Massive Debt Default: Bearly Alive, Wall Street Investment Giant Rushed to “Intensive Care” by Panicky Fed-Chief

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Global Research, March 15, 2008
15 March 2008

Region: USA
Theme: Global Economy

On Friday, Bear Stearns blew up. It was the worst possible news at the worst possible time. A day earlier, the politically-connected Carlyle Capital hedge fund defaulted on $16.6 billion of its debt. Carlyle boasted a $21.7 billion portfolio of AAA-rated residential mortgage-backed securities, but was unable to make a margin call of just $400 million. (Where did the $21.7 billion go?) The news on Bear was the last straw. The stock market started reeling immediately; shedding 300 points in less than an hour. Then, miraculously, the tide shifted and the market began to rebound. If there was ever a time for Paulson’s Plunge Protection Team to come to the rescue; this was it. For weeks, the markets have been battered with bad news. Retail sales are down, unemployment is up, consumer confidence is in the tank, inflation is rising, the dollar is on the ropes, and the credit crunch has spread to even the safest corners of the market. Facing fierce headwinds, Washington mandarins and financial heavyweights had to decide whether to sit back and let one small investment bank take down the whole equities market in an afternoon or stealthily buy a few futures and live to fight another day? Tough choice, eh?

We’ll never know for sure, but that’s probably what happened.

We’ll also never know if Bernanke’s real purpose in setting up his new $200 billion auction facility was to provide the cash-strapped banks with a place where they could off-load the mortgage-backed junk that Carlyle dumped on the market when they went belly-up. That worked out well, didn’t it? Now the banks can trade these worthless MBS bonds with the Fed for US Treasuries at nearly full value. What a deal! That must have been the plan from the get-go.

The Bear Stearns bailout has ignited a firestorm of controversy about moral hazard and whether the Fed should be in the business of spreading its largess to profligate investment banks. But the Fed had no choice. This isn’t about one bank caving in from its bad bets. The entire financial system is teetering and a failure at Bear would have taken a wrecking ball to the equities market and sent stocks around the world into a violent death-spiral. The New York Times summed it up like this in Saturday’s edition:

“If the Fed hadn’t acted this morning and Bear did default on its obligations, then that could have triggered a widespread panic and potentially a collapse of the financial system”.

Bingo.

So, what makes Bear so special? How is it that one of the smallest investment banks can pose such a threat to the whole system?

That's the question that will be addressed in the next couple weeks and people are not going to like the answer. For the last decade or so the markets have been reconfigured according to a new "structured finance" model which has transformed the interactions between institutions and investors. The focus has been on maximizing profit by creating a vast galaxy of exotic debt-instruments which increase overall risk and volatility in slumping market conditions. Derivatives trading which, according to the Bank of International Settlements, now exceeds $500 trillion, has sewn together the various lending and investment institutions in a way that one failure can set the derivatives dominoes in motion and bring down the entire financial scaffolding in a heap. That's why the Fed got involved and (I believe) approached Congress in a closed-door session (which was supposed to be about FISA legislation) to inform lawmakers about the growing possibly of a major economic meltdown if conditions in the credit markets were not stabilized quickly.

The troubles at Bear and the danger they pose to the overall system were articulated in an article by Counterpunch editor, Alexander Cockburn in a November, 2006 article "Lame Duck: The Downside of Capitalism":

"In a briefing paper under the chaste title, 'Private Equity: A discussion of Risk and Regulatory Engagement', the FSA raises the alarm.

"Excessive leverage: The amount of credit that lenders are willing to extend on private equity transactions has risen substantially. This lending may not, in some circumstances, be entirely prudent. Given current leverage levels and recent developments in the economic/credit cycle, the default of a large private equity backed company or a cluster of smaller private equity backed companies seems inevitable. This has negative implications for lenders, purchasers of the debt, orderly markets and conceivably, in extreme circumstances, financial stability and elements of the UK economy."

Translation: It's about to blow!

"The duration and potential impact of any credit event may be exacerbated by operational issues which make it difficult to identify who ultimately owns the economic risk associated with a leveraged buy out and how these owners will react in a crisis. These operational issues arise out of the extensive use of opaque, complex and time consuming risk transfer practices such as assignment and sub-participation, together with the increased use of credit derivatives. These credit derivatives may not be confirmed in a timely manner and the amount traded may substantially exceed the amount of the underlying assets."(snip)

Translation: "The world's credit system is a vast recycling bin of untraceable transactions of wildly inflated value.

The problem is that the oversight and stability of the world credit system is no longer within the purview of familiar international institutions like the International Monetary Fund or the Bank of International Settlements. Private traders are now installed at all the strategic nodes, gambling with stratospheric sums in such speculative pyramids as the credit derivative market which was almost nonexistent in 2001, yet which reached $17.3 trillion by the end of 2005. Warren Buffett, America's most famous investor, has called credit derivatives "financial weapons of mass destruction." (Alexander Cockburn, "Lame Duck: The Downside of Capitalism" counterpunch.org)

Cockburn's article anticipates the current problems at Bear and shows why the Fed cannot allow them to fester and spread throughout the system. The investment banks and brokerages all do business with each other, taking sides in trades as counterparties. If one player goes down it increases the likelihood of more failures. So the problem has to be contained.

The volume of derivatives contracts, that are not traded publicly on any of the major exchanges, has exploded in the last few years. These unregulated transactions, what Pimco's Bill Gross calls the shadow banking system, have taken center-stage as market conditions continue to deteriorate and the downward-cycle of deleveraging begins to accelerate. The ongoing massacre in real estate has left the structured investment market frozen, which means that the foundation blocks (ie mortgage-backed securities) upon which all this excessive leveraging rests; is starting to crumble. It's a real mess.

Derivatives trading, particularly in credit default swaps, is oftentimes exceeds the value of the underlying asset many times over. Credit Default Swaps are financial instruments that are based on loans and bonds that speculate on a company's ability to repay debt. (a type of unregulated insurance) The CDS market is roughly $45 trillion, whereas, the aggregate value of the US mortgage market is only $11 trillion; four times smaller. That's a lot of leverage and it can have a snowball effect when the CDSs trades begin to unwind.

In truth, the biggest risk to the financial system is counterparty risk; the possibility that some large investment bank, like Bear, goes under and sucks the rest of the market with it from the magnitude of its losses. Last year, Bear was the 12th largest counterparty to CDS trades according to Fitch ratings. If they were to suddenly disappear, the effects to the rest of the system would be catastrophic.

Fed Chairman Bernanke sat on the board of the FOMC when the investment gurus and brokerage sharpies customized the markets in a way that enhanced their own personal fortunes while increasing the risks of systemic failure. The SIVs, the conduits, the opaque derivatives, the off-balance sheets operations, the dark pools, the massive leverage, and the reckless expansion of credit; all emerged during his (and Greenspan's) tenure. The Federal Reserve is largely responsible for the brushfire they are presently trying to put out.

Now, once again, Bernanke is acting beyond his mandate and invoking a law that hasn't been used since the 1960s so the Fed can become the creditor for an institution that attempted to enrich itself through wild speculative bets on dubious toxic investments which are now utterly worthless. If that isn't a good enough reason for abolishing the Federal Reserve; then what is?

The world's most transparent and profitable markets have been transformed into a carnival sideshow managed by hucksters, flim-flam men, and rip off artists. The Bear bailout is yet another glaring example of a system that lacks all credibility and is quickly self-destructing.

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