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INTRODUCTION

Overview

Bear Stearns was a large investment bank, securities trader, and brokerage firm operating globally with headquarters in New York. The firm had been in operation for 85 years when its outsized position in subprime mortgages raised questions from investors, clients, and counterparties about the bank’s balance sheet and the quality of its assets. A failed hedge fund sponsored by a subsidiary of the bank in 2007 had brought unwanted questions about subprime loans in general in an increasingly wary market.

Bear Stearns had a reputation as an aggressive trading bank willing to take risks. The firm was proud of its reputation as a company run by employees with a “blue collar” background. Fortune magazine listed the firm as one of the most admired securities firms in 2005 through 2007 in its annual survey of most admired from companies.

Bear Stearns was one of the most highly leveraged firms on Wall Street. Throughout its history it was both innovative and creative which, at times, caused it to take some risky positions. The firm’s management was known to focus on immediate opportunistic returns with little long term strategic planning.

The Gramm Leach Bliley Bill (GLB) enacted in 1999 allowed Financial Holding Companies to engage in banking, securities, and insurance. Previously, the 1933 Glass-Steagall Act had prohibited banking and securities business in the same company. Under GLB the Federal Reserve was given authority to supervise financial holding companies but under the law had to rely primarily on functional supervisors to carry out front line oversight. The law was silent on the supervision of investment bank holding companies like Bear Stearns. In order to satisfy requirements of the European Community, where Bear Stearns had a number of major offices, the firm needed to have a consolidated supervisor. To satisfy this requirement the Securities and Exchange Commission (SEC) put in place in 2004 a voluntary program called the Consolidated Supervised Entities (CSE) program. Bear Stearns was supervised as part of this voluntary program. In the end the program was noted to have a number of serious deficiencies and has since been terminated. In other words there was little serious coordinated supervision over the holding company - Bear Stearns Companies Inc. - since investment banks are supervised by the State of New York, the SEC, and various Self-Regulatory Organizations.

Bear Stearns had pioneered the securitization of subprime mortgages but despite the growing evidence of weaknesses in this market the bank increased its exposure in 2006 and 2007 to gain market share. The collapse of the company in March 2008 and its eventual sale to JPMorgan was a key ingredient in recognizing the weaknesses of risk management in the industry as a whole that led to the meltdown in the financial services industry in September 2008 and the subsequent global financial crisis and ensuing recession.
Key Issues

- Weak supervision can lead to a bank taking undue risk and failing to maintain sufficient capital against the constellation of risks it faces
- Identifying when an institution is too big to fail when no depositors interests are at stake
- Oversight of a financial holding company where there is no legal authority
- Meeting legitimate and reasonable requirements of host supervisors

Learning Objectives

The Toronto Centre program provides you with simple but powerful processes to strengthen your leadership skills in your supervisory function. Each case used in the program enhances specific leadership capabilities.

This case is designed to enhance your ability to:

- Understand the debate between too big to fail and too important to the financial system to disappear
- Understand how markets react to government rescue attempts
- Understand how lack of coordination among supervisors and absence of a robust supervisory plan can lead to a bank’s failure
- Understand how lack of effective market oversight can lead to systemic weakness

Core Principles

Core Principle 1 requires “an effective system of bank supervision” to “have clear responsibilities and objectives for each authority involved in the supervision of banks”. “A suitable legal framework for banking supervision is also necessary”.

Core Principle 6 requires supervisors to “set prudent and appropriate capital adequacy requirements for banks that reflect the risks that the bank undertakes”.

Core Principle 7 states that “supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process to identify, evaluate, monitor, and control or mitigate all material risks and to assess their overall capital adequacy in relation to the risk profile”.

Core Principle 8 notes that “banks should have a credit risk management process that takes into account the risk profile of the institution”.

Core Principle 13 and 14 deal with banks having in place proper and adequate policies practices and procedures addressing and controlling risks related to market and liquidity risks.

And lastly, Core Principle 24 requires “supervisors to supervise the banking group on a consolidated basis”.

This case study demonstrates the need for proper supervisory oversight and strengthened coordination among supervisors and Self-Regulatory Organizations. It also underscores the futility of attempting to organize a supervisory program designed solely to meet the legitimate requirements of a foreign supervisor without taking the responsibility seriously.
This case is presented by William Ryback, former special advisor to the Financial Supervisory Service in Seoul, Korea; Deputy Chief Executive of the Hong Kong Monetary Authority; and career bank supervisor in the United States. The material presented is derived from public media sources.

