Presentation Report of Banking Fundamentals

{Merrill Lynch}

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Merrill Lynch

Merrill Lynch is the wealth management division of Bank of America. With over 15,000 financial advisors and $2.2 trillion in client assets it is the world's largest brokerage. Formerly known as **Merrill Lynch & Co., Inc.**, prior to 2009 the firm was publicly owned and traded on the New York Stock Exchange under the ticker symbol **MER**. Merrill agreed to a purchase by Bank of America on September 14, 2008, at the height of the 2008 Financial Crisis. It ceased to exist as a separate entity in January 2009.

History of Merrill Lynch

1907: Charles Merrill arrives in New York to work for a textile company. He meets Edmund Lynch, who is looking for someone to share his boarding-house room at the 23rd Street YMCA. Both men were born in 1885.

Merrill Lynch's oldest direct predecessor was the partnership of Burrill& Housman, founded in 1885. In 1890 William Burrill left the firm he had created, and the next year Arthur Housman's brother Clarence joined what was then A. A. Housman & Company. When Arthur Housman died in 1907, he left behind one of Wall Street's leading brokerage houses.

That same year, Charles Merrill and Edmund Lynch arrived in New York, where they met and became friends. The two 22-year-old entrepreneurs had both recently finished college and gravitated to Wall Street to seek their fortune. At that time, the stock market was chiefly the domain of a small number of eastern businessmen, but Merrill quickly realized the vast potential of financial markets funded by a broad spectrum of middle-class Americans. He received his initial training in the bond department of Burr & Company, and then set up his own firm in 1914. The following year he persuaded Edmund Lynch to join him.

1914 & 1915: Charles E Merrill & Co opens its doors in January. Lynch joins him, and in May they open an office at 7 Wall Street in downtown Manhattan. The firm changes its name to Merrill, Lynch & Co. An associate notices a difference between the partners: "Merrill could imagine the possibilities; Lynch imagined what might go wrong in a malevolent world."

The company prospered and grew quickly, earning a strong reputation in financial circles for financing the newly emerging chain store industry. Merrill himself was a founder of Safeway Stores, and the company underwrote the initial public offering for McCrory Stores. By the late 1920s, Merrill, Lynch was reaping the benefits of that decade's prolonged economic boom, but Charles Merrill gradually became uneasy about the frantic pace of investment. He predicted that bad times were ahead as early as 1928, warning his clients and his own firm to get ready for an economic downturn. When the crash came in 1929, Merrill, Lynch had already streamlined its operations and invested in low-risk concerns. Despite this foresight, in 1930 Merrill and Lynch decided to sell the firm's retail business to E. A. Pierce & Company and concentrate on investment banking.

E. A. Pierce & Company was the direct descendent of A. A. Housman & Company. The company was named for Edward Allen Pierce, who had joined Housman in 1901, become a partner in 1915, and the managing partner in 1921. After World War I, Pierce concentrated on building the firm into a nationwide network of branches connected by telegraph, in order to reach more customers. After a 1926 merger with Gwathmey& Company, the firm was renamed E. A. Pierce & Company the following year.

1938-1956: Edmund Lynch dies. Merrill Lynch drops the comma from its name.

The new firm was devoted to the radical concept of offering to its investors a "department store of finance." Clients were urged to research their financial options, and Merrill Lynch saw itself as a partner in that process, even providing educational materials. In 1941 the firm merged again; this time it became Merrill Lynch, Pierce, Fenner&Beane when it absorbed Fenner&Beane, a New Orleans company that was the nation's largest commodities house and the second-largest "wire house" (an investment firm that, like E. A. Pierce, depended on its private telegraph wires for a broad-based business).

During World War II the company benefited greatly from the economic turnaround brought by increasing military spending. Throughout the bull market of the postwar period and the 1950s, Merrill Lynch continued to be an innovator and a popularizer of financial information. The firm erected a permanent Investment Information Center in Grand Central Station, distributed educational brochures, ran ads with titles like "What Everybody Ought to Know About This Stock and Bond Business," and even sponsored investment seminars for women. These new ideas made Merrill Lynch the best-known investment firm of the day. Charles Merrill's reputation soared to such heights that shortly before his death in 1956 one Wall Street historian referred to him as "the first authentically great man produced by the financial markets in 50 years."

1956-1970: Merrill helps take Ford Motor Co public, giving the firm its first billion-dollar year in underwriting. The same year, Charles Merrill dies. Firm changes its name to Merrill Lynch, Pierce, Fenner & Smith. Merrill opens its first London office. Four years later, it opens its first Tokyo office. Merrill buys C.J. Devine, becoming a dealer in fixed-income securities.

