No Fed bail-out this time round

By Krishna Guha in Washington and Henny Sender in Hong Kong

Published: September 12 2008 15:28 | Last updated: September 12 2008 19:23

Six months ago the US authorities put $29bn of public money at risk to help secure a rescue takeover of failing investment bank Bear Stearns by JP Morgan Chase.

Today the Treasury and the Federal Reserve refuse to put any public money on the table to help close a rescue takeover for Lehman Brothers, even though it is also an investment bank and it is bigger than Bear was. So what has changed?

People familiar with the US authorities thinking highlight three important differences between the crisis at Lehman today and that at Bear in March.

First, Lehman's business mix differs from Bear's.

While Lehman is bigger than Bear, it is less deeply involved in the systemically important credit default swaps market and clearing system.

Second, while the crisis at Bear stunned the markets, other financial institutions have had six months to prepare for the possible failure of Lehman. In the Bear crisis, the risks were extreme in part because they were unknown and unmanaged.

The New York Fed has conducted extensive stress tests in order to attempt to evaluate the impact of a Lehman failure on markets such as the CDS market and it believes the systemic risk is quantifiable and lower than the risk that was posed by the imminent collapse of Bear back in March.

Regulators have also evaluated the risk mitigation strategies put in place by other banks and the authorities believe them to be robust.

That suggests the risk that a Lehman collapse could trigger a domino effect of failures at other financial institutions ought not to be great.

Third, the Fed now has in place an emergency liquidity facility to guard against the risk that Lehman could suffer the kind of sudden funding strike in the repo market that sank Bear.

This should ensure that if Lehman does collapse, it does so in a slower and relatively orderly fashion, allowing it to wind down business operations in a way that does not cause sudden shocks to markets.

"Bear Stearns happened so quickly," says a former Fed official. "At the time, there was no infrastructure to keep Bear alive.

"Now there is an infrastructure to prevent a disorderly liquidation with the Fed willing to lend against good collateral."

But there may be other factors at play as well, over and above those the authorities highlight.

The Fed – while believing to this day that it did the right thing with the Bear Stearns rescue – was nevertheless not keen to repeat its prominent role in that operation, which former chairman Paul Volcker said stretched its legal authority to the limit.

In subsequent months, Ben Bernanke, chairman of the Fed, has made it clear – with the full support of Hank Paulson, US Treasury secretary – that the decision to risk taxpayers funds must always be very clearly made by Treasury, and the Fed should in this respect act only as the Treasury's operational agent. Mr Paulson, meanwhile, fresh from his giant rescue takeover of Fannie Mae and Freddie Mac, and with an eye on demands by car makers for billions in government subsidies, has had to take into account the danger that another financial sector rescue would promote a bailout culture.

Several Washington-based experts have argued Lehman did not endear itself to the authorities by walking away from earlier rescue proposals because it felt the prices on offer were too low.

"Lehman may be the poster child for enough-is -enough," says a senior executive at a private equity firm that has been in talks with Lehman in regard to possible asset sales.

Policymakers want to get away from the notion there was a standard formula for resolving financial crises – ie. deploy public money to keep the debt whole once the equity is all but wiped out – knowing this has sponsored specific destabilising trades in financial markets.

The US government may judge that – with a record budget deficit looming next year and Fannie and Freddie's $5,400bn of liabilities now in public hands – its fiscal ammunition is not limitless, and it may be wise to keep some in reserve for what may prove to be many more such crises further down the road.

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