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Congress of the United States

House of Representatives

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

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SENSITIVE INFORMATION ENCLOSED:
This memorandum contains references to documents obtained from the Federal Reserve under subpoena which may be referenced at the hearing and should not be disclosed until the hearing.

To: Republican Members of the Committee on Oversight and Government Reform

From: Republican Staff, Committee on Oversight and Government Reform

Subject: Full Committee Hearing: "Bank of America and Merrill Lynch: How Did a Private Deal Turn Into a Federal Bailout?" – Part II

Hearing Date: Thursday, June 25, 2009, 10:00 a.m.

On Thursday, June 25, 2009, at 10:00 a.m., in room 2154 of the Rayburn House Office Building, the Committee will hold a hearing entitled, "Bank of America and Merrill Lynch: How Did a Private Deal Turn Into a Federal Bailout?" This is the second in a series of hearings the Committee plans to hold on this subject.

The Majority Staff Memorandum lays out background information about the hearing, which will feature just one witness, Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve. This memorandum includes supplemental information, including excerpts from internal Federal Reserve documents reviewed by Committee staff at the Federal Reserve and obtained under subpoena.[1] It lays out the key questions to be addressed at the hearing as well as the Minority's views about the critical issues related to this matter.

Background

On September 15, 2008, Bank of America announced its intention to merge with Merrill Lynch. However, Merrill's condition deteriorated rapidly as the financial crisis deepened. Shortly before Thanksgiving, Merrill's after-tax losses for the 4th quarter of 2008 had increased to over $9 billion. However, Bank of America decided to proceed with the deal and the two companies' shareholders voted to approve it on December 5.[2] By mid-December, however, Merrill's after-tax losses ballooned to about $14 billion and, on

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[1] All excerpts of Federal Reserve documents referenced in this memorandum have been produced from in camera reviews by Committee staff at the Federal Reserve.

[2] *See* Dan Fitzpatrick, Susanne Craig and Deborah Solomon, "In Merrill Deal, U.S. Played Hardball," *The Wall Street Journal*, (February 5, 2009).

December 17, Bank of America's CEO, Ken Lewis, called Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke, informing them of his intention to exercise a Material Adverse Change clause ("the MAC clause") in the contract to get out of the deal.[3] Ultimately, however, Bank of America went ahead with the merger, which was consummated on January 1, 2009. In the end, Merrill Lynch's 4th quarter losses exceeded $15 billion.[4]

On April 23, 2009, New York State Attorney General Andrew Cuomo sent a letter to Members of Congress in which he alleged that Ken Lewis, under duress from the Treasury and the Federal Reserve, may have violated his fiduciary responsibility to Bank of America's shareholders in the interest of the larger U.S. financial system. These allegations were based on testimony received by Cuomo from Ken Lewis in connection to an investigation into bonuses awarded at Merrill Lynch in which Lewis seemed to admit that, under government pressure, he acceded to a merger with Merrill Lynch that, in the short term, was not in the best interests of his own shareholders.[5]

Pursuant to the Oversight and Government Reform Committee's subpoena of internal Federal Reserve documents, staff uncovered emails which show that Messrs. Paulson and Bernanke threatened to fire Lewis and the entire Bank of America board if they chose to exercise the MAC clause. On June 11, 2009, the Committee received testimony from Lewis in which he admitted that the government's threat to fire him and his board "was a strong influence on [his] decision," not to exercise the MAC clause.[6] This revelation raises a critical issue: whether or not officers of the federal government improperly exercised their power under the U.S. Constitution to compel one private sector firm to merge with another private firm. In the current climate of deepening government intervention in the private sector and Administration proposals to give the Federal Reserve even more authority to regulate any company in the country it deems "systemically significant," there can be few more important questions than whether the Federal Reserve and the Treasury overstepped their authority and abused their power.

At this hearing, the Committee will be able to question Federal Reserve Chairman Ben Bernanke directly about his role in the Bank of America-Merrill Lynch merger, whether he personally threatened to fire Bank of America's management directly, and whether this threat was an appropriate use of government authority. His answers to these questions will provide an important opportunity to consider whether the Administration's proposal to give him and the Federal Reserve even more power is wise.

