

Statement of the Financial Services Authority

1. In September 2009 the FSA received a request from the Examiner appointed by the U.S. bankruptcy court to provide information about our involvement in the attempt by Barclays Bank Plc ("Barclays") to buy Lehman Brothers Holdings Inc. ("Lehman") during the period 12 to 15 September 2008.
2. Given the consequences that flowed from the failure of Lehman, we think there is a genuine public interest in helping the Examiner prepare for publication a fuller account of the events in question. We have prepared this Statement for that purpose. The Statement focuses, as did the Examiner's request, on the contacts between the FSA's most senior executives and their counterparts in Barclays and the U.S. authorities. It is not intended to be, and should not be taken as a comprehensive or verbatim account of every action taken by the FSA during the relevant period, or of every discussion that took place, whether internally or with external parties (in particular with HM Treasury and the Bank of England as the two other members of the U.K.'s Tripartite Authority, which collectively considers matters relating to the stability of the U.K.'s financial system). In any event this would not be possible. We are nevertheless satisfied that the Statement is an accurate summary of the events that it covers.
3. The Statement contains confidential information which the FSA received from Barclays which, under U.K. law, the FSA is usually prevented from disclosing. Barclays having reviewed the contents of this Statement, has given its consent for the FSA to include such information in the Statement.

Introduction

4. By the beginning of September, the FSA had become increasingly concerned about the financial condition of, and prospects for, the whole of the Lehman group. The collapse of Bear Stearns in March and the rescue of Freddie Mac and Fannie Mae in July had weakened confidence in U.S. investment banks and lenders. In June, Lehman, the parent company of the group, announced a second quarter loss of c.\$2.8bn. At the end of June, there was market speculation that Barclays might bid for Lehman, whose share price had fallen by 69% since the start of the year. During July and August the share price fell further, while the views of the credit rating agencies and market buyers of Lehman's CDSs and other funding instruments became more negative.
5. Against this background, and the general deterioration in the economic environment, the FSA intensified its supervision of Lehman Brothers International Europe ("LBIE"), the UK regulated broker dealer, and had frequent discussions with the Bank of England and HM Treasury in the U.K., and with the U.S. Securities and Exchange Commission ("SEC") and the Federal Reserve Bank of New York ("FRBNY") in the U.S.

Events of 10 September to 15 September 2008

Wednesday, 10 September 2008

6. Lehman announced its third quarter results. The loss of \$3.9bn was worse than the market had expected. There were discussions between the U.S. regulators and the FSA which focussed on the liquidity position of Lehman and market reaction to the various announcements from the firm. The FRBNY appeared to be encouraging Lehman to enter into discussions with possible investors and/or purchasers.
7. During the course of the day, John Varley, Group Chief Executive of Barclays, contacted Hector Sants, Chief Executive of the FSA, to advise that Barclays was considering a bid for Lehman. Sants responded that the FSA had no objection in principle to a deal of this nature, but it would be important and necessary for the FSA to see the detail of any emerging proposal and be kept closely informed of developments.

Thursday, 11 September 2008

8. Varley telephoned Sants again to advise that the Barclays Board would be meeting that day to consider whether in principle Barclays was interested in considering purchasing Lehman. Varley also noted that if they were to proceed with putting together a bid which would be attractive to Barclays' shareholders it would be on the basis of 1) a high level of certainty of completion with the necessary support from the Federal Reserve to ensure this; 2) liquidity support from the Federal Reserve; and 3) a discount on the Lehman net assets values.
9. Sants replied that he understood why Barclays was considering a possible bid. He also advised that the FSA would look very closely at the impact any transaction structure would have on Barclays' liquidity and capital and that the FSA would not countenance a drop of Barclays' core Tier 1 numbers below the minimum required by the FSA. Varley agreed with Sants and responded that he did not wish to put in place any transaction structure that would reduce Barclays' capital unacceptably.
10. On the same day, Callum McCarthy, the then chairman of the FSA, contacted Tim Geithner, then President of the FRBNY, to discuss Lehman's growing financial difficulties. Geithner told him that there was an institution which was considering bidding for Lehman. It would very probably seek financial support from the U.S. authorities for any bid. There was also the possibility of a consortium of financial institutions being assembled to rescue the firm. But without intervention of this nature he judged that Lehman would have to enter bankruptcy. He hoped this would not occur before the weekend.