In 1958 the firm juggled names again. Alpheus Beane, Jr., dropped out of the firm, and since Winthrop Smith had taken over as directing partner two years earlier, the firm was renamed Merrill Lynch, Pierce, Fenner& Smith (ML). The next year it became the first large Wall Street firm to incorporate, and earnings reached a record high of $13 million.

During the 1960s the company began to diversify and expand internationally. In 1964 Merrill Lynch entered the government-securities business when it acquired C. J. Devine, the nation's largest and most prestigious specialist in that market. Over the course of the decade the firm also entered the fields of real estate financing, asset management, and economic consulting, and added 20 new overseas offices. The company paid special attention to establishing a European presence, which allowed participation in the developing Eurobond market, and by 1964 had succeeded in becoming the first U.S. securities firm in Japan. In that same year ML was named lead underwriter for the $100 million public offering of Comsat, builder of the world's first telecommunications satellite, thus solidifying its position as one of the country's major investment-banking firms. The company underwrote the sale of Howard Hughes's TWA stock in 1965, and in the next ten years added significant new business with firms such as Commonwealth Edison, Fruehauf, and Arco. By the end of the decade Merrill was managing about $2 billion annually in such offerings.

1971-1990’s: Merrill goes public and lists on the New York Stock Exchange. Merrill creates Merrill Lynch Asset Management.

The firm also absorbed the New York Stock Exchange's fifth-largest brokerage house, Goodbody& Company, in 1970 when that company fell victim to Wall Street's so-called "paper crunch disaster." Overextended trading houses were generating more transaction records than their accounting departments could keep up with, resulting, in the case of Goodbody and many others, in massive confusion and eventual collapse. The exchange asked ML to step in and help Goodbody, and ML ended up acquiring the firm at the end of 1970. The bailout cost little and brought ML new expertise in the area of unit trusts and options trading.

In 1971 Merrill Lynch became the second member of the New York Stock Exchange to invite public ownership of its shares, and in July of that year became the first to have its own shares traded there. Shortly thereafter, the company adopted its most recent change of name, forming a holding company called Merrill Lynch & Co., Inc., with Merrill Lynch, Pierce, Fenner& Smith as its principal subsidiary.

Regan's diversification program continued with a 1972 move into international banking. London-based Brown-Shipley Ltd. soon became Merrill Lynch International Bank, and in 1974 ML acquired the Family Life Insurance Company of Seattle, Washington. In 1976 ML formulated a strategy to meet the challenge of the increasingly complex international financial marketplace by offering "a diversified array of securities, insurance, banking, tax, money management, financing, and financial counseling." Formerly clear demarcations between the various money professions were rapidly blurring, as ML demonstrated in 1977 when it announced the creation of the Cash Management Account (CMA). This unique account allowed individual investors to write checks and make Visa charges against their money market funds. Banks did not appreciate this incursion into their territory and mounted a number of legal campaigns to stop it, to no avail. By 1989, fully half of ML's $304 billion in customer accounts were placed in CMAs, and most of the other leading brokerage houses had developed similar integrated-investment vehicles.

Despite its sustained attempt to achieve a steady level of profit through diversification, ML's earnings have reflected the volatile nature of its core securities business. For example, 1971 profit reached a new high of $70 million, but was followed by the difficult oil-embargo years of 1972--74; and while 1975's record $100 million was not equaled for several years afterward, 1980 saw record highs of $218 million in profit and $3 billion in revenues. That year also marked the end of the Regan era at ML, as new U.S. President Ronald Reagan named Donald T. Regan secretary of the treasury and later made him White House chief of staff.

Roger Birk became the company's new chairman and CEO, followed in 1984 by William A. Schreyer. Schreyer, unhappy with ML's failure to match the earnings of some of its more flamboyant competitors, made increased profitability his chief goal. To that end, Schreyer reorganized the vast company, strengthened its trading, underwriting, and merger and acquisition departments, and made a $1 billion move into new offices in the World Financial Center. The firm also cut spiraling operating costs and trimmed 2,500 employees from its ranks.

In 1985 ML met a longstanding goal when it became one of the first six foreign companies to join the Tokyo Stock Exchange. The following year, when the firm became a member of the London Exchange, ML was able to offer round-the-clock trading. Later in 1986 ML sold its real estate brokerage unit as part of Schreyer's plan to unload low-profit concerns so that the company could focus more on using its powerful retail divisions to sell the securities its investment-banking department brought in. The strategy worked; profits increased to a record $453 million during that year.