Never Let a Crisis Go to Waste: The Great Bush-Obama Economic Intervention

The financial crisis of 2008 had its roots primarily in ill-conceived government policies. Many economists argue that the Federal Reserve under the leadership of Alan Greenspan and Ben Bernanke kept interest rates too low for too long after the recession of 2001, fueling a massive asset bubble in housing.[7] Added to this were government "affordable housing" policies which pushed the government-sponsored enterprises, Fannie Mae and Freddie Mac, to support a boom in risky and unsustainable mortgage lending.[8] The collapse of this bubble was the catalyst for the financial crisis.

Given the role of government policies in creating the conditions for the housing bubble which caused the financial crisis, it is remarkable that the prescription of the Bush Administration and the Democratic Congress was more government intervention in the economy. Yet under pressure from House Democrats

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[3] *See* document, *Analysis of Bank of America & Merrill Lynch Merger*, (December 21, 2008), Bates BOG-BAC-ML-COGR-00036 to BOG-BAC-ML-COGR-00076.
[4] *See* letter, Andrew Cuomo, Attorney General of the State of New York, (April 23, 2009).
[5] *Id*.
[6] *See* transcript, *Bank of America and Merrill Lynch: How Did a Private Deal Turn into a Federal Bailout?* (June 11, 2009).
[7] *See* John B. Taylor, *Getting Off Track: How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis*, Stanford, CA: Hoover Institution Press, (2009).
[8] *See* staff report, Committee on Oversight and Government Republicans, (forthcoming).

such as Nancy Pelosi and Barney Frank, Bush Treasury Secretary Paulson partially nationalized the U.S. banking sector, despite his own misgivings about the inevitably perverse consequences to follow.[9]

On October 13, 2008, Paulson summoned the top executives of the nation's nine largest banks to a meeting at the Treasury Department.[10] Bernanke was present at the meeting along with Federal Reserve Bank of New York President Timothy Geithner and Federal Deposit Insurance Corporation Chairman Sheila Bair. According to government documents obtained by the group Judicial Watch, media reports, and Ken Lewis' testimony at the June 11 hearing, these government officials forced the nine banks to take Troubled Asset Relief Program ("TARP") money appropriated by Congress whether they wanted it or not.[11] In exchange, the Treasury received preferred shares and warrants in the banks, giving the government partial ownership stakes.

The Bush Administration ultimately used $700 billion in TARP money to buy stakes in over 500 U.S. banks. It did not stop with a partial nationalization of the banking sector, however. Bush committed to spend up to $200 billion to bail out Fannie Mae and Freddie Mac and used TARP money to purchase an 80% stake in AIG for $40 billion and began the process of nationalizing GM and Chrysler. The Obama Administration has not missed a stride. Indeed, it has tremendously accelerated government intervention in the economy. President Obama has fully nationalized GM and Chrysler, providing them $56 billion in assistance, passed a $787 billion "stimulus" bill based on outdated Keynesian economic theories, doubled taxpayers' exposure to Fannie and Freddie to $400 billion, and proposed a $3.6 trillion federal budget including a nationalized health care system and a national energy tax on carbon.

As disturbing as this on-balance sheet fiscal expansion is to the American people, of equal concern should be the off-balance sheet explosion of U.S. debt, in which the Federal Reserve has played the primary role. Under a clause in the Federal Reserve Act that gives the Fed authority to act in "unusual and exigent circumstances," Bernanke more than doubled the Fed's balance sheet in just eight months. Among the actions taken, he has lent $29 billion to facilitate the sale of Bear Stearns to JPMorgan Chase, over $120 billion to AIG, guaranteed $306 billion of assets at Citigroup and up to $118 billion of assets at Bank of America, purchased over $450 billion of Fannie Mae and Freddie Mac mortgage-backed securities, and monetized the U.S. debt by directly purchasing Treasury bonds. At the same time, he has kept real interest rates down near zero, with the result that the U.S. monetary base has increased by over 100%, the largest percentage increase in the last 50 years by a factor for 10 (see graph on next page).[12]

