RISK, MORAL HAZARD AND THE BAILOUT OF BEAR STEARNS

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ABSTRACT

In March 2008 the Federal Reserve Bank and the US Treasury department made financial history by orchestrating the bailout of Bear Stearns, a major US and global investment bank, by a commercial bank JP Morgan Chase. Never before until this time had the Federal Reserve or US Federal Government come to the rescue of an major financial institution like this one. This research examines the factors leading up to the decision to rescue the Bear Stearns, and the issues of moral hazard and risk management the rescue operation raised. The paper has pedagogical value in teaching undergraduate students about moral hazard, risk and the role of the Federal Reserve Bank and the functioning of financial markets.

INTRODUCTION

Until March 2008 Bear Stearns was a highly respected large publicly traded investment banking firm head quartered in New York City, New York . On June 1, 2007, the shares of the firm (NYSE symbol: BSC) traded for as much as $153.95 per share giving the firm an aggregate market value in excess of $25 billion. The company operated as a financial supermarket having for its clients individuals, institutions, corporations and the government. The company made markets in a variety of US treasury securities, both short term and long term and like many investment banking firms the firm was active in the securitization of a variety of debt instruments including residential mortgage debt. The wealth management division of the firm provided investment advisory and management services to high net worth individuals. The firm also managed money for its clients via hedge funds it owned and operated.

HEDGE FUNDS

The start of the twenty-first century saw an explosive growth in hedge funds. Hedge funds are investment vehicles that have far fewer constraints in their investments relative to mutual funds and hedge funds are not regulated by the Securities and Exchange Commission. It is estimated that over $2 trillion dollars are invested in hedge funds all over the world and this number represents a 1000% increase over the amount invested in 1999. According to a study by D. MacDonald, [1] there are over 9000 hedge funds in existence of which over 350 manage more than $1 billion each in assets. Both individuals and institutions invest in hedge funds and Bear Stearns managed several hedge funds on behalf of its clients. Hedge funds typically charge high fees and in exchange promise large returns to their clients, but not all deliver on that promise. While hedge fund may have originally been designed to hedge, i.e, provide some downside risk

protection via active hedging strategies, increasingly hedge funds are highly leveraged and undertake very risk strategies attempting to generate higher returns for clients. In short hedge funds often make very risky investment bets. Many hedge funds in the recent past invested heavily in mortgage backed securities (MBOs) and collateralized debt obligations (CDOs) created from sub-prime mortgages.

SUB-PRIME MORTGAGE CRISIS

In the summer of 2007 a large number of sub-prime mortgage loans began to go sour and the defaults on CDOs and MBOs increased. Several hedge funds ran in to trouble and faced a capital shortfall on account of bets placed on sub-prime mortgages that went wrong. In June 2007 Bear Stearns pledged up to $3.2 billion in loans to bail out one of the hedge funds it ran. It was the biggest rescue of a hedge fund since 1998 when a group of lenders made a $3.6 billion loan to save the hedge fund known as Long Term Capital Management (LTCM). In 1998, the Federal Reserve Bank Chairman was sharply criticized for orchestrating the bail out of LTCM since it was a private hedge fund and not a publicly held financial institution. Critics argued that bail out of a hedge fund created moral hazard and encouraged risky behavior on the part of financial institutions.

THE BEAR TAKES A FALL

Despite its attempts to shore up its hedge funds, Bear Stearns continued to lose money. On Tuesday, March 12, 2008 Bear Stearns reported that it has $17 billion in capital and it felt comfortable that it would be able to meet its obligations. Nevertheless it continued to face pressure from clients in Goldman Sachs, Morgan Stanley and Credit Suisse who felt nervous about Bear Stearns ability to meet its obligations. Trust begets trust in the banking business and the reverse is also true [2] . It was ultimately lack of trust in Bear Stearn's ability to meet its obligations that precipitated a proverbial run on the bank. By Thursday March 14th Bear Stearns cash had fallen to mere $2 billion after several clients withdrew their funds from the bank. Late that evening Bear Stearns and the Securities and Exchange Commission told the Treasury and Federal Reserve Bank that Bear Stearns would have to file by bankruptcy by Friday morning if it did not receive liquidity assistance [3]. Over the weekend officials from the Federal Reserve Bank, The Treasury and JP Morgan devised a buyout of Bear Stearns so as to avoid a bankruptcy filing. The initial price offered by JP Morgan was $2 per share. Even though the deal averted a bankruptcy filing by Bear Stearns the low valuation of Bear Shares that had closed on Friday at over $26 per share, sent shock waves through financial markets. The offer was subsequently upwardly revised to $10 per share but that was small consolation to Bear insiders and employees that owned over 60% of the company and lost most of their life savings. The Federal Reserve Bank and Treasury officials subsequently testified before the US. Senate Banking Committee that the government orchestrated buyout of Bear Stearns was a necessity, but the deal is still plagued by many of the same concerns that dogged the bailout of Long Term Capital Management.

REFERENCES

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[3] Sidel, R., G. Ip, M.M Phillips and K. Kelly, 2008 'The Week that shook Wall Street http://online.wsj.com/article/SB120580966534444395.html accessed on March 18, 2008

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