Also in 1986, scandal hit when Leslie Roberts, a 23-year-old Merrill Lynch broker, was arrested by the FBI for mail fraud. Roberts's complex fraud scheme lost huge sums&mdash much as $10 million from a single investor's account. The Roberts case typified for many the money fever of pre-crash Wall Street, and the incident attracted international attention.

Then in April 1987, the company was caught speculating in hugely unsuccessful fashion when it lost $377 million trading mortgage-backed securities--the largest one-day, one-company trading loss in Wall Street history. Coupled with the crash of October 1987, profits were sent reeling and

ML was forced to freeze salaries, cut bonuses, dismiss employees, and slash commission payouts to its sales force. But profits increased dramatically the next year, reaching a record high of $463 million. During 1988 ML also achieved a long-held goal when it edged out Salomon Brothers to become the largest underwriter in America. The following year ML realized another long-term goal: the firm became the world leader in debt and equity securities, this time besting First Boston Corporation in the race for the top spot. Merrill Lynch remained in the thick of the hot merger-and-acquisition business as well, earning, for example, a tidy $90 million for helping put together the $25 billion leveraged buyout of RJR Nabisco Inc. that year.

Although Merrill Lynch's revenue and assets under management grew steadily from 1988 to 1990, its return on equity continued to lag behind other firms in the industry. Observers in particular cited the company's traditional inability to control costs&mdashcording to Business Week, it was "powerful but awkward and overweight ... hobbled by a costly, bloated bureaucracy." Schreyer embarked on an ambitious reorganization which created 18 operating divisions, the managers of which were accountable for all costs therein. ML also downsized, reducing its head count from 48,000 in 1989 to 37,000 in 1991 and eliminating unprofitable subsidiaries such as Merrill Lynch Realty, Inc. and its clearing service Broadcort Capital Corp. It made additional cuts in its non-U.S. operations. Schreyer's overall cost-containment program paid off by reducing costs $400 million dollars from 1989 to 1991.

1991-1999: Merrill is world's largest underwriter of stocks and bonds for the last time, a title it cedes the next year to Citigroup Inc.

Merrill Lynch's ROE figures improved dramatically in the early 1990s--5.8 percent in 1990, 20.8 percent in 1991, 22 percent in 1992, and 27.3 percent in 1993. This achievement did not, however, come at the expense of growth. From 1990 to 1993, gross revenues increased from $11.15 billion to $16.59 billion, while assets under management increased from $110 billion to $161 billion. In the midst of this success, Schreyer retired in 1993 and was replaced as chairman and CEO by Daniel P. Tully, who had been president and COO.

By 1994 ML had perhaps achieved a long-held goal of diversification to such a degree that it could achieve an average ROE of 15 percent across business cycles. Other firms in the industry struggled in 1994 as a series of U.S. Federal Reserve interest rate hikes battered the bond market and reduced underwriting dramatically. Merrill Lynch--though its profits were down significantly in the second, third, and fourth quarters--still managed a ROE of 18.6 percent for the year on record gross revenues of $18.23 billion. Since the company had the ability to offer its customers a full range of financial services and investment opportunities, it could generate revenues--and profits--in all types of market environments. ML's continuing growth in the global market--highlighted in 1994 by its first-time leadership in Eurobond and global bond underwriting--also promised to help the firm overcome downturns in the economies of individual countries or regions.

1994 did leave a cloud hanging over the otherwise sunny forecast for Merrill Lynch's future. Orange County, California, was forced to file for bankruptcy late in 1994 after losing nearly $2 billion in a $7.6 billion county investment fund. Throughout the 1990s, the Orange County treasurer had leveraged the fund in order to purchase securities that would increase sharply if interest rates fell. The scheme worked very well until the 1994 Federal Reserve rate hikes sent the fund's securities into a tailspin. The county subsequently sued ML for $2 billion, claiming that the firm had advised the treasurer to make investments that exceeded state-mandated limits on risk. Merrill Lynch denied that it had done anything wrong, and claimed that it had not been the treasurer's financial adviser.

In mid-1995 Merrill Lynch became the largest investment bank in the world in terms of equity sales, trading, and research through its acquisition of England's biggest independent securities firm, Smith New Court PLC. With the $842 million purchase, ML not only increased its presence in England but also gained businesses in several countries where it had none, such as South Africa, Malaysia, and Thailand. The acquisition thus brough further geographic diversification to Merrill Lynch's operations.

In the difficult environment of the mid-1990s financial services industry, Merrill Lynch was at the top and nearing its goal of "being the world's preeminent financial management and advisory company." If observers' predictions of an impending shakeout in the industry were to come to pass, the company was well positioned to take advantage of the fallout and strengthen its hold on various segments of the industry.

