

NEWSFLASH

The Bear Sterns Collapse and Implications in the US Financial Services Industry

Consumer Banking and Credit Advisory Service
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NEWS UPDATE

This week, the Federal Reserve took swift action to inject liquidity into the US financial services industry. First, it arranged for JP Morgan Chase to acquire Bear Stearns. Second, it made available credit lines to the largest investment banks. These efforts were taken to ensure that despite the collapse of trading markets for some of the most risky investment on their books, financial institutions could continue in their role as trusted financial intermediaries.

OUR VIEW

The Bottom Line

JP Morgan Chase has reaped the benefit of sitting on the acquisition sidelines. As the only real option to acquire Bear Stearns without liquidating its assets, JP Morgan Chase was able to purchase the firm at a shockingly low price. Penalizing Bear Stearns' shareholders, but ensuring a smooth transition. For JP Morgan Chase, the prime brokerage business of Bear Stearns will fill out its portfolio of offerings, and it expects the transaction will be accretive to earnings in 2008, generating \$1.2B in additional earnings.

The Federal Reserve's arranged marriage between failing Bear Stearns and JP Morgan Chase may have injected a degree of confidence that was sorely needed into the US financial services industry, but the repercussions will continue for years to come. The Federal Reserve has taken an unprecedented move into overseeing and protecting the stability of US investment banks. This grand gesture will be followed by increasing oversight and regulation of this segment of the financial services industry - which has grown dramatically and which provided the liquidity that fueled growth in sub-prime lending and led to the rapid descent that we're now experiencing.

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Bear Stearn's was the most aggressive and least diversified investor in mortgage-backed collateralized debt obligations (CDOs), and the failure of the institution can be traced to an inability to mark to market, or value these securities, after the market for CDOs evaporated in early 2007. No one can say what the real market value of Bear Stearn's portfolio will be over time, and this uncertainty led trading partners and investors to move their business out of the firm – in effect creating a run on the bank. It was the run that finally brought the bank down, not its investment strategy, although its investments and their uncertain valuation were the root of the problem. Even though JPMorgan Chase bought the firm for pennies on the dollar, it did so only with guarantee of a credit line from the Federal Reserve for up to \$30B. This credit line is collateralized by Bear Stearn's most illiquid, unpriceable assets. The Federal Reserve has taken control of those assets and will bear responsibility for all gains and losses of that portion of Bear's portfolio.

To assuage further uncertainty, the Federal Reserve has for the first time agreed to provide credit to the largest investment banks. This credit will be collateralized by their securities - in effect creating a market for the illiquid investments within their portfolios, and thereby allowing the markets to function more smoothly. This lending facility will be open for at least six months and will provide funds at the bank discount rate set by the Federal Reserve.

This move is important as it sets a precedent for the Federal Reserve to take a more interventionist role in the US capital markets industry. The Securities and Exchange Commission has provided a much lighter regulatory hand to this industry segment, without the safeguard of capital infusion that has been available to the commercial banking industry through the Federal Reserve. With review already underway to expand the supervisory role of the Office of the Comptroller of the Currency (OCC) to thrift institutions, and congressional motions toward increasing oversight of investment banks, Financial Insights predicts that increase regulation of investment banks will be the most far-reaching outcome of this week's actions.

Essential Guidance

Structural changes in the US commercial and investment banking industries have led to a disconnect in the financial markets. Commercial banks, retail banks, other lenders responded to demand for safe, high yield investments by investment banks by originating sub-prime and no documentation loans which, although riskier investments, generated higher returns for investors. Market forces finally reined in loan originations, but only after the market for CDOs dried up. This left originating banks on the supply side holding

mortgages on their books which they had intended to securitize, leading to the downfall of Countrywide. Now, it has ultimately led to the failure of Bear Stearns, one of the investors funneling CDOs to hedge funds and other investors and increasing demand for these mortgages.

Financial Insights expects that the Federal Reserve will act in the best interests of the financial services industry and the US economy as a whole to ensure that further disruptions are minimized. However, just as the previous market disruptions have led to increased regulatory oversight, this one will as well.

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Related Research

The Subprime Lending Debacle: The Mistakes Were in Market Risk Analysis Involving CDOs, not the Credit Risk Analysis of Those Applying for Mortgages, (Financial Insights #FIN206063, March, 2007)

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