

By Christopher E. Grant

The Fed Bails Out Wall Street **Main Street Pays the Tab**

In a matter of just four days culminating with the St. Patrick's Day weekend, the Federal Reserve, guardian of the country's banks since its creation in 1913, abandoned 75 years of precedent by expanding its role to include "protector" of Wall Street. **With the taxpayers' checkbook in hand, the Fed not only orchestrated the sale of beleaguered investment bank Bear Stearns to its rival, JP Morgan Chase, but also stood in as the lender of last resort and ultimate risk taker in the transaction.**

The course of events leading to the demise of Bear Stearns moved nearly at the pace of a David Baldacci novel.

Wednesday March 12th

In the wake of rampant rumors of developing liquidity problems, 85 year-old **Bear Stearns, the nation's fifth largest investment bank reaffirms its book value at \$84 per share.**

Thursday Evening, March 13th

In a conference call between the SEC (Securities and Exchange Commission), the Board of Governors of the Federal Reserve and the Treasury Department, **Bear Stearns concludes that, after a day-long "run" on the bank and the resulting inadequate funding resources to meet its obligations, it would file for bankruptcy on Friday morning.**

Friday March 14th, 5:00 a.m.

New York Federal Reserve bank extends overnight loan through the discount window to J.P. Morgan Chase who, in turn, "lends" that money to Bear Stearns. The stated intent is to get to the weekend to "explore options to avoid bankruptcy" and to "contain risk to the financial markets in the event no private-sector solution can be found."

That afternoon, Bear Stearns' credit rating is downgraded from A to BBB. **Market participants respond by halting virtually all transactions with Bear and preparing for the possibility that it would not open for business once Asian markets opened on Sunday night.**

Sunday March 16th

J.P. Morgan/Bear Stearns announce transaction whereby **JPM will buy Bear Stearns for \$236.2 million (\$2/share), roughly 1% of its value 16 days prior.** The Fed facilitates the transaction by lending \$30 billion to the deal, taking "troubled" mortgage securities as collateral for their "non-recourse" loan. To thwart threatened Bear Stearns shareholder litigation, the price is upped to \$10/share (Fed "guarantee" reduced to \$29 billion) a week later.

Washington's Line, Fed as Savior

In the wake of the government's intervention to "save" Wall Street giant Bear Stearns from bankruptcy by facilitating its sale to JP Morgan, the mandatory trek by the nation's financial regulators to capital hill began. As expected, representatives from the Fed, Treasury Dep't. and SEC explained how **the bailout was "necessary and appropriate"** (Robert Steel, Treasury Undersecretary for domestic finance and former Goldman Sachs executive). Justification for the non-recourse \$30 billion loan was provided by N.Y. Fed Reserve bank president Timothy Geithner, **"The risks (of loss to the taxpayers) are modest in comparison to the substantial damage to the economy and economic well-being that would have accompanied Bear's insolvency."** Fed Chairman Bernanke echoed, **"Main Street was more of a beneficiary of the rescue than Wall Street.** If the financial system crashes, or at least is severely hobbled, then the economy can't grow in a healthy way either, and that's why we did what we did."

Taxpayers' View, a Colossal Subsidy for JP Morgan

A substantial number of vocal “off Wall Street” financial managers and commentators have expressed a polar opposite view of this transaction. Representative of their observations and objections are the following arguments made by mutual fund manager/columnist John Hussman:

The \$30 billion “non-recourse loan” to J.P. Morgan, secured only by the worst of Bear Stearns’ mortgage securities is not in fact a loan. **Because the \$30 billion loan proceeds are secured only by the mortgage securities and not guaranteed by J.P. Morgan itself, the risk of loss is actually borne by the lender (the Fed and ultimately the taxpayer, although J.P. Morgan does assume the risk on the initial \$1 billion in losses under the modified structure).**

The Fed’s assumption of \$29 billion in risk in fact protects both the stockholders and bondholders of Bear Stearns. The Bear shareholders were able to “negotiate” a quintupling of share value from \$2/share up to \$10/share under the revised structure while the **\$75 billion in claims of the short and long-term bondholders of Bear Stearns remain unscathed.**

The Federal Reserve and the Treasury elected to ignore Title IX of the Bankruptcy Act of 2005 which would have provided for the orderly transfer and settlement of assets. **Instead, they provided a bailout for the benefit of Bear Stearns’ shareholders and bondholders at public expense.**

The “failure” of Bear Stearns was misrepresented. **Bear Stearns’ customers’ accounts and counterparties were never at risk of loss** and, as evidenced from the J.P. Morgan transaction, were easily transferred. The only “failure” was that of Bear Stearns’s stocks and bonds to be successful investments, which were “bailed out” in part or in full at public expense.