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[9] *See* Deborah Solomon, Damian Paletta, Michael M. Phillips, and Jon Hilsenrath, "U.S. to Buy Stakes in Nation's Largest Banks," *The Wall Street Journal*, (October 14, 2008).
[10] The banks were: Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, JPMorgan Chase, Merrill Lynch, Morgan Stanley, State Street, and Wells Fargo.
[11] *See* http://www.judicialwatch.org/news/2009/may/judicial-watch-forces-release-bank-bailout-documents.
[12] *See* Arthur B. Laffer, "Get Ready for Inflation and Higher Interest Rates," *The Wall Street Journal*, (June 10, 2009).

This is a profoundly disturbing trend, as it demonstrates a complete disregard of the lessons learned during the last great inflationary recession, when Fed Chairman Paul Volcker and President Ronald Reagan had to stop inflationary trends that caused prime interest rates to reach 21.5% by reigning in expansionary Keynesian monetary policy. In order to prevent massive inflation and a collapse of the dollar this time, the Bernanke Fed will need to contract the monetary supply before it is too late. Unfortunately, Bernanke's past track record gives no confidence that he will be able to do so. In 2003, with third quarter GDP growth of 8.2% (later restated to 7.5%) and rapidly rising commodity prices, Bernanke refused to see the inflationary writing on the wall, advocating for a continuation of the loose monetary policies that, as mentioned, helped to create the housing bubble and subsequent financial crisis.[13]

<u>Bernanke and Paulson Threaten to Fire Ken Lewis and His Board</u>

While government regulators are properly concerned with the overall health of the economy and the financial system, in the case of the Bank of America merger with Merrill Lynch, government officials crossed the line by applying inappropriate pressure on a private institution to go through with a business deal. This is extensively documented both in internal Federal Reserve emails and in the minutes of Bank of America's board meetings.

Bank of America's CEO, Ken Lewis, first called the government on December 17, 2008, to indicate that he was thinking about getting out of the Merrill deal by exercising the MAC clause. In response, Treasury Secretary Henry Paulson threatened to fire Lewis and the entire Bank of America Board of Directors.[14] According to Paulson, he made this threat at the request of Bernanke.[15] This is supported by an email from Jeffrey Lacker, an employee of the Richmond Federal Reserve:

[13] *See* "Bernanke at the Creation," *The Wall Street Journal*, (June 23, 2009).
[14] *See* testimony to the New York State Attorney General, Kenneth Lewis, (February 26, 2009).
[15] *See* note 4, *supra*.

> Just had a long talk with Ben [Bernanke]. Says that they think the MAC threat is irrelevant because its not credible. Also intends to make it even more clear that if they play that card and they need assistance, management is gone.[16]

This is confirmed by the minutes of Bank of America's Board meeting, which state that:

> [T]he Treasury and Fed stated strongly that were the Corporation to invoke the material adverse change ("MAC") clause in the merger agreement with Merrill Lynch and fail to close the transaction, the Treasury and Fed would remove the Board and management of the Corporation.[17]

Furthermore, by Lewis' own admission at the June 11 Committee hearing, Paulson may not have had the authority to directly fire Lewis, but Bernanke certainly did in his capacity as Chairman of the organization that regulates bank holding companies, which would surely have given such a threat by Bernanke more immediate credibility.

Bernanke also demonstrated the Fed's intent to take adverse regulatory actions against Bank of America if it pulled the MAC clause, although this may or may not have been explicitly threatened based on the emails reviewed by Committee staff. In an email, Ben Bernanke expressed his view that exercising the MAC clause would hurt Bank of America's relationship with its regulators:

> I think the threat to use the MAC is a bargaining chip, and we do not see it as a very likely scenario so that we can explain to [Bank of America] with some confidence why we think it would be a foolish move and why **the regulators will not condone it** [emphasis added].[18]

These threats amounted to a gun placed to the head of Bank of America to go through with the merger and an abuse of government power.

