Bear Stearns organises bailout but concerns remain

Nick Beams
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The giant Wall Street investment and brokerage firm Bear Stearns has put up $3.2 billion to bail out one of its troubled hedge funds in the biggest rescue operation of its kind since the collapse of the Long Term Capital Management hedge fund in 1998.

Bear Stearns agreed to put up the credit line on Friday to ensure that collateralised debt obligations (CDOs) seized by creditors led by Merrill Lynch were not liquidated in a “fire sale” that could have sent the valuation of the assets plunging.

As the *New York Times* noted, the bailout was a major departure for Bear Stearns, which has long resisted putting too much of its own capital at risk. “But in this case, the stakes were too high. If lenders had seized the assets of the funds and tried to sell billions of dollars of assets in mortgage-related securities at fire-sale prices, it could have exposed Bear Stearns and the market to substantial losses.”

The bailout will apply to the more stable of the two Bears funds—the High Grade Structured Credit Strategies Fund. It was set up three years ago and produced returns of between 1 and 1.5 percent per month until it reported its first loss last March.

The second fund—the High Grade Structured Credit Strategies Enhanced Leverage Fund, which was established just 10 months ago—has been left to die. Of the two it was the more highly leveraged, having borrowed around $6 billion on an equity base of $600 million to make bets on the sub-prime mortgage market. It is believed to have lost around 23 percent to the year ended April.

But the losses could go well beyond this figure because there is no accurate means of measuring the real value of the many of the assets, including CDOs, which formed the basis of the funds’ operations.

CDOs are bundles of other asset-backed securities. Since they are rarely traded, their valuation is not based on a well-established market price. Rather, their valuation is determined according to a model of their expected future performance. And the models themselves can vary, depending on which financial institution or bank has devised them. In the case of a sudden forced sale, the valuation of these assets can plunge virtually overnight.

As Joseph Mason, associate professor of finance at Drexel University, Philadelphia, and the author of a study on the CDO market, told *Bloomberg*: “The problem is not what we see happening, but what we don’t see. We don’t know the price of these assets. We don’t know which banks are exposed to this sector. These conditions are the classic conditions for financial crises across history.”

The problem is growing quickly. In the past few years the market in CDOs has ballooned to more than $1 trillion as banks, investment houses and pension funds seek new ways of making money from trading in debt.

The spread of such financial instruments and their implications for the stability of financial markets were the subject of a speech delivered by Bank of England Governor Mervyn King last Wednesday, just as the Bear Stearns crisis was breaking.

Financial stability, he noted, was a matter of topical concern under conditions where credit had never been so freely available and securitisation, which enables the spreading of risks among a much wider range of investors, had transformed banking. While this was a positive development, new and ever-more complex financial instruments had created different risks.

“Exotic instruments are now issued for which the distribution of returns is considerably more complicated than that on the basic loans underlying them,” he said.

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In such a system a CDO has a “distribution of returns which is highly sensitive to small changes in the correlations underlying returns which we do not understand with any great precision. The risk of the entire return being wiped out can be much greater than on simpler instruments.”

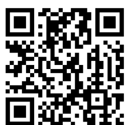
In other words, given the size and rapid growth of the CDO market, massive amounts of financial capital could disappear as a result of relatively small changes in market conditions. And, given their admitted lack of understanding, the world’s major central bankers, supposedly responsible for the stability of the system, would not even be able to forecast such an event, let alone take any action to prevent it.

According to King: “Assessing the degree of leverage in an ever-changing financial system is far from straightforward, and the liquidity of the markets in complex instruments, especially in conditions when many players would be trying to reduce the leverage of their portfolios at the same time, is unpredictable.”

Excessive leverage, he noted, had been the common theme of many financial crises in the past.

In the wake of the Bear Stearns debacle, attention has focussed on the financial instruments that have their origin in the sub-prime mortgage market. However, according to an article in the *Economist*, the most worrying thing for financial institutions may not be there but in “the unnerving parallels with an even bigger [market] to which they are exposed: leveraged loans to companies.”

As Daniel Arbess of the New York-based firm Xerion Capital Partners told the magazine, the high degree of leverage in the corporate world mirrors that in the mortgage market. Consequently, the problems in the sub-prime lending market, which triggered the Bear Stearns crisis, might well be “a dress rehearsal for something bigger and scarier”.



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