Friday, 12 September 2008

11. That morning, and during the day LBIE and the FSA held discussions about the firm's liquidity. The FSA also updated the SEC on LBIE's liquidity position and was advised that the SEC would escalate matters internally and inform the FRBNY and the U.S. Treasury.
12. Varley telephoned Sants during the course of the morning to advise that he has spoken to Hank Paulson, U.S. Treasury Secretary, about the Barclays Board (the "Board") being prepared to consider a possible bid for Lehman. Varley recounted that Paulson had advised that any purchaser for Lehman would need to make a bid prior to the end of the weekend. If no purchaser emerged by then, then the plan was to place Lehman into an orderly run off.
13. Varley advised Sants that Barclays would assess whether or not a bid for Lehman was in the interests of its shareholders. Sants reiterated that the FSA had no objection in principle to the deal and both agreed that if Barclays considered taking matters forward it would need to engage the FSA at a working level to ensure sufficient analysis had been undertaken of the key issues.
14. At approximately 2 p.m. British Summer Time (times are all British Summer Time unless otherwise stated) Geithner contacted Sants to advise that, as Lehman's short term liquidity was looking increasingly problematic, it was exploring the possibility of Lehman being taken over by Bank of America or Barclays, with progress with Bank of America being at a more advanced stage. Geithner also explained the possible options if neither firm proceeded with an acquisition. These included a consortium of U.S. banks providing additional capital to Lehman by way of preference shares to allow an orderly wind-down without going into Chapter 11, or alternatively, Lehman going into Chapter 11. While it was thought necessary to prepare for insolvency proceedings, at this stage Geithner was optimistic about the possibility of a takeover.
15. Subsequently in a Tripartite Authority deputies telephone conversation, Sants liaised with Tom Scholar of HM Treasury and John Gieve of the Bank of England about a possible Barclays bid for Lehman. He advised that the FSA was expecting Barclays to fully analyse the risks involved in any proposed transaction and draw up plans to mitigate against those risks. Barclays was then to present the FSA with any proposal it put to its Board prior to proceeding with any proposed transaction.
16. In the interim, throughout the day, the FSA was proactively identifying issues and questions that it would require Barclays to consider and resolve in the event that Barclays decided to proceed with any proposal to purchase Lehman.
17. LBIE, in its ongoing discussions with the FSA, contacted the FSA later that afternoon to advise that Lehman was in talks with Bank of America

and Barclays regarding a possible takeover.

18. Varley also contacted Sants mid afternoon to advise that Barclays had been given authority by its Board to investigate the feasibility of a bid for Lehman, but the Board had a number of questions and preconditions and therefore he did not yet have Board approval to proceed with a transaction. A major consideration the Board had clearly indicated it could not accept, was the possibility of Barclays needing to provide an unquantified amount of liquidity to meet Lehman's ongoing obligations to the market and other counterparties. Barclays therefore intended to enter into discussions with the U.S. authorities on the basis that, while it would be interested in pursuing a transaction, the U.S. authorities would have to provide adequate liquidity funding arrangements. Amongst other matters, Barclays wished to have available to it the Primary Dealer Credit Facility ("PDCF") that was available to Lehman. Also, Barclays wished to acquire Lehman without the troubled commercial mortgages and real estate assets still held on Lehman's balance sheet as a result of its securitisation programme.
19. Sants set out the basis on which the FSA would consider approving any transaction for the purchase of Lehman, which was that Barclays would need to be able to demonstrate that, after the acquisition, it would continue to hold adequate capital and could show that, even after applying appropriate stress tests to both its own portfolio and the assets acquired from Lehman, it would still hold capital (in particular core Tier 1 capital) sufficiently above the FSA minimum. A viable plan for funding Lehman's liquidity needs would also need to accompany any proposal for an acquisition. Varley reported that these were amongst the considerations being debated by the Board.
20. At approximately 4 p.m. McCarthy discussed Barclay's expression of interest in Lehman with Alistair Darling, Chancellor of the Exchequer. McCarthy advised that there were structural considerations and other issues that needed to be considered urgently if Barclays was to progress any bid for Lehman. The FSA would be engaging Barclays in discussions later that day to assess all the issues that could arise as a result of any possible Barclays bid. Until that happened it was impossible for the FSA to consider approving any transaction.
21. McCarthy also advised Darling that both he and Sants had spoken to Geithner advising him that because of the structural and other considerations, if Barclays progressed its discussions with Lehman, the FSA would need to scrutinise very carefully any proposed transaction structure.
22. Darling raised the government's concern that Barclays should not expose itself to inappropriate risk and that the FSA should very carefully scrutinise any proposal that Barclays put to it to ensure that all the risks inherent in the transaction had been adequately considered and managed.
23. Darling's office later contacted the FSA to report on a telephone

