

CRS Report for Congress

Bear Stearns: Crisis and “Rescue” for a Major Provider of Mortgage-Related Products

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Gary Shorter
Specialist in Business and Government Relations
Government and Finance Division



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Summary

In March 2008, Bear Stearns, the nation’s fifth largest investment banking firm, was battered by what its officials described as a sudden liquidity squeeze related to its large exposure to devalued mortgage-backed securities. On March 14, the Federal Reserve System announced that it would provide Bear Stearns with an unprecedented short-term loan. This was rendered essentially moot when, on March 16, a major commercial bank, JP Morgan Chase, agreed to buy Bear Stearns for about 1.5% of its share price of a year earlier. To help facilitate the deal, the Federal Reserve agreed to provide special financing in connection with the transaction for up to \$30 billion of Bear Stearns’s less-liquid assets. This report examines these developments and will be updated as events warrant.

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Introduction

On March 14, 2008, Bear Stearns (Bear), the nation’s fifth largest investment banking firm, was verging on bankruptcy from what its officials described as a sudden liquidity squeeze related to its large exposure to devalued mortgage-backed securities. On that day, it also received word that it was getting an unprecedented loan from the Federal Reserve System (Fed). The funding would take the form of a 28-day Fed loan to be channeled through the large commercial bank, J.P. Morgan Chase (JP Morgan). The decision was unprecedented: never before had the Fed committed to “bailing out” a financial entity that was not a commercial bank. This action was criticized by some Members of Congress, but gained support from Chairman Christopher Dodd of the Senate Banking Housing, and Urban Affairs Committee, which has Fed oversight.¹

Bear’s liquidity crisis and the resulting Fed intervention, largely viewed as an effort to stabilize the firm and to avert a wider financial panic, sent alarms throughout the stock markets over Bear’s fragility and more broadly over the potential precariousness of other major financial institutions. The day of the announcement, Bear’s stock lost almost half of its value, and the stocks of other major Wall Street firms also tumbled. These concerns then spilled over into the broader universe of stocks: the Dow Jones Industrial Average, a broad index of the overall stock market, lost nearly 200 points, slightly more than 1.5% of its value.

The Fed’s actions were characterized as a short-term fix; at the same time, Bear executives were also seeking a buyer to purchase the highly-leveraged firm, which was also one of the nation’s largest underwriters of now-troubled mortgage-backed securities. On March 16, two days after the announcement of the Fed intervention, JP Morgan agreed to buy it.

This report provides an overview of Bear Stearns, examines the Fed’s “rescue plan,” and JP Morgan’s subsequent agreement to acquire the firm.

¹ In recent memory, the Fed only approached this kind of specific non-bank intervention in 1998 when it helped organize a rescue of Long-Term Capital Management (LTCM), a large U.S.-based hedge fund. Concerned about the possible dire consequences for world financial markets if the failing LTCM collapsed, Fed officials were instrumental in convincing a group of U.S. and European financial institutions to inject several billion dollars into the hedge fund. They did so, and in exchange collectively received a majority share.

Some Background on Bear Stearns

With about 14,000 employees worldwide, 85-year-old Bear is a diversified financial services holding company whose core business lines include institutional equities, fixed income, investment banking, global clearing services, asset management, and private client services.

As is also the case for its Wall Street and commercial banking peers, as housing prices took off and the mortgage industry surged earlier in this decade, Bear became actively involved in aspects of this market. It was a vertically integrated involvement that ranged from the purchase and operation of residential mortgage originators to packaging and underwriting vast pools of mortgages into “structured” securities products broadly known as mortgage-backed securities (MBS). Such products would in turn be sold to institutional investors, such as hedge and pension funds, while some were retained by the bank itself.

With the collapse of the housing market, Bear began facing very dramatic financial travails in June 2007: the firm announced that two of its hedge funds that were significantly invested in subprime mortgages were in trouble. In an attempt to keep them afloat, Bear poured \$1.6 billion into the funds. Nonetheless, soon afterwards, the funds lost all of their value and were allowed to wind down. By various accounts, the funds’ meltdown signaled the start of a collapse in the vital element of trust that must exist between a firm like Bear and its many customers. In October 2007, Bear agreed to a needed \$1 billion capital investment from China’s government-controlled Citic Securities. Later, in the fourth fiscal quarter of 2007, having written down more than \$2 billion in devalued mortgage securities,² the company reported its first-ever quarterly loss, an unexpectedly high deficit of \$859 million.

