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Fed Made Taxpayers Junk-Bond Buyers Without Congress Knowing

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July 1 (Bloomberg) -- Federal Reserve Chairman Ben S. Bernanke and then-New York Fed President Timothy Geithner told senators on April 3, 2008, that the tens of billions of dollars in "assets" the government agreed to purchase in the rescue of Bear Stearns Cos. were "investment-grade." They didn't share everything the Fed knew about the money.

The so-called assets included collateralized debt obligations and mortgage-backed bonds with names like HG-Coll Ltd. 2007-1A that were so distressed, more than \$40 million already had been reduced to less than investment-grade by the time the central bankers testified. The government also became the owner of \$16 billion of credit-default swaps, and taxpayers wound up guaranteeing high-yield, high-risk junk bonds.

By using its balance sheet to protect an investment bank against failure, the Fed took on the most credit risk in its 96-year history and increased the chance that Americans would be on the hook for billions of dollars as the central bank began insuring Wall Street firms against collapse. The Fed's secrecy spurred legislation that will require government audits of the Fed bailouts and force the central bank to reveal recipients of emergency credit.

"Either the Fed did not understand the distressed state of some of the assets that it was purchasing from banks and is only now discovering their true value, or it understood that it was buying weak assets and attempted to obscure that fact," Senator Sherrod Brown, an Ohio Democrat and member of the Senate Banking Committee, said in an e-mail when informed about the credit quality of holdings in the Maiden Lane LLC portfolio. The committee held the April 3 hearing.

Bear Stearns Purchase

Maiden Lane, named for a street bordering the New York Fed's Manhattan headquarters, was created to hold the assets the central bank acquired to facilitate JPMorgan Chase & Co.'s purchase of Bear Stearns.

Downgraded to Junk

When Bernanke and Geithner testified in April 2008, \$42 million of the CDO securities the Fed would eventually buy had been downgraded to junk, data compiled by Bloomberg show. By the time the central bank funded its \$28.8 billion loan to Maiden Lane 12 weeks later, about \$172 million of such securities the Fed purchased were rated below investment grade, according to data compiled for Bloomberg by Red Pine Advisors LLC, a New York firm specializing in the valuation of complex, illiquid securities.

CDOs bundle assets ranging from mortgage bonds to high-yield loans and divide them into new slices, or tranches, of varying risks. High-yield, or junk, bonds are those rated below Baa3 by Moody's Investors Service and lower than BBB- by Standard & Poor's.

"As was noted in testimony, all of the cash securities in the Maiden Lane portfolio were investment grade on March 14, 2008, when the deal was agreed to in order to facilitate the acquisition of Bear Stearns and to prevent the systemic consequences of its sudden and disorderly failure," Michelle Smith, a spokeswoman for the Fed's Board of Governors, said in an e-mail.

Recover Principal

"The Federal Reserve considered not just credit-rating valuations, which have varied some over time based on economic conditions, but also relied on a separate assessment from an independent investment firm, which advised us that over time, we would likely fully recover our principal and interest," Smith said. "We continue to expect the loan to Maiden Lane to be fully repaid."

The Fed valued the loan at \$27 billion as of the end of last year, \$1.8 billion below the amount that was funded in 2008, according to financial statements audited by Deloitte & Touche LLP.

More than 88 percent of Maiden Lane's CDO bonds and 78 percent of its non-agency residential mortgage-backed debt are now speculative grade, according to data compiled by Bloomberg based on holdings as of Jan. 29.

Securities, Derivatives

The nonagency home-loan bonds and CDO securities made up about 44 percent of the \$74.9 billion in face amount of Maiden Lane's assets, Fed data show. Maiden Lane also contains commercial real-estate loans and other mortgage debt. The central bank hasn't released how or at what prices it has valued the securities and derivatives, which are contracts whose values are tied to assets, including stocks, bonds, commodities and currencies, or events such as changes in interest rates or the weather.

Being "investment grade" was a requirement for Maiden Lane's bonds even after Bernanke and Geithner publicly criticized inflated ratings for helping to cause the financial crisis.

"The complexity of structured credit products, as well as the difficulty of determining the values of some of the underlying assets, led many investors to rely heavily on the evaluations of these products by credit-rating agencies," Bernanke said in a January 10, 2008, speech in Washington. "However, as subprime-mortgage losses rose to levels that threatened even highly rated tranches, investors began to question the reliability of the credit ratings and became increasingly unwilling to hold these products."

Princeton, Dartmouth

Members of Congress pressed Bernanke, who received a doctorate in economics from the Massachusetts Institute of Technology and served as chairman of Princeton University's economics department, and Geithner, a Dartmouth College graduate who earned a master's degree in economics and East Asian studies from Johns Hopkins University, about the quality of the assets during the April Bear Stearns hearings.

"You've got about \$30 billion of collateral. And some comments have been made that you feel comfortable because it's highly rated," Senator Jack Reed, a Rhode Island Democrat, told Bernanke, according to a transcript. "But a lot of highly rated collateral these days is being subject to questions."

"Senator, as was mentioned, it is all investment-grade or current performing assets," Bernanke responded. "We do not know for sure what will transpire," he said. "But we have engaged an independent investment-advisory firm who gives us reasonable comfort that if we can sell these assets over a period of time that we will recover principal and interest for the American taxpayer."

Chances for Loss

When asked by Shelby during the hearing what the chances were for a loss, Robert Steel, then the U.S. Treasury undersecretary for domestic finance, said the transaction "was \$30 billion, approximately, of collateral, all investment-grade securities, all of them current in interest and principal."

