Free case study about forewords

Business, Company

The study of Bear Stearns abrupt fall and demise reveal the importance of credibility for a financial institution in a specific sense irrespective of its robustness. A business in general could fall if credibility and illiquidity become questionable. Bear Stearns is the first ever major investment bank to fail during the global financial crisis (Li and Mizrach, 2010). The 85 years old firm has survived a number of economic turmoil and recession, yet it fell when it was least expected to fall. A number of factors become apparent when studying the Bear Stearns demise, and these include the role of management, illiquidity, and leverage to every business. Of course, the investment bank could have survived the storm if it had applied the right strategies. This report takes a look at Bear Stearns cultures and how it contributed to its fall. In addition, it encompasses the immense importance of liquidity and the downside of illiquidity as well as the significant role of the Federal government in saving the day.

Bear Stearns Culture: Its Rise and Fall

Needless to say, Bear Stearns' culture had a tremendous impact on it and as a matter of fact, its success and subsequent demise can be traced to this culture. Stowell (2008) pointed out that Bear Stearns' culture was murderous and rebellious. The company believes that it can take over the market through its bold trading and that a slight turn in trading can distinguish it from other firms. Bear can be described as a man-of-its-own with a trader culture. As a result of its culture, Bear was focused on the result rather than qualifications. Thus, this is reflected in its choice of employees. The investment bank would rather hire employees who have initiatives and tenacity rather than those who have a pedigree. As a matter of fact, Bear's

culture set the pace for its extensive success in the market when it was launched. The culture played major significant role in positioning the bank with respect to its competitors. As a result of the strong culture, Bear was able to maintain resilience in its early days and made profound success. However, it is imperative to evaluate that the culture had grave negative effects on it. Bear Stearns was the only bank who refused to join the syndicate and share the burden to preserve market integrity when it was called upon by the Fed in the event of the collapse of LTCM. (Stowell, 2008). One can only understand Bear's stance and the reason, why it refused to join the syndicate by taking a look at its culture. It is undeniable fact that the culture played a significant role in its demise. Bear's demise can be attributed to its culture of bold investment even in a crash scenario. For instance, irrespective of the concerned raised by the vice president, Alan Schwartz, Bear Stearns hired all its fund managers internally to manage its fund with outside investor capital. In addition, Coffi continued to invest in sophisticated credit derivatives backed by mortgage securities even when it was seemingly unprofitable until it became disastrous. Thus, it is obvious that Bear Stearns’ demise is directly or indirectly due to its culture

How It Could Have Avoided the Fate

Obviously, the ugly fate of Bear Stearns could have been avoided if it had done things differently. But the question remains: how could Bear Stearns have avoided its state? What could the investment bank have done differently to counter the odd fate?

Even though Bear Stearns’ executives claimed that nothing could have been done to stop failure, it is obvious that they could have adopted strategies

differently to avoid it (Orol and Robb, 2010). Moyer (2010) explained that Bear should have been able to handle it. He pointed out that the prime reason for Bear Stearns' failure was betting the wrong way. In addition, they failed to foresee the disruption in the credit market to avoid the trouble.

In the Early 2000s

It is imperative to consider that even though Bear Stearns demise seems abrupt it was orchestrated by a number of factors and operational practices of the company. Martinez and Santiso (2003) pointed out that the question of confidence is very critical in every financial transaction. It comes into play in explaining the wealth of nations and also the death of firms. The case of Bear Stearns death has a lot to do with the question of confidence.

Like most other banks, Bear Stearns took advantage of the lucrative CDOs in the early 2000s and made a lot of profits. Mpsuser (2010) pointed out that the periods between the 1990s and the early 2000s was characterized by economic stability in the United States, but this economic stability led some firms like Bear Stearns to invest wrongly. For instance, Bear Stearns was one of the banks that offered loans that did not meet the stringent guidelines of Fannie Mae or Freddie Mac. These were targeted towards riskier homebuyers with lower income and bad credit history but carrying higher interest rates.

In addition, Coffi's investments in sophisticated credit derivatives backed by mortgage securities became unprofitable when the housing bubble burst in 2006 (Stowell, 2008). Contrarily, instead of discontinuing the investment, he rather redoubled his bets and raised a new Enhanced Leverage High Grade Structured Credit Strategies Fund that used 100x leverage. This resulted to a

very disastrous deal that contributed immensely to the fall of Bear Stearns. The investment bank could have done things differently here.

During the summer of 2007

Bear Stearns fall seem to be a big surprise by everyone including regulators. Freeman (2009) pointed out that investors who paid attention to the credit default swap market had already seen warnings about the fall before it became apparent. Bear Stearns hedge funds collapsed in the summer of 2007 and the collapse together with the firm's investments in the subprime mortgage resulted to the death of the firm in 2008 (Cohan, 2009). Bear had a culture of bold investments and therefore it bet heavily on risky mortgages leading to a default (Freeman, 2009).

