Statement No. 258

For Information Contact:

Robert A. Eisenbeis
770-416-0047

Richard Herring
215-898-5613

Chester Spatt
412-268-8834

Statement of the Shadow Financial Regulatory Committee on

If Bear Had Been a Bank

May 5, 2008

The Federal Reserve's recent involvement in the acquisition of Bear Stearns was part of a series of actions to address financial turmoil in the market. The Fed feared that if Bear entered bankruptcy proceedings the spillover in the repo market and the market for Credit Default Swaps could have systemic consequences. The Federal Reserve invoked a Depression-era amendment to the Federal Reserve Act authorizing the Fed to grant loans to individuals, partnerships and corporations in emergency situations. It used that power to make an overnight loan to Bear Stearns through JPMorgan Chase. Subsequently, it engaged in a complex financing arrangement that involved providing financial assistance to JPMorgan Chase to enable it to acquire Bear Stearns. To finance this transaction, the Fed established a special purpose entity (SPE) to acquire $30 billion in assets from Bear Stearns. The SPE was funded by a $29 billion loan from the Fed and $1 billion of subordinated debt from JPMorgan Chase. Black Rock will serve as trustee of the SPE to manage and liquidate the assets over a ten-year period with an optional extension.

Because Bear Stearns was an investment bank, not a commercial bank, the Fed faced a limited range of options when it was notified that Bear was experiencing financial difficulties. Although Bear Stearns was a prime dealer, it didn't have access to the discount window to deal with its own emergency liquidity needs. After the collapse, the Fed did open the discount window to prime dealers on a temporary basis.
The $1 billion in loss protection it extracted seems very small relative to the increase in the share value of JPMorgan Chase.

Second, the structure of the financing involved the acquisition of mortgages and mortgage-backed securities. Subsequently, the Fed has accepted a wide range of collateral that goes beyond the traditional limits on the credit risk in collateral traditionally honored by central banks.\textsuperscript{2} Third, the perception that the Fed bailed out Bear has heightened political pressure to use the Fed’s resources to support other risky assets including student loans and mortgage-related securities. Finally, the Fed has now evidently extended its safety net protection to all investment banks that are prime dealers. As the Bear example shows, these entities are not subject to prompt corrective action, least-cost resolution, or a sufficiently wide range of resolution alternatives. The most important reform would be to convey to the Fed bridge bank authority for the resolution of systemically important financial institutions.

\textsuperscript{2} The Fed will now accept agency mortgage backed securities, AAA-rated residential mortgage backed securities, commercial mortgage backed securities, agency- collateralized mortgage obligations, student loans, and asset-backed commercial paper.