CASE NARRATIVE

THE COMPANY

Bear Stearns was based in New York and was one of the largest global investment bank, securities trader, and brokerage firm. It engaged primarily in capital market activities, including equities, bond trading and investment banking (80%); wealth management (8%); and global clearing services. Headcount exceeded 15,000.

The company was founded as an equity trading house in 1923 by Joseph Bear, Robert Stearns, and Harold Mayer. The firm survived the Wall Street crash of 1929 and opened its first branch office in Chicago in 1933 and later established itself in 10 other U.S. cities. It opened an overseas office in 1985 in Amsterdam and eventually expanded to 12 locations covering Europe, Asia, and South America.

Its primary customers included corporations, financial institutions, hedge funds, governments, and individuals. The company’s business included corporate finance, mergers and acquisitions, institutional equities and fixed income sales, trading and research, private wealth management services, derivatives, foreign exchange futures and trading, asset management and custody services. Through a major subsidiary, Bear Stearns Securities Corporation, it conducted global clearing services to broker dealers and professional traders and was a major security lender.

By year-end 2007 its balance sheet showed $395 billion in assets supported by $11.1 billion in equity – a leverage ratio of around 36 to 1. Notional contracts amounted to around $13.4 trillion in derivative financial instruments of which around 14% were in listed futures and option contracts.

Bear Stearns was the fifth largest investment bank in the United States.

THE CULTURE

Bear Stearns had a history of aggressive market behavior. In the early days, Bear was a heavy investor in equities taking advantage of the thriving investment climate in the 1920’s. Trading fell off sharply in the market contraction of the early 1930’s but Bear managed to survive without shrinking the number of staff or eliminating the custom of employee bonuses. The Firm became a leading trader in government securities and corporate bonds taking advantage of the expanded activity in this market being generated by President Roosevelt’s New Deal emphasis on redevelopment of the nation’s infrastructure. At the time banks had plenty of cash with few opportunities to expand lending. Bear Stearns made its first substantial profits by selling large volumes of government and corporate bonds to banks around the country.
In 1935 the Public Utilities Holding Act was passed which led eventually to the breakup of privately held utility companies. Bear Stearns became an aggressive trader in the expanded market for securities being issued to place the utilities in public hands.

In the 1940’s, the firm became a large player in mergers and acquisitions, particularly in the freight and transportation industries as cars and trucks began to replace railroads as the primary mover of people and freight. A once booming rail industry was suffering a long and painful decline with most of the nation’s railroads close to bankruptcy.

In the 1950’s Bear Stearns was one of the principal originators of block trading which by 1960 was the foundation for most profitable Wall Street brokers until fixed brokerage commissions were eliminated in the 1970’s.

By the late 1960’s Bear Stearns was one of the first firms to significantly expand its retail business operations in selected locations. The company became very successful at attracting and managing accounts of wealthy clients which laid the foundation for its very profitable margin operations.

In the 1970’s Bear Stearns took a large gamble by investing heavily in securities issued by the City of New York which at the time was near bankruptcy. It came very close to losing much of its capital but the firm eventually profited handsomely.

As the decade closed, Alan “Ace” Greenburg became Chairman of Bear Stearns. He had a reputation as one of the most aggressive traders on Wall Street and like his predecessors he tended to ignore strategic planning and focused on immediate opportunistic returns.

The willingness to take risks enhanced Bear Stearns’ reputation as a primary player in corporate takeover activity. The firm was very adept at disguising takeovers until the last minute. Its ability in this area also led to it having a somewhat tarnished reputation as it would sometimes wage proxy battles against its own clients. The Securities and Exchange Commission brought action against some companies that had aided Bear Stearns in “parking stock” which was a tactic used to facilitate corporate takeovers.

By the 1990’s the firm was a major player in initial public offerings for a variety of foreign and domestic companies. It also was a leader in clearing trades for other brokers and brokerages and had one of the leading analysts to broker’s ratio in the business. Bear Stearns also continued its drive to establish itself as a leader in emerging markets such as Asia and Latin America.

