Fed rescue of Bear Stearns raises specter of Depression-era crash

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The Federal Reserve Board on Friday took emergency action to prevent the collapse of Bear Stearns, the fifth largest US investment bank and one of the world's largest finance and brokerage houses.

Invoking a little-used provision added to the Federal Reserve Act in 1932, at the height of the Great Depression, the US central bank agreed to allow the Federal Reserve Bank of New York to insure an infusion of credit to Bear Stearns by JP Morgan Chase. Under the terms of the "secured loan facility," to extend for up to 28 days, the risk of a default by Bear Stearns will be borne by the Federal Reserve Bank of New York, not JP Morgan Chase. The latter will serve essentially as a conduit for the cash provided by the US central bank.

This mechanism was used because only commercial banks, so-called depository institutions, can borrow directly from the Fed's discount window. Bear Stearns is not a depository bank, and hence the Fed was obliged to invoke a provision of the 1932 amendment to the Federal Reserve Act that applies when "unusual and exigent circumstances exist and the borrower is unable to secure adequate credit accommodations from other sources."

The announcement of the Fed bailout sent shivers through Wall Street and shook financial markets around the world. It confirmed rumors that had been mounting over the past week that Bear Stearns, the second largest US underwriter of mortgage bonds, did not have the cash to meet claims by its creditors. The rescue operation came one day after the collapse of Carlyle Capital Corporation, a $22 billion publicly traded investment fund controlled by the Carlyle Group, long one of the most profitable and well-connected private equity firms in the US.

With the de facto collapse of Bear Stearns, however, the housing and credit market collapse has claimed one of the titans of Wall Street. Founded in 1923 and employing some 15,500 people worldwide, Bear Stearns was one of the "big five" Wall Street investment banks. In 2005-2007, Bear Stearns was recognized as the "Most Admired" securities firm in *Fortune* magazine's "America's Most Admired Companies" survey.

Last July, the collapse of two Bear Stearns hedge funds as a result of the bursting of the US housing bubble sparked a crisis of confidence in the credit system that has gathered steam and expanded in scope to threaten the viability of some of the biggest banks and financial institutions in the world. The worsening credit crunch has deepened the crisis in the housing market and the economy in general, plunging the US into a recession and wreaking havoc with the economies of Europe and Japan.

The news of the bailout sent share prices tumbling on Wall Street. The Dow Jones Industrial Average fell 194.65 points, a drop of 1.6 percent. The Standard & Poor's 500 Index fared even worse, giving up 27.34 points (2.1 percent), while the Nasdaq Composite Index fell 51.12 points, or 2.3 percent.

Nine stocks fell for every one that rose, and the fears that other financial houses could follow Bear's demise was reflected in a 4.1 percent fall in the Standard & Poor's Financial Index. All 92 members of the index lost ground during the trading day.

Bear Stearns stock plunged $27, or 47 percent, to end the day at $30. Coming on the heels of a months-long slide in the bank's stock price, yesterday's panic sell-off reduced Bear Stearns's market valuation to $4.1 billion, less than one-fifth the size of Lehman Brothers.

Indicative of the broader reverberations from the Bear Stearns collapse, the share price of Ambac Financial Group, the world's second-largest bond insurer, fell 93 percent, on widespread fears that the company will not have sufficient capital to meet claims from its creditors.

The US dollar hit new lows against the euro and other currencies.

The Fed action on Friday confirmed speculation that its extraordinary announcement three days earlier that it would loan $200 billion in Treasury bonds to investment banks and brokerages and accept as collateral privately issued mortgage-backed securities—whose market value has plummeted—was a desperation measure aimed at forestalling the failure of a major Wall Street finance house.

Speaking of Friday's Fed rescue operations, the *Wall Street Journal Online* wrote: "The timing of the move made its urgency clear: If Bear could have held out until March 27, it could have borrowed directly from the Fed itself under a new program announced just Tuesday."

The maximum size of the loan is not predetermined, but is limited by how much collateral Bear Stearns can provide to satisfy the Fed's requirements, officials said. The loan by no means assures Bear Stearns's survival. More likely, it was granted in the hope that it would buy time for a more orderly disposition of the firm's fate and head off a panic response by bankers and investors to its demise.

As the *Wall Street Journal Online* noted, "The developments could mean the end of independence for Bear, founded in 1923. JP Morgan said it is 'working closely with Bear Stearns on securing permanent financing or other alternatives for the company'—Wall Street lingo for a sale of other strategic-level change—and CNBC reported that the bank is 'actively being shopped' to potential buyers."

Officials at Standard & Poor's and Moody's Investor Services met Friday to discuss whether to downgrade Bear Stearns's credit rating, and if so, by how much.

In its own statement on the bailout, Bear Stearns said, "The company can make no assurance that any strategic alternatives will be successfully completed."

Carl Lantz, a strategist at Credit Suisse, said the intervention by the New York Fed and JP Morgan showed that Bear "didn't have enough money to turn the light on this morning."

Geoffrey Yu of UBS said, "I don't think the market has seen anything of this magnitude before, such a big bank."

Wall Street Journal columnist Peter A. McKay wrote: "For investors, the arrival of the Federal Reserve and JP Morgan Chase with a financial life raft for troubled Bear Stearns served primarily as a reminder of how murky and deep the waters of Wall Street's credit crisis remain, with other market participants possibly drowning below the surface."

The immediate fear motivating the Federal Reserve, the Treasury Department and Wall Street banks was the danger that an uncontrolled collapse of Bear Stearns would have a domino effect on already turbulent financial markets. Were Bear Stearns forced to sell off assets at fire-sale prices to raise cash needed to meet creditors' demands, the value of untold billions in assets held by other financial institutions would drop, leading to more margin calls from creditors, further institutional collapses, more panic selling of debt and securities—a vicious spiral to the bottom with the potential of a breakdown in the entire capitalist financial system.

The temporary reprieve for Bear Stearns does not eliminate the potential for just such a scenario in the near future.

The underlying problem is the vast credit bubble that was inflated on the basis of reckless and intrinsically unviable home loans and other forms of speculation, including leveraged buyouts and a vast expansion in unregulated credit markets that delivered unsustainably high returns on investment. The immense fortunes amassed by the uppermost echelons of the US population on the basis of such parasitic financial operations have created, as their consequence, a social and economic disaster of historical proportions, threatening tens of millions of Americans, and hundreds of millions more people around the world, with pauperization.

President Bush, perhaps the consummate political personification of the social layer that benefited from the now-imploded speculative bubble, spoke Friday before the Economic Club of New York, only hours after the rescue of Bear Stearns had been announced. Moving from platitude to platitude, he declared the US economy "the envy of the world," referred to the financial crisis as a "rough patch," and reassured his audience that "in a free market, there's going to be good times and bad times. That's how markets work."

The only substance of his remarks was opposition to any resurrection of government regulation of the banks, denunciation of proposals, such as the timid half-measures being advanced by congressional Democrats, to contain the growing wave of home foreclosures, and a restatement of the demand that his tax cuts for the wealthy be made permanent.

His speech did nothing to reassure the financial markets, which are too mired in crisis to buy into the fool's paradise "optimism" of the commander in chief. Martin Feldstein, a conservative Republican who served for a time as Ronald Reagan's chief economic adviser, summed up the growing sentiment in a speech to a conference in Florida. "I believe," he said, "the US economy is now in recession. The situation is bad, it's getting worse and the risks are that the situation could be very bad."