conversation between Darling and Paulson. Paulson had advised that the U.S. Treasury was considering two prospective buyers, but it was unclear whether any transaction could be structured without external support. It was also considering an industry consortium or a wind down - although the latter option was the least favoured one. Darling had advised Paulson that no transaction with Barclays would be possible if the level of risk for Barclays was inappropriate. Paulson accepted this and advised that the FRBNY might be prepared to provide Barclays with regulatory assistance to support a transaction if it was required.

24. Subsequently, at approximately 6.30 p.m., McCarthy contacted Marcus Agius, Chairman of Barclays. He advised that, as discussed between Sants and Varley earlier in the day, in order for the FSA to consider any proposed Barclays acquisition of Lehman, there were critical issues of long-term funding and capital that Barclays would need to ensure it addressed.
25. Agius advised that the Board had yet to decide whether to formally consider putting together a proposal to bid for Lehman but assured him that the Board would require a comprehensive analysis of the Lehman business prior to making a decision to make a bid for it, and that a number of tests had to be satisfied before the Board could conclude that a deal was in Barclays' shareholders' best interests.
26. At approximately 9 p.m., McCarthy contacted Geithner to advise that the FSA was awaiting Barclays' analysis of the impact of possible transaction proposals on Barclays's capital and liquidity position and that FSA approval of any proposed transaction would depend on the funding and capital.
27. Discussions between the FSA and Barclays that evening centred on quantifying the size and nature of any proposed Lehman assets and the impact that this would have on Barclays' core Tier 1 ratios when consolidated with Barclays' assets. Barclays advised that it continued to seek unlimited access to the FRBNY discount window although there remained debate within the U.S. Treasury as to who should provide the funding.

Saturday, 13 September 2008

28. Early Saturday morning the SEC updated the FSA on Lehman's liquidity position and reported significant issues with the U.S. clearing banks. Because of the number of exit transactions, Lehman was suffering from operational difficulties and it could only estimate its liquidity pool.
29. At approximately 10.30 a.m. Varley contacted Sants to advise that the FRBNY was allowing Barclays to examine Lehman's accounts and Barclays was progressing its analysis before reporting back to the Board.
30. Varley and Sants again discussed the criteria that would need to be met if

Barclays were to effect an acquisition. Both Varley and Sants were in complete agreement that Barclays should not propose a transaction structure that from Barclays' point of view would not satisfy the requirements of shareholder value and from the FSA's point of view could put Barclays at risk. Barclays' considerations included the need to obtain liquidity safeguards, only to take on the quality assets at an appropriate price and to ensure that satisfactory arrangements for funding Lehman's liquidity needs were in place to ensure that the deal would be acceptable to Barclays. Varley advised that he would update Sants once he had a clearer indication of how Barclays proposed to progress any possible bid for Lehman.