In 1997 Bear Stearns made the first public securitization of Community Reinvestment Act Loans in the United States. The Community Reinvestment Act encouraged bank lending, especially mortgage loans, in poorer neighborhoods. Such lending is believed by many to have eventually led to the subprime crisis. Bear Stearns would claim special expertise in this market because of its early entry and long experience.

In late 1997 Bear Stearns was being investigated by the SEC for its role as a clearing broker for a firm that had gone bankrupt a year earlier. Bear Stearns was accused of assisting the firm by processing trades, loaning money, and extending credit despite evidence that the firm was
manipulating stock prices and conducting unauthorized trading using customer accounts. Bear Stearns eventually settled the case by paying a large fine. Its reputation was tarnished.

In 1998 Bear Stearns declined to join the syndicate of Wall Street firms in saving Long-Term Capital Management from collapse.

At the turn of the century Bear Stearns was focusing on its primary strengths – clearing operations and taking advantage of the housing boom by expanding its focus on packaging and selling bonds to investors averse to taking a position in equities.

Bear Stearns’ senior management used to refer to the company as a firm run by “PSD’s” – Poor smart employees with a deep desire to become rich.

In 2005 – 2007 Bear Stearns was listed as the “most Admired” securities firm in its annual “America’s Most Admired Companies” survey.

THE PROBLEM

Bear Stearns sponsored two hedge funds through its subsidiary, Bear Stearns Asset Management. The main fund, the High-Grade Structured Credit Strategies Fund, was made up of complex derivatives backed by home mortgages. During most of its life it was highly profitable but as the housing market began to stutter in late 2006 the returns suffered. This fund was leveraged at 35 times its invested funds.

As the market worsened the returns of the two funds sank. In urging investors to stay put the fund managers promised an eminent turnaround of the market (two Bear Stearns executives were subsequently indicted for misleading investors).

In June 2007, Bear Stearns pledged a collateralized loan of around $3.2 billion to arrest the deteriorating value of the High Grade Structured Credit Strategies Fund. It also was negotiating with other lenders to lend additional money to the other fund – Bear Stearns High Grade Structured Credit Enhanced Leverage Fund. Both funds were invested almost exclusively in very thinly traded collateralized debt obligations. As the market downturn accelerated the funds were left with billions of dollars of money losing securities that were unmarketable. Investors were trying to cut their losses and flee. Lenders, such as Merrill Lynch and J.P Morgan were threatening to seize the collateral. Bear Stearns managers tried to convince investors to allow more time for the situation to turn around and invest more money to plug the widening gap under the theory that the housing market dip was only a temporary blip. The investors attempted to get Bear Stearns to invest its own money to arrest the losses estimated at the time to be around $1.6 billion which was dismissed out of hand.

Merrill Lynch did eventually seize $850 million of the underlying collateral but was able to sell little of it in the market. This focused the markets’ and investors’ attention to the underlying value of the assets. It sparked fears that the Bear Stearns funds may need to dump assets into an already fragile market driving down the mark to market value of other assets in other portfolios.
In July both funds failed as the two subprime funds lost nearly all their value and Bear Stearns’ reputation was irreparably damaged. The capital it lost came at a time when the firm should have been seeking ways to augment its capital, attract a partner, reduce its large and growing inventory of weak assets, or otherwise stabilize the firm.

In November Standard and Poors downgraded the company’s credit rating to A from AA.

THE REGULATORS

The United States has a quilt work of supervisors combining both State and Federal Agencies. Additionally, there was a bias toward self-regulation especially in the securities area.

Investment banks are subject to supervision by the Securities and Exchange Commission (SEC), the State of New York, and Self-Regulatory Organizations. There is no clear evidence of coordinated supervision and with the number of supervisors active in overseeing the activities of Bear Stearns it was surprising there were no alarm bells raised on a number of critical issues – most importantly – capital adequacy.

The SEC lacks the authority to force large investment banks, including Bear Stearns, to report their capital, maintain liquidity, or submit to leverage requirements. Since they lack reporting requirements it is highly conjectural whether they could enforce any prudential rules.

