# Peak Credit – the US Approach: “Too Big to Fail”

As the credit market subsides in what is a continuing “Credit Crash” from a point of “Peak Credit” last year, we are seeing a continuing fall out among the key banking institutions responsible for the bubble and the Crash. We have already seen how the UK approached the collapse of the mortgage lender, Northern Rock, and we will now turn to the remarkable “market-based” solution applied in the US to the collapse of Bear Stearns and its acquisition by J P Morgan.

It was in fact J P Morgan themselves who invented credit derivatives – essentially a form of time limited guarantee against a loan default given in return for a payment - and in the years since then these derivatives have become widely used to enable portfolios of loans to be “diced and sliced” in ever more complex ways.

Both Bear Stearns and J P Morgan were investment banks hugely active both in the origination and “securitisation” of loans and also in the creation of “Collateralised Debt Obligations” and structured investments incorporating credit derivatives in varying degrees of complexity.

By early 2008 there was fairly widespread concern in relation to Bear Stearns position, and it appears to have been put about that they were the “first in line” for failure. Moreover, Bear Stearns, unlike J P Morgan, did not have direct access to Federal Reserve funding via the “discount window” although this access was subsequently extended to other banks - two weeks too late to save Bear Stearns.

There is a widespread perception that J P Morgan stepped in on March 16th 2008 to “rescue” Bear Stearns. However, some market commentators believe that J P Morgan was as much in need of rescuing as Bear Stearns.

Rob Kirby – a market commentator – had this to say in an April 23 article

*“. . . J.P. Morgan's derivatives book is 2-3 times bigger than Citibank's - and it was derivatives that caused losses of more than 30 billion at Citibank . . . . So, it only made common sense that J.P. Morgan had to be a little more than `knee deep' in the same stuff that Citibank was - but how do you tell the market that a bank - any bank - needs to be recapitalized to the tune of 50 - 80 billion?"*

Furthermore, in respect of a very large part of the J P Morgan derivatives portfolio – as was the case for most other major Investment Banks – their wholesale market counter-party was Bear Stearns, who were therefore part of that elite club of US banks “too big to fail”.

Note here that there is a significant difference between the US approach to Bear Stearns and the UK approach to Northern Rock which – being a retail operator, albeit with wholesale funding - had a market capitalisation a fraction of that of Bear Stearns.

The point is that the failure of Bear Stearns would have adversely affected the banking system: the failure of Northern Rock on the other hand would have adversely affected several million UK voters.

**“The Day Market Capitalism Died”**
*"Remember Friday March 14, 2008,"* wrote Martin Wolf in the Financial Times*; "it was the day the dream of global free-market capitalism died."*

There are two aspects to the Bear Stearns transaction: there is the takeover itself, where JP Morgan paid for Bear Stearns shares not with cash but with its own stock, and there is the matter of the price at which it took place - which collapsed from a high of $156 to a low of $2, to bounce back to $10 a week after the deal in response to a wave of shareholder outrage..

The necessary funds to keep Bear Stearns afloat were provided by the Federal Reserve (or "Fed") who lent $25 billion to Bear Stearns and another $30 billion to J P Morgan, a total of $55 billion that all found its way to J P Morgan'.

## The Collapse

John Olagues – a leading authority on stock options - maintains that the Bear Stearns collapse was artificially created to allow J P Morgan to be paid $55 billion of taxpayer money to cover its own insolvency and acquire its rival Bear Stearns.

This was allegedly achieved through a combination of a coordinated campaign of market rumour coupled with manipulation of Bear Stearns shares using a form of derivative called a “Put” option.

A put is an option to sell a stock at an agreed-upon price, called the strike price or exercise price, at any time up to an agreed-upon date. If the stock's price falls below the strike price, the option becomes profitable. By way of example the right to sell Bear Stearns shares at $20.00 each is worth virtually nothing (it is “Out of the Money”) if the market price is far above the $20.00 “strike price”. If the market price falls below, then shares may be bought in the market and sold to make a profit.

Olagues wrote

*On March 10, 2008, Bear Stearns stock dropped to $70 a share -- a recent low, but not the first time the stock had reached that level in 2008, having also traded there eight weeks earlier. On or before March 10, 2008, requests were made to the Options Exchanges to open a new April series of puts with exercise prices of $20 and $22.50 and a new March series with an exercise price of $25. The March series had only eight days left to expiration, meaning the stock would have to drop by an unlikely $45 a share in eight days for the put-buyers to score.*

*It was a very risky bet, unless the traders knew something the market didn't; and they evidently thought they did, because after the series opened on March 11, 2008, purchases were made of massive volumes of puts controlling millions of shares.*

*On or before March 13, 2008, another request was made of the Options Exchanges to open additional March and April put series with very low exercise prices, although the March put options would have just five days of trading to expiration. Again the exchanges accommodated the requests and massive amounts of puts were bought.*

Olagues then goes on to point out that:

*"The fact that the requests were made on March 10 or earlier that those new series be opened and those requests were accommodated together with the subsequent massive open positions in those newly opened series is conclusive proof that there were some who knew about the collapse in advance . . . . This was no case of a sudden development on the 13 or 14th, where things changed dramatically making it such that they needed a bail-out immediately. The collapse was anticipated and prepared for.*

**Manipulation – and the Curious Incident of the Dog in the Night-Time**
As a former Exchange regulator myself, I would be crawling all over these trades, which must have generated substantial profits and losses. It is not difficult to apply the fraud investigator's Golden Rule – "Follow the Money".

The most interesting thing in the whole saga is that *no-one seems to be complaining*.

This brings to mind the "Curious Incident of the Dog in the Night-time" – in the Sherlock Holmes story "Silver Blaze"

*Gregory (detective): "Is there any other point to which you would wish to draw my attention?"*

*Holmes: "To the curious incident of the dog in the night-time."*

*Gregory: "The dog did nothing in the night-time."*

*Holmes: "That was the curious incident."*

Perhaps the reason for the inaction is that the loss in the option market was insignificant by comparison to the benefits generated in another transaction - ie the takeover at very low value which resulted.

Such a "Sprat to Catch a Mackerel"" was precisely what happened on the International Petroleum Exchange in the late 90's when traders were routinely manipulating the daily settlement prices of IPE Brent Crude Oil contracts through abuse of the "Settlement Trade" facility.

The relatively minor losses they made "on exchange" to individual "local" IPE traders (who called these happy moments "Grab a Grand") were minor compared to the profits they were making "off-exchange" in contracts which used the manipulated settlement prices as a reference.

I "blew the whistle" on this manipulation in 2001 but made the mistake of describing this market abuse as "systematic" (taken, by the Commission appointed to investigate, to mean a few traders doing it most of the time) rather than as "systemic" (most traders doing it some of the time) and I was crucified as a result.

So far no "whistle blower" has emerged in the Bear Stearns case, so perhaps there is a perfectly reasonable explanation for the whole series of transactions.

But one of the interesting aspects that tends to support the thesis that there is something deeply wrong in the whole transaction is the alacrity with which JP Morgan raised their bid price from the original $2.00 to a price of $10.00.

In normal takeover transactions, even a rise to $2.50 would have been fought over tooth and nail: JP Morgan raised their bid by 500%. To a suspicious mind this indicates that there was a great deal of gravy on this particular plate.

In summary, the Bear Stearns takeover has all the hall marks of being what J K Galbraith memorably called "the Bezzle" - an economic loss *where the losers are not aware that they are losing.* It speaks volumes about exactly who are the true beneficiaries of the US financial system. Did the Bear Stearns takeover in fact also rescue the rescuer?

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