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7-1-2008

Federal Reserve Bank Email from Patrick M Parkinson to Scott Alvarez Re Our Options in the Event of a Run on Lehman Brothers

Patrick M. Parkinson

Scott G. Alvarez

Brian Madigan

Ben S. Bernanke

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From: [Patrick M Parkinson](#)
To: [Scott Alvarez](#)
Cc: [Brian F Madigan](#)
Subject: Re: Fw: Our Options in the Event of a Run on LB
Date: 07/21/2008 09:45 AM

I think it would be workable and helpful if you thought it was legal. But it would seem to require the authority to borrow.

Pat

▼ [Scott Alvarez/BOARD/FRS](#)

**Scott
Alvarez/BOARD/FRS**

To: Patrick M Parkinson/BOARD/FRS@BOARD
cc: Brian F Madigan/BOARD/FRS@Board
07/21/2008 09:43 AM Subject: Re: Fw: Our Options in the Event of a Run on LB 

We don't have general authority to borrow. And it would be hard to argue that this is within our section 14 open-market authority, since it seems designed to finance an extension of credit rather than to conduct monetary policy. If we want to pursue this, is there a time we could talk about this approach and its merits. It's not obvious to me that this scheme is workable from a practical point of view or helpful from a reserves point of view. And then there are the legal issues.

Thanks!

Scott

▼ [Patrick M Parkinson/BOARD/FRS](#)

**Patrick M
Parkinson/BOARD/FRS**

To: Scott Alvarez/BOARD/FRS@BOARD
cc: Brian F Madigan/BOARD/FRS@BOARD
07/21/2008 09:20 AM Subject: Re: Fw: Our Options in the Event of a Run on LB 

We lend to LB against non-OMO collateral, then we turn around and borrow against the same collateral, presumably from other PDs. The institutional investors who had fled LB presumably would fund the other PDs.

Do we have authority to borrow from PDs against non-OMO collateral or, for that matter, against OMO collateral?

Pat

▼ [Scott Alvarez/BOARD/FRS](#)

**Scott
Alvarez/BOARD/FRS**

07/21/2008 09:16 AM

To Patrick M Parkinson/BOARD/FRS@BOARD
cc Brian F Madigan/BOARD/FRS@Board
Subject Re: Fw: Our Options in the Event of a Run on LB 

Not sure we do have legal authority. How would this work?

Scott

▼ [Patrick M Parkinson/BOARD/FRS](#)

**Patrick M
Parkinson/BOARD/FRS**

07/21/2008 08:53 AM

To Brian F Madigan/BOARD/FRS@BOARD
cc Scott Alvarez/BOARD/FRS@BOARD
Subject Re: Fw: Our Options in the Event of a Run on LB 

Never have looked at it. Wasn't aware we had the authority to do reverse repos involving non-OMO collateral.

Pat

▼ [Brian F Madigan/BOARD/FRS](#)

**Brian F
Madigan/BOARD/FRS**

07/21/2008 08:51 AM

To Scott Alvarez/BOARD/FRS@BOARD, Patrick M
Parkinson/BOARD/FRS@BOARD
cc
Subject Fw: Our Options in the Event of a Run on LB

Scott and Pat,

I don't know that we did look at this reverse repo strategy. I would think that this would involve a number of legal issues.

Brian

----- Forwarded by Brian F Madigan/BOARD/FRS on 07/21/2008 08:49 AM -----

Chairman Bernanke

07/21/2008 08:47 AM

To Brian.F.Madigan@frb.gov
cc Donald.L.Kohn@frb.gov, Kevin.Warsh@frb.gov,
Patrick.M.Parkinson@frb.gov, scott.alvarez@frb.gov

Subject Re: Our Options in the Event of a Run on LB 

We also have the reverse repo strategy, don't we? Lend against non-OMO collateral, then repo it back to the market, effectively making the Fed the central counterparty. Did we explore this option?