Since all of the large investment banks, including Bear Stearns, had major operations in EC countries they needed, under EC rules, to have a consolidated supervisor. That was absent in the United States since the SEC lacked specific authority to act as the regulator of investment banks. The State of New York had authority to regulate and supervise activities of the chartered bank but had limited or no authority over non-bank subsidiaries, the holding company or subsidiaries of the holding company. In order to continue operations in the EC the investment banks submitted to a voluntary program called the Consolidated Supervised Entities (CSE) program which was inaugurated to fill the regulatory gap as to investment bank holding companies created in the wake of the passage of the Gramm-Leach-Bliley Act.

Since the collapse of Bear Stearns and the bankruptcy and liquidation of Lehman Brothers, the other major investment banks have converted to Bank Holding Companies supervised by the Federal Reserve. The CSE program is no longer in effect.

The Inspector General of the SEC, at the behest of Congress, conducted a review of the CSE program and issued a report titled “SEC’s Oversight of Bear Stearns and Related Entities” dated September 25, 2008. The report was highly critical of the program and specifically cited the lax supervision by the division of the SEC charged with oversight of Bear Stearns. The report concluded that “it is undisputable that the CSE program failed to carry out its mission in the oversight of Bear Stearns….”

The report notes that the CSE program requirements were inadequate and, in any event, red flags surrounding Bear Stearns were simply missed. There were a number of significant findings:

• Bear Stearns was compliant with the program’s requirements but collapsed anyway which raises disturbing questions about the adequacy of the requirements
• SEC was aware that Bear Stearns had a heavy concentration of mortgage-backed securities when it voluntarily joined the program in 2006 but the concentration continued to increase and the agency took no action
• The CSE program did not require a leverage ratio limit for member firms
• The responsible division for oversight at the SEC was aware that the risk management of mortgages at Bear Stearns had numerous shortcomings, including lack of expertise by risk managers in the mortgage-backed securities area, but took no action
• Following the collapse of two hedge funds in June 2007 significant questions were raised about senior management’s lack of attention in handling the crisis but the SEC failed to assess the seriousness of the problem
• The Division responsible for reviewing regulatory returns failed to conduct a review of Bear Stearns’ most recent 10-K filing in a timely manner which deprived investors of material information to make well-informed decisions
• Bear Stearns’ practice of using high leverage to take big investment bets was not criticized
• The oversight of Bear Stearns did not include actions to assess Bear Stearns’ Board of Directors’ and Senior Management’s tolerance for risk although this seems to be a prudent and necessary oversight procedure
• SEC regulations required that Bear Stearns use external auditors to do “certain defined audit work”; it gave permission for the firm to let employees do the work instead

The report noted there was no connection between Bear Stearns’ collapse and the poor oversight by the SEC or the gross shortcomings of the Consolidated Supervised Entities program. In a sense this is true but ignores the fact that Bear Stearns might have benefitted from more aggressive supervision especially with respect to strengthening capital and reducing the company’s high leverage. Since the CSE program was voluntary presumably Bear Stearns could have opted out of the program rather than comply with regulatory requirements the management may not agree with.

THE LAST WEEK

Bear Stearns was in desperate need to take action to reduce its portfolio of mortgages and the bonds that backed them or raise cash. There was internal pressure to reduce inventory. Bear Stearns made at least six efforts to raise billions of dollars but such efforts collapsed as either the company or the investor turned skittish. Senior management was concerned that Bear Stearns not appear weak and look as if it were desperate to raise cash as this might raise alarm bells. The market might think that the company was in trouble and customers would pull cash from the firm and Wall Street institutions might refuse to deal with a tarnished company.

Management was changed. The new sole CEO, Alan Schwartz, was a long time investment banker not familiar with monitoring trades or assessing capital. The previous co-president and CEO, Warren Spector, was closely associated with the sponsored hedge funds’ debacle and the Board of Directors, at the urging of James Cayne, Chairman, sacked him. The 12 Board members were all handpicked by the Chairman. Dissension within Bear Stearns was rife and a clear strategy to deal
with the many issues the company faced was not demanded by the Board of Directors or the regulators. The operating plan was to calm the market through conducting business as usual and talking up the former strengths of the company in an effort to calm investors, clients, and lenders.

March 2008 began quiet enough but the financial, political, and reputational situation was deteriorating rapidly and would soon lead to the unraveling of the company. The stock began to sink and rumors that Bear Stearns was strapped for cash began to circulate in the market. Nervous clients began to move their business and one major hedge fund and trading firm moved out $5 billion in one day. Still, at the beginning of the month Bear Stearns had over $18 billion in cash.