The argument that a Bank of America withdrawal would have been very bad for Merrill Lynch and its shareholders is indisputable. The markets would surely have perceived it as a strong vote of no-confidence in Merrill Lynch. An internal Federal Reserve analysis of both companies, conducted by the investment management firm PIMCO, found that Merrill Lynch's, "deterioration has been substantially worse than" Bank of America'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."[19]

However, there appears to be room for debate as to whether it would not have been in the best interests of Bank of America's shareholders to abandon the deal. While Bernanke, Paulson and others in the government argued that the markets would punish Bank of America for pulling the MAC clause, at least one Federal Reserve Bank of New York employee also questioned the government's contention that a withdrawal from the Merrill Lynch merger would be disastrous for Bank of America and its shareholders. In response to an email containing draft "talking points" for the government's discussions with Bank of America, the New York Fed's Adam Ashcraft expressed his view that the statement, "A collapse of the

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[16] *See* email, Jeffrey Lacker, Federal Reserve Bank of Richmond, (December 20, 2008), Bates BOG-BAC-ML-COGR-00020.
[17] *See* minutes of the Special Meeting of Board of Directors, Bank of America Corporation, (December 22, 2008).
[18] *See* email, Ben Bernanke, Chairman, Federal Reserve Board of Governors, (December 21, 2008), Bates BOG-BAC-ML-COGR-00019.
[19] *See* note 3, *supra*.

merger will have dire consequences for Merrill Lynch, and will likely have a severe adverse effect on Bank of America as well," was "a little over the top."[20] He went on to say:

> I think [sic] equally possible that the market looks at Merrill's 2008 [fourth quarter losses] and sees [Bank of America] making a smart move by walking away from a Black Hole into which large amounts of time, effort, and money would have been going. In other words, it is not clear that the market reaction to [Bank of America] is so clearly negative. It might be, but a little more balance here might be worthwhile.[21]

While it is true that Bank of America's own losses also accelerated rapidly in December, they remained about seven times smaller than Merrill's. PIMCO's analysis concluded that, as of December 21, Bank of America's after-tax quarterly net loss was about $1.4 billion, which "represents more than four times management's projected losses from just two weeks ago."[22] Mounting losses at Bank of America would make it even more desirable for the company to extricate itself from the Merrill Lynch merger.

<u>Bernanke and Paulson Seek to Control the Disclosure of Merrill's Losses</u>

Bernanke, Paulson and Lewis have all taken great pains to deny that the government pressured Bank of America or Merrill Lynch to violate federal securities laws by not disclosing material information to their shareholders. While none of the documents reviewed by Committee staff at the Federal Reserve show that government officials explicitly instructed Bank of America employees to not disclose the dramatically accelerating losses at Merrill Lynch, internal emails reveal at least the intent to influence disclosure decisions in order to allow the government to manage the situation.

Although both Bernanke and Paulson gave verbal assurances to Ken Lewis of additional taxpayer capital injections and asset guarantees to sweeten the merger in exchange for Lewis's agreement to drop the MAC clause threat, the government refused to put this into writing. In an email, Jeffrey Lacker of the Federal Reserve Bank of Richmond said:

> Spoke with [Bernanke] and he confirmed [Lewis's] appeal for a letter committing to future support, which was denied. His sense is that [Lewis] is just generally anxious about the merger, not trying to shake anyone down."[23]

Bernanke and Paulson insisted that Lewis rely solely on their verbal assurance of more support because, as Paulson told Lewis, a written pledge "would be a disclosable event and we do not want a disclosable event."[24] Bernanke and Paulson were concerned that disclosure of the government's commitment to provide additional support to Bank of America would expose Merrill's mounting losses and prompt a run on both banks. Therefore, while the government never instructed Ken Lewis to violate the law by not disclosing Merrill's losses to his shareholders, the government also went to great lengths to avoid creating a "disclosable event" in the first place. Thus the government's actions helped to ensure that information about Merrill's mounting losses was not revealed to Bank of America's shareholders or the American people.

