Overview

On Sunday, March 16, 2008, the Board of Governors of the Federal Reserve System (Board), with the support of the Secretary of the Treasury and by unanimous vote of its five members, authorized under section 13(3) of the Federal Reserve Act (12 U.S.C. § 343) the Federal Reserve Bank of New York (FRBNY) to make a non-recourse loan to a limited liability company (Maiden Lane LLC (“Maiden Lane”)) that would acquire $30 billion of identified, less liquid assets of The Bear Stearns Companies, Inc. (Bear Stearns). The loan would be repaid from the proceeds of the orderly disposition of these assets over time. The purpose of the loan was to facilitate the acquisition by JPMorgan Chase & Co. (JPMC) of Bear Stearns, which at the time was facing severe liquidity pressure that threatened to cause the default and bankruptcy of the company, with resulting risk to significantly stressed financial markets. The credit is secured by all of the assets acquired by Maiden Lane and by a subordinated loan of $1.1 billion from JPMC to Maiden Lane that would absorb any initial losses on the assets by that amount.

Background

In March 2008, Bear Stearns was one of the largest securities firms in the country. As of February 29, 2008, Bear Stearns reported total consolidated assets of approximately $399 billion. Bear Stearns engaged in a broad range of activities, including investment banking, securities and derivatives trading and clearing, brokerage services, and originating and securitizing commercial and residential mortgage loans. As a result of these activities, Bear Stearns maintained a large portfolio of mortgage-related securities and other debt instruments. Like most large securities firms, the company heavily financed itself in the short-term securities repurchase market.
Financial conditions deteriorated markedly between mid-January and mid-March 2008. Volatility was steadily increasing and liquidity was quickly declining in many credit markets – including in particular the market for residential mortgage-backed securities, but also in the markets for other asset-backed securities, corporate securities, and municipal securities. Moreover, many market participants were financing a large portion of their holdings of these long-term securities in short-term collateralized funding markets.

The senior management of Bear Stearns notified the Federal Reserve on the evening of Thursday, March 13, that it anticipated that many of its counterparties would on Friday not agree to roll over their repurchase agreements and, therefore, that Bear Stearns would be required on Friday to repay a significant portion of its repurchase agreement liabilities. Bear Stearns expected that it would not have sufficient funds or liquid assets to repay these obligations as they came due and would not be able during the short period before the markets opened on Friday to find a private-sector source of alternative financing. Bear Stearns reported that it would likely have to file for bankruptcy protection on Friday unless the Federal Reserve were willing to provide Bear Stearns with liquidity.

The sudden imminence of insolvency for Bear Stearns, the large presence of Bear Stearns in several important financial markets (including in particular the markets for repo-style transactions, over-the-counter derivative and foreign exchange transactions, mortgage-backed securities, and securities clearing services), and the potential for contagion to similarly situated firms raised significant concern that financial markets would be seriously disrupted if Bear Stearns were suddenly unable to meet its obligations to counterparties. Most crucially, the consequences of an unexpected and disorderly default or insolvency by Bear Stearns – a major borrower and lender in the repurchase agreement market – could have seriously disrupted this very large, important, and increasingly strained market for short-term secured financing. Market participants were likely to respond to the failure of Bear Stearns by withdrawing generally from short-term collateralized funding markets, resulting in a dramatic drop in the overall availability of short-term financing, and threats to the liquidity and possibly the solvency of other large and highly leveraged financial institutions.
To address the imminent liquidity needs of Bear Stearns and forestall the potential systemic disruptions a default or bankruptcy of the company would cause in the already stressed credit markets, on Friday, March 14, 2008, the Board determined that unusual and exigent circumstances existed and authorized the FRBNY to extend overnight credit to Bear Stearns through JPMorgan Chase Bank. The purpose of the loan was to ensure that Bear Stearns would meet its obligations as they came due on Friday. This would allow for time during the weekend for Bear Stearns to explore options with other financial institutions that might enable it to avoid bankruptcy and for policy makers to continue to seek ways to contain the risk to financial markets in the event no private-sector solution proved possible. The bridge loan provided on March 14, 2008, is the subject of a separate report being submitted under section 129 of the Emergency Economic Stabilization Act of 2008.

Despite the receipt by Bear Stearns of Federal Reserve funding on March 14, market pressures on Bear Stearns worsened throughout the day on March 14 and continued to worsen during the weekend. In light of the further erosion of confidence in Bear Stearns over the weekend by its chief short-term liquidity providers and capital markets transaction counterparties, Bear Stearns likely would have been unable to avoid bankruptcy on Monday, March 17, without either very large injections of liquidity from the Federal Reserve or an acquisition of Bear Stearns by a stronger firm.

During the period from March 13 through March 16, Bear Stearns actively sought both capital injections and acquisition partners. JPMC emerged as the only viable bidder for Bear Stearns on Sunday, March 16. Bear Stearns determined that only JPMC offered a credible proposal that would allow Bear Stearns to meet its obligations beginning Monday, March 17. Accordingly, on Sunday, March 16, Bear Stearns accepted the offer to merge with JPMC.

JPMC believed that it would be unable to acquire Bear Stearns, however, if it were required to obtain funding in the strained credit markets for a specified portfolio of less liquid assets of Bear Stearns. Bear Stearns itself was unable to secure adequate credit accommodations for those assets from private sources. Because no other funding source for these assets appeared available, emergency financing from the Federal Reserve with respect to those assets was necessary to facilitate JPMC’s prompt acquisition of Bear Stearns, which would alleviate the intense strains in the credit
markets described above that were likely to result from the failure of Bear Stearns.

