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# The Bear Flu: How It Spread

A novel financing scheme used by Bear Stearns' hedge funds became a template for subprime disaster

by David Henry and Matthew Goldstein

When the subprime mortgage market began to unravel late in 2006, global bond markets barely flinched. But when two Bear Stearns (BSC) hedge funds collapsed in June, the event sparked a global credit crisis that has yet to ease. New evidence sheds light on how those hedge funds—and their managers—became star players in the subprime bust, the biggest financial disaster in decades. The revelations also show how other players in the mortgage market adopted the Bear funds' tactics, collectively building a financing structure with many of the hallmarks of a pyramid scheme.

The legal consequences are still unfolding. In recent weeks securities regulators and federal prosecutors have stepped up their investigations into the two funds, probing the fuzzy math used to value the underlying assets, the aggressive sales pitches that portrayed the funds as safe, and frequent trades with other Bear-managed portfolios. On Dec. 19, Barclays (BCS), which lent one Bear fund hundreds of millions, filed a lawsuit alleging fraud over misleading statements about the portfolio's health. Says a Bear spokesman: "We believe that any such lawsuit is unjustified and without merit."

Investigators also are asking why Ralph R. Cioffi, the funds' top manager, moved $2 million of his own $6 million investment in the hedge funds into another fund in early 2007 while simultaneously raising cash for the funds, trying to sell them to Cerberus Capital Management, and telling investors they couldn't redeem their shares until the end of June. People familiar with the situation at Bear stress that Cioffi, who left the firm the week of Dec. 10, was simply investing in a different Bear fund with which he was involved. Cioffi's lawyers did not return e-mails or calls seeking comment.

### A CDO CALLED KLIO

It's too soon to tell whether authorities will find any wrongdoing. But a *BusinessWeek* analysis of confidential hedge fund reports and interviews with lawyers, investors, and securities experts reveals just how pivotal a role Cioffi's funds played in the mortgage market's dramatic rise, dizzying peak, and disastrous fall.

The analysis shows Cioffi and his team developed a novel investment product to attract money-market funds—a new class of investor—to the mortgage market. Their innovation, a particularly aggressive form of collateralized debt obligation, or CDO, became the building blocks of the industry's push to keep growing for longer than it otherwise would have. After the market turned, it became clear the Cioffi money machine contributed to much of the $10 billion-plus in writedowns that Citigroup (C) and Bank of America (BAC) revealed in November. Fresh evidence also suggests Cioffi's team may have engaged in self-dealing by using the new CDOs to buy assets from the funds, artificially boosting returns. Citi and Bank of America declined to comment.

At the center of it all was the new breed of CDO pioneered by Cioffi and his team to tap into the $2 trillion universe of money-market accounts in which individuals and corporations stash their spare cash. Cioffi's CDOs, initially branded "Klio Funding," were entities that sold commercial paper and other short-term debt to buy higher-yielding, longer-term securities. The Klios were a win-win proposition for money-market funds. They paid a higher interest rate than the usual short-term debt. And investors didn't need to worry about the risky assets the Klios owned because Citigroup had agreed to refund their initial stake plus interest, through what's known as a "liquidity put," if the market soured. Cioffi engineered three such deals in 2004 and 2005, raising $10 billion in all.

What did Citigroup get for guaranteeing the Klios? For one thing, fees. The Klios were also a ready buyer of Citi's own stash of mortgage-backed securities and other debt. Citi probably never imagined it would have to make good on those guarantees because the underlying assets had the highest credit ratings.

Cioffi used the money from each deal to purchase billions in mortgage-backed securities and pieces of other CDOs for his three Klios. He bought many of the assets directly from the two Bear hedge funds he managed. The move also supplied the hedge funds with cash.

### A PYRAMID STRUCTURE

The Klios had another powerful feature: They allowed the Bear funds to lock in longer-term financing. Typically, hedge funds borrow for short periods of time, usually just days or weeks. Under the terms of the Klio deals, Cioffi could use the money for at least a year without having to worry that it would disappear overnight if the market got volatile. He discussed that advantage in an Apr. 25 call with hedge fund investors, boasting that the funding wasn't subject to market fluctuations.

