**MEMORANDUM FOR THE RECORD**

Event: Interview with Paul McCulley of PIMCO

Type of Event: Phone Interview

Date of Event: April 23, 2010

Team Leader: Tom Krebs

Location: FCIC Small Conference Room

Participants – Non-Commission:
- Paul McCulley, PIMCO
- John Sopko, Akin Gump
- David Flattum, PIMCO

Participants – Commission:
- Tom Krebs

MFR Prepared by: Courtney Mayo

Date of MFR: May 2, 2010

Summary of the Interview or Submission:

When asked if PIMCO engages in tri-party or bilateral agreements, Paul McCulley responded that PIMCO is bilateral, historically they have not used the tri-party system, therefore they have taken in high quality repo. McCulley said the tri-party was where Wall Street could host low quality.

When asked if the reason PIMCO did not like the tri-party was because they cannot see the value, McCulley said that historically that is very much the case. They wanted to engage in bilateral and pay for trades on the wire. Historically, the tri-party market accepted all sorts of collateral and was driven by the two big tri-party banks (JPMorgan and BNY Mellon), they would monitor the value of the collateral and McCulley said they felt they had the duty to do the due diligence or do bi-lateral high grade. McCulley said that the tri-party market is being seriously evaluated, and is being reformed, and it is a market PIMCO did not want to use.

McCulley explained that in a bi-lateral agreement, if money is sent out to the broker he has to wire out the security to his client's custodians. So the custodian has physical collection of the collateral. If McCulley does not get his money back the next day, under the rules he can sell it out. In a tri-party agreement there is the lender, the borrower, and a third party.

When asked if he had a tri-party agreement where funds were fluctuating and decreases, how would he increase his collateral for that loan, or would he cash out at that time, McCulley said that if they had a tri-party where funds are fluctuating and decreases, he would make a collateral call on the person he was lending to, as they mark to market every day. If he was lending $102 in collateral and the collateral drops to $101, he is going to call and have the person send him $1 for collateral. If the instrument up a point then a borrower could say send me back my collateral.

PIMCO does have leverage accounts, but it makes up a small percentage of their business.

To trade in those particular accounts McCulley said that one must borrow money which can be done via repo, and they will do that, and rather than doing that one can buy the security forward which means that the seller of the security between now and the delivery is financing it for you. It's done under 2 different agreements: PSA purchaser agreement and PSA forwarder agreement. Both documents require collateral flow, different transactions but functionally essentially the same.

Regarding his/PIMCO's observation of the failure of Bear Stearns, McCulley states that Bear Stearns changed everyone's thinking about counterparty risk, margin flowing, and also haircuts on less-than pristine collateral. They would have been a Lehman except the Fed was able to declare it to be an unusual circumstance and was able to take out $30 billion of those assets JPMorgan didn't want, lend against $29 of them with JPMorgan hedging. The Fed never wanted to evoke Section 13.3 but they could find collateral with Bear Stearns that was good enough to lend against with JPMorgan taking the first loss piece. That caused everyone in the market to go back to the starting gate. There was a profound change in haircuts and spreads on various types of collateral and people started demanding regular margin flows. Frequently in these documents, you had the write and not the margin call. McCulley believes the market changed after Bear Stearns in a water shed way, but the real change was after the Fed was unable to do a Bear-like transaction with Lehman Brothers.

When asked to clarify his comment above regarding the profound changes in the spreads on collateral, McCulley said that in repo there are two issues. What is the haircut, how much do I want to lend? The other is pricing relative to general collateral, there is a rate at which you can borrow money and then there is a higher haircut and higher rate for lesser-quality instruments. McCulley says that what happened at Bear Stearns was that the lesser quality assets moved out and stayed out during that period between Bear Stearns and Lehman Brothers. After Lehman it was not about haircut or spread versus general collateral, after Lehman the market just wasn't functioning.

McCulley was asked if the types of collateral changed, after Bear, to where people would only take agencies, wouldn't think about a mortgage-backed. He states that most of the lesser quality stuff is financed in the tri-party market, which became dysfunctional after Lehman. The fed had opened the primary dealer credit facility. The only eligible assets were schedule 1, high quality agencies treasuries. After Lehman went down, the Fed expanded the eligibility and in their announcement they said they would expand all their collateral to what was accepted in the tri-party system. The fed essentially substituted itself for the repo market after Lehman. They would take schedule two assets, because the Fed realized that they needed to step in and have their balance sheet be the complement and backstop for the collateral.

