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

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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 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 Stearn's original claims. Instead of its original agreement to absorb up $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 argue that the help made sense in the interest of avoiding potential systemic financial risk. Others argue that it tells the market that it is willing to help a large and failing financial enterprise, setting a bad precedent in terms of corporate responsibility.

This report will be amended as events dictate.

Contents

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

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.

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[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, CRS Report RL34182, *Financial Crisis? The Liquidity Crunch of August 2007*, 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

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[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.
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> 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

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[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

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[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 have incurred no risk from the transaction but the Fed would.[9]

JP Morgan Initially 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 meltdtown, 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]

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]

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[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.

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

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 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]

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.[14] Under the new terms, Bear would be valued at about $1.2 billion up from the earlier $236 million.[15]

Also under the terms of the agreement, before April 8, Bear will 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 are probably hoping that combined with the 5% of Bear shares held by members of its board, the 39.5% vote will give them the majority votes required for eventual shareholder approval.

Generally, the New York Stock Exchange, where JP Morgan and Bear shares are listed and traded, requires shareholder approval if an issue of new shares are

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[12] Ibid.

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

[14] 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.

[15] There are a number of observers, however, who question whether shareholders will be uniformly satisfied with the new price and will be willing to either withdraw or desist from shareholder suits.

convertible into more than 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 are reportedly invoking the exception and according to some reports, the NYSE is not expected to oppose the transaction and press for the imposition of the rule.[16]

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."[17]

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

According to some reports, the Fed was not initially supportive of the $10/share deal, raising questions about the pricing during the negotiations. Some observers think that some officials at the regulator preferred a lower price because "of the message it sent to the rest of the market..."[18]

In the end, however, the Fed appears to have supported the new terms but arranged for a more favorable role for itself. It agreed to make a $29 billion non-recourse loan to JP Morgan at the discount rate (currently 2.25%, but fluctuating over time) for a term of 10 years, renewable by the Fed. In return, the Fed will receive collateral in the form of assets worth $30 billion (with a haircut) at marked to market prices. Twenty billion of the assets are reportedly mortgaged-backed securities. Unlike the original arrangement, JP Morgan will be responsible for the first $1 billion in losses if the collateral provided by Bear for the loan proves to be worth less than Bear's original claims.

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

- **Intervention made sense because of the threat of increased market instability if Bear went down.** It was argued by some,

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[16] Robin Sidel and Kate Kelly, "J.P. Morgan Quintuples Bid to Seal Bear Deal," *Dow Jones*, March 25, 2008, p. A-1.

[17] 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.

[18] Andrew Ross Sorkin, "The Hand Behind The Deal," *New York Times*, March 25, 2008.

including Treasury Secretary Henry Paulson,[19] 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 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."[20] 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 apt variation on this them is that "it was too widely connected (to clients and counterparties) to fail."

Some observers such as Senate Banking Committee Chairman Christopher Dodd, have said that the Fed's action was defensible given the threat of systemic risk.[21]

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

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

[21] William Neikirk, "Fed Action Awaited on Size of Rate Cut Markets Hope Likely Rate Cut will Stem Tide," *Baltimore Sun*, March 18, 2008.

However, others, like John Taylor, CEO of the National Community Reinvestment Coalition, are critical. Mr. Taylor have said that the action was an unjustifiable bailout because, " … we may be left holding the bill as taxpayers."[22]

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."[23]

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[22] David J. Lynch, "Is it a $30B Bailout by the Fed or Just a Smart Move?" *USA Today*, March 18, 2008.

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