15

MARCH 2008: THE FALL OF BEAR STEARNS

CONTENTS

After its hedge funds failed in July 2007, Bear Stearns faced more challenges in the second half of the year. Taking out the repo lenders to the High-Grade Fund brought nearly $1.6 billion in subprime assets onto Bear's books, contributing to a $1.9 billion write-down on mortgage-related assets in November. That prompted investors to scrutinize Bear Stearns's finances. Over the fall, Bear's repo lenders—mostly money market mutual funds—increasingly required Bear to post more collateral and pay higher interest rates. Then, in just one week in March 2008, a run by these lenders, hedge fund customers, and derivatives counterparties led to Bear's having to be taken over in a government-backed rescue.

Mortgage securitization was the biggest piece of Bear Stearns's most-profitable division, its fixed-income business, which generated 45% of the firm's total revenues. Growing fast was the Global Client Services division, which included Bear's prime brokerage operation. Bear Stearns was the second-biggest prime broker in the country, with a 21% market share in 2006, trailing Morgan Stanley's 23%.[1] This business would figure prominently in the crisis.

In mortgage securitization, Bear followed a vertically integrated model that made money at every step, from loan origination through securitization and sale. It both acquired and created its own captive originators to generate mortgages that Bear bundled, turned into securities, and sold to investors.[2] The smallest of the five large investment banks, it was still a top-three underwriter of private-label mortgage–backed securities from 2000 to 2007.[3] In 2006, it underwrote $36 billion in collateralized debt obligations of all kinds, more than double its 2005 figure of $14.5 billion.

The total included $6.3 billion in CDOs that included mortgage-backed securities, putting it in the top 12 in that business.[4] As was typical on Wall Street, the company's view was that Bear was in the moving business, not the storage business—that is, it sought to provide services to clients rather than take on long-term exposures of its own.[5]

Bear expanded its mortgage business despite evidence that the market was beginning to falter, as did other firms such as Citigroup and Merrill. As early as May 2006, Bear had lost $3 million relating to defaults[6] on mortgages which occurred within 90 days of origination, which had been rare in the decade. But Bear persisted, assuming the setback would be temporary. In February 2007, Bear even acquired Encore Credit, its third captive mortgage originator in the United States, doubling its capacity. The purchase was consistent with Bear's contrarian business model—buying into distressed markets and waiting for them to turn around.[7]

Only a month after the purchase of Encore, the Securities and Exchange Commission wrote in an internal report, "Bear's mortgage business incurred significant market risk losses" on its Alt-A mortgage assets.[8] The losses were small, but the SEC reported that "risk managers note[d] that these events reflect a more rapid and severe deterioration in collateral performance than anticipated in ex ante models of stress events."[9]

"I REQUESTED SOME FORBEARANCE"

Vacationing on Nantucket Island when the two Bear-sponsored hedge funds declared bankruptcy on July 31, 2007, former Bear treasurer Robert Upton anticipated that the rating agencies would downgrade the company, raising borrowing costs. Bear funded much of its operations borrowing short-term in the repo market; it borrowed between $50 and $70 billion overnight.[10] Even a threat of a downgrade by a rating agency would make financing more expensive, starting the next morning.

Investors, analysts, and the credit rating agencies closely scrutinized leverage ratios, available at the end of each quarter. By November 2007, Bear's leverage ratio had reached nearly 38 to 1. By the end of 2007, Bear's Level 3 assets—illiquid assets difficult to value and to sell—were 269% of its tangible common equity; thus, writing down these illiquid assets by 37% would wipe out tangible common equity.