31. In the course of the morning, FSA and Barclays staff met for further discussions on the possible acquisition of Lehman. Barclays advised that it was interested in buying the 'core' Lehman business, by which it meant the investment banking franchise but not the asset management business. Barclays' Board had indicated that there were two particular conditions precedent before it would approve any deal.
32. The first condition was that Barclays would not take on the assets that Lehman held and which it had intended to put into 'Spin Co' (i.e. the 'bad' bank component of the planned spin off. Barclays told the FSA that it had been in discussions with the U.S. authorities about a consortium of U.S. banks supporting a new company which would take on these assets, the so-called 'bad' bank. The U.S. authorities had indicated no willingness to acquire these assets themselves but were willing to act as coordinator for helping Barclays to produce an acceptable structure.)
33. The second condition was that the FRBNY would need to continue to make the PDCF available to Lehman on the same terms as currently applied. Barclays did not want any financing options to be closed to it as a result of a takeover. Barclays believed that these sources of liquidity might be available, but the Board had asked Barclays to seek written confirmation.
34. Although no definitive transaction structure proposal had been presented to the FSA to consider for approval, the FSA discussed internally what conditions would need to be satisfied before a takeover by Barclays could be approved. It was agreed that the key conditions remained the adequacy of Barclay's capital post-acquisition, and certainty of funding for Lehman's liquidity needs, including the continuation of the PDCF. It was also crucial to have a more detailed understanding of Lehman's financial obligations and the impact that these would have on Barclays. As Barclays was (and remains) one of the U.K.'s clearing banks it was important to ensure that Barclays did not expose itself to a level of risk that could weaken it to an extent that could have a wider systemic impact on the U.K. financial system.
35. McCarthy had discussions with Mervyn King, Governor of the Bank of England, that afternoon in which both agreed with the FSA's position in relation to the conditions Barclays would need to meet prior to it

proposing any transaction structure.

36. At approximately 3 p.m., in discussions on Lehman between international regulators (including the FSA, SEC and FRBNY), the FRBNY advised that it was considering as a contingency plan the winding down of Lehman without putting it into Chapter 11 but no update was provided by the U.S. regulators on the state of negotiations between any of the parties.
37. In meetings between the FSA and Barclays that afternoon discussions centred on Barclays' initial analysis of the impact of the taking on of Lehman's assets on its core Tier 1 capital and on other prudential issues such as large exposures limits.
38. Separately, the FSA spoke to the FRBNY to emphasize the importance of cooperation if the FRBNY decided that the best option for Lehman was to put it into Chapter 11 as that option would have a great impact in the UK.
39. During the evening, Barclays advised the FSA that the FRBNY had asked Barclays to guarantee Lehman's financial obligations in the period leading up to the closing of an acquisition (similar to the guarantee which JP Morgan provided when it rescued Bear Stearns in March). The guarantee would remain even if the transaction failed to complete (i.e. Barclays would be legally responsible for all existing and new Lehman business until the point of the transaction failure). Barclays recognised the magnitude of this issue, which would be a key point in the Board's deliberations. Barclays sought confirmation that, given the size and nature of the interim guarantee it was being asked to provide, the U.K. Listing Rules would require it to obtain prior shareholder approval. (Barclays is an issuer of listed shares. Under the FSA's Listing Rules it is necessary for such issuers to obtain prior shareholder approval before completing significant transactions. A transaction is "significant" if it meets or exceeds one of more of the prescribed size tests.)
40. Separately, Varley advised Sants in a telephone conversation late that evening that because of the guarantee that the FRBNY was now asking for, it was unlikely that a suitable structure to purchase Lehman could be put in place which would satisfy his Board.
41. In a late night briefing from Barclays the FSA was advised that it was not likely that any transaction could proceed. The U.S. regulators were insistent on Barclays guaranteeing all of Lehman's financial obligations and could or would not provide any support to any proposed transaction. Barclays was nevertheless still considering alternative ways of structuring any proposal.
42. McCarthy spoke to Giethner that evening to inquire about the state of negotiations between the parties. McCarthy repeated the message that no proposal had been brought to the FSA by Barclays, and that if one was, it would raise very significant issues. Since no proposal had yet been put forward, however, it was impossible to say whether any particular proposal would prove acceptable.