The Klio structure spread rapidly as other hedge funds, CDO managers, and banks, including Barclays, Bank of America, and Société Générale, followed Cioffi's lead. From 2004 through 2007, Wall Street raised some $100 billion through these innovative CDOs, essentially creating a whole new way for the industry to finance risky subprime loans. That success, in turn, inspired copycat products such as structured investment vehicles, which also sold short-term debt. At their peak, in February, 2007, SIV assets hit $300 billion. Barclays declined to comment, but the company announced on Nov. 15 losses from CDO investments that it had been forced to take on its books. A Société Générale spokesman said it has transferred all of its risk to a large, global financial institution.

In hindsight, CDOs and SIVs served as a foundation for a pyramid-like structure that Yale University economist Robert J. Shiller says occasionally arises from bull markets. As new investors arrive to the party, they bid up prices, boosting returns for those who got in earlier. The big gains attract more investors, and the cycle continues—as long as the players don't try to take out their money en masse.

The mortgage-market system played out much the same way. The new type of CDO lured a different tier of investors: money-market funds. The flood of fresh money made it even cheaper and easier for buyers to get mortgages. That, in turn, drove up home prices, holding off defaults and foreclosures. The process enriched the people who bought earlier in the boom and triggered more speculation.

### "AN INCESTUOUS RELATIONSHIP"

The complexity of the Klios and their ilk only encouraged lax lending practices by putting too much distance between the borrowers and the ultimate holders of their debt. Since the Klios offered a refund policy, money-market managers didn't have to worry about whether home buyers would pay back their loans. Their investments were protected even if the owners eventually defaulted on their mortgages.

Indeed, as the bubble inflated, there was little incentive for the array of middlemen collecting fees—mortgage brokers, real estate appraisers, bankers, money managers, and others—to do the proper checks. The lack of oversight likely contributed to the rampant fraud on some underlying loans, says S. Kenneth Leech, chief investment officer of bond-investing firm Western Asset Management. "Nobody wanted to take the punch bowl away from the party," adds Charles Calomiris, a professor at Columbia Business School. "They were all making fees."

Now investigators are trying to determine whether Cioffi and his team crossed legal lines. The Klios provided the Bear hedge funds with a ready, in-house trading partner. Their financial reports, which were reviewed by *BusinessWeek*, show many months in which the Cioffi-managed Klios traded only with the Cioffi-managed Bear funds. For example, in April, 2006, one Klio CDO bought $114 million worth of securities from one of the Bear funds. Such trades, says Steven B. Caruso, an attorney who represents several Bear hedge fund investors, may be "indicative of an incestuous, self-serving relationship that appears to have been designed to establish a false marketplace."

If that's why the trades were made, the maneuvers could have falsely boosted the hedge funds' returns—and the fees Cioffi and his team collected. In an e-mail to Cioffi and co-manager Matthew Tannin cited in a legal filing, Raymond McGarrigal, another executive at the Bear funds, gushed about the Klio setup, writing that "one of the great things we've done is allow the Klio to buy assets from the hedge fund." Lawyers for Tannin and McGarrigal declined to comment.

### THE END OF AN ERA?

Amid the market turmoil earlier this spring, Cioffi hoped the Klios would work their magic once again. In April, as losses at the funds began mounting, Cioffi set up another CDO, High Grade Structured Credit CDO 2007-1, which issued short-term paper and offered investors a money-back guarantee from Bank of America. Cioffi had raised nearly $4 billion by late May, making it the biggest CDO of the year, according to Thomson Financial (TOC).

Just as before, Cioffi used the money to buy assets from the hedge funds, perhaps to prop up the portfolios, which by then were on the brink of collapse. In an April conference call with the hedge funds' investors, Cioffi said the new CDO was part of his plan "to get the funds back on track to generate positive returns." It didn't work. Just weeks after the deal for the CDO closed, the Bear funds imploded, wiping out $1.6 billion of investors' money. (The fund into which Cioffi moved $2 million, Bear Stearns Structured Risk Partners, was up 6.5% as of Nov. 30.)

By autumn the practice of using CDOs to raise cash was dead. Money-market funds had stopped buying the short-term debt, and the credit markets were frozen. That forced Citigroup and Bank of America to make good on their guarantees to investors in Cioffi's CDOs, triggering big losses at the two banks.

The global markets are dealing with the consequences: The tab from the mortgage mess could run up to $500 billion, and central bankers are struggling to stave off recession. As investigators sort through the wreckage, the records of Bear Stearns' doomed hedge funds are turning out to be some of the most revealing in an era of financial folly.

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