At the end of each quarter, Bear would lower its leverage ratio by selling assets, only to buy them back at the beginning of the next quarter. Bear and other firms booked these transactions as sales—even though the assets didn't stay off the balance sheet for long—in order to reduce the amount of the company's assets and lower its leverage ratio. Bear's former treasurer Upton called the move "window dressing" and said it ensured that creditors and rating agencies were happy.[11] Bear's public filings reflected this, to some degree: for example, its 2007 annual report said the balance sheet was approximately 12% lower than the average month-end balance over the previous twelve months.[12]

To forestall a downgrade, Upton spoke with the three main rating agencies, Moody's, Standard & Poor's, and Fitch, in early August.[13] Several times in 2007—

including April 9 and June 22—S&P had confirmed Bear's strong ratings, noting in April that "Bear's risk profile is relatively conservative" and "strong senior management oversight and a strong culture throughout the firm are the foundation of Bear's risk management process." On June 22, Moody's had also confirmed its A1 rating, and Fitch had confirmed its "stable" outlook.

Now, in early August, Upton provided them information about Bear and argued that management had learned its lesson about governance and risk management from the failure of the two hedge funds and was going to rely less on short-term unsecured funding and more on the repo market. Bear and other market participants did not foresee that Bear's own repo lenders might refuse to lend against risky mortgage assets and eventually not even against Treasuries.

"I requested some forbearance" from S&P, Upton told the FCIC.[14] He did not get it. On August 3, just three days after the two Bear Stearns hedge funds declared bankruptcy, S&P highlighted the funds, Bear's mortgage-related investments, and its relatively small capital base as it placed Bear on a "negative outlook."[15]

Asked how he felt about the rating agency's actions, Jimmy Cayne, Bear's CEO until 2008, said, "A negative outlook can touch a number of parts of your businesses. . . . It was like having a beautiful child and they have a disease of some sort that you never expect to happen and it did. How did I feel? Lousy."[16]

To reassure investors that no more shoes would drop, Bear invited them on a conference call that same day. The call did not go well. By the end of the day, Bear's stock slid 6%, to $108.35, 36% below its all-time high of $169.61, reached earlier in 2007.

"WE WERE SUITABLY SKEPTICAL"

On Sunday, August 5, two days after the conference call, Bear had another opportunity to make its case: this time, with the SEC. The two SEC supervisors who visited the company that Sunday were Michael Macchiaroli and Matthew Eichner, respectively, associate director and assistant director of the division of market regulation. The regulators reviewed Bear's exposures to the mortgage market, including the $13 billion in adjustable-rate mortgages on the firm's books that were waiting to be securitized. Bear executives gave assurances that inventory would shrink once investors returned in September from their retreats in the Hamptons. "Obviously, regulators are not supposed to listen to happy talk and go away smiling," Eichner told the FCIC. "Thirteen billion in ARMs is no joke." Still, Eichner did not believe the Bear executives were being disingenuous. He thought they were just emphasizing the upside.[17]

Alan Schwartz, the co-president who later succeeded Jimmy Cayne as CEO, and Thomas Marano, head of Global Mortgages and Asset Backed Securities, seemed unconcerned. But other executives were leery. Wendy de Monchaux, the head of proprietary trading, urged Marano to trim the mortgage portfolio, as did Steven Meyer, the co-head of stock sales and trading.[18] According to Chief Risk Officer Michael Alix, former chairman Alan Greenberg would say, "the best hedge is a sale."[19] Bear finally reduced the portfolio from $56 billion in the third quarter of 2007 to $46.1 billion in the fourth quarter, but it was too little too late.

That summer, the SEC felt Bear's liquidity was adequate for the immediate future, but supervisors "were suitably skeptical," Eichner insisted. After the August 5 meeting, the SEC required that Bear Stearns report daily on Bear's liquidity. However, Eichner admitted that he and his agency had grossly underestimated the possibility of a liquidity crisis down the road.[20]

Every weeknight Upton updated the SEC on Bear's $400 billion balance sheet, with specifics on repo and commercial paper. On September 27, Bear Stearns raised approximately $2.5 billion in unsecured 10-year bonds. The reports slowed to once a week.[21] The SEC's inspector general later criticized the regulators, writing that they did not push Bear to reduce leverage or "make any efforts to limit Bear Stearns' mortgage securities concentration," despite "aware[ness] that risk management of mortgages at Bear Stearns had numerous shortcomings, including lack of expertise by risk managers in mortgage backed securities" and "persistent understaffing; a proximity of risk managers to traders suggesting a lack of independence; turnover of key personnel during times of crisis; and the inability or unwillingness to update models to reflect changing circumstances."[22]

