Bear Stearns Packet Dated May 30, Meeting held on June 20

DPG bullets:

- Bear Stearns Asset Management ("BSAM") Update: As of late June, both the BSAM "High Grade" and "Enhanced Leverage" funds had been significantly de-levered, largely via bilateral agreements involving the sale of BSAM assets to the fund's secured lenders. Consequently, total asset values as well as the size of outstanding repo lines had been reduced to a fraction of April levels for both funds. During this unwind period, Bear Stearns (parent) agreed to become the sole secured funding provider to the High Grade fund, taking all remaining repo counterparties out of their positions. While Bear's June 22nd press release asserted the firm was establishing a $3.2 billion repo facility in order to accomplish this, only $1.6 billion was required (as of June 25) due to further success in selling High Grade's positions, thus repaying credit lines. At that time, the value of the cash and collateral securing the new repo line was estimated to be between $1.7 and $2 billion. Meanwhile, Bear has not replaced any of the Enhanced fund's outside funding, as it appears there is no remaining investor equity to preserve.[1]

- As discussed in last month's memo, Bear Energy announced in May its agreement to buy the power portfolio of Williams Power Company. The portfolio consists of power plant tolling agreements, a set of full requirement power contracts, and an associated hedge book (which includes futures and other contracts). OPSRA staff reviewed the proposed regulatory capital calculation for the William portfolio during the June meeting. The standalone one-day 99th percentile VaR for the portfolio is currently estimated to be around $50 million, which is greater than the current Bear Stearns holding company VaR of under $40 million. Separately, during the month risk management hired a new Chief Risk Officer for Bear Energy. This individual, who is coming to Bear from Suez Energy, brings considerable risk management experience in the power and gas trading space.

- Bear's Non-agency CMO desk lost approximately $110 million in May, largely due to write downs on second lien and subprime residuals. However, the Mortgages business as a whole made nearly $200 million due to gains elsewhere. For instance, the Global CDO desk, which was long credit protection in 2006 vintage subprime and second lien tranches, made approximately $90 million. In addition, the ARMs desk made over $100 million due to a combination of factors including new deals and mark-ups on option ARM residuals as well as structured IO positions, the latter of which was driven by slowing prepayment speeds. We will continue to discuss mortgage P/L in detail with mortgage risk managers, as well as the price verification work done in this space.

BSAM Update

At the time of our meeting Bear was focused on executing de-levering transactions in order to maximize the funds available to return to investors. From an internal risk

[1] Bear personnel have articulated that the firm was stepping in as creditor to the High Grade fund in an attempt to prevent a fire sale liquidation and maximize recovery to the fund's investors.

perspective, there was $36 million in Bear money invested in the two funds, and Bear had done a de-minimus amount of trading with each fund (see also earlier emails from Matt E.). Mike Alix pointed out that BSAM had its own Risk Management department, which has a focus on monitoring the portfolio managers adherence to the stated fund strategies (we actually didn't talk about the BSAM Risk Management department during our principal investments meeting – only the existence of a Risk Committee and the capabilities of Bear MeasurRisk). Subsequent to our meeting, we learned that the Executive Committee asked to have Mike Alix take a more formal role in the risk overisight of BSAM, especially from the perspective of liquidity risk management (it was subsequently reported in the 7/3 WSJ that BSAM risk managers would start reporting up to Mike).

At the time of this discussion the proposal for an all creditor stand-still, with Bear taking on 15% of all the secured lending, had just died, as many of the creditors were not comfortable with the proposal. Separately, four counterparties had reached bilateral agreements to buy portfolios they were financing, and several others were in the process of negotiating such purchases. Mike A. said that we could end up seeing $4 or $5 billion in assets sold in this manner, with cash coming in/lines being repaid (it actually ended up being more than $5 billion – see 6/25 update email form S. Spurry). He noted such bilateral agreements represent the middle ground between a creditor stay and creditors seizing collateral and putting it up for auction. Through the latter approach, the fund would not be agreeing to the price at which the collateral is sold, and the lender could be introducing the assets to a bunch of new parties that don't know those assets well.

