Bear Stearns Funds' Failure Opens the Door to Credit Crash

by Richard Freeman

Major sectors of the world financial system were paralyzed by the failure on June 19 of two Bear Stearns hedge funds, linked to the subprime mortgage and Mortgage Backed Securities (MBS) market. The failure has caused the near-freezing up of the highly risky $2.6 trillion Collateralized Debt Obligations (CDOs) market. By June 28, at least five planned bond or Initial Public Offering (IPO) issuances had been cancelled, and another billion-dollar hedge fund, Caliber Global Investments, had failed because of MBS losses.

The Plunge Protection Committee—officially the President's Working Group on Financial Markets—has worked frantically behind the scenes to try to relieve pressure, first on one crisis, then on another, but the Bear Stearns crisis is merely one part of a shock wave that could overwhelm the world financial system.

Lyndon LaRouche, who described the financial system as nothing but a "gambling system" in his June 21 webcast,[1] commented June 28 on the latest credit market failures of IPOs and funds: "They were having a fantasy; the fantasy turned into a nightmare; they woke up and found out that the nightmare was real.... The plain fact is, they're investing in nothing! This is a John Law bubble, and the bubble has reached its end point."

1. LaRouche said: "The great danger of a financial crash today, is that most people, in what they call economics, believe actually not in economics: They believe in gambling. It's called a financial system. It's a gambling system. And... ever since Galileo came up with this idea about gambling as the basis of discovering how markets would work, everyone has tried to get a better statistical system for gambling. Like breaking the bank at Monte Carlo, making a killing at Las Vegas, probably one's own. And therefore, these guys who are running the financial world today, depend on the assumption that they've got a 'better system'—as they used to have at the race tracks, a 'better system' for handicapping the horses. And it would really handicap the bettor, in the end, as he found himself on the street without cash—and being pursued by his lenders."

For the full transcript of the webcast, see *EIR*, June 29, 2007.

Largest Bail-Out Since LTCM

To recap the way the financial disintegration is spreading: On June 22, Bear Stearns investment bank announced that it intended to bail out two of its failing hedge funds, by extending to them $1.6-3.2 billion in emergency loans—the latest twist in Wall Street efforts to prevent a full-blown mortgage securities market crisis. The loans have two purposes: first, to prevent the hedge funds' creditors from seizing and selling assets; and second, to prevent the hedge funds' failure from triggering a systemic breakdown of the world financial system.

This constitutes the largest known bail-out since then-Federal Reserve Board chairman Alan Greenspan coordinated a Plunge Protection Committee $3.6 billion bail-out of the Long Term Capital Management (LTCM) hedge fund in September 1998, on the verge of a general crisis.

The two Bear Stearns hedge funds—the High Grade Structured Credit Enhanced Leverage Fund (HGSCELF), and the High-Grade Structured Credit Fund (HGSCF)—invested in exotic and insanely risky Collateralized Debt Obligations (CDOs). These CDOs were predominantly invested in MBS bonds, especially those of subprime mortgages. The two hedge funds borrowed what is now reported to be $9 billion, from the largest commercial and investment banks, including Merrill Lynch, JPMorgan Chase, Citigroup, Deutsche Bank, and Lehman Brothers.

The two hedge funds, predominantly the HGSCELF, leveraged the $9 billion in borrowings into $29.7 billion in gambling bets on CDOs linked to the housing market. But the meltdown of the subprime mortgage market, and the rise of interest rates caused the Bear Stearns funds' bets to go wrong; they have lost billions of dollars, and are going under.

The fly in the ointment, is that the Bear Stearns hedge funds had given the lending banks CDOs as collateral. As the hedge funds' difficulties intensified, on June 19, Lehman Brothers, one of the smaller lenders, seized and sold the col-

lateral—the CDOs—on the market, but received only *50¢ on the dollar.* A big lender, Merrill Lynch, threatened to auction $825 million of Bear Stearns CDOs that it holds. Reportedly, Merrill Lynch sold $100 million of the higher quality CDOs. Were Merrill Lynch to have attempted to sell the remaining CDOs on the market, it would have found that they were worth only 30-50¢ on the dollar.

