US financial system faced collapse, bank regulators tell Senate hearing on Bear Stearns bailout

Barry Grey
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At a hearing of the Senate Banking Committee on Thursday, top financial regulators said the unprecedented actions by the Federal Reserve Board last month to prevent the failure of investment bank Bear Stearns were taken to avert a collapse of the entire US financial system.

Federal Reserve Board Chairman Ben Bernanke, New York Federal Reserve Bank President Timothy Geithner, Securities and Exchange Commission (SEC) Chairman Christopher Cox and Under Secretary for Domestic Finance Robert K. Steel defended the government bailout of Bear Stearns and the decision to lend Federal Reserve funds to all of the major US investment banks as emergency measures necessitated by a mounting panic on Wall Street that reached a crescendo in the days preceding the government-engineered takeover of Bear Stearns by JPMorgan Chase.

While the regulators had a vested interest in justifying the allocation of tens of billions of taxpayer dollars to prop up giant Wall Street firms by portraying the immediate crisis they confronted in dire terms, there is no doubt that the disaster scenario over the weekend of March 14-17 which they described was very real. The very fact of their admission of a financial emergency of historic proportions is an extraordinary testament to the profound and systemic nature of an economic crisis that only a few weeks ago President George W. Bush called a "rough patch."

What none of the officials, and none of the senators on the Banking Committee, broached was what the development of such a potentially catastrophic crisis says about the nature and condition of American capitalism and the responsibility of the CEOs on Wall Street who justify their multi-million-dollar salaries by their supposedly irreplaceable expertise.

Far from the crisis having been resolved by the rescue of Bear Stearns and the associated steps taken by the Fed, when asked by the ranking Republican on the committee, Richard Shelby of Alabama, what were the chances that another emergency bailout would occur, Under Secretary Steel said that he "couldn't say there will not be another problem."

The deprecatory demeanor of the senators, led by the senior Democrats on the committee, left no doubt as to who wields the real power in the United States. Sitting across from officials who have overseen and facilitated financial abuses, speculation and gambling with borrowed money on an unprecedented scale, resulting in a social catastrophe for millions of American families, most of the senators went out of their way to commend the assembled regulators and demonstrate their deference to the financial elite.

Democratic Senator Christopher Dodd of Connecticut, the chairman of the committee, reiterated several times in his opening remarks that the bailout of Bear Stearns and the financial markets was "the right decision." He effusively thanked Bernanke and the other officials for their "patience" in putting up with questions from Congress.

His only criticism was that the Fed should have opened the spigot of cash from its discount window to Wall Street investment banks sooner.

Charles Schumer, Democrat of New York, said, "Everyone agrees that the Fed had no choice and it had to be done." Tom Carper, Democrat of Delaware, said that "at the end of the day, what the Fed did passes muster." Evan Bayh of Indiana declared, "You made the right decision." Jack Reed, Democrat of Rhode Island, said, "Thank you for steering us through a crisis that could have had catastrophic consequences."

The only discordant note was struck by Jim Bunning of Kentucky, a right-wing Republican, who denounced the bailout of Bear Stearns as an affront to the free market and a form of "socialism."

Fed Chairman Bernanke opened the testimony with a grim picture of the current financial situation. "Although the situation has recently improved somewhat," he said, "financial markets remain under considerable stress. Pressures in short-term funding markets, which had abated somewhat beginning late last year, have increased once again.

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"Many lenders have been reluctant to provide credit to counterparties, especially leveraged investors, and increased the amount of collateral they required to back short-term security financing agreements. To meet those demands, investors have reduced their leverage and liquidated holdings of securities, putting further downward pressure on security prices.

"Credit availability has also been restricted because some large financial institutions, including some commercial and investment banks and the government-sponsored enterprises, have reported substantial losses and write-downs, reducing their capital available to support increased lending. Some key securitization markets, including those for nonconforming mortgages, continued to function poorly, if at all."

He outlined the massive injection of funds into the financial markets and steep cuts in interest rates carried out by the Fed in an attempt to counter the housing and credit market crises. This, he said, was the context in which the Fed was advised by Bear Stearns on March 13 that it would have to file for bankruptcy the next day unless the government intervened.

The prospect of a collapse of Bear Stearns, he continued, raised issues that "extended well beyond the fate of one company." He then outlined its likely impact: "The sudden failure of Bear Stearns likely would have led to a chaotic unwinding of positions in those markets and could have severely shaken confidence. The company's failure could also have cast doubt on the financial positions of some of Bear Stearns' thousands of counterparties and perhaps of companies with similar businesses.

"Given the exceptional pressures on the global economy and financial system, the damage caused by a default by Bear Stearns could have been severe and extremely difficult to contain. Moreover, the adverse impact of a default would not have been confined to the financial system but would have been felt broadly in the real economy through its effects on asset values and credit availability."

In the question-and-answer period, Bernanke objected to characterizations of the Fed's action as a bailout of Bear Stearns, saying that the firm's shareholders had suffered massive losses. The issue, he insisted, was the broader threat to the financial system. Saying he was concerned about "other institutions and markets," he added, "If you want to say we bailed out markets in general, I guess that's true."

In response to a question as to how the failure of a single investment bank could bring down the entire financial system, Bernanke said the crisis was the outcome of a "credit boom" which saw a massive growth of debt, "excess risk-taking" and a "deterioration in underwriting standards."

None of the senators suggested that the heads of major Wall Street firms should be held accountable for, in effect, using the banking system as a giant casino.

The same theme of impending catastrophe was sounded by the other witnesses. SEC Chairman Cox said, "In the cauldron of these events, the actions that the Federal Reserve took—in particular, extending access to the discount window not only the Bear Stearns, but also to the major investment banks—were addressed to preventing future occurrences of the run-on-the-bank phenomenon that Bear endured."

He noted that the crisis of confidence in financial markets had reached such an extreme point that by March 13, Bear Stearns was unable to borrow against "high-quality collateral," calling this "an unprecedented occurrence."

New York Federal Reserve Bank President Geithner outlined in some detail the round-the-clock meetings and negotiations involving the Fed, the Treasury Department, the SEC, Bear Stearns and JPMorgan Chase that occurred during the 96 hours between Bear Stearns' warning that it was about to declare bankruptcy and the announcement late on March 16 of the investment bank's takeover by JPMorgan Chase.

He made clear that federal regulators believed they had to reach an agreement before Asian markets opened Sunday night, US time, in order to avoid a full-scale panic. No less significant was his revelation that regulators feared, even after the Bear Stearns takeover had been announced, that other investment banks might fail when markets opened Monday morning. That, according to Geithner, prompted the Fed to announce that it was opening up its discount window to all major investment banks—something that had not occurred since the Great Depression.

He then gave a decidedly somber prognosis for the future. "By reducing the probability of a systemic financial crisis," he said, "the actions taken by the Fed on and after March 14 have helped avert substantial damage to the economy, and they have brought a measure of tentative calm to global financial markets... Nevertheless, liquidity conditions in markets are still substantially impaired and the process of de-leveraging remains underway. And this will amplify the headwinds facing the US and global economy."

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