2001-2006: Most of Merrill's 9,000 Wall Street employees evacuate their offices opposite the World Trade Center during the 9/11 attacks. Three die. Merrill reaches $100 million settlement with New York Attorney General Eliot Spitzer over alleged conflicts of interest by research analysts. The same month, it names Stanley O'Neal chief executive. He becomes chairman in April 2003. Merrill adds billions of dollars of mortgages to its balance sheet. It acquires First Franklin Financial Corp, a subprime mortgage lender owned by National City Corp.

Why Merrill Lynch failed and had to be sold to Bank of America

- **2007 subprime mortgage financial crisis**

In November 2007, Merrill Lynch announced it would write-down $8.4 billion in losses associated with the national housing crisis and remove E. Stanley O'Neal as its chief executive. O'Neal had earlier approached Wachovia bank for a merger, without prior Board approval, but the talks ended after O'Neal's dismissal. In December 2007, the firm announced it would sell its commercial finance business to General Electric and sell off major shares of its stock to Temasek Holdings, a Singapore government investment group, in an effort to raise capital. The deal raised over $6 billion. In July 2008, the new CEO of Merrill Lynch, John Thain, announced $4.9 billion fourth quarter losses for the company from defaults and bad investments in the ongoing mortgage crisis. In one year between July 2007 and July 2008, Merrill Lynch lost $19.2 billion or $52 million daily. The company's stock price had also declined significantly during that time. Two weeks later, the company announced the sale of select hedge funds and securities in an effort to reduce their exposure to mortgage related investments. Temasek Holdings agreed to purchase the funds and increase its investment in the company by $3.4 billion.

Andrew Cuomo, New York Attorney General, threatened to sue Merrill Lynch in August 2008, over their misrepresentation of the risk on mortgage-backed securities. A week earlier, Merrill Lynch had offered to buy back $12 billion in auction-rate debt and said they were surprised by the lawsuit. Three days later, the company froze hiring and revealed that they had charged almost $30 billion in losses to their subsidiary in the United Kingdom, exempting them from taxes in that country. On August 22, 2008, CEO John Thain announced an agreement with the Massachusetts Secretary of State to buy back all auction-rate securities from customers with less than $100 million in deposit with the firm, beginning in October 2008 and expanding in January 2009. On September 5, 2008 Goldman Sachs downgraded Merrill Lynch's stock to "conviction sell" and warned of further losses from the company. Bloomberg reported in September 2008 that Merrill Lynch had lost $51.8 billion in mortgage-backed securities as part of the subprime mortgage crisis.

- **CDO controversies**

Merrill Lynch, like many other banks, became heavily involved in the mortgage-based collateralized debt obligation (CDO) market in the early 2000s. According to an article in Credit magazine, Merrill's rise to be the leader of the CDO market began in 2003 when Christopher Ricciardi brought his CDO team from Credit Suisse First Boston to Merrill. In 2005 Merrill took out advertisements in the back of Derivatives Week magazine, touting the fact that its Global Markets and Investing Group was the "#1 global underwriter of CDOs in 2004". To provide a ready supply of mortgages for the CDOs, Merrill purchased First Franklin Financial Corp., one of the largest subprime lenders in the country, in December 2006. BusinessWeek would later describe how between 2006 and 2007, Merrill was "lead underwriter" on 136 CDOs worth $93 billion. By the end of 2007, the value of these CDOs was collapsing, but Merrill had held onto portions of them, creating billions of dollars in losses for the company. In mid 2008, Merrill sold a group of CDOs that had once been valued at $30.6 billion to Lone Star Funds for $1.7 billion in cash and a $5.1 billion loan.

In April 2009, bond insurance company MBIA sued Merrill Lynch for fraud and five other violations. These were related to the credit default swap "insurance" contracts Merrill had bought from MBIA on four of Merrill's mortgage-based collateralized debt obligations. These were the "ML-Series" CDOs, Broderick CDO 2, Highridge ABS CDO I, Broderick CDO 3, and Newbury Street CDO. MBIA claimed, among other things, that Merrill defrauded MBIA about the quality of these CDOs, and that it was using the complicated nature of these particular CDOs (CDOs squared and cubed) to hide the problems it knew about in the securities that the CDOs were based on. However, in 2010 Justice Bernard Fried disallowed all but one of the charges: the claim by MBIA that Merrill had committed breach of contract by promising the CDOs were worthy of an AAA rating when, it alleges, in reality they weren't. When the CDOs lost value, MBIA wound up owing Merrill a large amount of money. Merrill disputed MBIA's claims.

