Finance Term Paper

Transparency of Financial Institutions during the Credit Crisis

Professionals (economists, statisticians, gurus of mathematical modeling and all sorts of bell-curve experts) – or the ones that we are used to calling professionals – use their previous judgments (or judgments of their peers) to make predictions about future events; thus, they derive expectations based upon past empirical evidence. However, certain events happen precisely due to the fact that they were not expected to happen. The magnitude of such events is not that enormous – they are fast, they happen within days and the impact they produce is devastating. However, in the general time-line of events (in a fairly large sample), they would not stand out and affect the average outcome. The scholars of uncertainty can make claims about the truthfulness of their predictions after the particular events happen. However, as they unfold, it is quite hard to determine whether certain factors, combinations of factors and systemic errors would result in a collapse, since every new collapse is not like the previous one. Among those completely unexpected events were the bankruptcy of Latin American countries in 1982 and the following debt crisis, the dot-com bubble and the credit crisis of 2007.

It should be noted that there were multiple scholars (including Noriel Roubini, famously known for his ability to foresee) in the United States and the United Kingdom that were trying to warn the authorities about the fact that the system is about to collapse. However, if we look deeper into the question, we might discover that the occurrence of a credit-related crisis was forecast by Karl Marx in 1867.

Despite all those multiple warnings and wide availability of information on the problems that financial institutions were experiencing, the collapse of Lehman Brothers did suddenly happen and dragged the financial system of the United States into the crisis. There is an important property of information and the way people analyze it: when there is a lot of it available, it is impossible to know which pieces are significant and which are not. This is why when the financial system of the United States was on the brink of a crisis, messages that were informing of the upcoming collapse could be (and were) ignored.

Bearing all this in mind, let us discuss a financial institution that had serious financial problems as a result of a crisis. This paper reviews stories in the media that were published about this institution and tries to investigate whether there were any clues that the institution was having problems. Finally, the paper analyzes the annual report and tries to find problems that were about to unfold.

The institution chosen for analysis in this paper is Bear Stearns Companies, Inc. - a global investment bank and securities brokerage and one of the systemic institutions in the U.S. Financial system. It was founded in 1923, survived the Great Depression and sold to JPMorgan Chase in 2008. According to Boyd (2008), “It took only a few days, a rising sense of panic... to spell the end of a 85-year old investment bank”. Bear Stearns was involved in trading mortgage-backed securities. The crush of the company started in 2007, when one of its hedge-funds had to be bailed-out. This hedge fund was involved in subprime mortgage lending. After that, another hedge fund collapsed. In July 2007, the New York Times reported that the company announced 61% loss in its third-quarter profits due to hedge fund losses. According to Grynbaum (2007), in 2007 “Bear posted net income for the quarter of $171.3 million, or $1.16 a share, down from $438 million, or $3.02 a share, in the period a year earlier”. Thus, in July 2007, when the hedge fund crisis was unfolding, Bear Stearns was experiencing losses. At the same time, Goldman Sachs was posting increases in profits. It was still 6 months until Bear Stearns' emergency takeover.

Before proceeding with the analysis of the media messages that reported the instability of the institution, we should take a closer look at the factors that facilitated the upcoming crisis and try to understand that the institution under study was not performing anything extraordinary; on the contrary, it was operating on the market where everyone was subject to the same rules. Thus, it was a matter of risk diversification and the speed of information spreading that contributed to the collapse. The collapse of the company started much earlier, when the initial conditions of market operation were put in action.

The factors that contributed to the crisis are to be divided into factors of economic policy, bank strategy factors, the emergence of new financial instruments (derivatives), deregulation factors, oversight issues, and accounting problems.

Economic policy factors involve the lowering of interest rates after 9/11 and application of rules that facilitated borrowing by unqualified applicants (this was initially aimed at increasing home ownership). Banks in turn created new loans to satisfy demand for loans and created new institutions to finance subprime lenders. The new financial instruments included credit default swaps (primarily configured for conservative institutional investors).

Deregulation included primarily downgrading capital requirements to purchase highly rated mortgage-backed securities. Oversight issues included actions of credit-rating agencies that awarded collateralized debt products highest ratings. Finally, accounting rules allowed banks to write-down mortgage loans. This is how the crisis mechanism was gradually offset.

The fact that Bear Stearns was doing the same thing as its fellow investment banks was supported by the original rules of the game. The demand for loans was high and there was little or no liquidity to support those loans; thus, banks were issuing new instruments. However, it is quite difficult to determine whether the situation is to be blamed on the regulators or on banks themselves. Having understood the rules of the game, we may now proceed to the analysis (post-factual investigation) of the information that was available on the situation inside Bear Stearns.

In 2007, after the collapse of the two hedge-funds, the company's CFO stated that “our capital position is strong” and added that “balance-sheet liquidity has continued to improve throughout the course of the year. We spent an awful lot of time trying to reduce our higher-risk asset categories” (Boyd, 2008). In fact, the collapse of the two hedge funds in 2007 marked the beginning of the meltdown for the company: clients started to pull out assets and rumors started to spread that the company was about to fail. There were two significant facts that made Bear Stearns different from other banks: the bank had liquidity problems (a ratio of 35 to 1; it had $11.1 billion in tangible equity and had to support $395 billion in assets); the assets that the bank held were less liquid that everyone else was holding. However, had the situation with subprime lending lasted for another six months or so, Bear Stearns would have improved its asset structure. Finally, Bear's competitors were playing against it (and against each other), trying to diminish share prices. The company's executives claimed that they were surrounded by a significant amount of negative rumors that contributed to the company's collapse. Multiple lawsuits were filed against the bank. Interestingly, when in November of 2007 the company's CFO announced that Bear was to face its first loss in almost 80 years, S&P downgraded Bear's credit rating from AA to A (a fairly sound and reliable rating that did, hoverer, scare off investors).

In March 2008, the Fed agreed to provide Bear Stearns with a loan to cover up for the liquidity that the bank needed. The loan was to be collateralized by “clean” assets. However, on March 13, 2008, the company's CEO desperately contacted JPMorgan Chase executives to arrange for a stock swap agreement. On March 14 the company was experiencing a tremendous decline in its stock prices. Finally, on March 22, 2008, an acquisition agreement was signed.

It may be true that the collapse of Bear Stearns was caused by lack of confidence that the bank needed. There is information that the company’s CEO was trying to have some of its well-known clients to assure the financial world that everything was under control. However, it was not the lack of confidence that brought Bear Stearns down. The rules that the company had to play and the situation on the market would have inevitably caused the collapse. The primary reason was the structure of assets that Bear Sterns held.

Works Cited

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