Bear Stearns Packet Dated July 31, Meeting held on August 15th

Trading Revenues

Rough trading revenue estimates were provided for the period of July 28th to August 8th. These numbers were given with many caveats (constantly changing) and do not incorporate non-trading P/L.

Firmwide: -$570 million

Mortgages: -$250 million
Leveraged Finance: -$165 million
Credit Trading - $100 million
Fixed Income Investments: -$80 million
Principal Strategies: -$30 million
Muni (bond swap arb business): -$25 million

Equity Derivatives: +$45 million
Rates (largely Fixed Income Derivatives): +$40 million
Distress Debt: +$25 million
FX: +$10 million

Mortgage Update (Mike Alix and Dan _)
The new Mortgage market risk manager, Dan ( ), was introduced. His title is actually co-head of Fixed Income Risk Management (with Oliver), but he is going to be focused on mortgages and will be "re-vamping" the risk management framework. Dan just spent 3.5 years as the mortgage market risk manger at Barclays, apparently building out their infrastructure (he said Barclays' mortgage business is relatively small in overall size but now covers a wide range of products/asset classes). Prior to Barclays he spent 10 years at Greenwich Capital Markets, where he worked on the trading desk doing fixed income options modeling and started their price verification group.

Dan's first priorities are to get a handle on the firm's positions, develop independent views on the price verification process, and develop risk metrics. As part of this "risk management initiative", Barring Point has been hired to review the mortgage risk architecture, and Phil is coming back to work for a couple of months on the project.

Mike Alix echoed the sentiments of some of the other firms in describing the mortgage environment as having deteriorated significantly further in July and August. Not only have things been challenging in the Alt-A markets, some prime originators were under distress. Securitizations had virtually stopped (there was a "factory disruption"), which was attributed entirely to investor demand, and Bear was originating loans at a much slower pace (they also laid off a lot of people at BearRes/Encore, we saw in the newspaper). The greatest area of concern is the possibility of the asset backed conduits and money markets evaporating as a source of funding for market participants. While Bear has no direct exposure to the conduits in that it is not a placement (or re-marketing) agent and is not a liquidity backstop or market value swap provider, the potential impact on the market as a whole of so much paper trying to find a home at a new price is significant. Compared to the troubles with Alt and subprime securities, which can been attributed to fundamentals (i.e., relating to cash flows to underlying tranches), more recently investors were placing much higher risk premiums on "better assets" – thus pushing out high quality paper (AAA paper backed by jumbo prime collateral for instance). Dan noted that one year high grade paper was trading at Libor plus 100, which is a wider spread than the Libor plus 90 to 95 observed in 1998. (After our meeting, we learned that Bear has about $4.4 billion in funding through ABS CP type vehicles).

Mike feels the price verification process will be very important throughout this market (currently a lot of effort is being placed on getting prices right for the upcoming quarter end it would seem). There are many challenges given the lack of liquidity. Mike used the marking of the BSAM ABS fund to illustrate the diminished willingness of dealers to price things. He said historically the fund would receive multiple prices on each of its 600 CUSIPS; now it gets no quotes on 10% of its book, one quote on some positions, and a wide range of prices on CUSIPS for which it receives multiple quotes. (This calls into question the ability of hedge funds to come up with fair NAVs). We indicated that at some later point in time we would like to receive a fairly granular reporting of Mortgage P/L.

In terms of loan origination, Bear previously (2005-2006) bought around 60%-70% of its loans through bulk purchases, and the remaining came either through its conduit or its internal BearRes/Encore origination platform (which is also broker based but the loans are closed by Bear and Bear controls the underwriting standards). Currently, no loans are being purchased in bulk and there is almost nothing coming in through the conduit. Furthermore, the amount of origination has fallen drastically, resulting in the total amount of loans coming into the factory being down to "tens of millions" (USD) per month, versus the hundreds of millions that previously came through. While Bear stands ready to originate through its platform, hardly any borrower quality now. The largest contributor to whole loan inventory recently has been distressed repo counterpaties, where Bear has taken financed product into inventory. Along these lines, Mike remarked that the line between market and counterparty credit risk in the mortgage space is not a bright one.

