

**MEMORANDUM FOR THE RECORD**

Event: Interview with Kyle Bass, Hayman Capital Advisors

Type of Event: Phone interview

Date of Event: Monday, April 26, 2010; 4:30-5:30pm

Team Leader: Tom Krebs

Location: 1717 Pennsylvania Avenue NW, Suite 800, Washington, DC; Small conference room

Participants - Non-Commission:

- Brandon Osmond, former Bear Stearns
- Kyle Bass, Hayman Advisors

Participants - Commission:

- Brad Bondi
- Greg Feldberg
- Kim Shafer
- Vic Cunicelli
- Ryan Bubb
- Landon Stroebe
- Karen Dubas

MFR Prepared by: Karen Dubas

Date of MFR: April 26, 2010

Summary of the Interview or Submission:

**This is a paraphrasing of the interview dialogue and is not a transcript and should not be quoted as such.**

**BASS:** I reached out to Mina because I've been giving my two cents worth about the investment banks and the rating agencies. We had a lot of interaction with the rating agencies during the crisis and there are a couple of places where I believe they have indefensible positions.

The mezzanine CDOs, just in their construction, I believe include elements of criminality. I don't know how you can take BBB collateral and alchemize it into AAA bonds. If the probability of default of the collateral is high and all of the collateral is the same, I don't know how you can call it AAA. I believe the genesis was the desire to move these subordinated tranches out of Wall Street banks and shift them to unsuspecting buyers.

**BUBB:** Let me give you the devil's advocate position. What the rating agencies would say that they had a model of the default probability of the collateral of these mezz CDOs, and if the correlation is low enough, you can make the subordination

**BASS:** That's their out. They assumed that correlation was low because of geographic diversification. If every piece of collateral was BBB or lower, it had an implied probability of default. You can't amalgamate all of these together and assume that the probability of default was lower.

**BONDI:** What role did the rating agencies play in coming up with this?

**BASS:** I'm not sure.

The second piece that I think that you should really look into was that in 2007, they changed the ratings methodology. The things that had driven their methodology were home price appreciation, default severity, and number of defaults. In 2007, they changed their assumptions for home price appreciation from 6-8% to 3-5%. They have two departments: the initial ratings group and the market surveillance group (monitors past ratings). In 2007, they started to change home price appreciation, and they moved more toward Mark Zandi's expectations. When they did that, they started to require more collateral at the bottom.

Our problem with that was they didn't go back and re rate everything in 2006 based on their new expectations. They would set 5 year expectations, so theoretically you had 5 data sets. Once it was issued, the ratings were set. It made the losses more severe when they happened. We met with them about it, and they said that it wasn't their policy to change their ratings based on new methodologies.

I think those are the two areas where you can go after them—in other areas, they can claim free speech. In my opinion, they're a regulator; they're not just another data point that can claim free speech rights.

During the first House Financial Services Committee hearing on rating agencies, I was testifying, and Michael Kanef, who I think was the general counsel at the time, came up to me while the mikes were still on and said that a lot of those things are true, but we can't tell them that. The unfortunate thing was that anyone who was listening to the hearing on the internet could hear that.

**BONDI:** Is that the November 2008 hearing before the House Oversight Committee?

**BASS:** If one of you sends me an email, I'll look it up and confirm which day it was. My friends and people in the firm that were watching it couldn't believe that he was saying that.

**BONDI:** Some folks have made money shorting where they thought the ratings were far off.

**BASS:** We had done qualitative research and bucketed the issuers and originators and found the ones who had no standards. We were short specific RMBS. We never dealt with CDOs. We did have positions in some of the companies that we thought would be adversely affected.

**BONDI:** Who were the big ones?

**BASS:** We didn't short Countrywide. We had a couple of Countrywide's last deals in 2007—the worst ones that Countrywide put together—and we shorted those. Countrywide was in the higher bucket of originators.

We would short People's Choice, Fremont, Long Beach—the quick loan funders and the people who had no underwriting standards at all. We didn't short Ameriquest or Argent.