During the week of 10 March, 2008

The colossal fall of Bear Stearns became apparent during the week of 10 March 2008, yet it could have done things differently to avert the demise. News of the investment bank's financial instability began to develop in the first quarter of 2008 (Stowell, 2008). But obviously the approaches opted by Bear took to weather the storm instead caused it to escalate. When the news of Bear’s illiquidity was aired in the media, Bear did well by denying it. However, on Wednesday of the week, bear blew up the situation in the process of making people believe that it was not going liquid. Schwartz interview by CNBC correspondent David Faber went a long way to raising further question mark on their confidence. As Martinez and Santiso (2003) clearly stated, behind financial turbulence is the game of confidence.

Market Perception for Liquidity

Market perception for liquidity is of significant importance to any business (Rösch and Kaserer, 2014; Zreik and Louhichi, 2014). However, studies show that market perception for liquidity is more important in case of an investment bank as compared to traditional manufacturing or distribution business). The case study of Bear Stearns makes it quite apparent. To understand why market perception for liquidity is more important for investment banks like Bear Stearns than traditional manufacturing firms it is important to take a look at how the two kinds of businesses operate. Investment banks are banks that deal on securities. The functions of the banks include the provision of capital for corporations and local governments by underwriting and distributing new issues of securities. It also includes trading and executing orders in secondary market transactions to maintain markets in securities and so forth (Cao and Madura, 2014; Investment Banking, 2009). Investment banks do not raise money from retail depositors, but rather their funding comes from equity, long-term debts and the short term funding from interbank markets. Thus, owing to their source of funds, it is very important that the banks hold very liquid assets. Issues of illiquidity in such banks like in the case of Bear Stearns can cause a lot of havoc that caused withdrawal of funds by investors (Stowell, 2008). Most investment banks collapse because they were financed by interbank market, which is a short-term fund, and were holding illiquid securities. This not only affects the investment banks but also it can easily spread to the entire economy. However, traditional manufacturing or distribution businesses seldom face such an illiquidity problem because they are funded by long-term funds

rather than interbank short term funds. Such businesses can only have a problem if it does not hold a steady flow of cash (Chanchai, 2012; Chi, Yang and Young, 2014).

Rösch and Kaserer (2013) examined the dynamics and the drivers of market illiquidity during the financial crisis. According to the report, a positive relationship exists between market and liquidity risk. In other words, a decline in the stock market causes market liquidity to become impaired. He pointed out that market liquidity evaporates when it is most needed; that is during times of financial crises and downturns. More so, market liquidity tends to dry up during the financial crisis, and it greatly causes financial contagion during the financial crisis. Due to their source of funds, investment banks bear the brunt of illiquidity and to a large extent it can lead to the demise of the bank as in a particular case of Bear Stearns.

How Bear Stearns Could Have Addressed the Perception of its Illiquidity?

Bear Stearns illiquidity problem could have been addressed if it had successfully gained the confidence of its customers and investors. Essentially, the best way to address Bear Stearns' perception of illiquidity was to stop the run on the bank. Dealbook (2008) pointed out that the run on the bank was caused by a rumor spread by a unanimous source that the bank was in trouble, and this resulted to unimaginable withdrawals from the bank. Of course, this withdrawal was to be expected because the confidence or trust on the company had become questionable. However, what could have been done to stop this run on the bank at the early stage before it escalated.

The rumor does have a base. It was propagated because two of Bear's hedge funds imploded due to the subprime housing crises (Stowell, 2008). The comprehensive way to stop or prevent the run on the bank was to get a strong evidence to counter the rumor (Arifovic, Hua Jiang and Xu, 2013; Cañón and Margaretic, 2014). However, every indication pointed to the fact that the rumor was true. For instance, in June 14, 2007, Bear Stearns reported 10 percent decline in quarterly earnings and August 01, 2007, Bear Stearns hedge funds file for bankruptcy. In November, 2007, articles were released allegedly accusing CEO of Bear Stearns, Cayne of smoking marijuana who denied the specific incident, but did not say anything of the past usage. (Li and Mizrach, 2010; Stowell 2008).

Obviously, the run on the bank was caused by the accumulation of these factors and not just the 2007 incidence. In other words, the investors and customers had already lost a large part of their confidence in the bank. The bank could have avoided the disaster by trading carefully. Thus, the bank's culture of rough trading not only contributed in its rise but also it played a significant role in its fall. It is imperative to consider that liquidity perception is very important for every investment bank (Schmeling, 2009; Vuillemey, 2014). This is because investors will not want their money to be at risk, and this is why they will withdraw their finances as fast as possible in order to avoid them from loss. Such excessive withdrawal can cause illiquidity as in the case of Bear Stearns. Bear Stearns could have avoided this from happening in the first place by securing investors' confidence in the bank and trading carefully (Bumgarner and Prime, 2000; Tarumizu, 1993).