Sunday, 14 September 2008

43. On Sunday morning, the FSA again discussed a possible Barclays acquisition of Lehman. Barclays' core Tier 1 capital position was discussed. It was agreed that the criteria for judging the capital position remained unchanged and that the FSA continued to need reassurance on liquidity. The FSA had still not been presented by Barclays with any definitive proposal for how it would structure an acquisition of Lehman and therefore the FSA was not in a position to provide any comment on what type of transaction structure it could approve. The FSA also discussed the issue that Barclays had raised the previous evening, of Barclays being asked to guarantee Lehman's financial obligations. While no such request had been made by Barclays, and although the FSA could in theory waive the requirement that Barclays obtain prior shareholder approval, there was no precedent for this in the envisaged circumstances and therefore granting a waiver would represent a compromise of one of the fundamental principles of the FSA's Listing Regime. As there is a requirement for shareholders to approve any significant transaction undertaken by a listed firm, granting a waiver would have involved a serious interference with shareholder expectations.
44. The FSA went on to consider that, if the FRBNY or any parties other than Barclays were to guarantee Lehman's financial obligations, then Barclays' need for shareholder approval for any proposed transaction would be likely to be less of an obstacle. Barclays' primary consideration then would continue to be to put together a viable transaction structure that could be approved by its Board on the basis of its attractiveness to shareholders and would also meet the FSA's capital and liquidity requirements.
45. During the course of the day the FSA again discussed internally the possible acquisition and confirmed the conditions which would need to be satisfied by Barclays in order to receive regulatory approval for the takeover. These were that Barclays would have to show a sufficiently robust capital position and it would need to have enough liquidity. These tests had been set out clearly to Barclays. However, it was also agreed that, if and when Barclays came to the FSA with a formal proposal for its purchase of Lehman, it would be necessary to consider these tests in the aggregate, to determine if the overall level of risk to Barclays was acceptable to the FSA.
46. At approximately 1 p.m. McCarthy contacted Geithner to advise him that the FSA's concerns in relation to any proposed transaction centred on the issues of liquidity and capital. The requirement for Barclays to obtain shareholder approval under the Listing Rules, if Barclays rather than the FRBNY was going to have to bear the risk of guaranteeing Lehman's financial obligations from the announcement of a takeover to the closure of the transaction, would also need to be resolved.
47. Geithner responded that the FRBNY was hoping that a consortium of

banks would support the new "bad" bank, although this would need an increased contribution from Barclays, but it would improve the overall capital position. Geithner added that a guarantee from Barclays would still be required and in view of the urgency of the situation, there would have to be a waiver of the requirement for prior shareholder approval.

48. McCarthy considered that, without an interim guarantee from the FRBNY, Barclays would have had to provide a (possibly unlimited) guarantee, for an undefined period of time, covering prior and future exposures and liabilities of Lehman that would continue to apply including in respect of all transactions entered into prior to the purchase, even in the event the transaction ultimately failed. This would have a major impact on Barclays' own capital and liquidity. He also advised Geithner that the waiver of the relevant Listing Rules would be unprecedented in the envisaged circumstances and, given the ongoing concerns, as long as Barclays was bearing the real risk of providing the guarantee, he was not currently minded to consider waiving the requirements, even if asked to do so by Barclays, which was not the case.
49. Geithner asked if an acquisition could be restructured in the available time. McCarthy replied that, while the FSA had not been asked by Barclays to approve a definitive transaction structure for the acquisition of Lehman, he had doubts about what could now be achieved in the time available. Geithner then advised that the next steps in the U.S. would be to advance Chapter 11 plans.
50. Subsequently Bill Rutledge, Executive Vice President of Banking Supervision at the FRBNY, telephoned Sants to discuss the FSA's requirements for a Barclays proposal to prove successful. Sants advised that Varley had not provided him with any proposal that he intended to put to the Barclays Board, but if one was made it would be considered in its entirety by the FSA.
51. In the early afternoon the FSA again discussed the possible acquisition, as Barclays had completed its scenario analysis and concluded that, in its view, on the basis of its preferred transaction structure, it could meet the FSA's capital requirements. In the time available it had not proved possible to subject this to detailed supervisory scrutiny. At this stage Barclays had yet to put together a formal proposal for the FSA to consider, the funding position was still not clear and no resolution of the guarantee issue had been reached.
52. The FSA remained concerned about whether Barclays could structure a transaction that would enable it to maintain the necessary core Tier 1 capital ratio. It also appeared that the FRBNY was unable or unwilling to provide assurances to Barclays that the PDCF or other funding for the transaction would be made available to it on a long term basis.
53. In addition, the FSA remained concerned that, in aggregate, without the conditions precedent being required by the Barclays Board being satisfied and the FSA's prudential tests being met, a transaction remained risky for