At the heart of Bear’s problems have been MBS, which Bear and other Wall Street firms such as Merrill Lynch were actively engaged in packaging, underwriting, trading, and investing in for themselves. What follows is a brief primer on MBS.

Mortgage-Backed Securities

In an overview of the general credit market doldrums that are a product of problems that originated in the housing and mortgage markets, a CRS report described MBS:

Securitization allowed mortgage lenders to bypass traditional banks. Securitization pools mortgages or other debts and sells them to investors in the form of bonds rather than leaving loans on lenders’ balance sheets. The MBS market developed in part because long-term fixed rate mortgages held in banks’ portfolios place banks at significant risk if interest rates rise (in which case, the banks’ interest costs could exceed their mortgage interest earnings). MBS were

² David Smith and Dominic Rushe, “Bear Stearns: The Banking Twister Heading Your Way,” *The (UK) Sunday Times*, March 16, 2008.

popular with investors and banks because it allowed both to better diversify their portfolios. But because the MBS market was growing rapidly in size and sophistication, accurate pricing of its risk was difficult and could have been distorted by the housing boom.

There are several forms of MBS. The simplest are called pass-throughs — interest and principal payments from homeowners are collected by the lender (or a service firm) and passed through to the owner of the MBS. More complex securities are created by pooling MBS as well as mortgages, and by giving investors a menu of risk and return options. A mortgage pool may be split into parts (called tranches) to allow cautious investors to purchase safer portions and aggressive investors to purchase the riskier, high-return tranches (e.g., tranches that bear initial losses). Finally, mortgage cash flows may be combined with derivative instruments that link payment levels to the performance of financial variables, such as interest rates or credit conditions. These securities — combinations of traditional bonds and derivatives — are called structured products.

The growth of securitization meant that more loans could be originated by non-banks, many of which are not subject to examination by federal bank examiners and not subject to the underwriting guidances issued by federal financial regulators....³

Bear Stearns and the Initial Fed “Rescue”

A little more than a week before the Fed’s announced rescue on March 14, 2008, fixed income traders reportedly began hearing rumors that European financial institutions had ceased doing fixed income trades with Bear. Fearing that their funds might be frozen if Bear wound up in bankruptcy, a number of U.S.-based fixed-income and stock traders that had been actively involved with Bear, had reportedly decided by March 10 to halt such involvement.⁴

That development placed firms that still wanted to do business with Bear in a quandary: in the event that Bear did succumb, they were likely to be in the difficult position of explaining to their clients why they had ignored the rumors; on March 11, a major asset-management company ceased doing trades with Bear.⁵ The same day, however, the Bear’s Chief Executive Officer, Alan Schwartz, wrote that the firm’s “balance sheet, liquidity and capital remain strong.”⁶

That same week, many other firms began exercising extreme caution in their dealings with Bear, as the firm saw the exodus of a growing number of its trading

³ CRS Report RL34182, *Financial Crisis? The Liquidity Crunch of August 2007*, by Darryl E. Getter, Mark Jickling, Marc Labonte, and Edward Vincent Murphy.

⁴ Kate Kelly, Greg Ip, and Robin Sidel, “Fed Races to Rescue Bear Stearns in Bid to Steady Financial System Storied Firm,” *Wall Street Journal*, March 15, 2008, p. A1.

⁵ *Ibid.*

⁶ *Ibid.*

counterparties. Some hedge fund clients, demanding that Bear provide cash as collateral on trades they had done with the firm, withdrew funds from their accounts with the firm. Hedge funds that had used Bear to borrow money and clear trades were withdrawing cash from their accounts. Some large investment banks stopped accepting trades that would expose them to Bear, and some money market funds reduced their holdings of short-term Bear-issued debt. Concerned that the firm's ability to pay claims was looking less assured, a number of institutional investors with credit default swaps (insurance policies that protect against corporate bond defaults) purchased from Bear, were attempting to undo those trades. (Bear had developed a sizeable market in swaps.)

