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(1/24) The Merrill Lynch Debacle

How a management team of true degens gambled away a 91 year old institution. And, unlike the Brothers it conspired with, how it was rescued from the jaws of death.

The story of the excesses of the American Mortgage Barons.

(2/24) Merrill Lynch, founded in 1914, grew to be the worlds largest securities firm in the world by 1957.

In 1964, Merrill acquired the leading dealer of US gov securities, fueling the firms growth in the 1980/90s.

(3/24) Although the Great Financial Crisis occurred so early in the 21st century, it is the second major financial crisis of the 2000s; the first was at the close of the dot com bubble.

After the massive bumble and violent correction, interest rates were pushed to painful lows.

(4/24) Investors, having been burnt on fanciful dot com equities and being repulsed by anemic bond yields, turned to the investment banks and demanded return. And so, the bankers delivered.

First the Collateralized Debt Obligation (CDO) - a product backed by a pool of loans.

(5/24) CDOs provide a deep secondary market for loans, allowing underwriters to sell their loans and use the proceeds to make new loans

They were also safe (supposedly); A CDO is made up a "diverse" basket of loans. Even if a few loans went bad, the overall product was healthy

(6/24) The first (private) CDOs were issued by The Junk-Bond King in the 1980s. In 1997, the bankers at J.P. Morgan created the synthetic CDO.

Using a group of financial products, a synthetic CDO tracks the price of a CDO without actually owning any mortgages.

(7/24) So this is the picture in 2002:
- Merrill Lynch is one of the largest and oldest firms in the nation
- Investors, recently recovering from the dot com bust, are demanding returns
- Regulations are becoming more welcoming to an increasingly complex set of financial tools

(8/24) By this point, the housing bubble was in full swing. Other investment banks had made jaw-dropping profits servicing and growing the residential real estate market.

Particularly noteworthy was Lehman Brothers, the clear pack-leader in the mortgage industry.

(9/24) Over the previous 5 years Lehman had a mortgage assembly line. And Lehman made money every step of the way: originating, administering and servicing mortgage loans and packaging them into CDOs.

Merrill, a latecomer to the mortgage industry decided to swing for the fences.

(10/24) From January 2005-2007, it made 12 major purchases of residential or commercial mortgage-related companies or assets.

The firm's goal: generate in-house mortgages to package into CDOs.

It was never clear how well Merrill's understood the risks in the mortgage business.

(11/24) Risk management was tossed out; the team responsible was gutted.

Regarding a failed 2005 merger, the CEO of North Fork Bancorp said: "we couldn't get past the fact that we thought there was a distinct possibility that they didn't understand fully their own risk profile."

(12/24) Merrill was not only reckless in risk management, it also took huge risks directly in the CDO market - primarily synthetics

The bankers of JP Morgan were engineers, building products & selling products, minimizing exposure

Merrill was full of degens. Degens who hodl

(13/24) Although Merrill had a scant presence in the CDO market in 2002, four years later it was the world's biggest underwriter.

In 2005, AIG stopped issuing insurance against CDOs, exposing a huge amount of Merrill's portfolio.

Incredibly, Merrill just sped up.

(14/24) Merrill, the clear leader of the CDO industry, was a cash printer. After an incredible year in 2006, it produced a record Q1 in 2007, finally beating Lehman, Goldman Sachs and Bear Sears in profit growth.

But this is where the subprime mortgage crisis cuts in.

(15/24) Merrill, being the largest player in the CDO market, was also the most exposed when the subprime mortgage crisis raged across America

As mortgages started to fail, the ratings on CDOs were cut; suddenly mortgaged-backed securities, the largest asset class, were illiquid

(16/24) In October 2007, the firm shocked investors when it announced a $7.9B write-down related to its exposure to mortgage CDOs, resulting in a $2.3B loss, the largest in Merrill's history.

The board ousted CEO Stanley O'Neal. But don't worry about Stan - they gave him $161MM.

(17/24) Merrill began selling off CDOs and other assets at fire sale prices just to generate capital and salvage the firm.

For the first 9 months of 2008, Merrill recorded net losses of $14.7B on its CDOs. Through October, some $260B of asset-backed CDOs had begun to default

(18/24) As Merrill hemorrhaged, its counter-parties lost confidence. As they withdrew their liquidity, Merrill Lynch faced mortal stakes.

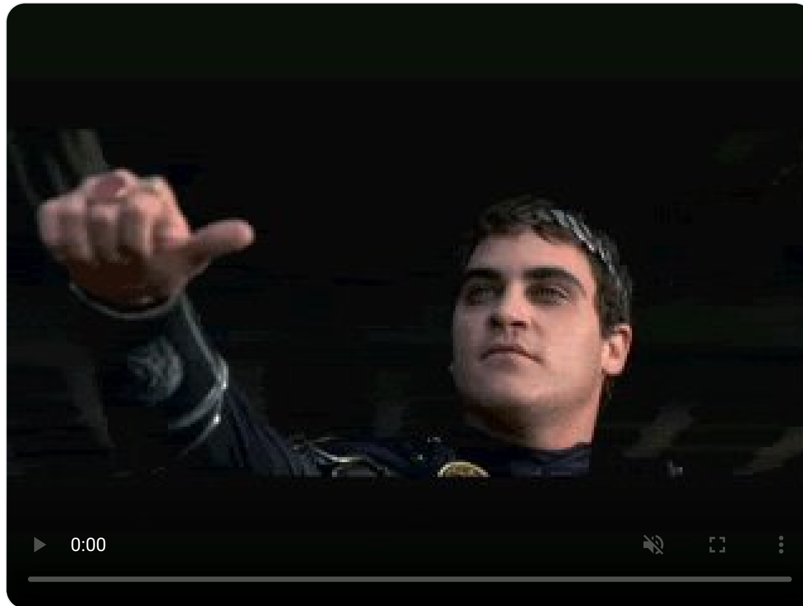
Then September 2008 came. The shaky situation became incredibly volatile once again. By September 8th, Lehman Brothers was on life support.

(19/24) If Lehman could fall, everyone was vulnerable... and none looked more vulnerable than Merrill Lynch.

On Sunday, September 15th the moment had come. If Lehman didn't receive a bailout, it would file for bankruptcy at market open.

(20/24) The moment came, and Treasury Security Geithner raised his arm and flashed the thumbs down:

On a phone call, Geither said Lehman could not be saved, Lehman filed for bankruptcy, and the US government turned to bail out ever other major bank and financial institution.



(21/24) And Merrill?

Well on that Sunday Bank of America announced it was in talks to purchase the dying giant. By the end of the day, Merrill was sold for $50B - 61% down from its September 2007 value.

Curious to why BofA "stepped up to the plate" to "contain the contagion?"

(22/24) Well, one side of the story is that the federal government directly pressured BofA to make the purchase. (Apparently) the threat was simple:

If you want government assistance during the upcoming financial tsunami, pick one: buy Merrill or replace your management team.

(23/24) The other side of the story is the survivors lesson:

BofA was positioned to weather the worst volatility had to offer. It sustained damage during the crisis, but lived to fight another day.

And to grow much bigger than it ever was before.

(24/24) In 2008, when push came to shove there were 3 types of banks/financial institutions:

- those that needed a government bailout
- those that needed to be swallowed up to protect the system
- those that needed to fail

Merrill Lynch was in that middle category.

Why: 🤷‍♂️

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