In sum, Hussman concludes that the **transaction was a clear break from the historical role of the Federal Reserve and was nothing more than “unelected bureaucrats committing public funds to facilitate a private business transaction and selectively defend the holders of corporate securities.”**

The “Moral Hazard” of the Fed’s New Role

While this intervention by the Fed into the dealings of Wall Street was not a first, its method clearly was. Unlike 1998 when the New York Fed summoned the heads of the major investment banks and “convinced” them to jointly purchase the assets of the failing hedge fund Long-Term Capital Management, this time the Fed exercised power granted under a 1930s law to intervene due to “unusual and exigent circumstances.”

Whether intended or not, **in one fell swoop, the Fed became an emergency lender to all of Wall Street’s major investment firms.** As observed by Neil Irwin of the Washington Post, “The Fed has made a special lending facility – essentially a bottomless pit of cash – available to large investment banks for at least the next six months. Even if that program is allowed to expire, the Fed’s actions will have a lasting impact.”

One such potential impact is the “moral hazard” of establishing the Fed as perceived guarantor to investment banks, their investors or their counterparties. The breadth and depth of future Fed action raises important questions. For example, will the investment banks take on excess risk, assuming that the Fed will bail them out if their bets don’t pan out? Will investor/bondholders assume that they are insulated against loss as was the case in the Bear transaction? Perhaps most important, will the ongoing measurement and control of counter-party risk by market participants which has been the cornerstone of the predominantly self-regulated capital markets be supplanted by a new government backstop coupled with

expanded federal regulation? Although we will have to wait for the answers to these and many similar questions, **what we know for sure is that the Fed's role has been redefined.** Unlike in the past when the Fed chose not to walk down Wall Street, the central bank's role may now encompass virtually everything in the financial system in one way or another.

The Aftermath – Lessons Learned?

Rather than join in the finger pointing and blame game that is abundantly available in the financial press, we will instead focus on the broader issues underlying the credit market freeze and what main street investors can expect going forward. As described by *Against The Gods* author Peter L. Bernstein, **the key to both credit creation and market liquidity is trust.** And in a financial market that is dominated by complex financial instruments, where the end borrower and collateral are virtually unidentifiable, trust in ratings agencies like S&P and Moody's or bond insurers like MBIA is paramount.

As the old fashioned, face-to-face personal relationship between lender and borrower has given way to the "new world" of credit securitization, the character of financial instruments has simultaneously become totally reliant on the risk measurement ratings ladders published by these agencies. **With the destruction of the credibility of these ratings agencies and the viability of the bond insurers, the entire chain of credit creation, risk-taking and economic growth has come to a standstill.** With no trusted measurement of risk or value, buyers have vanished and market liquidity has dried up.

While the Fed's combination of interest rate cuts, term lending facilities for both commercial and investment banks, and even direct intervention in the case of Bear Stearns has provided sufficient liquidity to keep the country's financial machinery from totally seizing up, **the job of restoring faith in the credit markets will be a long and more tedious process.**

As is all too often the case, **much of the suffering will be felt by Main Street America, those who have been prudent, paid their mortgages and credit cards and lived within their means.** They are the ones whose incomes will shrink due to the miniscule interest rates on their money market accounts and CDs, a direct result of the Fed rate cuts. Equally painful will be the higher cost of gas and other dollar-priced commodities caused by the falling value of the greenback. **Most disconcerting is the realization that, while the enormous profits associated with the run-up to this debacle flowed into private hands; too much of the cost for cleaning up the mess will be borne by the taxpaying public.**

On a more positive note, however difficult this rebuilding task, the need and demand for credit will continue. **While the financial landscape is certain to change, the extraordinary drive for financial innovation will again create new sources of credit.** There is little or no doubt we will see new regulations and oversight along with tougher lending standards. **Equally predictable is the eventual emergence of another ill-fated market "bubble" and the accompanying mantra, "It's different this time."** And as with the current crisis, our role will be to ground our clients in reality, reminding them of past follies and keeping them on track toward the successful achievement of their own goals.

Grant/GrossMendelsohn, LLC

36 South Charles Street, 18th Floor

Baltimore, MD 21201

Office: 410 685-9685

Facsimile: 410 752-1148

E-mail: chris@GGMWealthAdvisors.com