

An hourglass-shaped graphic with a globe inside. The top bulb is dark blue, and the bottom bulb is light blue. The globe is a darker shade of blue. The hourglass is centered on the page.

WikiLeaks Document Release

<http://wikileaks.org/wiki/CRS-RL34420>

February 2, 2009

Congressional Research Service

Report RL34420

*Bear Stearns: Crisis and "Rescue" for a Major Provider of
Mortgage-Related Products*

Gary Shorter, Government and Finance Division

April 9, 2008

Abstract. 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 in an exchange of stock shares for about 1.5% of its share price of a year earlier, a price that translated to \$2/share. 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.

WikiLeaks



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

Gary Shorter
Specialist in Financial Economics

April 9, 2008

<http://wikileaks.org/wiki/CRS-RL34420>

Congressional Research Service

7-5700

www.crs.gov

RL34420

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 in an exchange of stock shares for about 1.5% of its share price of a year earlier, a price that translated to \$2/share. 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.

During the weekend of March 22, in the wake of criticism from Bear shareholder and employees (employees own about one-third of the firm's outstanding stock) over the \$2/share price, Bear Stearns and JP Morgan renegotiated the terms of the deal: JP Morgan will purchase 95 million newly issued shares of Bear's common stock at \$10/share in a stock exchange. In response to the changed deal conditions, the Fed altered the terms of its financial involvement: it got JP Morgan to agree to absorb the first \$1 billion in losses if the collateral provided by Bear for a loan proves to be worth less than Bear Stearns's original claims. Instead of its original agreement to absorb up to \$30 billion, the Fed will now be responsible for up to \$29 billion.

The Fed's unprecedented role has generated a widespread debate on the implications of such an intervention. Some, including Senate Banking, Housing, and Urban Affairs Committee Chairman Chris Dodd, have argued that in order to avoid potential systemic financial risk, the involvement made sense. But others, including Senator Richard Shelby, ranking member of the Senate Banking Committee, have concerns that it tells the market that the Fed is willing to help a large and failing financial enterprise, setting a bad precedent in terms of corporate responsibility.

The Senate Banking Committee held a hearing on April 3, 2008, solely devoted to issues surrounding the acquisition of Bear Stearns.

This report will be amended as events dictate.

Contents

Introduction	1
Background on Bear Stearns	1
Mortgage-Backed Securities	2
Bear Stearns and the Initial Fed “Rescue”	3
JP Morgan Initially Agrees to Acquire Bear Stearns with Fed Assistance	4
The Amended Buyout Offer	5
The Altered Terms for the Fed and the Debate over Moral Hazard and Systemic Risk.....	6
Related Congressional Concerns	10

Contacts

Author Contact Information	11
----------------------------------	----

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. The 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.

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.

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.

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, CRS Report RL34182, *Financial Crisis? The Liquidity Crunch of August 2007*, by Darryl E. Getter et al.

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 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

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

³ CRS Report RL34182, *Financial Crisis? The Liquidity Crunch of August 2007*, by Darryl E. Getter et al.

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 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.

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.

⁷ Ibid.

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 an overnight 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 of collateral Bear could provide. JP Morgan would have incurred no risk from the transaction but the Fed would.⁹

JP Morgan Initially Agrees to Acquire Bear Stearns with Fed Assistance

On Monday, March 17, the \$13 billion back-to-back non-recourse loan through JPMorgan Chase to Bear was repaid to the Fed (with weekend interest of nearly \$4 million). This event, however, was eclipsed when on Sunday, March 16, two days after the announcement of the loan lifeline, 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, 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 had reportedly arisen after the announced sale. Interested in keeping the firm out of bankruptcy, and protecting their investment in it, bondholders were generally said to be supportive of the sale. But many shareholders, including some employees with an equity interest in the firm, were said to be opposed to the \$2 a share offer. In heavy trading on Tuesday, March 18, the firm's share price closed at \$5.91.¹⁰

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

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

¹⁰ Landon Thomas, "It's Bondholders vs. Shareholders in a Race to Buy Bear Stearns Stock," *New York Times*, March 19, 2008.