This ongoing activity contributed to a precipitous and alarming drop in Bear's cushion of liquidity reserves. By the afternoon of March 13, the firm's CEO was convinced of the severity of the problem. After deliberating with other senior company staff and company lawyers, a call was made to James Dimon, CEO of JP Morgan, the nation's second largest bank in stock market capitalization. As the clearing agent for Bear's trades, JP Morgan was familiar with Bear's collateral position and thus seemed like a good prospect for lending to the firm.⁷

Later, JP Morgan's CEO and other JP Morgan senior officials held conversations with representatives from the Fed. The conclusion was that something needed to be done because a failure at Bear could have widespread financial repercussions.

By the evening of March 13, Bear had been unable to secure emergency financing or negotiate a strategic acquisition deal. Officials from the firm and the Securities and Exchange Commission, the principal Bear regulator, then informed officials from the Fed that Bear had lost far more of its liquidity than it had previously been aware of. The Fed then sent a team of examiners to look at Bear's books overnight. Early on the morning on March 14, a cadre of financial regulators, including New York Fed Chief Timothy Geithner, Fed Chairman Ben Bernanke, and U.S. Treasury Department Secretary Henry Paulson conducted a conference call. At 7:00 a.m., at the call's conclusion, the Fed decided it would offer a short-term "discount window" loan.⁸

Through the discount window, the Fed can make direct short-term loans to commercial banks. A 1932 provision of the Federal Reserve Act allows it to lend to non-banks if at least five of its seven governors approve, a provision that has not been used since the Great Depression. With two governors' seats vacant and one governor out of the country and inaccessible, the Fed invoked a special legal clause, allowing it to approve the 28-day loan to Bear with only four governors. The arrangement would involve providing collateral-based financing to Bear through JP Morgan, which would be used as a conduit, since as a commercial bank, it already has access to the discount window and is also under the Fed's supervision. Exact terms were not disclosed, but the loan amount would only be limited to the amount

⁷ Ibid.

⁸ This is credit extended by a Federal Reserve Bank to an eligible depository institution that must be secured by collateral.

of collateral Bear could provide. JP Morgan would incur no risk from the transaction but the Fed would.⁹

After the announcement, a vigorous debate over the policy implications ensued. Two opposing views predominated:

- **Intervention made sense because of the threat of increased market instability if Bear went down.** It was argued by some, including Treasury Secretary Henry Paulson,¹⁰ that the Fed's intervention was wholly justified in pursuit of the larger goal of ensuring financial stability by averting potentially far reaching spillovers into the larger financial world if Bear were to collapse. One concern was that such a failure would unleash additional lack of confidence into markets already fraught with substantial pessimism and uncertainty. Another concern involved the \$46 billion in mortgages, mortgage-backed and asset-backed securities (as reported on November 30, 2007) held by the firm. If Bear failed, it would likely have to liquidate such assets, a large fraction of which held somewhat questionable valuations based on what it said were estimates derived from "internally developed models or methodologies utilizing significant inputs that are generally less readily observable."¹¹ A large stream of such assets released into risk-averse markets with leery and anxious buyers would be likely to force many institutions with similar assets into substantial asset write downs. The outcome of all of this could be a financial meltdown.
- **The intervention helps shield the firm and the markets from the consequences of running a badly performing firm.** Moral hazard occurs when entities do not bear the full cost of their actions, thus becoming more likely to repeat them. And a major concern here is that with Fed intervention, neither Bear nor the markets in general, would benefit from the painful but important lesson that failed firms should simply be left to their own fate. For example, if, after the Bear intervention, another Wall Street firm like Lehman also found itself "on the ropes" — would there be an expectation that it also would be rescued? These kind of arguments are often used to challenge the widely held belief in "Too Big to Fail" — the idea that the largest and most powerful financial institutions are too large a part of the financial system to let fail.

⁹ Kate Kelly, Greg Ip, and Robin Sidel, "Fed Races to Rescue Bear Stearns in Bid to Steady Financial System Storied Firm."

¹⁰ Andrew Clark, "Bear Stearns Saved by Rock-Bottom JP Morgan Bid," *Guardian.co.uk*, March 16, 2008.