The business was still moving AAA paper, but this is more through secondary trading it seemed, as securitization activity was so slow. The desk was expecting to have some new AAA's price soon, but would probably retain most of the risk from the deal (believe this was an ARMs securitization, we later heard it priced on Aug 20th and would settle a week later). In total, the mortgage business had a "few billion" USD of sales in the last week. Bear has been running a net short BBB (or BBB-?) synthetic position, which hedges its various longs. The widening of the higher rated traches (longs) relative to the hedges has been greater than expected, resulting in net losses.

<u>Counterparty Credit Risk to Originators (Wayne Buchan)</u>

Many bankruptcy/distressed stories were evolving in real time. Wayne felt that in general Bear had fared well/was in good shape, but there have a couple of bumps along the way. Probably the most important high level takeaway is that higher quality companies, which originate a lot of Alt A and prime in addition to subprime, are coming under distress. The main culprit cited is reliance upon ABS CP, and (to a lesser extent) not being able to decrease origination. Another takeaway is that counterparty failures are putting the firm longer inventory than it would otherwise like to be. Three names that Bear had exposure to that that filed for bankruptcy during the month are:

- American Home Mortgage – Had to file for Chapter 11 because it "ran out of time", as it couldn't roll its CP. At the time of filing Bear was holding $237 million of collateral it had financed (didn't get the loan amount). This collateral was auctioned off. The way this works is that a bid list is prepared and sent to the sales force, who then contract clients. Bear has the right to bid, but prefers not win (Bear must enter its bid first). With AHM, Bear won the auction(s) for all but $17 million of AAA bonds, and it was the only bidder on $150 million in whole loan collateral. The prices were above the repo principal, so there were no credit losses; although they now have a market risk position. Separately, some derivatives trades were voluntary unwound, resulting in no loss.
- Home Bank – filed chapter 11 on Aug 9th. This firm, which had a REIT attached, had been struggling for at least six months, partly due to high costs. It had basically given its origination business away (in order to reduce liabilities) and was left with its REIT, which it was unwinding. Again, the liquidity of the REIT dried up (don't know if this was a story just about secured funding or equity as well). Two auctions were held for the $60 million in collateral Bear had financed, and Bear won both auctions at prices slightly above the loan amount.
- Aegis – A privately owned subprime and Alt-A originator (partly owned by Cerebrus), filed on the 13th. This one came as somewhat of a surprise to GCD. Bear was financing $122 million in whole loans, $10 million of which turned out to be scratch and dent. They auctioned the collateral the day before our meeting; there were no other bidders and Bear incurred a $1.7 million credit loss. (Although they think they will get some money back on refis).

There were also three names that had not filed but were in the ICU:

- Luminent – is a Fixed Income Customer Clearing (FICC) client. The firm recently could not roll its paper, and made a call to rally its lenders, which had the opposite effect of scaring them. Its repo providers sent default notices and its ABS CP program extended. Wayne said there probably will be a loss to CP holders (no market value swap?). He also said that this is a pretty good company. Bear has lent $328 million at a variety of haircuts ranging from 3% on AAAs to 38% on some subordinates. They are netting all calls and will probably put the counterparty in default soon. They should have ample collateral (but "you never know"). Bear also had some derivatives on with Luminent, which it sounds like have already been unwound.
- Thornburg – is a jumbo prime and Alt A originator (and if you look them up you will see that it has been around for a long time). On Friday Thornburg looked ok, but it turned out they had $8 billion in ABS CP (surprise to GCD?). Once it knew

its CP was not going to roll, the counterparty began selling assets to meet liquidity needs, and was actually able to sell around $6 billion between Friday and Monday at prices in the 98 to 99 (they have actually sold a tremendous amount of AAA assets over the last few weeks). It looked like they "were going to make it" until Barclays sent them a default notice on Tuesday, and liquidated the collateral it held in the afternoon (without an auction), which Thornburg disputed. [Wayne clearly thought Thornburg had a legitimate grievance]. This is also a FICC counterparty, and Bear feels they have "plenty of collateral". The fact Thornburg was able to sell assets at 98-99 was somewhat reassuring in that it meant there is some smart money out there, but up until a week ago these bonds would have sold above par (given the quality of the assets, it would have actually been surprising for the AAAs not to move).