While the High Grade fund was not in default/had not missed any margin calls, creditors were cutting off its liquidity by increasing haircuts or not rolling repo facilities. At this point it was felt that Enhanced's investors would have significant losses (while the fate of High Grade investors seemed less clear). By the end of the weak the perception was that all of the equity in Enhanced had been wiped out, as well as part of the mez loan provided by Barclays.

We asked about the possibility of other funds (i.e., third party funds that are counterparties to Bear) who have ABS strategies running into similar difficulties, as it seems this sort of pain could not be isolated in the way that the Amaranth losses were. Bear's credit risk managers have been looking at counterparties active in this space; Bear has approximately $1 billion advanced against CDO, CDO-squared, and CLO tranches across "dozens" of hedge fund counterparties. We asked how likely it is that there are other funds out there that should be getting hit as hard as BSAM Enhanced. Mike said that the Enhanced was net long quite a significant amount relative to its capital, and that the funds Bear was facing as counterparties did not appear as long or levered in the more complex part of the market. (Jeff Farber made the comment that it only would have taken a 2 or 3% decline in the underlying assets to put Enhanced down 18%.

Good question to ask other places.

Mike noted that, going forward, it was going to be important to see the reaction of investors with redemption rights (particularly FoFs) in this space.

CDPCs

Intra-month we requested to make credit derivative product companies (CDPCs) a discussion item, given that Bear was planning to launch a CDPC, but also from a broader counterparty perspective. This initiative was actually being sponsored by BSAM, by "some of the same individuals" involved in the High Grade and Enhanced funds. Consequently, the plans to launch the company had been put on hold/cancelled. It was also noted that it was unclear what the status of the Evergreen IPO was, as Evergreen was also managed by the same fund manager (we later heard that Bear had cancelled the Evergreen IPO).

From a counterparty perspective, GCD's view has been one of "enormous skepticism", as "the ability of the counterparty to meet the claim is going to be impaired by the market condition causing the claim". As a result, Bear has "modest" exposure to these vehicles. Namely, they did some trades with Primus, which was the first CDPC and did only single name trades. Rupert thought there was only one other CDPC that Bear had done trades with, and actually had a CSA (with a non-trivial threshold) with that one. We asked about who was buying protection from the new CDPCs, which sell super senior protection at massive leverage levels. Rupert thought it might simply be dealers or banks that had sold super senior protection to customers and were hedging their MTM P/L volatility.

Mike also said they viewed monocline insurers in the same light as CDPCs.

Market Risk

Kan noted that the quality of the VaR attribution was still something that he was looking at, as some of the marginal numbers he gave us last month changed quite a bit after the subsequent VaR re-run. He wasn't quite sure what to make of those results at that point.

an ongoing issue → If we don't see significant impact over the rest of summer & Fall should have a significant discussion this.

Firmwide 1-Week VaR was down slightly from $63.6 million to $60.3 million. Interestingly, while Fixed Income VaR was essentially driving 100% of firmwide VaR last month, its contribution had fallen to around 85% this month. The main driver of this was Bear Energy, which exhibited a VaR increase of $2 million to $5.3 million (not including the Williams Portfolio).

High Yield and Distressed

The Distressed Desk – made $33 million, having an "overall good month". Large gains were made on Safety Clean (?) and Adelphia. $5 million was lost on Delta, bringing YTD losses on that name to $25 million (LTD is about flat). The total airline exposure is approximately $340 million. The desk is also close to buying $180 million in airline pension claims (it already has $170 million). Kan didn't really know the details of the nature of this type of position (perhaps follow-up).

This desk (as well as Credit Trading) also has a growing number of equity positions. Most notably, it lost $5 million on a $220 million short position in subprime names, as some of those names rallied during the month. Separately, the desk also increased its short position in the high yield index (I didn't know they had an index short on, Jim?). I don't understand this either

Leveraged Finance

Leveraged Finance as whole made $31 million - $14 million came from eight bank debt deals and about the same was made on 4 bond deals (Capital Markets desk). The firmwide VaR attribution for LF fell from $20 million to $7 million, which is a number that Kan has been watching due to its instability. what do they think is causing the instability.