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[20] *See* email, Adam B. Ashcraft, Federal Reserve Bank of New York, (December 21, 2008), Bates BOG-BAC-ML-COGR-000120.
[21] *Id*.
[22] *See* note 3, *supra*.
[23] *See* email, Jeffrey Lacker, Federal Reserve Bank of Richmond, (December 23, 2008), Bates BOG-BAC-ML-COGR-000128.
[24] *See* testimony to the New York State Attorney General, Kenneth Lewis, (February 26, 2009).

Nevertheless, some Fed employees naturally expected that, given the severity of the losses at Merrill Lynch, Bank of America's management may be required to report those losses to its shareholders. In an email, Kevin Stiroh of the New York Fed asked:

> How confident are we that we have until [the Bank of America earnings announcement on] 1/20? Given the increase in [Merrill Lynch's] losses and [the] difference from expectations, there might be pressure for a pre-announcement to investors and analysts. Has this been discussed and ruled out by the companies? The concern about drawing attention to [Bank of America] is fair, but the upside is for the [U.S. Government] to be ahead of the curve and not appear so reactive.[25]

Another email from Federal Reserve Bank of New York employee Arthur Angulo to New York Fed General Counsel Thomas Baxter also demonstrates the government's concern to control the flow of information to the public. In this email, Mr. Angulo says he will call Merrill Lynch's Chief Financial Officer Nelson Chai:

> I'll ask about: [Merrill Lynch's] current estimate of [4th Quarter] loss[es] v[ersus] market expectations and whether and when [Merrill Lynch] intends to file an 8-K. **If I get a sense that [Merrill Lynch] is leaning toward an early January filing, I'll try to steer him toward a later filing. If I get a sense that [Merrill Lynch] is committed to an early January filing, I'll ask for a follow-up discussion with appropriate securities counsel at [Merrill Lynch] to gain a better sense as to the amount of flexibility [Merrill Lynch] has in this regard** [emphasis added]**.**[26]

This attempt to manage the disclosure situation was mooted when it became clear that Merrill Lynch had intended all along to defer responsibility to publicly disclose its mounting losses to Bank of America, as demonstrated in the following email from Merrill's Chief Financial Officer to Merrill CEO John Thain:

> Had a call with art angelo [sic] at fed, had a quick discussion on where we are quarter to date. His hope is that there is no disclosure prior to [Bank of America] quarterly announcement. We told him this was the current plan. He asked [sic] this course changes [sic] and we planned on issuing an 8k on [Merrill Lynch] stand alone to alert him.[27]

While Merrill's existing public disclosure plan happened to conform to the government's wishes, this does not alter the fact that some within the Federal Reserve clearly intended to control the timing of public disclosure. The government's reason to do so is rational if one accepts the premise that the government's proper role in the crisis was to succeed in propping up failing financial institutions. An untimely disclosure of Merrill Lynch's huge 4th quarter losses would have started a run on the investment bank, greatly complicating the government's attempts to engineer a bailout. However, this does not answer the question of whether the government had already exceeded its authority in preserving the existing financial system at tremendous taxpayer expense.

The Federal Reserve Keeps Other Government Regulators in the Dark

The Federal Reserve apparently sought to control the disclosure of information about the Bank of America-Merrill Lynch merger to other government regulators as well, including the Office of the Comptroller of the Currency ("OCC") and the Securities and Exchange Commission ("SEC"). Media reports indicate that Paulson told New York Attorney General Cuomo that he intentionally kept SEC Chairman Christopher Cox

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[25] *See* email, Kevin Stiroh, Federal Reserve Bank of New York, (December 28, 2008), Bates BOG-BAC-ML-COGR000217.
[26] *See* email, Arthur Angulo, Federal Reserve Bank of New York, (December 22, 2008), Bates BOG-BAC-ML-COGR-000127.
[27] *See* email, Nelson Chai, Merrill Lynch, (December 22, 2008), Bates HOC-DPS-00002097.

