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Statement of the Shadow Financial Regulatory Committee on

If Bear Had Been a Bank

May 5, 2008

The Federal Reserve's recent involvement in the acquisition of Bear Stearns was part of a series of actions to address financial turmoil in the market. The Fed feared that if Bear entered bankruptcy proceedings the spillover in the repo market and the market for Credit Default Swaps could have systemic consequences. The Federal Reserve invoked a Depression-era amendment to the Federal Reserve Act authorizing the Fed to grant loans to individuals, partnerships and corporations in emergency situations. It used that power to make an overnight loan to Bear Stearns through JPMorgan Chase. Subsequently, it engaged in a complex financing arrangement that involved providing financial assistance to JPMorgan Chase to enable it to acquire Bear Stearns. To finance this transaction, the Fed established a special purpose entity (SPE) to acquire $30 billion in assets from Bear Stearns. The SPE was funded by a $29 billion loan from the Fed and $1 billion of subordinated debt from JPMorgan Chase. Black Rock will serve as trustee of the SPE to manage and liquidate the assets over a ten-year period with an optional extension.

Because Bear Stearns was an investment bank, not a commercial bank, the Fed faced a limited range of options when it was notified that Bear was experiencing financial difficulties. Although Bear Stearns was a prime dealer, it didn't have access to the discount window to deal with its own emergency liquidity needs. After the collapse, the Fed did open the discount window to prime dealers on a temporary basis.

If Bear Stearns had been a bank, events during the second week of March should have unfolded quite differently. If Bear had been a bank, it would have been subject to the prompt corrective action requirements like those in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), long before it experienced difficulties in March. As its capital fell, it would have been subject to increasing incentives to recapitalize and to regulatory constraints on its ability to take risk. The authorities would have had broad and deep knowledge of its positions. If Bear had not taken sufficient corrective action, it would have been subject to the least-cost resolution requirement unless policy makers determined that a systemic risk exception should be exercised.[1] It is likely that the authorities would have invoked the systemic risk exception in the case of Bear, but it would have required the appropriate approvals and a rigorous review by an independent government authority.

If Bear had been a bank, a bridge bank could have been established. This would have enabled the authorities to continue all of the systemically important functions of Bear on a seamless basis, without necessarily guaranteeing all claimants. A bridge bank would have stabilized markets because the new institution's obligations would have been guaranteed for a two-year period by the Federal Reserve with three possible one-year extensions if necessary. This would have provided an opportunity to make the optimal disposition of Bear, whether by merger on market terms, or in piecemeal sell-off of lines of business or phased liquidation.

Despite claims to the contrary by Treasury officials, the Federal Reserve's involvement amounted to a bailout of Bear Stearns that benefited several parties. Shareholders did receive some value, albeit less than the market value of their holdings several weeks prior, but certainly more than would have been the case had it gone into bankruptcy. JPMorgan acquired what it regarded as a valuable franchise at a very low price with financial support from a governmental agency. Creditors and debt holders of Bear Stearns also benefited since their claims will be settled in full and, in the case of debt holders, the value of their debt increased substantially in value. Finally, counterparties were made whole and avoided the disruption and costs that would have resulted had Bear Stearns gone into bankruptcy. Protecting all counterparties, however, undermines their incentives to monitor and discipline risk taking and can ultimately lead to larger crises in the future.

The Committee is concerned about several aspects of the transaction. First, the use of government resources to finance a private sector acquisition conveys a windfall to an individual institution. Indeed, the increase in market value of $12 billion of JPMorgan Chase at the initial announcement of the purchase provides a rough estimate of the substantial subsidy embedded in the deal. This increase is all the more remarkable because other leading financial institutions suffered a decline that day. In light of this market signal, the Federal Reserve should have been in a strong position to reduce the subsidy.

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[1] An affirmative judgment would require a two-thirds vote of Boards of the Federal Reserve and the FDIC and the approval of the Secretary of Treasury after consultation with the President. This would be followed by notification to Chairs of the House and Senate Banking Committees. The Government Accountability Office would perform an audit to verify that the systemic risk exception was justified. Any loss incurred by the FDIC would be paid by special assessments on all banks according to asset size.

The $1 billion in loss protection it extracted seems very small relative to the increase in the share value of JPMorgan Chase.

Second, the structure of the financing involved the acquisition of mortgages and mortgage-backed securities. Subsequently, the Fed has accepted a wide range of collateral that goes beyond the traditional limits on the credit risk in collateral traditionally honored by central banks.[2] Third, the perception that the Fed bailed out Bear has heightened political pressure to use the Fed's resources to support other risky assets including student loans and mortgage-related securities. Finally, the Fed has now evidently extended its safety net protection to all investment banks that are prime dealers. As the Bear example shows, these entities are not subject to prompt corrective action, least-cost resolution, or a sufficiently wide range of resolution alternatives. The most important reform would be to convey to the Fed bridge bank authority for the resolution of systemically important financial institutions.

[2] The Fed will now accept agency mortgage backed securities, AAA-rated residential mortgage backed securities, commercial mortgage backed securities, agency- collateralized mortgage obligations, student loans, and asset -backed commercial paper.