Michael Halloran, a senior adviser to SEC Chairman Christopher Cox, told the FCIC the SEC had ample information and authority to require Bear Stearns to decrease leverage and sell mortgage-backed securities, as other financial institutions were doing. Halloran said that as early as the first quarter of 2007, he had asked Erik Sirri, in charge of the SEC's Consolidated Supervised Entities program, about Bear Stearns (and Lehman Brothers), "Why can't we make them reduce risk?" According to Halloran, Sirri said the SEC's job was not to tell the banks how to run their companies but to protect their customers' assets.[23]

"TURN INTO A DEATH SPIRAL"

In August, after the rating agencies revised their outlook on Bear, Cayne tried to obtain lines of credit from Citigroup and JP Morgan. Both banks acknowledged Bear had always been a very good customer and maintained they were interested in helping.[24] "We wanted to try to be belts-and-suspenders," said CFO Samuel Molinaro, as Bear attempted both to obtain lines of credit with banks and to reinforce traditional sources of short-term liquidity such as money market funds. But, Cayne told the FCIC, nothing happened. "Why the [large] banks were not more willing to participate and provide lines during that period of time, I can't tell you," Molinaro said.[25]

A major money market fund manager, Federated Investors, had decided on October 1 to drop Bear Stearns from its list of approved counterparties for unsecured commercial paper,[26] illustrating why unsecured commercial paper was traditionally seen as a riskier lifeline than repo. Throughout 2007, Bear Stearns reduced its unsecured commercial paper (from $20.7 billion at the end of 2006 to only $3.9 billion at the end of 2007) and replaced it with secured repo borrowing (which rose from $69 billion to $102 billion). But Bear Stearns's growing dependence on overnight repo would create a different set of problems.

The tri-party repo market used two clearing banks, JP Morgan and BNY Mellon.

During every business day, these clearing banks return cash to lenders; take possession of borrowers' collateral, essentially keeping it in escrow; and then lend their own cash to borrowers during the day. This is referred to as "unwinding" the repo transaction; it allows borrowers to change the assets posted as collateral every day. The transaction is then "rewound" at the end of the day, when the lenders post cash to the clearing banks in return for the new collateral.

The little-regulated tri-party repo market had grown from $800 billion in average daily volume in 2002 to $1.7 trillion in 2005, $2.4 trillion in 2007, and $2.8 trillion by early 2008.[27] It had become a very deep and liquid market. Even though most borrowers rolled repo overnight, it was also considered a very safe market, because transactions were overcollateralized (loans were made for less than the collateral was worth). That was the general view before the onset of the financial crisis.

As Bear increased its tri-party repo borrowing, it became more dependent on JP Morgan, the clearing bank. A risk that was little appreciated before 2007 was that JP Morgan and BNY Mellon could face large losses if a counterparty such as Bear defaulted during the day. Essentially, JP Morgan served as Bear's daytime repo lender.

Even long-term repo loans have to be unwound every day by the clearing bank, if not by the lender. Seth Carpenter, an officer at the Federal Reserve Board, compared it to a mortgage that has to be refinanced every week: "Imagine that your mortgage is only a week. Instead of a 30-year mortgage, you've got a one-week mortgage. If everything's going fine, you get to the end of the week, you go out and you refinance that mortgage because you don't have enough cash on hand to pay off the whole mortgage. And then you get to the end of another week and you refinance that mortgage. And that's, for all intents and purposes, what repos are like for many institutions."[28]

During the fall, Federated Investors, which had taken Bear Stearns off its list of approved commercial paper counterparties, continued to provide secured repo loans.[29] Fidelity Investments, another major lender, limited its overall exposure to Bear, and shortened the maturities.[30] In October, State Street Global Advisors refused any repo lending to Bear other than overnight.[31]

Often, backing Bear's borrowing were mortgage-related securities and of these, $17.2 billion—more than Bear's equity—were Level 3 assets.

