Bear Stearns

No picnic

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Illustration by Satoshi Kambayashi

JPMorgan Chase quintuples its bid for its battered rival. Now for the hard part

THE dramatic $2-a-share rescue of Bear Stearns was, almost everyone agreed at the time, the best way out of an awful situation. Bear was going for a song, but that was better than bankruptcy, which might have caused global markets to collapse. The only aggrieved parties were Bear's shareholders and employees—but they had got it into the mess in the first place.

And yet, a week later on March 24th, JPMorgan Chase raised its offer fivefold and other elements of the deal, brokered by the Federal Reserve, were amended. The world's bankers heaved a sigh of relief at the improved terms—so did many at Bear. But why the reprieve?

For sure, nobody knows precisely what Bear is worth, so stuffed is it with hard-to-value, illiquid mortgage securities and other nasties. That explains how a respectable firm like Lazard, Bear's adviser, could in the space of a few days endorse both the $2 and $10 bids in fairness opinions.

Dimon geezer

The main reason for improving the offer, however, was to overcome disaffection among Bear's employees and shareholders, who had threatened to torpedo the deal. In offering more, Jamie Dimon, JPMorgan's boss, hopes to recast himself not as a plunderer but as a pragmatist focused on people as well as price.

Other things needed revisiting, too. The original deal had been cobbled together in such a hurry that key clauses were mangled. One sloppy sentence appeared to require JPMorgan to continue guaranteeing Bear's trades even if its shareholders voted down the takeover. But the bigger problem, according to a JPMorgan executive, was that the guarantee would fall away if Bear's board recommended a rival bid. Unlikely though that was, it unnerved some of Bear's biggest trading partners, who continued to pull away last week. The higher bid was a price deemed worth paying to stop the exodus.

The higher price looks a bit more like the kind of rescue for shareholders that the Fed had wanted to avoid, fearing accusations of a bail-out. In exchange, it will no longer be responsible for all $30 billion of Bear's least liquid assets; JPMorgan has agreed to bear the first $1 billion of losses. But the Fed (and thus the taxpayer) could still end up losing billions. Upcoming congressional hearings on the deal are likely to be stormy. The Fed, however, will stick to its line that, however imperfect the rescue, letting Bear die would have been much worse. “It has been messy, but bear in mind it was done in the fog of war,” says Roy Smith, a finance professor at New York University's Stern School.

As well as giving Bear's shareholders more money, the revised deal does give JPMorgan a lot more certainty that it will be completed. The bank gets 39.5% of Bear straight away through an issue of new shares. Sympathetic Bear directors own around 6% more, bringing it close to the simple majority needed.

But much litigation looms. Already, several class-action and other suits have been filed against Bear and its board. Executives could be in the line of fire too, since they assured shareholders that the bank was fine just before it almost went belly-up. JPMorgan has set aside $6 billion for legal and other merger-related costs.

With perhaps half of Bear's 14,000 employees facing redundancy, many feel they have nothing to lose by kicking up a fuss. JPMorgan is stepping up efforts to win over those it wants to keep—it has offered star brokers signing bonuses of up to 100% of the annual revenue they generate. Some, however, are being offered double that to decamp to rivals. Mr Dimon has appealed to other firms not to poach.

Bear offers some attractive franchises, for instance in prime brokerage, clearing and energy. But not everyone is convinced these are worth the effort. Prime brokerage has been haemorrhaging clients to Goldman Sachs and others. Morale at other businesses is said to be rock-bottom. So JPMorgan may not be getting a bargain after all, reckons Dick Bove of Punk Ziegel. He points out that the total cost of the deal, adding in the $6 billion charge (but excluding the new share issue), is around $65 per share. Hardly a snip.

The assumption that JPMorgan is strong enough to absorb Bear may also be tested soon. Certainly, the bank is in better shape than its arch-rival Citigroup, having largely avoided the most toxic subprime securities. But its mix of businesses suggests plenty of pain to come.

The bank is heavily exposed to rising corporate defaults. It is also big in home-equity loans, which are souring at an alarming rate. More importantly, it is a giant in the over-the-counter derivatives market, and number one by a long way in credit-default swaps. With such a large derivatives book, the bank can withstand losses of only 15 basis points (hundredths of a percentage point) across its positions before eating through its regulatory risk-based capital, according to Institutional Risk Analytics (IRA), a research firm. These positions are, like those of America's housing giants, Freddie Mac and Fannie Mae, too big to hedge effectively, IRA says. It also calculates that JPMorgan needs almost five times its current capital to cover its economic risks.

The bank hotly disputes this. It points out that its actual exposure to derivatives, at $67 billion, is a mere thousandth of the notional value of the trades. But this is still a big number. And the backdrop remains bleak: this week Goldman put banks' eventual credit losses at an eye-watering $460 billion. Mr Dimon is likely to face some worrying distractions as he integrates what is left of Bear.