The Bear Market Posse, *or* Counterparty Risk Management *during the* Recent Turmoil

After the failure of the computer models, the **"market posse"** *assessed the degree of risk that existed for Bear Stearns's counterparties, and it turned out to be quite accurate.*

BY ED BLOUNT

IN AUGUST 1998, scenes reminiscent of the pre-Depression failures of U.S. banks showed long lines of Muscovites waiting anxiously to pull their devalued rubles from failing Russian banks. In March 2008, just like the Russian bank runs of 10 years earlier, legions of broker/repo counterparties moved to the sidelines of the market after each new report of staggering bank losses in asset-backed securities and waited anxiously for their own investors to draw down cash, leading to a chain-reaction run on the U.S. and global capital markets.

The 1998 Russian financial crisis triggered the collapse of Long-Term Capital Management. The 2008 American financial crisis finished off Bear Stearns. The surprising inability of the best contemporaneous risk models to anticipate, in either case, the impending defaults by such respected counterparty firms was exceeded for shock value only by the failings of the firms' own internal trading models. Neither lesson has been lost on financial market regulators.

The failure of the models was linked to the discovery of a hitherto-unknown "shadow banking system," publicly announced in Ottawa this past May by deputy general manager Hervé Hannoun of the Bank for International Settlements (BIS), at the 45th annual meeting of central bank governors of the American continent. Hannoun explained that the shadow banking system existed off-balance-sheet at the large global banks in the form of special-purpose vehicles. As a result, the BIS, commonly known as the central bank for central banks and based in Basel, Switzerland, found that "there was an underestimation of the leverage and hence an overestimation of the capital buffers in the financial system. The initial presumption that large banks were very well capitalized turned out to be wrong, and this also came as a surprise." Hannoun attributed these failings to the value-at-risk (VaR) methodology and went on to say:

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"The global credit crisis is in part a VaR crisis, that is, a serious weakness of the VaR risk management technique.… VaR-type methodologies have proven procyclical and unable to prevent excessive leverage in a context of very low volatility. Economic capital calculation based on such methodologies is a useful tool, but it should be complemented by stress testing and by basic judgment and simple indicators.… Economic capital and VaR techniques amount to transforming large nominal amounts into very small values-at-risk. This reduces the perceived order of magnitude of risk exposures and gives a false sense of comfort."

As the credit crisis continues to evolve, the insight that seems to be gaining traction in the highest offices of central banks is the renewed importance of lending officers who use "basic judgment and simple indicators" to keep themselves well informed of their customers' exposure to exogenous influences on their capital bases, such as a sudden erosion of confidence in the customer's marketable inventory. For Bear Stearns, it was the firm's inventory of asset-backed securities. For other bank customers, it could be any number of depreciable assets. In both cases, a loss of confidence by the borrower's own customers can spell the rapid collapse of its balance sheet—and creditworthiness. As useful as credit models and rating systems have become over the last decade or so, the bank still needs its frontline lending officers to understand the markets that their customers depend on for their ability to repay their obligations. One more, underappreciated key to understanding customer markets is a keener appreciation of the wisdom and value of the "market posse."

The Market Posse on Alert

In both the Russian and American crises, traders exchanged intelligence informally and self-organized into loose vigilante groups, not unlike a Texas posse, to protect their own assets and territories. Given the failure of the computer models, the posse's assessment of the degree of risk that existed for counterparties turned out to be quite accurate, as proven by the subsequent actions of the central banks. (In Russia, after the ruble's devaluation, the central bank forced the closure of most banks and struggled to control inflation. In the U.S., the central bank forced a merger and injected massive liquidity into the funding markets to save the banks, which raised fears that consequential inflation would further devalue the dollar and depreciate the deposits of bank customers.)

In both crises, despite the proximity of domestic counterparties, the first tremors of the impending collapse were noticed by overseas counterparties. For the Russians, foreign investors were the first to lose confidence in ruble bonds. For America, the European fixed-income traders triggered the crisis of confidence that led to the demise of Bear Stearns. The posse didn't create the crisis, but its members saw the risks and then took steps to protect themselves and their market community.

Timothy Geithner, president of the Federal Reserve Bank of New York, explained the chain reaction during his congressional testimony: "As some investors attempted to liquidate their holdings of these assets, many of the traditional providers of unsecured funding to banks pulled back from their counterparties in anticipation of the potential withdrawals of funds by their own investors." Geithner emphasized that "over the past 30 years, we have moved from a bank-dominated financial system to a system in which credit is increasingly extended, securitized, and actively traded in a combination of centralized and decentralized markets."

