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Bear's Clearing Strengths Attract JP Morgan

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JP Morgan Chase & Co., in a deal backed by the Federal Reserve, agreed last week to purchase faltering Bear Stearns at a discount price. Bear Stearns' correspondent clearing unit, long second fiddle to the firm's high-profile prime brokerage and trading businesses, could prove to be a significant acquisition for JP Morgan.

"We think Bear will be better for this situation, we'll be better for it, and we have confidence [in Bear] going forward," said Howard Abner, chairman of Jersey City, N.J.-based Abner Herman & Brock, which manages \$800 million in unleveraged assets and is one of Bear Stearns' larger brokerage correspondents.

Bear is seeking to foster more than confidence. "We and our new parent company are as committed to this business as ever, and we will continue to offer sophisticated and innovative solutions to help investment advisers and broker-dealers achieve their strategic goals," said Joe Triarsi, senior managing director and co-head of broker-dealer investment advisory services at Bear Stearns, in a statement to *Securities Industry News*.

JP Morgan announced the deal, for \$2 a share, on March 16. Despite less severe reported losses than many rivals' in the wake of the credit market crisis, rumors had been swirling around the fifth-largest U.S. brokerage since the collapse of two of its hedge funds last summer.

After that event, a number of Bear Stearns' hedge fund clients, such as quantitative hedge fund Renaissance Technologies, reportedly opened up accounts at competitors, to diversify custodial risk and ensure the leverage spigots continue to flow. For broker-dealer correspondents of the unit, however, moving to a new clearer is a more complicated affair--the process can involve the transfer of numerous customer accounts and the brokers tend to rely on their clearer's technology.

Even if Bear correspondents were inclined to swap clearers, industry consolidation has whittled the number of clearers servicing institution-oriented broker-dealers--Bear's forte--to a handful. Goldman Sachs, which declined to comment, reportedly has been a prime-brokerage destination for some of Bear's hedge fund clients and, given the prominence of its clearing unit, the recipient of broker inquiries as well. Bank of New York Mellon Corp.'s Pershing unit and Fidelity Investments' National Financial are also options, particularly for brokerages servicing more traditional buy-side customers who are looking for large, stable custodians.

Norman Malo, president and CEO of National Financial, said he regrets Bear Stearns' unexpected circumstances. Nevertheless, he said, National Financial has received a "tremendous increase in phone calls" from the firm's brokerage correspondents and seen increased activity on the Depository Trust & Clearing Corp.'s (DTCC) Automated Customer Account Transfer Service, or Acats. He said the account transfers stem from a variety of sources, including retail investors taking the advice of their registered investment advisers and brokerage correspondents with clearing relationships at both firms. "We've had to add more people to get all these new accounts in," Malo said.

Clearing Savings

Any gains for National Financial, however, could be mitigated by a significant loss down the road, when JP Morgan--currently one of the Boston-based firm's largest correspondents--begins clearing its own retail advisory business, which it is likely to do through its Bear-acquired clearing operations. Indeed, the potential cost savings and control accrued through self-clearing could be a big benefit for JP Morgan.

Despite agreeing to pay only \$240 million for Bear Stearns, JP Morgan CFO Michael Cavanaugh said in a conference call that the bank anticipates annual incremental earnings of \$1 billion from the deal, with clearing and prime brokerage

the leading contributors.

Jamie Dimon, JP Morgan's chairman and CEO, has been seeking to bolster the firm's prime brokerage and clearing services, and the Bear acquisition would do that at a relatively cheap price. A source close to the firm noted that JP Morgan currently offers clearing services for U.S. fixed-income products and commercial paper--an area in which it is a leader--international securities through its GlobeClear unit, and DTCC-settled securities on an omnibus basis.

Those services, however, are offered on an agency basis. Bear's clearing services are fully disclosed and enable correspondents to leverage the firm's capital, a far more profitable business. In addition, said the source, platform integration issues that have bedeviled other clearing firm mergers won't exist. "Because Bear's correspondent clearing is different from what JP Morgan does, there isn't any integration to do," he said. That's also a major benefit to correspondents, who won't need to worry about converting to a new platform.

However, the risk remains that the acquisition could fall through, potentially leaving correspondents scrambling to find another clearer. Clearing firm implosions such as MJK Clearing's in 2001 and Refco's in 2005 left correspondent broker-dealers stranded without clearing and custodial services, threatening their client relationships and even their business viability.

The Bear Stearns transaction has the support of the Federal Reserve, which, Cavanaugh noted, extended a \$20 billion non-recourse loan to aid the bank in managing and de-leveraging Bear's estimated \$33 billion in risk positions. Those positions include, according to information provided by JP Morgan, \$2 billion in subprime-related exposure, \$15 billion in prime and Alt-A mortgages, and \$16 billion in commercial mortgage-backed securities, a market that has been showing signs of stress.

JP Morgan estimates \$6 billion in additional, pre-tax costs to complete the deal. If that number turns out to be significantly higher, it may affect the bank's willingness to complete the transaction or stunt investment in the operations. And large Bear Stearns shareholders, such as British billionaire Joseph Lewis, are griping about the low price and threatening to scuttle the deal.

Some brokerage correspondents, especially those catering to jittery hedge funds, had already started taking precautionary measures by forming additional clearing relationships. Aaron Vermut, partner and COO of New York-based Merlin Securities, which caters to midsize and smaller hedge funds, said his firm began considering a clearing relationship in addition to Bear more than a year ago.

Merlin initially settled on Merrill Lynch Professional Clearing Corp. before opting for Goldman Sachs in January. Merrill has faced its own mortgage-related issues and has recorded losses that are larger than Bear's, although Vermut said that did not factor into the firm's decision. He described Goldman as a "better fit" and called the decision "purely operational."

Merlin has no plans to leave Bear. "We see the combination of Bear and JP Morgan as very strong," Vermut said, adding that Merlin's reporting system enables clients to seamlessly diversify risk at multiple clearers--now a large commercial bank and a broker-dealer.

Abner said there "shouldn't be any concern about custodying assets at Bear for a great number of reasons." He pointed to the Securities Investor Protection Corp., which insures securities accounts up to \$500,000 per customer, with a maximum of \$100,000 for cash claims. Bear augments that with additional private insurance from the Customer Asset Protection Co. Abner also cited the Bear Stearns Securities Corp. subsidiary, created in 1991, which is separately capitalized and segregates customer assets from the Wall Street firm's trading businesses.

"Now JP Morgan is behind Bear, and with its financial strength and capabilities it can make even greater investments in improving services," Abner said.

Bear correspondents will probably have a substantial window to mull their options. On the conference call, Cavanaugh said that JP Morgan is guaranteeing Bear Stearns' current trading obligations through the approval of the acquisition by Bear shareholders, expected in about a year. He added, however, that should shareholders reject the deal, the guarantee would disappear "prospectively."

Correspondents seem to be willing to take a wait-and-see approach. Robert Jersey, president and CEO of Chicago-

based Gar Wood Securities, a Bear client that caters to hedge funds, has additional clearing relationships with Penson Worldwide and Interactive Brokers and has been talking with Merrill's Broadcort clearing unit since November. Such relationships enable a broker to take advantage of a clearer's specific strengths.

"My intention is to stay with Bear," Jersey said, adding that even if the acquisition doesn't happen, he is confident correspondents have little to worry about. "Bear's clearing and prime brokerage units are prized commodities on the Street," he said. "Somebody would immediately step up to buy them and aim to keep them intact--they're too good to let implode."

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