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 providing management oversight for its operations.... The transaction is expected to have an expedited close by the end of the calendar second quarter 2008...."¹¹

An integral part of the initial merger deal was that the Fed would agree to provide what is described as a non-recourse loan to JP Morgan for up to \$30 billion of Bear's less-liquid assets.¹² The Fed 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 deemed necessary to overcome JP Morgan's reluctance to taking on much of Bear's risky portfolio of complex mortgages and other questionable investments.¹³

As JP Morgan CEO James Dimon told the Senate Committee on Banking, Housing, and Urban Affairs on April 4, we "could not and would not have assumed the substantial risk" of buying Bear without the Fed's involvement.¹⁴

The Amended Buyout Offer

Reportedly responding to Bear shareholders and employees (who own about one-third of Bear stock) angry over the \$2 a price share offer and to avert the attendant threat of shareholder litigation, Bear and JP Morgan renegotiated the terms of the merger during the weekend of March 22. The ensuing stock-for-stock merger agreement would value Bear stock at \$10 a share. JP Morgan will also buy 95 million new shares of Bear Stearns for the offering price. Under the new terms of the stock-for-stock deal, JP Morgan will pay 0.21753 of a share for each share of Bear, up from the original exchange ratio of 0.05473.¹⁵ Under the new terms, Bear would be valued at about \$1.2 billion up from the earlier \$236 million.

Also under the terms of the agreement, before April 8, Bear would sell 39.5% of 95 million shares of newly issued stock to JP Morgan, allowing the transaction to avoid a law in the state of Delaware, where both firms are headquartered. Delaware state law states that a shareholder vote is not necessary for the particular transaction if a company is selling up to 40% of its holdings. JP Morgan and Bear officials probably hoped that between the roughly 8% of Bear shares it acquired on the open market and the 5% of Bear shares held by members of its board, the 39.5% vote would give them the majority votes required for eventual shareholder approval.

Generally, the New York Stock Exchange (NYSE), where JP Morgan and Bear shares are listed and traded, requires shareholder approval if an issue of new shares are convertible into more than

¹¹ "JP Morgan Chase To Acquire Bear Stearns," *J. P. Morgan News Release*, March 16, 2008.

¹² Ibid.

¹³ Andrew Clark, "Bear Stearns Saved by Rock-Bottom JP Morgan Bid."

¹⁴ Kara Scannell and Sudeep Reddy, "Officials Say They Sought To Avoid Bear Bailout," *Wall Street Journal*, April 4, 2008. P. A-1.

¹⁵ There are reports that during a March 17, 2008, phone call with JP Morgan's CEO, the Chairman of Bear's board, James Cayne, criticized the \$2-a-share price, even after voting for it. Additional reports have said that after the initial terms of the deal were made, Bear's CEO, Alan Schwartz, was privately telling people that he felt that the company had been "mugged." Robin Sidel and Kate Kelly, "J.P. Morgan Quintuples Bid to Seal Bear Deal," *Dow Jones*, March 25, 2008, p. A-1.

20% of a listed company stock. But the rule has an exception if adherence to the procedure delays or seriously jeopardizes the financial viability of the listed company. Bear and JP Morgan invoked the exception and the NYSE accommodated them. On April 8, the shares were issued.

JP Morgan Chief Executive Jamie Dimon said that "... we believe the amended terms are fair to all sides and reflect the value and risks of the Bear Stearns franchise and bring more certainty for our respective shareholders, clients, and the marketplace." Bear's CEO, Alan Schwartz, observed "...our board of directors believes the amended terms provide both significantly greater value to our shareholders, many of whom are Bear Stearns employees, and enhanced coverage and certainty for our customers, counterparties, and lenders."¹⁶

A number of shareholder lawsuits have been filed over the proposed sale. For example, during the last week of March, the Wayne County Employees' Retirement System of Michigan and the Police and Fire Retirement System of the City of Detroit sued Bear Stearns, its directors, and JP Morgan, and asked the Delaware Chancery Court to initially issue a temporary restraining order blocking Bear's plan to issue stock representing a 39.5% of its stake. The court refused to do so. And after the shares were issued on April 8, the pension funds changed their request and asked for a preliminary injunction to stop JP Morgan from voting any of the newly acquired shares. On April 9, a judge on the court responded by ordering a temporarily pause to the lawsuits, accepting the investment banks' argument that fighting simultaneous lawsuits in Delaware and New York (where other suits are pending) would be wasteful and burdensome.

The Altered Terms for the Fed and the Debate over Moral Hazard and Systemic Risk

When asked about whether they had encouraged the far smaller original offer, Fed Chairman Ben Bernanke said there was no "interjection" by the Fed "to my knowledge." Treasury Undersecretary Robert Steel indicate that "there was a view .. [that] ...the price should not be very high." But he noted that "with regards to the specifics, the actual deal was negotiated."¹⁷

With respect to the amended buyout, the Fed arranged for a more favorable role for itself.