<u>Bank Debt –</u> We did not meet with Marc due to a relatively full agenda (and Kan had to go to a 2:00 meeting; if this happens again we might need to request they block out until 3:00). Looking at the bank debt report, Bear's Offered-not-Accepted Non-IG commitments fell considerably, after reaching an all-time high last month. These 1-signature commitments grew from $10.1 billion to $25.2 billion from March to April, and then fell back to $13.4 billion in May. The decrease occurred as $11 billion in deals were terminated, and nearly $10 billion were transferred to the Accepted-not-Closed (ANC) column. Consequently, the ANC non-IG commitments were up from (around $5.2 billion - check) to $12.7 billion. (<u>I believe this is high for ANC, check history</u>).

It appears that no outsized commitments were approved by the PAC in May, as the largest approved commitment was $3.45 billion (rated B-).

Note the ANC total on Tab 4 doesn't tie to the new Pipeline Commitments line on Tab 1; <u>ask why</u>. In any event, Pipeline Commitments were up from $10.2 billion to $19.2 billion, due to the increase in Non-IG ANC commitments mentioned above, as well as an approximate $3.5 billion increase in IG commitments (<u>from beginning of May, check versus April end</u>).

<u>CLO</u>

CLO Accumulation (note CLO Accumulation is no longer its own separate line) moved approximately half of its second lien inventory, reducing that position to about $120 million.

Mortgages

Mortgages as whole made $190 million; however, this was the net result of many significant ups and downs. As noted below, there were significant mark-downs on subprime and second lien residuals, and there continues to be deteriorating performance in the 2006 subprime and second lien loans. In total, there was approximately $280 million in remarks that were largely offsetting (some longs and shorts), which are "significant revals". Last month Kan had largely had described the mortgage market as exhibiting a recovery. This month he said that it turns out this wasn't really the case.

In terms of VaR attribution, Fixed Income currently accounts for $50 million of the firm's $60 million VaR. Within Fixed Income, $30 million is attributed to Credit, Rates, and FX, and $20 million to Mortgages. Finally, within Mortgages, the $20 million is split evenly (10 and 10) between the ARMs and Non-Agency CMO desks.

Agency CMO Desk – made $20 million, $15 million of which came on 22 new deals (on $4 billion in collateral). The desk had been running a fairly significant VaR of $13 million last month due to a TBA roll trade. That trade settled and the VaR fell to $7 million.

ARMs Desk – made $110 million. $23 million was made on 6 new deals of $2.9 billion in collateral. $45 million was made on mark-ups on Option Arm residuals, and $40 million was made on servicing and structured IO positions. The net market value position fell by $243 million to $9.5 billion.

In terms of the Option Arm Residuals, John explained that the desk had gotten some trading volume going, and was able to observe cumulative loss curves at different levels than where it had been marking. He said they also could have taken similar mark-ups on subordinated notes, but did not due to the lack of trading volume there. The gains on the structured IO positions, and to some extent servicing, were attributed to slowing prepayment speeds (longer annuity stream), which was overwhelming the increase in delinquencies. (There was also something about "catch up payments" on the servicing side).

Non-Agency Desk – lost $110 million, driven by write-downs on second liens and subprime residuals. The desk did do 3 new deals on $6 billion in collateral, making $12 million. It also made $9 million on a bulk sale of $450 million of subprime loans. The net market value of the desk's positions decreased from $9.24 billion to $7.3 billion (lowest in a long time).

More of the Non-Agency losses came from long synthetic positions than from cash positions. John described this as the third waive of write-downs, which involves the same sort of analyses we have talked about for the previous waives. (I believe he also said that the desk was currently holding about $600 million in second lien loans, which it can't do much with, and is not buying any more). Broadly speaking, he said they expect to continue to face re-pricing in the market.

Commercial Conduit – made $31 million, 80% of which came from EOP.