In the fourth quarter of 2007, Bear Stearns reported its first quarterly loss, $379 million. Still, the SEC saw "no evidence of any deterioration in the firm's liquidity position following the release and related negative press coverage." The SEC concluded, "Bear Stearns' liquidity pool remains stable."[32]

In the fall of 2007, Bear's board had commissioned the consultant Oliver Wyman to review the firm's risk management. The report, "Risk Governance Diagnostic: Recommendations and Case for Economic Capital Development," was presented on February 5, 2008, to the management committee. Among its conclusions: risk assessment was "infrequent and ad hoc" and "hampered by insufficient and poorly aligned resources," "risk managers [were] not effectively positioned to challenge front office decisions," and risk management was "understaffed" and considered a "low priority." Schwartz told the FCIC the findings did not indicate substantial deficiencies. He wasn't looking for positive feedback from the consultants, because the Wyman report was meant to provide a road map of what "the gold standard" in risk management would be.[33]

In January 2008, before the report was completed, Cayne resigned as CEO, after receiving $93.6 million in compensation from 2004 through 2007.[34] He remained as non-executive chairman of the board. Some senior executives sharply criticized him and the board. Thomas Marano told the FCIC that Cayne played a lot of golf and bridge.[35] Speaking of the board, Paul Friedman, a former senior managing director at Bear Stearns, said, "I guess because I'd never worked at a firm with a real board, it never dawned on me that at some point somebody would have or should have gotten the board involved in all of this," although he told the FCIC that he made these comments in anger and frustration in the wake of Bear's failure.[36] In its final report on Bear, the Corporate Library, which researches and rates firms for corporate governance, gave the company a "D," reflecting "a high degree of governance risk" resulting from "high levels of concern related to the board and compensation."[37] When asked if he had made mistakes while at Bear Stearns, Cayne told the FCIC, "I take responsibility for what happened. I'm not going to walk away from the responsibility."[38]

At Bear, compensation was based largely on the return on equity in a given year. For senior executives, about half of each bonus was paid in cash, and about half in restricted stock that vested over three years and had to be held for five.[39] The formula for the size of each year's compensation pool was determined by a subcommittee of the board. Stockholders approved the performance compensation plan and capital accumulation plan for senior managing directors. Cayne told the FCIC he set his own compensation and the compensation for all five members of the Executive Committee. According to Cayne, no one, including the board, questioned his decisions.[40]

For 2007, even with its losses, Bear Stearns paid out 58% of revenues in compensation. Alix, who sat on the Compensation Committee, told FCIC staff the firm typically paid 50% but that the percentage increased in 2007 because revenues fell—if management had lowered compensation proportionately, he said, many employees might have quit.[41] Base salaries for senior managers were capped at $250,000, with the remainder of compensation a discretionary mix of cash, restricted stock, and options.[42]

From 2000 through 2008, the top five executives at Bear Stearns took home over $326.5 million in cash and over $1.1 billion from stock sales, for more than a total of $1.4 billion. This exceeded the annual budget for the SEC.[43] Alan Schwartz, who took over as CEO after Cayne and had been a leading proponent of investing in the mortgage sector, earned more than $87 million from 2004 to 2007. Warren Spector, the co-president responsible for overseeing the two hedge funds that had failed, received more than $98 million during the same period. Although Spector was asked to resign, Bear never asked him to return any money. In 2006, Cayne, Schwartz, and Spector each earned more than 10 times as much as Alix, the chief risk officer.[44]

Cayne was out, Schwartz was in, and Bear Stearns continued hanging on in early 2008. Bear was still able to fund its balance sheet through repo loans, though the interest rates the firm had to pay had increased.[45] Marano said he worried this increased cost would signal to the market that Bear was distressed, which could "make our problems turn into a death spiral."[46]

"DUTY TO PROTECT THEIR INVESTORS"

On Wednesday, January 30, 2008, Treasurer Upton reported an internal accounting error that showed Bear Stearns to have less than $5 billion in liquidity—triggering a report to the SEC. While the company identified the error, the SEC reinstituted daily reporting by the company of its liquidity.[47]

Lenders and customers were more and more reluctant to do business with the company. On February 15, Bear Stearns had $36.7 billion in mortgages, mortgage-backed securities, and asset-backed securities on its balance sheet, down almost $10 billion from November. Nearly $26 billion were subprime or Alt-A mortgage–backed securities and CDOs.