In 2009 Rabobank sued Merrill over a CDO named Norma. Rabobank later claimed that its case against Merrill was very similar to the SEC's fraud charges against Goldman Sachs and its Abacaus CDOs. Rabobank alleged that a hedge fund named Magnetar Capital had chosen assets to go into Norma, and allegedly bet against them, but that Merrill had not informed Rabobank of this fact. Instead, Rabobank alleges that Merrill told it that NIR Group was selecting the assets. When the CDO value tanked, Rabobank was left owing Merrill a large amount of money. Merrill disputed the arguments of Rabobank, with a spokesman claiming "The two matters are unrelated and the claims today are not only unfounded but weren't included in the Rabobank lawsuit filed nearly a year ago".

Sale to Bank of America

Significant losses were attributed to the drop in value of its large and unhedged mortgage portfolio in the form of Collateralized Debt Obligations. Trading partners' loss of confidence in Merrill Lynch's solvency and ability to refinance short-term debt ultimately led to its sale. During the week of September 8, 2008, Lehman Brothers came under severe liquidity pressures, with its survival in question. If Lehman Brothers failed, investors were afraid that the contagion could spread to the other surviving investment banks. [Lehman Brothers filed bankruptcy on September 15, 2008, after government officials could not find a merger partner for it.] On Sunday, September 14, 2008, Bank of America announced it was in talks to purchase Merrill Lynch for $38.25 billion in stock. The Wall Street Journal reported later that day that Merrill Lynch was sold to Bank of America for 0.8595 shares of Bank of America common stock for each Merrill Lynch common share, or about US$50 billion or $29 per share. This price represented a 70.1% premium over the September 12 closing price or a 38% premium over Merrill's book value of $21 a share, but that also meant a discount of 61% from its September 2007 price. Congressional testimony by Bank of America CEO Kenneth Lewis, as well as internal emails released by the House Oversight Committee, indicate that Bank of America was threatened with the firings of the management and board of Bank of America as well as damaging the relationship between the bank and federal regulators, if Bank of America did not go through with the acquisition of Merrill Lynch.

In March 2009 it was reported that in 2008, Merrill Lynch received billions of dollars from its insurance arrangements with AIG, including $6.8bn from funds provided by the United States tax payers to bail out AIG.

Global Reach

Bank of America Merrill Lynch spans the Globe with divisions in United States, South America, Europe, and Asia. The U.S. headquarters are located in New York, South American Headquarters are at Brazil and Uruguay, European headquarters are based in London, and Asia headquarters are based in Hong Kong.

Industry awards

- Ranked No.1 in Barron's 2010 Top 1000 Advisors
- Ranked No.1 in Barron's 2010 list for most advisors with No. 1 ranking in their state
- Ranked No.1 in Barron's 2009 Top 1000 Advisors
- Ranked No.1 in Barron's 2009 list for most advisors with No. 1 ranking in their state
- Institutional Investor
    - Ranked No.3 in 2009 All-America Fixed-Income Research Team Survey
    - Ranked No.1 for Pan European coverage in the 2009 All-Europe Research team survey
    - Ranked No.3 in 2009 for Emerging EMEA coverage
    - Ranked No.3 in the 2009 All-Latin America survey and No.2 in the All-Brazil survey
    - Ranked No.5 in the 2009 All-Asia Research team survey
    - Ranked No.3 in 2009 All-America Equity Research Team Survey
- Alpha Magazine – Ranked No.3 by hedge funds in survey for All-Asia research teams
- Forbes/Zacks – Best Brokerage for stock picking and estimate accuracy; captured more than twice the awards of the runner-up. Seven out of 12 analysts named to “Dazzling Dozen”

- Wall Street Journal “ Best on the Street Stock Picking” Award – No.3 in the U.S.; 17 ranked analysts
- Thomson Reuters Extel – No.1 for Pan-European Equity Sectors Rsch; No.2 for Pan-European Equity & Equity Linked Rsch; No.2 for Continental European Small & Mid Caps Rsch
- Financial Times/StarMine
    - Ranked No.1 Global Broker, No.1 US Broker; No.2 Europe Broker and No.5 Pan-Asia Broker; received 42 individual analyst awards (May 2009)

Ranked No.1 in the U.S., No.2 in Latin America, No.2 in Asia Pacific ex-Japan, No.3 in Developed Europe in the 2009 for earnings forecasts; Ranked No.4 in Asia Pacific ex-Japan, and No.5 in Latin America in the 2009 for Stock Recommendations.