**BUBB:** What was your process?

**BASS:** We met with a lot of brokers and asked them who the lenders were with the easiest standards and the easiest whole loans to get through. It costs the desk originator about 102% to get a loan closed. Countrywide's loans would trade at 104% right away—the bad loans would trade around 102.5%. Most of the loans got packaged together in bad securitizations.

**BONDI:** Why wasn't Wall Street throwing bad loans in with the good ones as filler?

**BASS:** I noticed in reading a lot of offering documents that they threw some bad loans in with the good ones. These securitizations were all supposed to be first liens. You'd find that Lehman and Morgan Stanley's shelves did much worse than their own originations. They would sprinkle in 4-9% second liens. It only took 3% to wipe out the BBB-. You'd have to look through all 300 pages to find out how many second liens were in there.

I asked Scott Eichel at Bear Stearns and he said that “we've created these innovative products, and we can keep on creating new ones to replace the old ones.”

**BUBB:** Did the rating agencies not incorporate any information about the identity of the originator?

**BASS:** Correct.

**BUBB:** And that enabled your strategy?

**BASS:** If you assumed that home price appreciation was zero, the loss would have been about 9% of assets. That burns through everything up to the AA securities. You'll see subprime losses on average and half the pool would default. This is 2006, 2007 and some 2005.

I understand there was a belief that home prices could never go down and that they could keep on innovating new products to replace the old ones.

**BONDI:** We understand that Countrywide was the major source of RMBS for many CDOs.

**BASS:** Countrywide was one-third of the entire subprime market. I think it's the law of large numbers. These other third tier subprime lenders just didn't originate enough. Countrywide had the best standards of a business that had very low standards.

**BONDI:** Are there any CDO deals that we ought to focus on?

**BASS:** I can point you in a direction but can't help much beyond that: CDOs that were titled by the names of dead presidents. Morgan Stanley's prop group was the mastermind behind the dead president CDOs. They were written to fail. Those CDOs were put together with loans that Paulson deemed to be problematic over time—but if they succeeded, he would have lost money.

Think about the synthetic CDO marketplace like a fantasy football team. You put together groups of RMBS securities and you never have to sell equity. You just say: here is the synthetic CDO. You have to have someone willing to buy the risk and sell the risk. There doesn't have to be an equity tranche—there just has to be a theoretical one, but it never has to trade.

If you take some time to figure out who issued the dead president CDOs, they were all ABS CDOs—I think all subprime RMBS CDOs. I think Morgan Stanley was the architect that was going short on the CDOs.

**BUBB:** Is there a way to get the CDS price on a particular bond?

**BASS:** The market price would be the only thing that would predict the probability of default. But the problem is that the inmates ran the asylum. The guys who traded it priced it. The ABX indices were the barometer for the tenor of the underlying collateral. The fallacy that I hear all of the time is that you can't price it because there's no market—we priced it every day.

**FELDBERG:** How common was the structure of the Magnatar deal?

**BASS:** I don't think it was common, but it was well known. I know from talking to people on the Street that they were the biggest player of those types of deals—shorting the bottom, putting up a little equity, and going long on the difference.

I also think they were the kings of the deceptive practice of creating these things to short them. These RMBS securities trade in \$5-10M increments. When you put together a mezz CDO with 80% AAA, you could trade \$800M at once. The AAA buyers universe was much bigger than the BBB buyers universe.

**FELDBERG:** Did most BBB end up in CDOs?

**BASS:** European countries would invest in it. You had this pro-cyclical insatiable appetite. They didn't know what it was, they just knew that it yielded a few more points than Treasuries and was rated AAA.

For what it's worth, I think the SEC indictment of Goldman Sachs was a *de facto* indictment of the rating agencies.