Management was assuring the market that the company was still a viable firm and attempted to allay the growing concerns of staff even as investors were becoming increasingly worried that Bear Stearns would not be able to settle its trades.

On Thursday, March 6th, Moody’s downgraded some mortgage-backed securities that had been issued by an affiliate of Bear Stearns citing greater default risk of the underlying collateral. Worse, a major European bank informed the company that it would not renew a $500 million loan coming due. The bank had an additional $2 billion credit line due for renewal and it was clear this was in jeopardy as well. Bank lines available to Bear Stearns totaled just short of $120 billion but the European bank’s actions was a major signal that the lenders were getting concerned, yet it still appeared that the company could survive.

By Monday, March 10th, the cost of a credit default swap on $10 million of Bear Stearns debt jumped to $625 thousand from $450 thousand just the Friday before. Clearly the market was betting that Bear Stearns would shortly run out of cash.

Bear Stearns’ trading partners were losing confidence. Some clients of Bear Stearns, not wanting to call their agent directly, began to ask a major German bank whether they would assume the settlement risk for a fee. The Bank agreed but was charging a premium to do so.

Late in the day Bear Stearns issued a press release stating the company’s balance sheet, liquidity, and capital remained strong.

On Tuesday, March 11th a Dutch bank pulled its $500 million line. Hedge funds were calling on a Swiss bank to take over trades where Bear Stearns was the counterparty. The bank, overwhelmed by the number of requests, informed its staff that any novation requests or other unusual exceptions relating to Bear Stearns would require one up approval from a credit risk manager. News of this action by the Swiss bank was widely circulated in the market

It was clear that a good old fashioned run on the bank was happening to Bear Stearns. The CEO, Alan Schwartz, asked for air time on a major business news network to make another public statement about the “good health” of the company and to emphasize that the firm, while having some problems associated with subprime mortgage securities, was still viable. Unfortunately, late breaking news unrelated to Bear Stearns crowded out the message.

On Wednesday, March 12th, prime-brokerage clients continued to flee worrying that Bear Stearns would be unable to settle trades. Mr. Schwartz realized he now needed assistance and advice and
placed a number of phone calls. One was to a top legal expert in New York. The attorney in turn placed a call to the President of the New York Federal Reserve Bank, Mr. Timothy Geithner. The Federal Reserve, in response to the broader financial crisis unwinding globally, was in the process of making arrangements to lend to investment banks if necessary. Such a program was hoped to be in place by month’s end and the attorney inquired if “there was something that could be done to speed the program along”. Although the Federal Reserve Act allows the Federal Reserve to lend to institutions that are outside the commercial banking system it has never done so in its 96 year history. There were technical problems as well since investment banks do not have accounts at the Federal Reserve Bank and therefore some conduit involving a commercial bank would need to be arranged. In addition, Bear Stearns was not regulated by the Federal Reserve and its true condition would take some time to determine. A central bank does not lend to bankrupt companies.

Mr. Geithner was surprised to receive a phone call from an intermediary rather than the company itself. He was not sure that the attorney had authority to speak for the company and, being a wizened central banker, suggested that the CEO of Bear Stearns should call him directly.

Early the next morning, Thursday March 13th, the CEO called Mr. Geithner to brief him of the fast moving situation. Interestingly, he failed to ask for assistance.

By mid-day another major hedge fund joined the growing number of clients exiting from a Bear Stearns relationship and was arranging to withdraw $5 billion. In one week Bear Stearns had burned through nearly $18 billion in cash reserves and was continuing to hemorrhage cash. It still owed another large New York City bank another $2.5 billion due by the close of business. It was clear that the firm might not last through the next business day. The Board of Directors, in emergency session, authorized the management to file for bankruptcy, if necessary.

Bear Stearns called in its lawyers. The lawyers were separated into two groups – one working on a bankruptcy filing while the other worked on various scenarios related to a cash infusion from outside parties. One attractive possibility, a takeover by JPMorgan, was beginning to look as a way out. A call was placed to Jamie Dimon, CEO of Morgan.