out of the loop about his and Bernanke's efforts to force Bank of America to carry through with the Merrill merger.[28]

This has been confirmed by Committee staff review of internal Fed emails. It was not until January 11, 2009, three weeks after Ken Lewis was forced to abandon the notion of pulling a MAC clause, that the SEC finally got wind of what had transpired and the following exchange took place between an employee of the Federal Reserve Bank of New York and the General Counsel of the Federal Reserve Board in Washington:

> Have we conveyed anything to the SEC re the [Bank of America] situation? I [received] an e-mail and follow up [voicemail] from [an SEC employee] on Friday evening…Based on his [voicemail], he knows something is up…I intend to give him the broad outlines, but before doing so I wanted to check to [see] how much (if anything) has been shared with the SEC…"[29]

The reply came about 30 minutes later:

> I have not discussed this with the SEC. [Bank of America] has complained that someone did talk to the SEC, with the result that the SEC called late last week to say they heard [Bank of America] was negotiation [sic] a Citi type deal with the [U.S. Government] and to ask [Bank of America] to explain the unexpectedly high losses at [Merrill Lynch]…So I agree you should give him the broad and tentative outlines.[30]

Even the OCC, Bank of America's direct regulator, was kept in the dark by Federal Reserve employees when it came to the Fed's negotiations with Ken Lewis over the MAC clause. In one exchange, Fed employees refer to an upcoming conference call in which they express their interest in withholding Bank of America's negotiations with the government over the MAC:

> Given the presence of the OCC on the call, I think we should not discuss or reference the call with Ken Lewis and Paulson.[31]

The reply came:

> Agree. Also not the MAC discussion.[32]

Given the Obama Administration's proposal to vastly expand the Federal Reserve's financial regulatory power over virtually any economic actor as well as its putative commitment to transparency and accountability, the Fed's willingness to keep key regulatory partners such as the SEC and OCC in the dark raises important questions about its willingness as an organization to work collaboratively with its partners in the federal government.

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[28] *See* "Busting Bank of America," *The Wall Street Journal*, (April 28, 2009).
[29] *See* email, Arthur Angulo, Federal Reserve Bank of New York, (January 11, 2009), Bates BOG-BAC-ML-COGR000254.
[30] *See* email, Scott Alvarez, Federal Reserve Board of Governors, (January 11, 2009), Bates BOG-BAC-ML-COGR000254.
[31] *See* email, Brian Peters, Federal Reserve Bank of New York, (December 19, 2008), Bates BOG-BAC-ML-COGR000308.
[32] *See* email, Jennifer Burns, Federal Reserve Bank of Richmond, (December 19, 2008), Bates BOG-BAC-ML-COGR000308.

Timothy Geithner's Role in Government Intervention Remains Non-Transparent

While Paulson and Bernanke appear to have been the principal actors in interventionist government policies during the waning days of the Bush Administration, the seamless transition from the Bush to the Obama Administrations leads one to question the role that Treasury Secretary Timothy Geithner played as well.

We know that Geithner was in the room at the infamous October 13 meeting at which Paulson forced nine banks to take $125 billion in TARP money, according to the "talking points" obtained by Judicial Watch, Inc. under a Freedom of Information Act ("FOIA") request.[33] However, the Treasury Department redacted multiple versions of Paulson's "talking points" in draft. Among the redacted drafts that remain hidden from public disclosure is a version containing Geithner's "suggested changes."[34]

Geithner was also fully briefed and involved in the Bank of America-Merrill Lynch discussions in mid-December. One document that demonstrates this is an email Geithner sent on December 20 – one day before Lewis backed down from the MAC threat –
recording what appears to have been a discussion with Paulson on Bank of America pulling a MAC. It reads in part:

> BofA/ML [i.e., Bank of America/Merrill Lynch]. Can't MAC. Have to close. Maybe more time than 1/1.[35]

On that same day, Geithner emailed Federal Reserve Governor Kevin Warsh to ask him:

> Are you all over [Bank of America/Merrill Lynch] and are you getting what you need from the troops?[36]

Warsh responded that, in his opinion:

> [the] [b]igger issue is Treas[ury] – who is undermanned and less than crisp in their views.[37]

Not only do these exchanges make it clear that Geithner was fully briefed and engaged in the Bank of America-Merrill Lynch merger issue, they also speak to the Federal Reserve's view of itself as in the driver's seat when it came to the government's response to Ken Lewis's desire to pull the MAC clause. Furthermore, this adds credence to the theory that Bernanke led the effort to threaten to fire Lewis.