Global CDO – made $93 million, as the desk was long protection on 2006 subprime and second lien CDO tranches (the CDS actual reference CDO cussips). We also asked about how hard the CDO Accumulation business had been hit. John said they recently did 2 multi-sector deals that took $25 million in losses on (Neptune and one other), and that CDOs were "dicey deals" with "dicey collateral pools". We asked if this business was winding down; he said it would continue to shrink and that laying off risk there is a big focus right now, but he didn't know if it would go away altogether. (I believe he said that could still be as large as $2 billion currently – follow up next month).

follow up

Foreign Exchange – made $14 million, and the desk's VaR grew from $400 thousand to $5.3 million. The risk manager suspected the desk's options risk may be overstated, and is being investigated. (Look for next time).

Fixed Income Derivatives – lost $12 million for the month, as this business is having a "tough time". The NY Flow options desk lost $14 million on "core positioning" (rates backed up 25 bps) and on a volatility calendar spread position. The risk manager noted that this desk recently hired a new trader, who is already down $15 million.

This business has been building up its ASIA operations, and did its first Vietnamese swap and Malaysian FX option during the month.

Municipals – a prop desk within Munis lost about $10 million on rate moves. In all, the firm lost about 30 million on rates during the month.

Fixed Income Investments
Max Recovery – made about $30 million, $12 million of which was due to a change in the valuation methodology to a yield based approach (I don't have very good notes on what this change entailed, something about essentially changing the discount rate by using a perspective yield?). Separately, the risk manager noted there was some re-calibration occurring for the UK model, due to the fact that the servicer was "slow to pass on some data points".

Credit Trading – had a "stellar month", making $85 million. Vox made $18 million on about 30 trades, and the desk currently has a pricing reserve of about $18 million due to mark differences with Markit. Regarding the previously discussed dealer dispute, Kan said that, because the two sides were unable to reach an agreement, the next step was to go to a dealer pole (apparently this is in the CSA). However, (I believe the other counterparty relented before that actually occurred). Kan also clarified the fact that Bear had never actually posted the margin it was on call for by the other dealer.

Trading was good basically everywhere else in Credit as well. Global Structured made $18 million, HG Flow made over $20 million, and HY Flow made $18 million.

Credit Trading's equity position is currently at its largest level the risk manager has scene (I thought he said $25 million, but that seems too small?). Some of this is comes from restructurings, while other positions come from capital structure arbitrage and other prop plays. The business is also currently running a fairly significant short spread position (-$35 million Pops). Also, the risk managers are looking into changing the manner in which spread sensitivities are computed for risk purposes. The current methodology entails bumping each name individuality, but due to the current significance of the cross terms, this approach is being re-visited. (Note the Credit Trading VaR moved very little, which was not discussed; look out for next month)

Equity Derivatives – made $74 million. The Asia business "continues to do well" (didn't get P/L breakdown). The business had an operational risk issue, where there was a “mis-processed” corporate action on 1 of 6 exotics transactions (a trade dating back to 2005).

Risk Arbitrage – made $18 million, but has since given all of that back in June. The desk has requested another limit increase to $2 billion (long MV), which is currently under discussion. (Follow-up next time, it seems a little counter-intuitive that they would keep feeding these guys with all of the P/L volatility they exhibit).

Principal Strategies – made $34 million. There was a noteworthy trade that came out of the “CDO Arb book”, that involved a distressed high yield backed CDO that was downgraded to CCC following 1998. This CDO was bought in the 30s (when?), moved into a trust and restructured, and some of the resulting paper was put into another re-securitization (Rhino deal?). The result of this was (I believe a re-mark on the remaining position up to the 60s?).

Separately, the Math Arb book, which is about $1.5 billion in size, made $8 million.

Model Review Update

RMD did hire the individual mentioned last month, who will work primarily on credit models. Also, two additional hires could be imminent; although it did not sound as if RMD has honed in on a candidate to head the group. The Model Review Committee did meet intra-month, and Kan described the meeting as productive, with a good variety of FAST and other business people present. He said they needed to really re-establish the framework by year end.

As part of our update, Kan walked us through the “High Level Summary” of the meeting. See handout → get a copy from Steve