Bernanke and Geithner didn't detail during the hearing that the Fed would expose itself to below-investment-grade assets through credit derivatives it was also acquiring. The \$16 billion of credit-default swaps included bets protecting some junk-rated asset-backed securities against default, according to two people familiar with the agreement who declined to be identified because the terms weren't made public.

'Related Hedges'

The Fed hasn't disclosed how much was tied to below-investment-grade debt. Geithner, who is now Treasury secretary, said in an addendum to the text of his remarks only that the Fed was assuming "related hedges," without elaborating.

Credit-default swaps are used to hedge against losses or to speculate on creditworthiness. The derivatives pay the buyer face value if a borrower fails to meet its obligations, less the value of the defaulted debt.

"I strongly object to the mischaracterization of the portfolio," Sylvain Raynes, a principal at R&R Consulting in New York, said in an interview. "The ratings that were purportedly investment-grade had long lost their utility" and to call several billion dollars of derivatives "related hedges" is "nonsense" and a "material omission."

So-called hedges aren't without risk, said Raynes, who is also co-author of "Elements of Structured Finance," which was published in May by Oxford University Press. "You can be on the wrong side of a hedge, by definition. Which side are they on?"

Shrinking Holdings

Maiden Lane has been unwinding its credit-default swaps, according to the people familiar with the agreement. The holdings shrank to a face amount of \$11.8 billion in December 2008 and \$7.3 billion at the end of last year, according to its financial statements.

Of the \$7.3 billion, \$2.45 billion were contracts guaranteeing debt against default, including \$2.1 billion of junk-rated securities. The bank valued the credit swaps it sold at a \$1.8 billion loss, according to the 2009 statement.

Overall, Maiden Lane assumed more bets against securities than for them, the people familiar with the agreement said. The market value of its entire swaps book, including more than \$3 billion of interest-rate contracts, was \$1.13 billion as of Dec. 31, 2009, according to year-end financial statements.

The Senate Banking Committee also called JPMorgan Chief Executive Officer Jamie Dimon to testify on the Bear Stearns deal on April 3, 2008.

Riskier, More Complex

"The assets taken by the Fed consist entirely of loans that are current and rated investment grade," Dimon said, according to a transcript. "We kept the riskier and more complex securities in the Bear Stearns portfolio for our own account. We did not cherry-pick the assets in the collateral pool."

If the Fed hadn't engineered the takeover, "the consequences could have been disastrous," Dimon said.

JPMorgan didn't pick the individual securities for Maiden Lane, Geithner said in an annex to his April 2008 testimony. Instead, it selected groups of assets that met criteria set by the central bank, and the Fed and its adviser, New York-based BlackRock Inc., reviewed those assets, according to one of the people familiar with the agreement. As part of the bailout, JPMorgan agreed to absorb the first \$1 billion in losses.

Assets, Liabilities

JPMorgan had to weigh how many real-estate assets it could absorb against its existing inventory, Dimon said, adding that the New York-based company acquired about \$360 billion of Bear Stearns assets and liabilities in the transaction.

JPMorgan spokesman Justin Perras declined to comment further on Maiden Lane.

"We certainly had doubts at the time: Why wouldn't JPMorgan want a bunch of AAA assets?" said Mark Calabria, a former Senate Banking Committee staff member who was present at the April 2008 hearings and is now director of financial-regulation studies at the Cato Institute in Washington. "The answer is it was all borderline junk."

The average CDO security was cut 7.6 grades by Moody's and 7.3 levels by S&P in the 22 months between the time the Fed funded the loan and April 2010,

according to Red Pine.

"That is quite steep," said Wade Vandegrift, a Red Pine partner. "The default rates and the delinquency rates of these deals were a significant multiple of even the worst-case projections that rating agencies and other people projected."

Foreclosed Loans

WaMu Asset-Backed Certificates Series 2007-HE1 M2, a \$4.1 million mortgage-bond position the Fed acquired, was backed by home loans originated by the subprime-lending unit of Washington Mutual Inc., the Seattle-based thrift that went bankrupt in September 2008. As of March 2008, the month Bear Stearns collapsed, more than 26 percent of the loans were at least 60 days late, in foreclosure or the properties had already been seized, according to data compiled by Bloomberg.

Three weeks after the Fed agreed to the Bear Stearns rescue and four days after Bernanke's April testimony, Moody's cut the security to junk. S&P followed a month later and now rates it D.

"It is hardly surprising or particularly newsworthy that the value of" the Maiden Lane "portfolio deteriorated in the midst of the worst financial crisis in generations, but it is unlikely that the taxpayers will lose a dime on the government's loan," Treasury spokesman Andrew Williams said in an e-mail. The Congressional Budget Office estimates the Fed will make \$200 million on Maiden Lane from inception through 2020.

Demanding Accountability

Billions of dollars in Fed loans -- some possibly involving subsidies for the biggest banks and corporations -- remain secret, and Congress is demanding more accountability from the Fed than at any time in its history.

House and Senate negotiators agreed on the sweeping Dodd- Frank Wall Street Reform and Consumer Protection Act last week, which requires the Government Accountability Office to audit the Fed's emergency loans and forces the Fed to reveal recipients of such credit by Dec. 1. The House approved the measure 237-192 yesterday. It awaits approval by the Senate and will then go to President Barack Obama for his signature.

Vermont Senator Bernard Sanders wrote the legislation requiring an audit of Maiden Lane and other credit facilities. The act also would make it more difficult for the Fed to provide emergency loans in the future.

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