Summarizing the terms of the Fed's involvement, the CRS Report, *Financial Turmoil: Federal Reserve Policy Responses*, reports that "As part of the [buyout] agreement, the Fed announced a \$29 billion loan to a corporation it created to buy \$30 billion of assets from Bear Stearns. In the event that the proceeds from the asset sales exceed \$30 billion and the outstanding interest, the Fed will keep the profits. In the event that the loan principal and interest exceed the funds raised by the liquidation, the first \$1 billion of losses would be borne by JP Morgan Chase, and any subsequent losses would be borne by the Fed. The statutory authority for the loan was based on a clause of the Federal Reserve Act to be used in "unusual or exigent circumstances" that had not been invoked in more than 70 years."¹⁸

¹⁶ Peter Coy, "A Sweeter Bear Bid May Sour the Fed, JP Morgan Raises its Offer in Hopes of Winning over Shareholders. Is the Federal Reserve too Cozy with Wall Street?" *BusinessWeek.com.*, March 25, 2008.

¹⁷ Robert Novak, "Wall Street in D.C." *Washington Post*, April 9, 2008.

¹⁸ CRS Report RL34427, *Financial Turmoil: Federal Reserve Policy Responses*, by Marc Labonte, p. 1.

Explaining the terms in greater detail, the report observed:

As part of the agreement, the Fed will purchase up to \$30 billion of Bear Stearns' assets through a Limited Liability Corporation (LLC) based in Delaware that it has created and controls. Upon its creation, two loans will be made to the LLC: the Fed will lend the LLC up to \$29 billion, and JP Morgan Chase will make a subordinate loan to the LLC worth \$1 billion. The Fed's loan will be made at an interest rate set equal to the discount rate (2.5% when the terms were announced, but fluctuating over time) for a term of 10 years, renewable by the Fed. JP Morgan Chase's loan will have an interest rate 4.5 percentage points above the discount rate.

Using the proceeds from that loan, the LLC will purchase assets from Bear Stearns worth \$30 billion at marked to market prices by Bear Stearns on March 14. The Fed reported that The portfolio supporting the credit extensions consists largely of mortgage-related assets. In particular, it includes cash assets as well as related hedges. The cash assets consist of investment grade securities (i.e. securities rated BBB- or higher by at least one of the three principal credit rating agencies and no lower than that by the others) and residential or commercial mortgage loans classified as "performing." All of the assets are current as to principal and interest (as of March 14, 2008).

All securities are domiciled and issued in the U.S. and denominated in U.S. dollars. The portfolio consists of collateralized mortgage obligations (CMOs), the majority of which are obligations of government-sponsored entities (GSEs), such as the Federal Home Loan Mortgage Corporation ("Freddie Mac"), as well as asset-backed securities, adjustable-rate mortgages, commercial mortgage-backed securities, non-GSE CMOs, collateralized bond obligations, and various other loan obligations.

The LLC will own these assets, and will liquidate them in order to pay back the principal and interest owed to the Fed and JP Morgan Chase. The LLC's assets (purchased from Bear Stearns) are the collateral backing the loans from the Fed and JP Morgan Chase. A private company, BlackRock Financial Management, has been hired to manage the portfolio. Neither Bear Stearns nor JP Morgan Chase owe the Fed any principal or interest, nor are they liable if the LLC is unable to pay back the money the Fed lent it. The New York Fed explained that the LLC was created to "ease administration of the portfolio and will remove constraints on the money manager that might arise from retaining the assets on the books of Bear Stearns." JP Morgan Chase and Bear Stearns will not receive the \$29 billion from the LLC until the merger is complete. In the meantime, JP Morgan Chase and the Fed have delegated control of the assets to the LLC, including the right to liquidate them before the merger.¹⁹

The unprecedented Fed intervention has triggered a widespread debate over the action's merits. The two predominant and opposing views are as follows:

- **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,²⁰ 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—often called systemic risk. One concern was that such a failure would unleash

¹⁹ Ibid, p. 7-8.

²⁰ Andrew Clark, "Bear Stearns Saved by Rock-Bottom JP Morgan Bid," *Guardian.co.uk*, March 16, 2008.

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."²¹ 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. In the case of Bear Stearns, a more aptly put variation on this might be that "it was too widely connected (to clients and counterparties) to fail."