Documents previously released by Bank of America also attest to Geithner's involvement in the government's efforts to pressure Bank of America to go through with the Merrill Lynch merger. In handwritten notes, Bank of America's Chief Financial Officer, Joe Price, chronicled a conversation between Ken Lewis and Henry Paulson regarding Lewis's desire to pull the MAC clause. The notes include the comments: "Fire BOD if you do it – irresp[onsible] for country. Tim G. agrees."[38]

The Fed's "Systemic Risk" Obsession: "Nationalization Here We Come"

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[33] *See* note 11, *supra*.
[34] *See* http://www.judicialwatch.org/files/documents/2009/TreasuryDocsPart3.pdf at 36.
[35] *See* email, Timothy Geithner, Federal Reserve Bank of New York, (December 20, 2008), Bates BOG-BAC-ML-COGR000309.
[36] *See* email, Timothy Geithner, Federal Reserve Bank of New York, (December 20, 2008), Bates BOG-BAC-ML-COGR000310.
[37] *See* email, Kevin Warsh, Federal Reserve Board of Governors, (December 20, 2008), Bates BOG-BAC-ML-COGR000310.
[38] *See* notes, Joe Price, Bank of America, (December 21, 2008), Bates HOC-DPS-00002107.

The Federal Reserve's justification for forcing a "shotgun wedding" between Bank of America and Merrill Lynch was predicated on the notion that if Merrill Lynch failed, "systemic risk" would cause the other dominoes in the financial system to fall. Whether something called "systemic risk" even existed in relation to the collapse of an investment bank like Merrill remains an open question, in spite of what Bernanke may assert.[39] If, for the sake of argument, however, one accepts the "systemic risk" justification for limitless federal bailouts, it must be pointed out that the actions of Messrs. Paulson and Bernanke actually spread that risk even further by forcing Bank of America to merge with Merrill Lynch.

The Wall Street Journal pointed out that, "[i]n order to save a Wall Street brokerage, the feds spread the risk to one of the country's largest deposit-taking banks." The *Journal* rightly noted that if Paulson and Bernanke "were convinced that Merrill had to be saved, then they should have made the public case for it."[40] Instead, they used the furtive threat to fire the management of Bank of America in order to spread the risk of Merrill's toxic assets among Bank of America's shareholders, its depositors, and the American taxpayers.

The ultimate commitment of Messrs. Paulson and Bernanke to prop up Merrill Lynch by any means is made even clearer by internal Fed documents. In response to an inquiry from the United Kingdom's Financial Services Authority one day prior to the shareholder vote on the merger, a Federal Reserve Bank of Richmond employee wrote:

> We have had recent discussions with [Bank of America] and [Merrill Lynch] management who contend that they have the required shareholder support and are confident that the transaction will be approved with tomorrow [sic] vote. If approval is withheld, [Merrill Lynch] would continue to have access to the various facilities and programs currently in place in the US. Additionally, it is reasonable to expect that [Merrill Lynch] would be provided support necessary to preclude significant systemic disruption.[41]

The government's commitment to prop up Merrill Lynch even if Bank of America successfully backed out of the deal is revealed by the Fed's contingency planning to provide additional backing to the troubled investment bank once Lewis raised the prospect of a MAC. In a document entitled "Contingency Actions re MER Should BAC Refuse to Consummate Acquisition," the Federal Reserve said:

> In the event that [Bank of America] were to abruptly announce that it does not intend to consummate its acquisition of [Merrill Lynch] on January 1, 2009, [Merrill Lynch] would face an immediate run. Emergency liquidity provision actions that could be taken to provide some time for the sale/disposition of [Merrill Lynch] businesses and assets include the following…[42]

The document goes on to list options including an expansion of Merrill's access to Federal Reserve lending and an emergency conversion to a bank holding company, which would give Merrill access to additional federal backing, including FDIC deposit guarantees.[43]

Internal documents show that not everyone was fully on board with the Federal Reserve's "systemic risk" obsession, however. For example, the FDIC continued to have serious reservations about the justification for providing massive new taxpayer support to Bank of America in order to cover Merrill Lynch's toxic

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[39] *See* Peter J. Wallison, "Systemic Risk and the Financial Crisis," *American Enterprise Institute*, (October 2008).
[40] *See* note 28, *supra*.
[41] *See e*mail, Jennifer Burns, Federal Reserve Bank of Richmond, (December 4, 2008), Bates BOG-BAC-ML-COGR-000116.
[42] *See d*ocument, "Contingency Actions re MER Should BAC Refuse to Consummate Acquisition," attached to an email, Arthur Angulo, Federal Reserve Bank of New York, (December 21, 2008), Bates BOG-BAC-ML-COGR-000123.
[43] *Id*.

assets. In an email, Deborah Bailey of the Federal Reserve Board in Washington tacitly acknowledged that the Bernanke Fed was out on a limb. She told the Fed's General Counsel, Scott Alvarez, that:

> Based on my experience with the FDIC, they are much more likely to make a decision **after the evidence of instability actually exist** [emphasis added].[44]

While most observers would likely join the FDIC in demanding actual evidence of "systemic risk" before abusing government power and committing hundreds of billions of dollars of taxpayer money, Bernanke apparently did not. Indeed, FDIC Chairman Sheila Bair, in an email to Bernanke on this topic, wrote:

> Dear Ben, Strong discomfort with this deal at the FDIC, for all of the reasons you and I have discussed…My board does not want to do this, and I don't think I can convince them to take losses beyond the proportion of assets coming out of the depository institutions.[45]

Perhaps most troubling, however, is the apparent dissension at the top of the Federal Reserve's own ranks regarding the bailout of Bank of America and its impact on the Fed's balance sheet. In an email from Fed Governor Kevin Warsh to General Counsel Scott Alvarez, Warsh asked Alvarez if he had approached William Dudley and Brian Madigan of the New York Fed about a Bernanke idea related to the Bank of America bailout: "[S]cott[,] are you running trap with dudley and Madigan on chairman idea?"[46] A few hours later, Fed Vice-Chairman Donald Kohn, who had been copied on the email, chimed in:

> [G]ot to admit [I] didn't really grasp his suggestion, though the motivation could be troublesome. A lot of what's under discussion, including agg[r]egator bank or Citi like wrap would involve at least the pot[en]tial for FR [Federal Reserve] balance sheet in size.[47]

Despite protests from Fed employees and the FDIC's Sheila Bair, Bernanke and Paulson got their way. The response to the announcement of Bank of America's bailout was poignantly summed up by a New York Fed employee when she said: "And there you have it. Nationalization here we come."[48]

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[44] *See* email, Deborah Bailey, Federal Reserve Board of Governors, (January 14, 2009), Bates BOG-BAC-ML-COGR000324
[45] *See* email, Sheila Bair, Federal Deposit Insurance Corporation, (January 14, 2009), Bates BOG-BAC-ML-COGR000256.
[46] *See* email, Kevin Warsh, Federal Reserve Board of Governors, (December 29, 2008), Bates BOG-BAC-ML-COGR000315.
[47] *See* email, Donald Kohn, Federal Reserve Board of Governors, (December 29, 2008), Bates BOG-BAC-ML-COGR000315.
[48] *See* email, Patricia Mosser, Federal Reserve Bank of New York, (January 16, 2009), Bates BOG-BAC-ML-COGR000327.