- <u>Impact</u> – Bear is financing about $300 million of whole loans. Wayne believed they would be able to sell these off the line and there would be an orderly liquidation.

Bear had no exposure to C-Bass.

<u>Counterparty Credit Risk to Product Purchasers (Barbara Biel)</u>
Barbara provided statistics for the financing of various collateral (ABS CDO, CLO, Alt-A or Subprime MBS, whole loans, etc.) by non-IG counterparties. See handout. What this table does not include is counterparty credit risk stemming from PAUGS or other synthetic exposures (they are currently trying to understand their synthetic risk better, there are some challenges such as how to look at relative value portfolios). Note the very large "other" collateral category on this table includes all other fixed income, such as Treasuries and agencies (equities financing not included, but Barbara said it is unlikely any of these counterparties deal in equities).

Interestingly, the table shows that the bulk of loan/advanced amounts are with 28 counterparties. Most of the counterparties on this list are hedge funds (some REITS, etc, as well), and most have received multiple margin calls recently, which have been met. In some instances Bear has been able to increase haircuts, especially when willing to provide longer terms/maturities as a trade off (there has been a fair amount of interest in this from funds). Barbara said they have also been engaging in "much deeper" conversations with their counterparties regarding what they consider qualifying as liquidity; a lot of funds are keeping upwards of 20% of assets (or NAV?) in liquidity and what they are counting as liquidity is more cash like.

Barbara did not walk through specific names this month to the extent she did last month (see that write-up), as there was not much new in terms of distressed exposures to speak of (she did note that Basis "was resolved"). Some PB clients had taken serious losses on Strat Arb, but nothing that exceeded the GCS risk managers' risk tolerance levels (given the level of collateralization). Separately, regarding Stat Arb, apparently Bear's Math Arb desk in its Principal Strategies business would have fully recovered its losses had it not cut its positions.

Mark/Margin Disputes (Barbara Biel and Mike Alix)
Breaks in the valuation process have been putting stress on Bear and others. More disputes are occurring not only due to disagreements on marks, but also due to trade reconciliation issues. Often, Bear is even finding that both counterparties (itself and the CP it is facing) are simultaneously calling each other for collateral. Also, as a result of the infrastructure challenges, Mike noted that the novations protocol had been relaxed to extend the 6:00pm affirmation deadline, so as not to stop assignments from occurring.

The issue of agreeing on the set of trades in place is apparently specific to OTC derivatives, as CUSIPS allow for a single number for two counterparties to reconcile to with ease on the repo financing activity. For OTC derivatives, dealers often do not put each others trade identification numbers into their systems, and reconciliations only occur when there is a dispute. Expanding upon the use of a centralized data warehouse like DTCC is seemingly the long-term solution, as processes are very laborious right now. However, in the interim one possibility suggested for improving the things would be for counterparties (particularly dealers) to perform bilateral reconciliations more frequently (despite whether there are disputes).

In terms of Non-IG counterparties with margin calls outstanding, there were three with calls outstanding more than 10 days, of which the total call amount was only $5 million. There were six counterparties with calls outstanding between 5 and 10 days, of which the total call amount was $37 million. Separately, the Citadel Equity Fund was on call for $35 million, but this had to do with them taking on another portfolio (Sowood's I believe), and Bear and Citadel were in the process of matching trades and agreeing on numbers.

In terms of margin disputes with dealers, there a couple with disputed amounts greater than $100 million. One of these is JPM, which Bear has more than 25,000 trades with. Another is UBS, who they have 11,000 trades with.

Leveraged Lending Update (Marc and Helen)

Bear did not have a PAC meeting in the month prior to our meeting, and there have been no new deal approvals in six weeks. The total leveraged bank loan and CMBS pipeline is nearly $12 billion, which is largely made up of Cablevision and Hilton ($5 billion and $4.8 billion respectively). (See handout provided.) There is also about $3 billion in exposure remaining on deals that have been recently syndicated (with the $3 billion representing the pieces that were not syndicated). About half of this is Chrysler, despite the fact that the desk syndicated the majority of that exposure at $95, loosing $28 million in the process.

