Fed minutes show extent of Bear Stearns crisis

Nick Beams
30 June 2008

While the language is bureaucratically bland, the minutes of the Federal Reserve Board's emergency meetings of March 14 and 16, released on Friday, do convey some of the fear that gripped financial authorities as it became apparent that the investment bank Bear Stearns was about to collapse.

The Fed became involved on March 13 when Bear Stearns notified it and other government agencies that its liquidity position had deteriorated and that it would have to file for bankruptcy the next day unless alternative sources of funds were found. Bear Stearns had been experiencing increasing difficulty since the previous June when two major hedge funds it owned collapsed, losing about $1.6 billion of investors' funds.

The Fed's board of governors met at 9.15 the following morning to authorise a bailout operation. As the minutes make clear, there was a real fear that the entire financial system was on the point of collapse.

"Board members agreed that, given the fragile condition of the financial markets at the time, the prominent position of Bear Stearns in those markets, and the expected contagion that would result from the immediate failure of Bear Stearns, the best alternative available was to provide temporary emergency financing to Bear Stearns through an arrangement with JPMorgan Chase & Co. also in New York. Such a loan would facilitate efforts to effect a resolution of the Bear Stearns situation that would be consistent with preserving financial stability," the minutes read.

Not only did the board authorise credit to Bear Stearns via JPMorgan Chase, it also decided to make funds available more broadly.

The minutes note that "given the unusual and exigent circumstances", the board authorised the Federal Reserve Bank of New York, in consultation with Fed chairman Ben Bernanke, to provide financing "to other primary securities dealers, when the Reserve Bank finds that adequate credit accommodations are not available to the borrower from other banking institutions."

In other words, the board feared the collapse of Bear Stearns would induce a general crisis of confidence across financial markets leading to the drying up of credit.

Such was the haste with which the meeting had been called that the board could not summon the requisite five governors, and so invoked emergency powers enabling it to make decisions with only four present.

Fed chairman Bernanke elaborated on the potential for a US and global financial collapse in his later testimony to the US Congress on the crisis. Because Bear Stearns was extensively involved in a "range of critical markets", he said, its sudden failure "likely would have led to a chaotic unwinding of positions in those markets and could have 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 the 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."

The extent of the Bear Stearns involvement in "critical markets" is indicated by reports that it held trading contracts with firms around the world amounting to $2.5 trillion.

Wide-ranging as they were, the Fed's decisions on

March 14 were not enough to halt the crisis and the board of governors had to reconvene on the afternoon of Sunday March 16 in order to arrange the sale of Bear Stearns to JPMorgan Chase. The crucial component of the deal was the decision by the Fed to make available a loan collateralised by a pool of Bear Stearns assets of up to $30 billion. Never before had the Fed agreed to take on mortgage-backed securities as collateral.

But the unprecedented action was central to the deal through which JPMorgan Chase would take over Bear Stearns. As chief executive Jamie Dimon later testified: "We could not and would not have assumed the substantial risks of acquiring Bear Stearns without the $30 billion provided by the Fed."

And if the deal were not closed, there was a risk of a global financial collapse with the Monday morning opening of Asian markets just a few hours away.

According to the minutes: "The evidence available to the board indicated that Bear Stearns would have difficulty meeting its repayment obligations the next business day. Significant support, such as an acquisition of Bear Stearns or an immediate guarantee of its payment obligations, was necessary to avoid serious disruptions to financial markets."

The $30 billion loan was not the only extraordinary feature of the deal. The Fed also granted JPMorgan Chase an 18-month exemption from Fed statutes governing capital requirements in connection with the Bear Stearns acquisition.

In addition, it further elaborated on the decision of two days before allowing the New York Reserve Bank to extend credit to primary securities dealers. These dealers would be able to access the new facility via their own clearing bank. The decision to provide finance for primary securities dealers was "based on recent, rapidly changing developments" which had demonstrated that "there had been an impairment of a broad range of financial markets in which primary dealers finance themselves" and that "dealers might have difficulty obtaining necessary financing for their operations from alternative sources."

Three and a half months on, the immediate crisis surrounding Bear Stearns has passed. But this does not mean that the crisis of the US and global financial system—widely described as the most serious since the 1930s—is anywhere near over. In fact, it may only be just beginning as the fall in the housing market translates into a downturn for the US economy.

Former US Treasury Secretary Lawrence Summers noted in a comment published in today's *Financial Times*: "It is quite possible that we are now at the most dangerous moment since the American financial crisis began last August. Staggering increases in the prices of oil and other commodities have brought American consumer confidence to new lows and raised serious concerns about inflation, thereby limiting the capacity of monetary policy to respond to a financial sector which—judging by equity values—is at its weakest point since the crisis began. With housing values still falling and growing evidence that problems are spreading to the construction and consumer credit sectors, there is a possibility that a faltering economy damages the financial system, which weakens the economy still further."

Summers said that after a period of intense activity earlier in the year "policy has again fallen behind the curve."

Warning there was a real possibility that "significant financial institutions will encounter not just liquidity but solvency problems" in the months ahead, he called for new legislative authority to ensure that regulators have the power to deal with a crisis. "It was fortunate that a natural merger partner was available when Bear Stearns failed—we may not be so lucky next time."