Very early Friday morning, March 14th, a conference call was in play with top government officials. Mr. Ben Bernanke, Chairman of the Board of Governors of the Federal Reserve System, Mr. Henry Paulson Jr., Secretary of the Treasury, and Mr. Timothy Geithner were the participants. They were running through the options relating to Bear Stearns and the fallout that would occur from letting a major brokerage firm collapse. The call lasted over an hour. At the end Mr. Geithner told them the government had run out of time and markets would open shortly. “What’s it going to be, gentlemen?” Mr. Geithner asked.

At 6:45 a.m. Bear Stearns received a draft of a press release from the General Counsel of JPMorgan. The press release would say that the bank agreed to provide Bear Stearns with financing for up to 28 days. The money for the rescue, some $30 billion, would actually be coming from the Federal Reserve through a special arrangement. JPMorgan was used because it was a commercial bank already subject to the FED’s supervision and already had access to the discount window. The Federal Reserve would guarantee the loan. This allowed JPMorgan to get around the tricky issue of doing due diligence on a loan of this magnitude.
The CEO of Bear Stearns breathed a sigh of relief. The firm had 28 days to find a buyer for the ailing company. Or so he thought.

The quick action by the Federal Reserve allowed Bear Stearns to open its doors for another day. But, like other cases where a central bank stepped in to rescue a financial firm, it was clear to the market that Bear Stearns was now a ward of the government. The stock continued its downward spiral, the exodus of clients was not arrested, and trading partners looked for other options. The firm was an unattractive nuisance in the market.

Henry Paulson Jr., the Treasury Secretary had had enough. He placed a call to CEO Alan Schwartz that Friday evening to inform him that he and Federal Reserve President Geithner expected Bear Stearns to arrange a deal to sell the company by Sunday before the Asian markets opened. The public spectacle of an ailing company flopping around in the market was not helping market confidence. The rescue was being seen as a desperate measure and underscored the weakness of the company rather than providing the desired salutary effect on the market.

JPMorgan had a small army of legal, technical and market experts looking over the books of Bear Stearns. J.C. Flowers & Company was also looking at making a deal to buy 90% of Bear Stearns at $28 a share contingent on arranging financing of at least $20 billion to finance Bear’s continuing operation. JPMorgan was thought to be looking at an offer of around $8 to $12 a share. By Sunday morning, March 16th, a rough draft of an agreement was given to Bear Stearns from JPMorgan with the price blank but later that day Morgan rescinded the offer. Morgan was getting cold feet. The due diligence period was too short and posed major risks to the bank. Bear was still losing clients, facing a number of lawsuits related to the collapse of the hedge funds a year earlier, and its large portfolio of toxic assets could continue to decline in value. All things considered it was too risky a proposition for Morgan.

J.C. Flowers & Company was having a difficult time in arranging the financing necessary to keep Bear Stearns operating.

The Secretary of the Treasury contacted Jamie Dimon wanting to know the status of the deal. After much internal discussion Morgan was ready to reconsider a deal valued at $4 a share. Treasury Secretary Paulson thought that price was a little high. The government did not want to appear to be bailing out Wall Street investors and usually in a classic failure shareholder value was reduced to zero. From his point of view, the lower the price the better. JPMorgan offered $2 a share.

The Board of Bear Stearns, after much angst, accepted the offer. It was announced at 7:00 p.m. Sunday night.

The deal contained an interesting clause. JPMorgan apparently agreed to finance Bear Stearns trades for a year even if shareholders rejected the deal which was very likely given that 30% of Bear’s stock was owned by employees who were not at all happy with their own management and certainly would see their personal wealth wiped out at such a meager price. The possibility that JPMorgan’s offer would be rejected was quite real.

It was a tense week. JPMorgan wished to make no more concessions, but, on the other hand, while Bear Stearns’ franchise value had no doubt eroded significantly Morgan still prized many of its
business lines. Morgan threatened to withhold financing for Bear’s trades if it did not accept the offer. Bear Stearns could sue, of course, but little merit would be gained and in the end Bear Stearns knew if it did not accept the terms and price offered by Morgan it would have no other option but to file for bankruptcy liquidation. The ride was over.

In the end, a share price of $10 was agreed. In order to please the FED JPMorgan assumed responsibility for the first $1 billion in losses reducing the government’s exposure to $29 billion.

Bear Stearns was dead.