The hedge funds that were clients of Bear's prime brokerage services were particularly concerned that Bear would be unable to return their cash and securities. Lou Lebedin, the head of Bear's prime brokerage, told the FCIC that hedge fund clients occasionally inquired about the bank's financial condition in the latter half of 2007, but that such inquiries picked up at the beginning of 2008, particularly as the cost increased of purchasing credit default swap protection on Bear. The inquiries became withdrawals—hedge funds started taking their business elsewhere. "They felt there were too many concerns about us and felt that this was a short-term move," Lebedin said. "Often they would tell us they'd be happy to bring the business back, but that they had the duty to protect their investors." Renaissance Technologies, one of Bear's biggest prime brokerage clients, pulled out all of its business. By April, Lebedin's prime brokerage operation would be holding $90 billion in assets under management, down more than 40% from $160 billion in January.[48]

Nonetheless, during the week of March 3, when SEC staff inspected Bear's liquidity pool, they identified "no significant issues." The SEC found Bear's liquidity pool ranged from $18 billion to $20 billion.[49]

Bear opened for business on Monday, March 10, with approximately $18 billion in cash reserves. The same day, Moody's downgraded 15 mortgage-backed securities issued by Bear Stearns Alt-A Trust, a special purpose entity. News reports on the downgrades carried abbreviated headlines stating, "Moody's Downgrades Bear Stearns," Upton said.[50] Rumors flew and counterparties panicked.[51] Bear's liquidity pool began to dry up, and the SEC was now concerned that Bear was being squeezed from all directions.[52] While "everything rolled" during the day—that is, Bear's repo lenders renewed their commitments—SEC officials worried that this would "probably not continue."[53]

On Tuesday, the Fed announced it would lend to investment banks and other "primary dealers." The Term Securities Lending Facility (TSLF) would make available up to $200 billion in Treasury securities, accepting as collateral GSE mortgage–backed securities and non-GSE mortgage–backed securities rated triple-A. The hope was that lenders would lend to investment banks if the collateral was Treasuries rather than other highly rated but now suspect assets such as mortgage-backed securities. The Fed also announced it would extend loans from overnight to 28 days, giving investment banks an added breather from the relentless need to unwind repos every morning.

With the TSLF, the Fed would be setting a new precedent by extending emergency credit to institutions other than commercial banks. To do so, the Federal Reserve Board was required under section 13(3) of the Federal Reserve Act to determine that there were "unusual and exigent circumstances." The Fed had not invoked its section 13(3) authority since the Great Depression; it was the Fed's first use of the authority since Congress had expanded the language of the act in 1991 to allow the Fed to lend to investment banks.[54] The Fed was taking the unusual step of declaring its willingness to soon open its checkbook to institutions it did not regulate and whose financial condition it had never examined.

But the Fed would not launch the TSLF until March 27, more than two weeks later—and it was not clear that Bear could last that long. The following day, Jim Embersit of the Federal Reserve Board checked on Bear's liquidity with the SEC. The SEC said Bear had $12.5 billion in cash—down from about $18 billion at the start of the week—and was able to finance all its bank loans and most of its equity securities through the repo market. He summarized, "The SEC indicates that no notable losses have been sustained and that the capital position of the firm is 'fine.'"[55]

Derivatives counterparties were increasingly reluctant to be exposed to Bear. In some cases they unwound trades in which they faced Bear, and in others they made margin or collateral calls.[56] In Bear's last few years as an independent company, it had substantially increased its exposure to derivatives. At the end of fiscal year 2007, Bear had $13.4 trillion in notional exposure on derivatives contracts, compared with $8.7 trillion at 2006 fiscal year-end and $5.5 trillion at the end of 2005.