**Terms of the Extension of Credit To Facilitate the Acquisition of Bear Stearns**

On Sunday, March 16, 2008, the Board, finding unusual and exigent circumstances, authorized the FRBNY under section 13(3) to extend non-recourse credit of up to $30 billion to a limited liability company that would acquire a pool of assets of Bear Stearns in connection with the acquisition of Bear Stearns by JPMC. The credit would be repaid from the earnings on and the proceeds of the disposition of the assets in an orderly manner over time.

In the following weeks, the interested parties negotiated the details of these transactions and refined the terms. On March 24, 2008, the FRBNY and JPMC agreed to a Summary of Terms and Conditions that described the basic elements of the FRBNY’s extension of credit. A copy of the Summary of Terms and Conditions is Attachment A to this report.

Pursuant to the summary of terms and conditions, a newly-formed limited liability company, Maiden Lane, would purchase $30 billion in assets from Bear Stearns on or about the date JPMC acquired Bear Stearns. The assets would be valued based on Bear Stearns’ marks as of March 14, 2008. The assets purchased would have to meet each of the following parameters: (i) U.S. dollar denominated; (ii) U.S. domiciled; and (iii) performing residential and commercial mortgages or investment-grade or Agency issued securities (and related hedges). A performing mortgage is a mortgage that was no more than 30 days past due (as of March 14, 2008), and an investment-grade security is a security rated BBB- or higher by all rating agencies that have rated the security (as of March 14, 2008), including at least one of the three principal credit rating agencies. The FRBNY would retain an asset manager, BlackRock Financial Management, Inc. and its affiliates, to manage the assets of Maiden Lane.

To finance the purchase, the FRBNY would lend $29 billion to Maiden Lane. JPMC would make a $1 billion loan to Maiden Lane that would be subordinated in right of payment to the FRBNY’s loan. Maiden Lane would be obligated to repay all of the principal and interest on the FRBNY’s loan before making principal or interest payments on the JPMC loan. Any residual cash flows would be paid to the FRBNY. The FRBNY
would not receive any warrants or other equity interest in exchange for the loan in addition to the right to receive any residual cash flow. The FRBNY and JPMC loans would be secured by a first priority security interest in all of the assets of Maiden Lane.

Both loans would mature in ten years, subject to extension by the FRBNY. The FRBNY loan would earn interest at the rate for primary credit extended by FRBNY in effect from time to time. The loan by JPMC would earn interest at the primary credit rate in effect from time to time plus 450 basis points.¹

On June 26, 2008, after all applicable regulatory approvals were obtained, JPMC’s acquisition of Bear Stearns closed and the FRBNY and JPMC loans to Maiden Lane were closed in accordance with the provisions of the Summary of Terms and Conditions.²

Beginning after June 26, 2008, the Board’s weekly H.4.1 Statistical Release, “Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of the Federal Reserve Banks,” includes information related to Maiden Lane. Among other things, the release discloses, as of the date of the release, the aggregate fair value of Maiden Lane’s net portfolio holdings and the book value of the principal and interest on the loans made to facilitate the Bear Stearns acquisition. The fair value of the net portfolio holdings of Maiden Lane is updated quarterly to reflect values at the end of each calendar quarter. Consistent with generally accepted accounting principles, the assets and liabilities of Maiden Lane have been consolidated with the assets and liabilities of the FRBNY in the statements of conditions shown on the release because the FRBNY is the primary beneficiary of Maiden Lane. The H.4.1 release is published on Thursdays and is available on the Board’s public website.

As noted above, the FRBNY loan will be repaid from the proceeds of the sale of the assets held by Maiden Lane, plus any earnings derived from

¹ On June 26, 2008, when the loan transactions were executed, the primary credit rate was 2.00 percent.
² Because of adjustments in the values of some of the assets purchased by Maiden Lane from Bear Stearns, the amounts of the loans by FRBNY and JPMC were modified slightly from the values stated in the Summary of Terms and Conditions. The actual amount lent by the FRBNY was approximately $28.9 billion and the subordinated loan from JPMC was approximately $1.1 billion.
the assets prior to sale. The aggregate fair value of the Maiden Lane net portfolio holdings, which is updated quarterly to reflect values at the end of each calendar quarter, is reflected in the financial statements of the Federal Reserve Banks. Because the fair value reflects an estimated price that would be received if the assets were sold on the measurement date, the current fair value of the Maiden Lane holdings may fluctuate over different reporting periods. However, because the collateral assets for the loans are expected to be sold over time, the aggregate fair value for the Maiden Lane net portfolio holdings reported in any particular H.4.1 release does not reflect the amount of aggregate proceeds that could be received when the assets are actually sold over time.

A number of facts mitigate the risk of losses being incurred on the FRBNY loan. First, there is a substantial pool of professionally-managed collateral at Maiden Lane that, as of March 14, 2008, was valued at $30 billion. In addition, JPMC’s subordinated loan to Maiden Lane will absorb the first $1.1 billion of any loss that ultimately occurs. Moreover, and perhaps most importantly, the collateral will be sold over time in an orderly manner that is not affected by the unnaturally strong downward market pressures that have been associated with the recent liquidity crisis. Finally, the FRBNY is entitled to any residual cash flow generated by the collateral after the FRBNY and JPMC loans are repaid. Given these protections, the Board at this time does not believe that the extension of credit to facilitate the acquisition of Bear Stearns will result in any net cost to the taxpayers resulting from the failure to repay the principal and interest of the FRBNY loan.
ATTACHMENT A