¹¹ Gretchen Morgenson, "Rescue Me: A Fed Bailout Crosses a Line," *The New York Times*, March 16, 2008, p. Bu-1.

JP Morgan Agrees to Acquire Bear Stearns with Fed Assistance

The Fed's rescue effort would soon, however, be eclipsed and essentially made moot by a bigger development: on Sunday, March 16, two days after the lifeline's announcement, JP Morgan, one of the only major banks not to be significantly battered by the mortgage meltdown, agreed to acquire Bear for \$236 million. In the preceding days, Bear executives were both preparing for a possible Chapter 11 bankruptcy filing and pursuing a purchaser for either all or parts of the firm. The idea was that securing an immediate acquirer before trade resumed on Monday, March 17 would allow the firm to avoid likely mass withdrawals by its clients in early opening markets like Japan. After intense negotiations between Bear and JP Morgan with the active encouragement of the Fed and Treasury officials, JP Morgan signed on as Bear's purchaser.

JP Morgan's stock-for-stock buyout was valued at \$2 a share for Bear stock, the closing share price on March 15, which represented a 94% discount to Bear's closing share price of \$30 on March 14,¹² and slightly over 1% of the \$170 share price that Bear stock had fetched a year earlier. The boards at both Bear Stearns and JP Morgan quickly approved the deal, as did the Fed, and the Office of the Comptroller of the Currency.

The deal needed the approval of shareholders at both Bear and JP Morgan. At Bear, a schism between its bondholders and its shareholders has reportedly arisen after the announced sale. Interested in keeping the firm out of bankruptcy, and protecting their investment in it, bondholders are generally said to be supportive of the sale. But many shareholders, including some employees with an equity interest in the firm, are said to be opposed to the \$2 a share offer. In heavy trading on Tuesday, March 18, the firm's share price closed at \$5.91.¹³

A release from JP Morgan said that, "effective immediately, JP Morgan Chase is guaranteeing the trading obligations of Bear Stearns and its subsidiaries and is

¹² Ibid. Some unhappy Bear Stearns' investors have criticized Bear Stearns' CEO, Alan Schwartz, for comments he reportedly made on CNBC on Wednesday, March 11 in which he said that the firm's liquidity position was strong and described a \$17 billion liquidity cushion that had "virtually been unchanged" from the end of 2007. Responding to such concerns, the SEC's enforcement arm has reportedly sent a letter to JP Morgan that discussed "investigations and potential future inquiries into conduct and statements by Bear Stearns" before the announcement of the acquisition. "S.E.C. Eyes Bear Stearns' Comments," *the New York Times Dealbook*, March 19, 2008. The SEC has also opened an investigation into whether some Bear Stearns' investors spread false rumors about the company's financial situation as they took short positions on the company's stock, betting that share prices would fall. Landon Thomas, "It's Bondholders vs. Shareholders in a Race to Buy Bear Stearns Stock," *New York Times*, March 19, 2008.

¹³ Landon Thomas, "It's Bondholders vs. Shareholders in a Race to Buy Bear Stearns Stock," *New York Times*, March 19, 2008.

providing management oversight for its operations.... The transaction is expected to have an expedited close by the end of the calendar second quarter 2008....”¹⁴

According to spokespersons at the Fed, the initial loan commitment to Bear (via JP Morgan) was made on Friday, March 14 and was then repaid on Monday, March 17. An integral part of the merger deal is that the Fed agreed to provide what is described as a non-recourse loan to JP Morgan for up to \$30 billion of Bear’s less-liquid assets.¹⁵ Sources at the Fed told CRS that it would then be in a position to liquidate the assets. If they rose in value before they are sold, the Fed will make money. If they fell in value, the Fed would lose. The Fed’s role in this was reportedly necessary to overcome JP Morgan’s reluctance to taking on much of Bear’s risky portfolio of complex mortgages and other questionable investments.¹⁶

In a recap of the aforementioned debate over the threat of systemic risk versus the concern over moral hazard surrounding the Fed’s earlier effort, the Fed’s latter actions are also controversial. Some observers such as Senate Banking Committee Chairman Christopher Dodd, say that the Fed’s action was defensible given the threat of systemic risk.¹⁷