Derivatives counterparties who worried about Bear's ability to make good on their payments could get out of their derivative positions with Bear through assignments or novations. Assignments allow counterparties to assign their positions to someone else: if firm *X* has a derivatives contract with firm *Y,* then firm *X* can assign its position to firm *Z,* so that *Z* now is the one that has a derivatives contract with *Y*. Novations also allow counterparties to get out of their exposure to each other, but by bringing in a third party: instead of *X* facing *Y*, *X* faces *Z* and *Z* faces *Y*. Both assignments and novations are routine transactions on Wall Street. But on Tuesday, Brian Peters of the New York Fed advised Eichner at the SEC that the New York Fed was "seeing some HFs [hedge funds] wishing to assign trades the clients had done with Bear to other CPs [counterparties] so that Bear 'steps out.'"[57] Counterparties did not want to have Bear Stearns as a derivatives counterparty any more.

Bear Stearns also encountered difficulties stepping into trades. Hayman Capital Partners, a hedge fund in Texas wanting to decrease its exposure to subprime mortgages, had decided to close out a relatively small $5 million subprime derivative position with Goldman Sachs. Bear Stearns offered the best bid, so Hayman expected to assign its position to Bear, which would then become Goldman's counterparty in the derivative. Hayman notified Goldman by a routine email on Tuesday, March 11, at 4:06 P.M. The reply 41 minutes later was unexpected: "GS does not consent to this trade."[58]

That startled Kyle Bass, Hayman's managing partner. He told the FCIC he could not recall any counterparty rejecting a routine novation.[59] Pressed for an explanation, Goldman the next morning offered no details: "Our trading desk would prefer to stay facing Hayman. We do not want to face Bear."[60] Adding to the mystery, 16 minutes later Goldman agreed to accept Bear Sterns as the counterparty after all.[61] But the damage was done. The news hit the street that Goldman had refused a routine transaction with one of the other big five investment banks. The message: don't rely on Bear Stearns.

CEO Alan Schwartz hoped an appearance on CNBC would reassure markets. Questioned about this incident, Schwartz said he had no knowledge of such a refusal and rhetorically asked, "Why do rumors start?"[62] SEC Chairman Cox told reporters his agency was monitoring capital levels at Bear Stearns and other securities firms "on a constant basis" and has "a good deal of comfort about the capital cushions at these firms at the moment."[63]

Still, the run on Bear accelerated. Many investors believed the Fed's announcement about its new loan program was directed at Bear Stearns, and they worried about the facility's not being available for several weeks. On Wednesday, March 12, the SEC noted that Bear paid another $1.1 billion for margin calls from 142 nervous derivatives counterparties.[64]

Repo lenders who had already tightened the terms for their contracts over the preceding four or five months shortened the leash again, demanding more collateral from Bear Stearns.[65] Worries about a default quickly mounted.[66]

By that evening, Bear's ability to borrow in the repo market was drying up. The SEC noted that some large and important money funds, including Fidelity and Mellon, had told Bear after the close of business Wednesday they "might be hesitant to roll some funding tomorrow." The SEC said that though they believed the amounts were "very manageable (between $1 and $2 billion)," the withdrawals would not send a helpful signal to the market.[67] But the issue was almost moot. Schwartz called New York Fed President Timothy Geithner that night to discuss possible Fed flexibility in the event that some repo lenders did pull away.[68]