Bear Stearns' Failure and the Viability of " Pure Play" Investment Banks

Even though Bear Stearns failure was quite colossal, it did not undermine the viability of investment banks. As a matter of fact, it teaches investment banks hard lessons as they can use Bear Stearns as a case study to avoid the problem of illiquidity and lack of confidence by investors. Stowell (2008) pointed out that the Fed's Treasury Secretary, Paulson, offered Bear Stearns $2 per share of its holdings. This was because not to encourage moral hazard and increased risky behavior by investment banks being secure and hoping that they would be bailed out by the Feds in the critical situation. Staff, (2005) defined a pure-play company as a company that makes investment of its resources in only one directional business. The performance of the stock's particular industry determines the performance of the pure-play venture. Due to the nature of their business and investments, pure play companies tend to be risky and shaky depending on the condition of the stocks they trade on. However, Bear Stearns failure did not affect the viability of such investment banks.

However, the abrupt fall of Bear Stearns and some other investment banks put some fears on investors and raises doubts in their minds. The Economist, (2008) pointed out that three doubts were raised in their minds. The first relates to the risk of insolvency since investment banks have lower leverage than other banks. Thus, the impact of falling asset values tends to be grave. The second doubt relates to their funding profile since pure-play investment banks rely heavily on short-term funds (mostly repo transactions) for their funding. Thirdly, profitability is another doubt that should be considered since the surviving pure-play investment banks now play to shift to long-

term unsecured financing. In other words, even though the failure of Bear Stearns did not undermine the practicability of pure-play investment banks, it did put doubts on their capability.

The Federal Reserve and the World Securities Markets

The case study of Bear Stearns clearly shows that the Federal Reserve has important roles to play in maintaining order in the global securities market. Stowell (2008) pointed out that the major reason, why the Feds intervened Bear Stearns to prevent it from collapsing on its accord was to avoid the possible financial Armageddon. Regulators and the Federal Reserve can maintain global confidence and minimize systematic failure in the world securities markets by synthesizing harmonious regulation. (Cyree, Griffiths and Winters, 2013; Meltzer, 2012; Phillips and Rechtschaffen, 1997).

As a matter of fact, appropriate regulation is the key to maintaining order in the security market. Regulators and the Federal Reserve should set orders that could serve as bounds ensuring that financial organizations do not go beyond these bounds. Such regulations could save the day and prevent such an abrupt and colossal fall as in the case of Bear Stearns.

Phillips and Rechtschaffen (1997) further reported that the Federal Reserve should monitor a broad set of institutions in the capital market. They also need to track developments in the markets for corporate bonds, mortgage pools, commercial papers, asset-backed securities, U. S government bonds, the equity markets and so forth. The Federal Reserve also has the reliability of acting as a Central Bank with respect to its monetary policy responsibilities. By acting as the Central Bank, the Federal Reserve can go a long way to ensuring financial stability. In addition, the Federal Reserve can

come into the play during the disruption of a financial sector or institute or when such disruption tends to become contagion. In such an instance, the Federal Reserve can go a long way to helping in steady the flow of things in the market by providing liquidity. This is quite evident regarding Bear Stearns because the Federal Reserve stepped in when the fall became inevitable, and the investment bank cannot handle the condition anymore. Such role of the Federal Reserve goes a long way to maintaining order in the system and also leave some confidence or trust with the investors.

This is quite obvious that the role of the Federal Reserve simply centers on acting as the banking supervisor. By acting as a supervisor, the Federal Reserve gains the opportunity to acquire essential knowledge about the operational processes of the financial system and the key players in such a system. Such knowledge is very important as it will help the Federal Reserve to play a crucial role in times of the financial crisis. This is also made apparent in the case of Bear Stearns and how the Federal Reserve collaborated with J. P Morgan to save the day (Li and Mizrach, 2010; Stowell, 2008).

Conclusion

This report examines the pure-play investment banking system with Bear Stearns as a case study. The rise of Bear Stearns and its abrupt fall teach important lessons. These lessons have been studied by evaluating the culture of the investment bank and the reason, why it fell. What it could have done differently to avert the demise and other factors responsible for the fall. The culture is seen to have played an important role in its operation, including its success as well as failure. In addition, the management of the

company that is a product of the culture did play an important role. Additionally, the role of the Federal Reserve is considered as ultimately important in saving the day and also maintaining order in the world securities' market. This is made obvious in the case study of Bear Stearns. In conclusion, financial institutions, especially investment banks, should note the immense importance of liquidity in their operations. The costly mistake made by Bear Stearns has left a sign of interrogation in the minds of the public with respect to its liquidity. This resulted to lack of confidence on the investment bank and hence its demise.

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