Defending the Fed's role during April 2nd testimony before the Joint Economic Committee, Fed Chairman, Ben Bernanke, observed:

... Our financial system is extremely complex and interconnected, and Bear Stearns participated extensively in a range of critical markets. With financial conditions fragile, the sudden failure of Bear Stearns likely would have led to a chaotic unwinding of positions in those markets and could have severely shaken confidence. The company's failure could also have cast doubt on the financial positions of some of Bear Stearns' thousands of counterparties and perhaps of companies with similar businesses. Given the current exceptional pressures on the global economy and financial system, the damage caused by a default by Bear Stearns could have been severe and extremely difficult to contain. Moreover, the adverse effects would not have been confined to the financial system but would have been felt broadly in the real economy through its effects on asset values and credit availability. To prevent a disorderly failure of Bear Stearns and the unpredictable but likely severe consequences of such a failure for market functioning and the broader economy, the Federal Reserve, in close consultation with the Treasury Department, agreed to provide funding to Bear Stearns through JPMorgan Chase. Over the following weekend, JP Morgan Chase agreed to purchase Bear Stearns and assumed Bear's financial obligations...

Some congressional observers such as Senate Banking Committee Chairman Christopher Dodd and Joint Economic Committee Chairman Charles Schumer, have said that given the potentially

²¹ Gretchen Morgenson, "Rescue Me: A Fed Bailout Crosses a Line," *New York Times*, March 16, 2008, p. Bus.-1.

negative consequences of letting Bear Stearns fail, the Fed's action appears to have been justified.²²

Several Members of Congress have publicly expressed some concerns over the merits of the Fed's role. For example, Senator Sam Brownback commented that "the Federal Reserve acted swiftly and decisively during the Bear Stearns-JP Morgan marriage. However, I am concerned when taxpayer money is used to rescue sophisticated private investment and commercial banks from the consequences of the banks' own strategic decisions. I am interested in learning more about how the Federal Reserve will quantify the financial risk to the taxpayer resulting from the Fed's recent and any future actions to help private companies."²³

Echoing this theme, Representative Scott Garrett observed that "... Government isn't supposed to be in the business of picking winners and losers."²⁴ And, at an April 3 Senate Banking Committee hearing on Bear Stearns, Senator Richard Shelby, ranking member of the Senate Banking Committee, reportedly expressed general concern that the Fed's actions would create a "moral hazard" which "encourages firms to take excessive risk based on the expectations that they will reap all the profits while the federal government stands ready to cover any losses if they fail."²⁵

Outside of Congress, a number of observers have also criticized the Fed. For example, writing in the *Dow Jones Capital Market Report*, financial columnist Jim Murphy, rebutted the assertion that rescuing Bear Stearns was necessary to avoid systemic repercussions. He observed that "Here is the problem with the bailout of Bear Stearns: The assumption behind the operation is that Bear Stearns is a global investment bank and brokerage that offers goods and services not offered by the many other global investment powerhouses. This is simply untrue. Bear Stearns offered nothing and offers nothing that isn't offered by, say, JP Morgan Chase and Merrill Lynch, to name but two huge investment banks and brokerages. Had Bear Stearns been allowed to fail, the damage would have been limited to Bear Stearns shareholders, including the firm's employees. The collapse of Bear Stearns didn't really put much of a dent in the capital of the blueblood investors and institutions who were said to be the mainstays of the firm. In fact, of course, it was the flight of the big plungers to other wire houses that triggered the near collapse of Bear Stearns."²⁶

Former Fed Chairman Paul Volcker is similarly critical, observing that "...the Federal Reserve has judged it necessary to take actions that extend to the very edge of its lawful and implied powers, transcending in the process certain long-embedded central banking principles and practices What appears to be in substance a direct transfer of mortgage and mortgage-backed securities of questionable pedigree from an investment bank to the Federal Reserve seems to test the time-honored central bank mantra in time of crisis: lend freely at high rates against good collateral; test it to the point of no return."²⁷

²² William Neikirk, "Fed Action Awaited on Size of Rate Cut Markets Hope Likely Rate Cut will Stem Tide," *Baltimore Sun*, March 18, 2008. Robin Sidel, Greg Ip, Michael M. Phillips and Kate Kelly, "The Week That Shook Wall Street: Inside the Demise of Bear Stearns," March 18, 2008, *Wall Street Journal*, p. A-1.

²³ "Brownback Comments on Bernanke Testimony," *States News Service*, April 2, 2008.

²⁴ David Fredosso, "The Mother of All Government Bailouts," *NationalReviewOnline*, April 2, 2008.

²⁵ Dana Milbank, "Buddy Can You Spare a Million," *Washington Post*, April 3, 2008.

²⁶ Jim Murphy, "There Was No Reason to Rescue Bear Stearns," *Dow Jones Capital Markets Report*, March 27, 2008.

²⁷ John Brinsley and Anthony Massucci, "Volcker Says Fed's Bear Loan Stretches Legal Power," *Bloomberg*, April 8, 2008.

But in an essentially "middle ground" view on the Fed's intervention, Vincent Reinhart, a former Fed official who is now with the American Enterprise Institute, noted 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."²⁸

Related Congressional Concerns

Congressional interest in the Bear Stearns buyout is manifesting itself in a number of ways, which are described below.