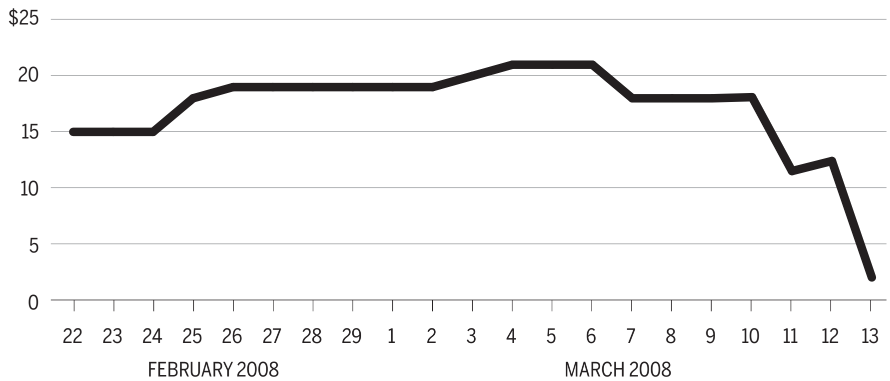
Upton, the treasurer, said that before that week, he had never worried about the disappearance of repo lending. By Thursday, he believed the end was near.[69] Bear executives informed the board that the rumors were dissuading counterparties from doing business with Bear, that Bear was receiving and meeting significant margin calls, that $14 billion in repo was not going to roll over, and that "there was a reasonable chance that there would not be enough cash to meet [Bear's] needs."[70] Some repo lenders were already so averse to Bear that they stopped lending to the company at all, not even against Treasury collateral, Upton told the FCIC.[71] Derivatives counterparties continued to run from Bear. By that night, liquidity had dwindled to a mere $2 billion (see figure 15.1).

Bear had run out of cash in one week. Executives and regulators continued to believe the firm was solvent, however. Former SEC Chairman Cox testified before the FCIC, "At all times during the week of March 10 to 17, up to and including the time of its agreement to be acquired by JP Morgan, Bear Stearns had a capital cushion well above what is required."[72]

Bear Stearns Liquidity

In the four days before Bear Stearns collapsed, the company's liquidity dropped by $16 billion.

IN BILLIONS OF DOLLARS, DAILY



SOURCE: Securities and Exchange Commission

Figure 15.1

"THE GOVERNMENT WOULD NOT PERMIT A HIGHER NUMBER"

On Thursday evening, March 13, Bear Stearns informed the SEC that it would be "unable to operate normally on Friday."[73] CEO Alan Schwartz called JP Morgan CEO Jamie Dimon to request a $30 billion credit line. Dimon turned him down,[74] citing, according to Schwartz, JP Morgan's own significant exposure to the mortgage market. Because Bear also had a large, illiquid portfolio of mortgage assets, JP Morgan would not render assistance without government support. Schwartz spoke with Geithner again. Schwartz insisted Bear's problem was liquidity, not insufficient capital. A series of calls between Schwartz, Dimon, Geithner, and Treasury Secretary Henry Paulson followed.[75] To address Bear's liquidity needs, the New York Fed made a $12.9 billion loan to Bear Stearns through JP Morgan on the morning of Friday, March 14. Standard & Poor's lowered Bear's rating three levels to BBB. Moody's and Fitch also downgraded the company. By the end of the day, Bear was out of cash. Its stock plummeted 47%, closing below $30.

The markets evidently viewed the loan as a sign of terminal weakness. After markets closed on Friday, Paulson and Geithner informed Bear CEO Schwartz that the Fed loan to JP Morgan would not be available after the weekend. Without that loan, Bear could not conduct business. In fact, Bear Stearns had to find a buyer before the Asian markets opened Sunday night or the game would be over.[76] Schwartz, Molinaro, Alix, and others spent the weekend in due diligence meetings with JP Morgan and other potential buyers, including the private equity firm J.C. Flowers and Co. According to Schwartz, the participants determined JP Morgan was the only candidate with the size and stature to make a credible offer within 48 hours.[77] As Bear Stearns's clearing bank for repo trades, JP Morgan held much of Bear Stearns's assets as collateral and had been assessing their value daily.[78] This knowledge let JP Morgan move more quickly.

On Sunday, March 16, JP Morgan informed the New York Fed and the Treasury that it was interested in a deal if it included financial support from the Fed.[79] The Federal Reserve Board, again finding "unusual and exigent circumstances" as required under section 13(3) of the Federal Reserve Act, agreed to purchase $29.97 billion of Bear's assets to get them off the firm's books through a new entity called Maiden Lane LLC (named for a street alongside the New York Fed). Those assets—mostly mortgage-related securities, other assets, and hedges from Bear's mortgage trading desk—would be under New York Fed management. To finance the purchases, JP Morgan made a $1.15 billion subordinated loan and the New York Fed lent $28.82 billion. Because of its loan, JP Morgan bore the risk of the first $1.15 billion of losses; the Fed would bear any further losses up to $28.82 billion.[80] The Fed's loan would be repaid as Maiden Lane sold the collateral.

