

PIMCO conversation of March 24, 2010:

1. John Sopko arranged a discussion today with Bill De Leon, the executive vice president of PIMCO's portfolio management group. PIMCO is a large money manager having 1200 accounts for 2100 separate fiduciary accounts. PIMCO does not invest its own money rather invest the funds of its clients. Some of its accounts are designed for leverage and in those accounts PIMCO buys bonds and then lends the bonds out for the purpose of obtaining money to purchase bonds. These are commonly called reverse repos or "forward transactions". PIMCO engages in these transactions based on its desire to have no undue counterparty exposure by ensuring that the counterparty has a strong credit. Most all of PIMCO's transactions are bilateral in nature. This is because PIMCO has to confirm what was agreed to be done has been done and typically these "forward transactions" are short-term, meaning either overnight or one week in duration.
2. When asked to describe the market conditions following the failure of Bear Stearns, Mr. De Leon stated, "there was a massive dislocation in the market and not much trading was occurring." He further stated that the haircuts for borrowed bonds changed dramatically from 2% or 3% to 5% to 10%. He described these haircuts as "unsecured" and explained that when he gave \$100 worth of securities and received only \$95 in collateral the five dollars was unsecured. He also stated that the vast majority of PIMCO's transactions were bilateral in nature and were not tri-party repos. Tri-party repos, he said, "do not let me see the collateral or agree on the value of the collateral.
3. With respect to the activity in the market following the failure of the Bear Stearns hedge fund, he described that as a short-term scare that went away after the summer of 2007. To be sure he said, "the value of some collateral did go down, but the market recovered." He also said that some of the smaller players, small hedge funds, had some problems and spreads were marginally higher but not so high as to dislocate the market.
4. However following Bear Stearns failure in the spring of 2008 things changed permanently. Haircuts went up to 10% and never returned to their 2% margin before Bear Stearns failure. Those haircuts, he said, staying at 4% to 5% on high quality securities. The haircuts on mortgage pools, he said went up to 30%.
5. Things really got ugly, he said after Lehman's failure. There was great uncertainty in the market and haircuts went way up, so much so that lots of paper could not be financed. An additional problem, he said, was that a lot of Lehman paper was involved and fails to deliver because they could not find it. If you used Lehman as your prime broker your securities disappeared for a time. Lehman's matched book, "fell over", he said. And no one could tell where the securities were located. Haircuts were very high and everyone felt counterparty risk was very high. Rates for borrowing went up. The CP market stopped working, the market just was not functioning as there were no buyers for commercial paper
6. David Flattum, PIMCO's General Counsel, said that PIMCO rehypothecated securities acquired in its repo agreements into their clients' separate accounts for cash. PIMCO prefers bilateral repo agreements to the tri-party repos for the reason that the details in the tri-party repo agreements are the issue and that the values are determined by the custodial banks. Those values are too low and the haircuts are not sufficient.

7. The CPFF program slowly got things moving and it took 3 to 6 months for the market to recover. The SIVs had disappeared.
8. PIMCO's clients did have exposure to the Lehman bonds. It was explained that it is difficult to exit a large bond position, generally. And no one expected Lehman to fail.