Barclays and that, although Barclays might in the event be able to satisfy the FSA's conditions, each condition would only just be met and that the aggregate level of risk might still be unacceptable. However, it was decided that the core tests would be reiterated to Barclays.

54. At approximately 3 p.m. Christopher Cox, Chairman of the SEC, contacted McCarthy to discuss whether there was any flexibility on waiving the Listing Rules. McCarthy explained that the Listing Rules issue was only part of the problem that had not been resolved. The FSA had received no firm proposal from Barclays nor a waiver request. Therefore, as well as the question of the Listing Rules and the underlying guarantee, issues of capital and funding remained important and unresolved. McCarthy noted that there was no precedent for a waiver of the relevant Listing Rules in the envisaged circumstances. None of the suggestions advanced by Cox in the conversation provided any solution to those problems.
55. In the interim, discussions between Barclays and the FSA continued around the impact of any proposal on Barclays' core Tier 1 capital on the basis of Barclays' continuing reviews of the Lehman portfolio.
56. At approximately 4 p.m. Varley contacted Sants and advised that both the FRBNY and Barclays were of the opinion that, in view of the remaining outstanding issues, it was unlikely that an acceptable transaction could be put together in time and therefore discussions had ceased.
57. Sants repeated that the FSA had no objection in principle to Barclays purchasing Lehman. He also confirmed that the FSA remained focussed on the three main criteria (capital, liquidity, and the guarantee issue) as previously raised with Barclays. Varley confirmed that Lehman's long term liquidity position was not certain, and that the U.S. authorities would struggle to provide an assurance that any funding or liquidity support they provided would last beyond the change of U.S. president due in January 2009. Sants and Varley agreed that neither the Barclays Board nor the FSA could approve any transaction structure that required Barclays to provide the guarantee asked for by the FRBNY.
58. The FSA continued to receive updates from the U.S. authorities on the Lehman group's liquidity position, which was showing a much worse position than had been expected.
59. During the course of the day the FSA learned from public announcements that Bank of America was to purchase Merrill Lynch.
60. LBIE contacted the FSA late that evening to formally advise that LBIE would likely file for administration.
61. Later that evening a conference call took place between the FSA and the FRBNY. The FRBNY explained that Lehman would shortly file for Chapter 11, but that Lehman Brothers Inc. would be kept afloat using FRBNY financing. The FSA asked if this funding would be made

available to LBIE and was told that this was not possible.

62. A further call with the FRBNY took place at midnight involving international regulators and central banks. Relatively little new information came to light during this call. The FRBNY explained that it had arranged a special trading session in OTC derivatives to help firms reduce risk caused by the anticipated Lehman bankruptcy filing.

Monday, 15 September 2008

63. On 15 September, at 7:56 a.m., Lehman Brothers International (Europe), Lehman Brothers Limited, Lehman Brothers Holdings Plc and LB U.K. Holdings Ltd. entered administration in the U.K. On the same day Lehman entered into Chapter 11 bankruptcy in the U.S.

20 January 2010