▼ Brian.F.Madigan@frb.gov

Brian.F.Madigan@frb.gov

07/20/2008 01:46 PM

To Donald.L.Kohn@frb.gov
cc Chairman Bernanke Kevin.Warsh@frb.gov,
Patrick.M.Parkinson@frb.gov, scott.alvarez@frb.gov
Subject Re: Our Options in the Event of a Run on LB

Bill or Debby Perelmuter would be able to speak more authoritatively to how firm their commitment is. I think it is a serious commitment. We have a letter from the Treasury, and Treasury and the Fed have been working out a set of talking points. One of those points says "The Treasury will conduct these bill auctions [auctions to raise the necessary funds] consistent with the needs of the Federal Reserve Bank of New York." Of course, there is also language that indicates that the final decisions are the responsibility of the Secretary.

Donald.L.Kohn@frb.gov

07/20/2008 01:39 PM

Patrick.M.Parkinson@frb.gov

To

cc

Chairman Bernanke

v,

scott.alvarez@frb.gov

Subject
Re: Our Options in the Event of a Run on LB

there's that capacity issue again. Brian, how firm is our agreement with the Treasury to boost their balances? Of course they would be constrained by the debt limit. We'll have to see how that turns out. Reinforces the urgency of some version of interest on reserves.

Patrick.M.Parkins

on@frb.gov

07/20/2008 12:42
PM

Chairman Bernanke

Kevin.Warsh@frb.gov,
scott.alvarez@frb.gov,
brian.f.madigan@frb.gov

To

cc

Subject
Our Options in the Event of a Run
on LB

The short answer is the one that Tim gave to the FOMC on Wednesday: There are no good options.

Here is my version of the long answer.

Focusing for the moment on LB's vulnerable tri-party borrowings, as of July 14 it was financing \$200 billion of collateral. Of that amount, all but \$12.8 billion was PDCF-eligible. Of the non-PDCF-eligible, \$8.7 billion was equities.

JPMC, LB's clearing bank, is likely to be the first to realize that the money funds and other investors that provide tri-party financing to LB are pulling back significantly. If some morning it fears that the investors are unlikely to roll their repos, it may threaten not to unwind LB's previous night's repos. If it did that, LB would be done because the tri-party investors would control its securities inventory. The investors presumably would promptly liquidate the \$200 billion of collateral and there is a good chance that investors would lose confidence in the tri-party mechanism and pull back from funding other dealers. Fear of those consequences is, of course, why we facilitated Bear's acquisition by JPMC.

We could try to dissuade JPMC from refusing to unwind by pointing out that if the investors don't roll the repos LB can borrow from us through the PDCF. Even if we did so, for two reasons JPMC might still balk. The first is the non-PDCF collateral. We could address that concern by making the equities and other non-PDCF collateral eligible. Or we could try to get LB to wire \$12.8 billion of cash into JPMC to cover the rollover risk. The other reason is a fear that LB could be placed in bankruptcy intra-day, before the next day's tri-party repos and any PDCF loans are settled, in which case JPMC would be stuck with \$200 billion in secured loans to LB. I'm not sure that this is at all likely, but JPMC and BNYM are sufficiently concerned that they have arranged a meeting Monday afternoon with SIPC. (LB's PD is a SIPC member (as are some but not all of the other PDs) and its bankruptcy would be administered by SIPC.) Board staff plan to sit in on this meeting.

But even if we are willing to extend as much as \$200 billion of financing to LB, absent an acquirer our action would not ensure LB's survival. If stigma associated with PDCF borrowing is justified, LB likely would face other (non-tri-party) liquidity demands and I'm not sure whether its liquidity resources would allow it to meet them. (Presumably our PD supervisory team has a better idea but any judgment is likely to be qualified.) So we would have protected LB's tri-party counterparties but not its other counterparties (e.g, securities (mainly equities) borrowers and lenders and derivatives counterparties). Further, the demonstration of our willingness to lend large amounts through PDCF may not reassure tri-party investors that the mechanism is safe, especially if they start asking about our remaining capacity to meet further runs. That's not to imply that it would not be worth the gamble, but it would be a gamble.

Pat