On April 3, 2008, the Senate Banking, Housing, and Urban Affairs Committee held a hearing 3 solely devoted to the issue of Bear Stearns' acquisition and Fed involvement. The Senate Finance Committee has also shown some interest in the acquisition. On March 26, Committee Chairman Max Baucus and Ranking Member Senator Charles Grassley wrote to Fed Chairman Ben Bernanke, Treasury Secretary Henry Paulson, New York Fed Chairman Timothy Geithner, and the Bear Stearns and JP Morgan CEOs, requesting details of the sale agreement, how and by whom it was negotiated, and all the parties involved.²⁹

In making the request, Chairman Baucus observed, "Americans are being asked to back a brand new kind of transaction, to the tune of tens of billions of dollars. With jurisdiction over the federal debt, it's the Finance Committee's responsibility to pin down just how the government decided to front \$30 billion in taxpayer dollars for the Bear Stearns deal, and to monitor the changing terms of the sale..."³⁰

Additionally, on April 2, Chairman Baucus and Senator Grassley asked the SEC to provide them with complete details on the role of its regulatory oversight leading up to the acquisition, including information on the conduct of business, the influence of outside parties, the potential role of hedge funds, and the compensation of the firms' executives. The letter also requested information on whether, with respect to Bear Stearns, the SEC's capital and liquidity standards had been adequate and whether the company had avoided adhering to such standards.³¹

The same day, the Senators also wrote Bear Stearns and JP Morgan, requesting information on compensation and severance arrangements provided to their top management prior to and as a result of the merger agreement. They specifically requested data on various forms of compensation, including stock options, deferred compensation arrangements, and health care and other employee benefits. The letter also cited news reports that the SEC had previously been investigating Bear Stearns for improperly valuing mortgage securities. It also asked whether the probe represented a lost opportunity for the agency's Enforcement Division to discover the presence of systemic market risks.³²

²⁸ "Fed Cuts Discount Rate, Backs Bear Stearns Deal," *Providence Business News*, March 15, 2008.

²⁹ "Finance Leaders Question Players in Bear Stearns Deal," *Senate Finance Committee News Release*, March 26, 2008, p. 1.

³⁰ *Ibid.*

³¹ "Grassley Seeks Details of Executive Compensation, SEC Knowledge of Bear Stearns Collapse," *States News Service*, April 2, 2008.

³² *Ibid.* Separately, Senator Grassley has also reportedly asked the SEC's inspector general to examine why the agency failed to pursue reports of trouble at Bear Stearns, including an assessment of allegations that it was improperly valuing (continued...)

In early April 2008, Henry Waxman, chairman of the House Oversight and Government Reform Committee, wrote to New York Fed Governor Timothy Geithner, a key figure in the Fed's involvement in the merger, to inquire about the Fed's selection of BlackRock Financial Management Inc. as the asset manager for the deal that allowed JP Morgan Chase & Co. to purchase Bear Stearns at bargain-basement price.

Chairman Waxman observed, "Only limited details are known about the Federal Reserve's understandings with BlackRock. It appears, however, that BlackRock is now directly responsible for managing a \$30 billion portfolio on behalf of the American taxpayer ... If BlackRock does its job well, the taxpayers will be made whole or even experience a gain. If BlackRock is not successful, the taxpayers stand to lose billions of dollars. In effect, it appears that BlackRock is serving as a government contractor providing complex financial services to the Federal Reserve."

The chairman also inquired about how the Fed selected BlackRock, which he said appears to have gotten a long-term deal with the Fed without the competition that is usually found in a government bid. The chairman also asked about the nature of the compensation BlackRock will receive as reimbursement for its involvement.³³

Author Contact Information

Gary Shorter
Specialist in Financial Economics
gshorter@crs.loc.gov, 7-7772

(...continued)

mortgage-related securities. Specifically, the Senator reportedly requested information on communications between Bear Stearns and senior SEC officials and information on why SEC examiners failed to bring an enforcement action. He also reportedly asked whether there were any indications of any "improper action or misconduct" related to the SEC investigation and whether "more aggressive action" by the SEC's enforcement division might have provided an earlier sense of the conditions that may have contributed to Bear Stearns' problems. Ron Orol, "SEC, Bear Dealings Questioned," *TheDeal.com*, April 3, 2008.

³³ Letter to Timothy Geithner, President and CEO Federal Reserve of New York from Henry A. Waxman, Chairman of the House Oversight and Government Reform Committee, April 7, 2008, available at <http://oversight.house.gov/search/search.asp>.