As a result of this evolution of the financial markets, the business models of financial institutions also have evolved, to the degree that many banks today act as agents while securities firms act as principals in the credit process. The securities financing markets are prime examples of this evolution, as well as prime movers. Agent banks provide high-quality securities to broker-dealers in exchange for cash collateral or lesser-quality securities collateral. Any brokerage firm that becomes ostracized in the securities financing markets invites its own speedy dissolution from denial of critical liquidity.

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Passive Runs from Fails-to-Renew

The funding differences between banks and broker-dealers create differences in the pattern of redemption demands, and these differences should be considered carefully in designing realistic stress tests. Banks rely on unsecured deposits for most of their funding. By contrast, securities firms fund their activities through secured repurchase agreements. A run on a traditional bank triggers a demand for cash through the withdrawal of deposits. However, depletion of the cash on a broker-dealer's balance sheet can take place very passively.

The active nature of the deposit withdrawal process is a key difference compared with a run on a broker-dealer. Very quietly, broker counterparties simply fail to renew their investments. Only the highest-quality assets seem to attract the interest of repo counterparts. These are very hard signals for outsiders to monitor. Even within the brokerage firm, the signs are subtle. Financing costs will rise as the funding desk tries to replace the balances of vanishing counterparties with costlier deals offered to attract investors from the fringes of its relationships. That's when the posse begins to sense the danger.

During the market turmoil surrounding the difficulties of Bear Stearns, the firm's counterparties were so risk-averse that only the most liquid assets were being accepted in repurchase agreements. According to Geithner, "Some large investment banks stopped accepting trades that would expose them to Bear, and some money market funds reduced their holdings of short-term Bear-issued debt."

As the 85-year-old brokerage firm's standing declined among its counterparties, Bear's hedge fund customers redirected their trade-clearing business to other prime broker relationships. As a result, the cash in Bear's hedge fund accounts began shrinking. Customer-margined securities in those accounts became far more difficult for Bear to hypothecate (re-fund) in the securities financing markets. No matter the quality of the collateral, counterparties will always be reluctant to enter into transactions with any broker-dealer, no matter how prestigious, if there is a chance their funds might be frozen during bankruptcy liquidation.

The situation became so destructive that the Federal Reserve was forced to make its own Treasury securities available to broker-dealers. "It became clear that Bear's involvement in the complex and intricate web of relationships that characterize our financial system, at a point in time when markets were especially vulnerable," Geithner testified, "was such that the sudden failure would likely lead to a chaotic unwinding of positions in already damaged markets."

At this point in the crisis, it became apparent that not only was the situation "dire," to use Geithner's term, but also an almost complete surprise to the Fed, the SEC, and the Treasury. Although Bear Stearns had been in the news months earlier when two of its in-house hedge funds nearly failed, the in-market regulators were taken aback at the sudden imminence of Bear's bankruptcy that was developing as a result of its deteriorating liquidity position.

Critics have asked why the Fed had not been more vigilant in monitoring Bear Stearns, given the very public nature of its difficulties. The answer was quite apparent in Geithner's testimony. The "complex and intricate web of relationships" was virtually impossible for any regulator to monitor. *It was necessary to be in the web*—that is, part of the posse. Indeed, even Bear's insiders had difficulty appreciating the speed at which their business was collapsing.

According to the *Wall Street Journal*, the senior partners at Bear Stearns were conducting business as usual, unaware of the looming catastrophe as the firm's cash position was dwindling. "Do you have any idea what is going on?" the Bear Stearns treasurer asked his CEO during a pep-rally meeting of top executives. "Our cash is flying out the door. Our clients are leaving us." The posse was on the move.

The *Journal* reporter captured the key insight: "The brokerage's sudden fall was a stark reminder of the fragility and ferocity of a financial system built to a remarkable degree on trust. Billions of dollars in securities are traded each day with nothing more than an implicit agreement that trading partners will pay up when asked. When investors became concerned that Bear Stearns wouldn't be able to settle its trades with clients, that confidence evaporated in a flash."

Fragility of Derivatives Risk Mitigators

The knock-on effect of the crisis of confidence that threatened to take down Bear Stearns posed an enormous risk, not just to its counterparties, but also to corporate treasuries, in ways that might not have been immediately apparent to the treasurers. According to Geithner, "The sudden discovery by Bear's derivatives counterparties that important financial positions they had put in place to protect themselves from financial risk were no longer operative would have triggered substantial further dislocation in markets. This would have precipitated a rush by Bear's counterparties to liquidate the collateral they held against those positions and to attempt to duplicate those positions in already very fragile markets." To illustrate, corporate treasurers who entered into swap agreements with Bear as counterparty could have found those contracts severed in liquidation, leaving their receivables exposed to unexpected (and unmanageable) currency or interest rate risks. This was a dramatic reminder that derivatives contracts, especially the more complex, OTC variety, are only as secure as the capital base of the issuing dealer.