If the Cablevision deal closes at all, it is expected to be restructured, and there is a strong feeling that that would occur in November at the earliest. The Hilton exposure of $4.8 billion is down from last month because the business syndicated about $800 million; it also has circled another $300 million (still included). This deal is not expected to close until September or October, and CMBS group is apparently very optimistic about this deal. Bear is again the #1 lead banker, like with EOP (Mike is calling on August 23rd with a Hilton update). More immediately, in the next two months risk management estimates that about $1.5 billion in bank loans will fund.

In terms of the mark downs (see $165 million referenced above as a rough estimate), the firm has marked all ANC commitments down with the exception of Cablevision. The feeling is that most other deals are relatively certain to close and thus were marked to the mid 90s. In terms of the hedge performance, Marc said he felt the hedges served really well until August, as since then they have given back some gains (although they have been slower to mark the loans back up, for instance Chrysler is now trading around 98).

Bear has $3 billion in its IG pipeline, which they expect to be reduced by $2.2 billion soon (due to Schering-Plough I believe). The firm has a retained IG portfolio of $4.3 billion (these are Bear's small portion of larger backstop facilities). While these revolvers are not expected to fund, the firm is going through an exercise of estimating what it could have to fund, which obviously depends on the types of assumptions one makes about the corporate CP market.

Marc and Helen provided a hand out summarizing the CLO Accumulation desk's positions as well (broken by rating and placement in capital structure). The net market value exposure stood at $2.3 billion. While we did not get separate CLO p/l numbers (not sure if that is included in the Leveraged Finance total above or not), Marc did say that term loans in the secondary market had backed up to around 96.

For Memo

- The top concern of the chief risk officer at the time of our meeting was the market for asset-backed commercial paper. While Bear does not have any direct market risk exposure to this market in that it is not a dealer (or placement agent) of asset-backed paper, nor does it provide liquidity backstops or credit enhancements to asset-backed conduits, the potential implications to the market as a whole of so much paper trying to find a new home at a new price are significant. In the weeks preceding our meeting, numerous higher quality mortgage originators, focusing on Alt-A and prime products, came under distress largely due to an inability to roll asset-backed paper. This led to the firm taking more mortgage inventory onto its balance sheet from prime and alt-A mortgage originators that it had provided warehouse lines to. However, in contrast to the size of the subprime warehouse lines last year, these repo facilities were much smaller. The credit losses from the closing of these warehouse lines were negligible but it left the firm longer inventory than it would otherwise have liked to be given current market conditions. Separately, another area of focus for the firm currently is the marking and price verification of mortgage inventory, which is quite challenging given the current lack of liquidity for many products. We will continue to discuss with risk managers developments in this space.

- Bear's leveraged lending business had not entered into a new loan commitment in the six weeks prior to our meeting. Thus the firm's commitments pipeline is currently relatively small, and is dominated by two large exposures: one which is expected to fund in early October and one which if it closes at all, is likely to be restructured and done much later in the year. The concentrated commitment that is expected to close in early October is for the acquisition financing for Blackstone's purchase of Hilton Hotels. Bear is the lead on this deal and its share of this commitment was $5.3 billion, which has subsequently been brought down to $4.8 billion by bringing in other banks into the syndicate. Unlike most leveraged loan acquisitions, the take-out for this transaction is meant to be in the CMBS market rather than the bank loan market (similar to previous real estate deals such as Equity Office Properties and Extended Stay). However, this deal is more unique in that roughly half of the securitization exit is planned to be CMBS collateralized by the franchise and royalty fees that Hilton charges its franchisees (with the other half of the CMBS being collateralized by the hotel properties). If the securitization of the fees is pulled either because of unfavorable rating agency action or lack of investor demand, this portion of the financing would revert back to a traditional leveraged bank loan, which would likely be a loan that required a non-trivial mark down to be able to syndicate. We have will continue to discuss with the firm developments regarding this transaction from both a risk and funding perspective.