However, others, like John Taylor, CEO of the National Community Reinvestment Coalition, are critical. Mr. Taylor said that the action was an unjustifiable bailout because, “... we may be left holding the bill as taxpayers.”¹⁸

Expressing a kind of “middle ground” view on the Fed’s intervention, Vincent Reinhart, a former Fed official who is now with the American Enterprise Institute, observed that “it is a serious extension of putting the Federal Reserve’s balance sheet in harm’s way. That’s got to tell you the economy is in a pretty precarious state.”¹⁹

¹⁴ “JP Morgan Chase To Acquire Bear Stearns,” *J. P. Morgan News Release*, March 16, 2008.

¹⁵ *Ibid.*

¹⁶ Andrew Clark, “Bear Stearns Saved by Rock-Bottom JP Morgan Bid.”

¹⁷ William Neikirk, “Fed Action Awaited on Size of Rate Cut Markets Hope Likely Rate Cut will Stem Tide,” *Baltimore Sun*, March 18, 2008.

¹⁸ David J. Lynch, “Is it a \$30B Bailout by the Fed or Just a Smart Move?” *USA Today*, March 18, 2008.

¹⁹ “Fed Cuts Discount Rate, Backs Bear Stearns Deal,” *Providence Business News*, March 15, 2008.

article on Bloomberg details losses on mortgage-backed securities-related CDOs. June, 2007 Washington Mutual shuts down Long Beach Mortgage Corporation as a separate entity (Source: Levin report, page. Borrowings in the name of JPMorgan, Bear Stearns, and Washington Mutual: Borrowing dates: \$175 million on March 3, 2008. Average from JPMorgan Chase would absorb Bear Stearns in a Fed-supported rescue. The graph below shows the dual peaks in the consolidated borrowings in the names of JPMorgan Chase, Bear Stearns and Washington Mutual. The first peak borrowing for the combined firms from the Fed was \$101.1 billion on April 3, 2008, two weeks after the rescue of Bear Stearns. The second peak was \$67.5 billion on October 15, 2008, one month after the rescue. At Bear Stearns, I worked with an outstanding group of people who built a relatively small firm into the fifth-largest investment bank. But similar to other banks, we became deeply embroiled in the crisis when our risk models, which were primarily based on previous market cycles, failed to account for the devastating impact of untested financial instruments, such as structured mortgage-backed debt. A fertile environment for an overheated market. A former waitress for a North Carolina-based restaurant chain is suing the company after enduring months of alleged sexual assault and harassment including one instance when she received an anonymous threat after reporting that her private sex tape had been circulated amongst coworkers. MarketWatch. Congressional Research Service, "Bear Stearns: Crisis and "Rescue"™ for a Major Provider of Mortgage-Related Product." (March 26 2008), (accessed May 16, 2009). "Statement by Secretary Henry M. Paulson, Jr. on Comprehensive Approach to Market Developments." (September 19, 2008), (accessed March 2, 2009). U.S. Department of the Treasury. "Fact Sheet: Financial Stability Plan." (February 10, 2009), (accessed February 10, 2009). Bear Stearns was an investment bank located in New York City that collapsed during the subprime mortgage crisis in 2008. Despite surviving and then thriving after the Great Depression, Bear Stearns was a player in the mortgage meltdown and Great Recession that followed. Bear Stearns operated a wide range of financial services. Inside this mix were hedge funds that used enhanced leverage to profit from collateralized debt obligations (CDOs) and other securitized debt markets. In April 2007, the bottom fell out of the housing market, and the investment bank quickly began to realize that the actual risk of these hedge fund strategies was much larger than originally believed. Bear Stearns didn't collapse because its stock was low--the company crumbled because no one would lend it money. The Federal Reserve then intervened, not because they were worried about Bear Stearns, but because they feared a meltdown in the credit markets if Bear defaulted on its debt. The dangers in this cycle, says Waggoner, could be bigger than we've seen in a long time. Investors need to act now in order to protect their portfolios, and Waggoner shows how. Panics in the stock market are nothing new--so what makes the recent events surrounding the credit crisis and Bear Stearns collapse so worrisome? More importantly, what does it mean to you as an individual investor?