In this turbulent sea of vanishing counterparties, Bear Stearns turned to the one port of call that still promised a somewhat hospitable welcome. JPMorgan Chase was Bear's clearing bank for its repo agreements. Ironically, the bank founded by J.P. Morgan, the most famous advocate of "character" in lieu of collateral for a borrower's creditworthiness, found itself, nearly 100 years later, forced to make good on the famous thesis he articulated during the 1912 Money Trust investigation.

At that moment, the Fed's Geithner was involved directly in reviewing the offers for Bear Stearns as a far more desirable alternative to public bailout: "Although several different institutions expressed interest in acquiring all or part of Bear, it was clear that the size of Bear, the apparent risk in its balance sheet, and the limited amounts of time available for a possible acquirer to conduct due diligence compounded the difficulty. Ultimately, only JPMorgan Chase was willing to consider an offer of a binding commitment to acquire the firm and to stand behind Bear's substantial short-term obligations."

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Federal Marshal to the Posse's Rescue

Since many of the players in Bear's "complex and intricate web of relationships" were the other primary dealers in the U.S. Treasury's regular underwriting syndicate, the Fed expanded its Term Securities Lending Facility. This action allowed the dealers "to pledge a wider range of collateral in order to borrow Treasury securities." In turn, the dealers could then use the Treasury securities as collateral to obtain funding, both directly and indirectly, for that "wider range of collateral" in the tightening repo markets.

Broker-dealer counterparties and investors in Bear Stearns securities may have taken a passive, non-rollover position with respect to the struggling broker-dealer, but its hedge fund customers took a far more aggressive, active stance. According to the *Wall Street Journal*, "Hedge funds flooded Credit Suisse group's brokerage unit with requests to take over trades opposite Bear Stearns." Several of the largest hedge fund conglomerates redirected relationships from Bear Stearns to other prime brokers. In a matter of days, more than two-thirds of Bear Stearns's cash reserves were gone.

Under congressional authority granted for extraordinary circumstances, the Board of Governors of the Federal Reserve System created the Primary Dealer Credit Facility immediately after expanding the Term Securities Lending

Facility. This action allowed the Federal Reserve Bank of New York to lend cash to investment banking corporations, not just to commercial banks. In effect, the Federal Reserve and the U.S. Treasury served as central, indeed "conduit," counterparties to create market liquidity at a time when the market's regular counterparties were becoming dangerously passive.

These extraordinary steps were not taken without cost. Market observers have pointed out that the unprecedented infusion of liquidity created inflationary pressures that the economy will be forced to handle without benefit from the Federal Reserve, at least in the short term. Any increase in short-term rates driven by Federal Reserve actions may trigger further deterioration in the mortgage-backed securities markets and risk the failure of other broker-dealers. As has been seen, even when a firm's difficulties are well known to the public as well as regulators, the remedies available for regulatory protections can be hamstrung by the complexity and magnitude of the relationships that keep most firms afloat. At times like that, only the market posse is a reliable source for the counterparty credit analyst and bank lending officer charged with protecting the bank's capital.

In effect, this was the ultimate self-regulatory market condition. Principal counterparties working for their own self-interest evaluated the likelihood that the collapse of a major counterparty could trigger a cascade of defaults, collapsing a crucial market for supporting the national economy and also for facilitating the international market system. Their evaluation, in the heat of the crisis, was so pessimistic that no other firm was willing to come forward to cover the firm's obligations without government protection. In that circumstance, the principal market regulator and national treasury had no choice but to intervene to inject sufficient liquidity to permit a temperate, measured unwinding and redistribution of capital commitments in the market system.

Taken from a truly American perspective, even the market posse found itself unable to cope with the crisis and had to send for help. "U.S. Marshal" Geithner had to bring in the cavalry, that is, the unlimited lending authority of the U.S. Treasury, to quiet the uprising and allow the citizen-traders to regain control of their community. "It was the first time since the Great Depression that the Fed had made a loan like this to an entity other than a bank," said Geithner, with an uneasy allusion to a crisis that stretched out for more years than anyone today cares to contemplate. ❖

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