**BONDI:** Do you have any leads on Moody's or S&P guys?

**BASS:** Nicholas Weill, the head of Moody's surveillance unit.

For the record, my firm has no position in S&P or Moody's

**BONDI:** Did you ever do any side-by-side analysis of the ratings?

**BASS:** We were short the bottom 3%. The BBB- and the BBB—that's about the first 5%.

I will send you the first public contemplation of a Wall Street firm (UBS) of home price appreciation of zero. You can see a side-by-side model of the loss severity. I can't remember who wrote it. It was in 2007.

**FELDBERG:** Where were the CDO managers in all of this? Were their interests originally aligned with investors and the synthetic CDOs messed it up?

**BASS:** I would agree with that. I went to the American Securitization Forum meeting in 2007. They would say that they had terabytes of data and that they understood this more than anyone else, but they used the same data inputs as the rating agencies and believed that home prices would go up.

ASF had about 8 CDO managers that spoke to a ballroom full of people. I really don't remember any of their names.

**FELDBERG:** Were some CDO managers better than others?

**BASS:** I was just turned off of them completely. I think that cash CDO managers who were putting up equity had incentives that were absolutely aligned with the investors, but in synthetic CDOs it was fantasy football,

**BUBB:** You said that synthetic CDOs were a zero-sum game. Who came out ahead prior to the fall?

**BASS:** People who were short CDOs lost every time.

If the synthetic CDOs were marketed to orphans and widows, that's not good, but I don't think that there's anything wrong with sophisticated investors buying these things.

**BUBB:** Synthetic CDO bonds—did they perform worse or better than cash CDO bonds?

**BASS:** I don't know. I know that RMBS synthetic traded at higher levels than cash---they were better levels for the long buyer. (CDS on RMBS are synthetic RMBS)

**FELDBERG:** Was there a secondary market for it?

**BASS:** Only if there was a primary market for CDOs.

**FELDBERG:** CDO managers would pay more for synthetic RMBS than RMBS?

**BASS:** You get CDO managers like Trust Company of the West (TCW). They lost so much money for people and claim that there was no housing bubble. They're just a marketing machine.

**SHAFER:** Can you talk about how you saw ABX and other indices affecting the market from 2005-7. We're trying to think through to what extent synthetics kept the bubble going and helped burst the bubble.

**BASS:** I don't think it kept the bubble going at all. The key determinant was home price appreciation. With or without synthetics, this was going to happen because it was driven by home prices.

I thought that the ABX indices were a pretty good barometer. It's like true mark to market. The market was going to launch an Alt-A index, and the owners of Alt-A fought against it because they didn't want to mark them to market. If there's no price transparency, then no marking has to happen. The lobbying against new indices was enormous.

The reason synthetics came about was not because short sellers wanted to drive this. In 2004, that marketplace exploded, and anyone who put positions on lost from 2004-mid 2007. The synthetic marketplace was about \$450 billion.

**SHAFER:** Who should we talk to at MarkIt?

**BASS:** I don't know.

**FELDBERG:** I've heard a theory that the ABX gave hope to those widows and orphans, and it kept it going for longer than it would have.

**BASS:** I don't buy it. It all is dependent on home prices.

**BUBB:** Did synthetic CDOs concentrate losses in individuals?

**BASS:** I buy that. You enabled Wall Street to push the most garbage to the biggest buyers. BBB securities only had a coupon of 100 bps—1%. They had to come up with some more hyper leveraged structure that they could sell as AAAs. All it did was enable Wall Street to clean up their books.

**SHAFER:** Who bought BBBs before CDOs?

**BASS:** If you look at a distribution of BBB pieces, the real money buyers of BBB assets in mortgages were pension funds, and they stopped when subprime started.

You should find the head of structured products and marketing for any Wall Street firm and ask who created the mezz CDO and what was the reason behind it?

**FELDBERG:** This creates a supply/demand cycle where you couldn't have the subprime market without the CDO market?

**BASS:** I agree with that on the cash side.

When Moody's started to lay people off—their gross margins were bigger than Google—they laid off people in every department except for mortgages because they didn't want disgruntled employees talking to investigators.