With respect to Bear Stearns, McCulley was asked if people would not lend to them on the basis of their treasuries, and he said that it became more of an issue of prior to the merger into JPMorgan, because JPMorgan wrapped all of the counterparty risk of Bear Stearns. McCulley states that the shot gun marriage you were facing JPMorgan and concerns about dealing with Bear Stearns was about getting people to reengage with Bear because they were under run and people did not want to fund them against any collateral, which makes sense if you believe there is a significant chance that the firm would go under. Exercising legal right to sell the collateral, they had been shut out of the unsecured market well before that. One of the situations with a levered up financial intermediary that does not have access to support, you get runs. In aggregate, Bear did not have enough good collateral that President Geithner was willing to make a bet against.

McCulley was asked about the run up to and following Lehman, and he responded that in the run up, they faced a run. People did not want to face them bilaterally or in the tri-party market. Essentially they could not fund themselves in the run up to their bankruptcy. That effect was starting to spill over to the other standalone investment banks. It was contagion, and lenders quite appropriately were circumspect in terms of who they would lend to. The entire investment banking industry became shorter and shorter. After Lehman, people were staring over the abyss to Armageddon and that's when Treasury had to provide funding to the mutual fund market. McCulley states that that week was the most intense run on the financial system, absolute demand for perfect liquidity. Treasury bills went to negative yield that week. It was only broken by the combined efforts of the Fed, Treasury and the FDIC.

When asked if not for the action of the Fed, Treasury and FDIC what would have happened; McCulley said Depression 2.0.

McCulley was asked to explain what Lehman engaging in financing on the basis of the matched book meant and he responded that a matched book is when a dealer is both borrowing and lending money. They are doing it for themselves and as well to facilitate their customers. For instance, suppose you have a broker with a hedge fund dealing with it. So the broker is levered and the broker takes in the hedge fund through the hair cut and takes the money and goes into the market to hedge against it for themselves. A matched book is a broker both borrowing and lending. A matched book allows a dealer to make money on the fact that quite frequently various securities will be in very high demand which is going on special in the repo market, so therefore if they have securities that are not special they can borrow them at rates below general collateral and invest them in general collateral, or something similar. A matched book is a funding operation where they are both borrowing and lending.

McCulley states that "going on special" happens when someone has sold a security short and they have to cover the short by borrowing it, and if there's a shortage of that security in the lendable market, they will be willing to lend money below market rates if you have the security.

When asked about the suggestions that Lehman's fell over, and for a term did not know where their assets were, McCulley stated he was not inside that firm from the standpoint of knowing precisely of knowing that book, but that he could answer that question generically because you had people on both sides of the book and if you were borrowing money from them, you would have to post more than the normal amount for the securities.  McCulley said that suppose he is a hedge fund and he is borrowing money from Lehman brothers in a repo transaction, when Lehman goes down he has the $100 worth of cash and they have $105 worth of collateral.  If you were borrowing from Lehman, you over collateralized and you'd be happy to give back the $100 of cash if you could get your collateral.  The borrowers who were over collateral had their collateral frozen.

McCulley's response to the question what he believes the answer to shadow banking is, and who should take charge, he says that from a functional perspective, shadow banks and investment banks were the biggest and shadow banks were operating as real banks without the operation. Banking inherently is about maturity, liquidity and transformation.  Banking has a mismatch between liquidity and its assets.  He says to think back to savings and loans, they would take in deposits at 3 and lend them out to longer dated mortgages and hold them.  If all the depositors at one time want their money back, that is a problem because there is a long term loan.  Banking is inherently given to runs.  Back in the 1930s, he says they embraced that inherent reality of banking and instituted deposit insurance.  The deposit insurance itself should be a prophylactic against the bank.  The bank can get cash against its collateral form the deposit window.  There were strong prudential regulations in terms of capital, how much leverage and types of liquidity you should run.  Banking requires that there be a lender of last resort and so as to prevent runs, and parallel to that is FDIC insurance.  Shadow banks were doing the same things as traditional banks, but they were not regulated by the FDIC, they were regulated by the SEC and were therefore able to get a higher return of equity because they had higher degrees of freedom, ultimately used this freedom to their own demise.  McCulley says in terms of where we should go, what you do should determine the nature of your regulation, functional relationship.  You should be regulated accordingly to the standards of capital.  He says that is the philosophical answer.