50¢ Implications

This is a huge problem. If CDOs were shown in a large sale in the market to be worth half or less of their claimed or rated value, then this would expose the fact that most CDOs, especially those linked to subprime housing, were worth only 50¢ on the dollar. The holders of CDOs would have to devalue their holdings, and not just Bear Stearns, but *all financial firms that hold CDOs*. This would mean the write-down of hundreds of billions of dollars worth of fictitious CDO asset valuation, wiping out overnight the $2.6 trillion-plus CDO market, one of the fastest-growing parts of the financial bubble.

It appears that deep into the night of June 21, the Plunge Protection Committee and Bear Stearns senior executives hammered out an arrangement, whereby Bear Stearns would provide $3.2 billion in loans—equivalent to one-quarter of the bank's $13 billion in capital—to the two hedge funds, and thus to their creditors, rather than allow the creditors to sell CDOs, and rupture the system.

Bear Stearns also did a reorganization of its hedge funds. On June 28, it assigned veteran Thomas Marano, head of the firm's mortgage department, to carry out hedge fund "damage control," according to Reuters. Michael Winchell, another Bear Stearns veteran, was also detailed to that job. But this cleared up nothing.

As the Bear Stearns funds exacerbated the CDO crisis, the $2.6 trillion CDO market was already like a basement full of gasoline-soaked rags, ready to ignite. While touted as "brilliant creative new instruments," the reality is, they are a form of refuse. Some CDOs are based on faulty mortgage instruments—and they may be the "soundest" of all. Some CDOs are composed of risky highly leveraged loans (called CLOs), used for predatory takeovers. Others, known as "CDOs squared," are CDOs based primarily on other CDO vehicles. Finally, the wildest CDOs, comprising one-third to one-half of the entire CDO market, are "synthetic CDOs," securities based mostly on no assets at all.

In late June, a report assembled by Lombard Street Research, indicated a catastrophe for the vulnerable and heavily pyramided CDOs. The Lombard report read: "Excess liquidity in the global system will be slashed. Banks' capital is about to be decimated, which will require calling in a swathe of loans. This is going to aggravate the U.S. hard landing."

Suddenly, the issuance of new CDOs—and the CDO cancer can survive only if it is growing—began to shrivel up. According to JPMorgan Securities, Inc. on June 28, one month earlier, $20 billion of new high-grade CDOs were in the pipeline; but that week, only $3 billion of such CDOs were marketed.

Dan Fuss, vice chairman of Loomis Sayles investment bank, a Boston Brahmin firm, asserted June 26: "If investors start dumping [CDOs], oh boy, watch out for some massive credit widening. This is just the beginning of ugly things to come."

Liquidity Pullback

The mutually reinforcing MBS and CDO losses exposed in the Bear Stearns hedge fund crisis, spread to other sectors, and produced a dramatic pullback of liquidity in crucial sectors across the United States, Europe, and the world financial system—exactly what the Plunge Protection Committee, headed by Treasury Secretary Hank Paulson and Federal Reserve Board chairman Ben Bernanke, had worked to forestall.

This liquidity pullback has devastating implications for the hedge fund- and private equity fund-driven mergers and acquisitions wave, one of the only things that holds up the bloated world financial bubble. (Last year a record $4.1 trillion was consummated, and this year the pace was set to exceed that.)

On June 28, the Carlyle Group, the giant buy-out firm, "postponed" the $415 million IPO that it planned for one of its funds, and reduced it to $300 million. MISC, the world's largest owner of liquefied natural gas tankers, cancelled a $750 million bond offering June 27. Foodservice, the American subsidiary of the Dutch supermarket giant Ahold, had to cancel a $650 million bond offering required by its takeover by KKR. The pall cast over all CDOs—not just those based on mortgages—by the failure of the Bear Stearns funds, had spread over junk bonds and commercial bonds generally.

However, there are further consequences. The failure of CDOs, and the associated credit derivatives, has the potential to rupture the $750 trillion-plus world derivatives market—a crash which would bring down the world financial system.

LaRouche's June 21 webcast laid out the overall process governing what now is unfolding. This breaking news adds urgency for adoption of LaRouche's proposals for capital-budget initiatives and infrastructure great projects by the United States, Russia, China, and India—his "four-power" solution to the debt crisis.

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