On Sunday night, with Maiden Lane in place, JP Morgan publicly announced a deal to buy Bear Stearns for $2 a share. Minutes of Bear's board meeting indicate that JP Morgan had considered $4 but cut it to $2 "because the government would not permit a higher number. . . . The Fed and the Treasury Department would not support a transaction where [Bear Stearns] equity holders received any significant consideration because of the 'moral hazard' of the federal government using taxpayer money to 'bail out' the investment bank's stockholders."[81]

Eight days later, on March 24, Bear Stearns and JP Morgan agreed to increase the price to $10. John Chrin, co-head of the financial institutions mergers and acquisitions group at JP Morgan, told the FCIC they increased the price to make Bear shareholders' approval more likely.[82] Bear CEO Schwartz told the FCIC the increase let Bear preserve the company's value "to the greatest extent possible under the circumstances for our shareholders, our 14,000 employees, and our creditors."[83]

"IT WAS HEADING TO A BLACK HOLE"

The SEC regulators Macchiaroli and Eichner were as stunned as everyone else by the speed of Bear's collapse. Macchiaroli had had doubts as far back as August, he told the FCIC, but he and his colleagues expected Bear would be able to fund itself through the repo market, albeit at higher margins.[84]

Fed Chairman Ben Bernanke later called the Bear Stearns decision the toughest of the financial crisis. The $2.8 trillion tri-party repo market had "really [begun] to break down," Bernanke said. "As the fear increased," short-term lenders began demanding more collateral, "which was making it more and more difficult for the financial firms to finance themselves and creating more and more liquidity pressure on them. And, it was heading sort of to a black hole." He saw the collapse of Bear Stearns as threatening to freeze the tri-party repo market, leaving the short-term lenders with collateral they would try to "dump on the market. You would have a big crunch in asset prices."[85]

"Bear Stearns, which is not that big a firm, our view on why it was important to save it—you may disagree—but our view was that because it was so essentially involved in this critical repo financing market, that its failure would have brought down that market, which would have had implications for other firms," Bernanke told the FCIC.[86]

Geithner explained the need for government support for Bear's acquisition by JP Morgan as follows: "The sudden discovery by Bear's derivative counterparties that important financial positions they had put in place to protect themselves from financial risk were no longer operative would have triggered substantial further dislocation in markets. This would have precipitated a rush by Bear's counterparties to liquidate the collateral they held against those positions and to attempt to replicate those positions in already very fragile markets."[87]

Paulson told the FCIC that Bear had both a liquidity problem and a capital problem. "Could you just imagine the mess we would have had? If Bear had gone there were hundreds, maybe thousands of counterparties that all would have grabbed their collateral, would have started trying to sell their collateral, drove down prices, create even bigger losses. There was huge fear about the investment banking model at that time." Paulson believed that if Bear had filed for bankruptcy, "you would have had Lehman going . . . almost immediately if Bear had gone, and just the whole process would have just started earlier."[88]

COMMISSION CONCLUSIONS ON CHAPTER 15

The Commission concludes the failure of Bear Stearns and its resulting government-assisted rescue were caused by its exposure to risky mortgage assets, its reliance on short-term funding, and its high leverage. These were a result of weak corporate governance and risk management. Its executive and employee compensation system was based largely on return on equity, creating incentives to use excessive leverage and to focus on short-term gains such as annual growth goals.

Bear experienced runs by repo lenders, hedge fund customers, and derivatives counterparties and was rescued by a government-assisted purchase by JP Morgan because the government considered it too interconnected to fail. Bear's failure was in part a result of inadequate supervision by the Securities and Exchange Commission, which did not restrict its risky activities and which allowed undue leverage and insufficient liquidity.