

MEMORANDUM FOR THE RECORD

Event: Interview with Kyle Bass, Hayman Advisors LP

Type of Event: Phone interview

Date of Event: Friday, April 30, 2010; 11:30 a.m.

Team Leader: Tom Krebs

Location: 1717 Pennsylvania Avenue, Suite 800, Washington, DC; Tom Krebs' office

Participants - Non-Commission:

- Kyle Bass, Hayman Global

Participants - Commission:

- Tom Krebs
- Mina Simhai
- Karen Dubas

MFR Prepared by: Karen Dubas

Date of MFR: April 30, 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.

KREBS: What is a novation?

BASS: You referred to what was described in *House of Cards* by William Cohan. We never spoke to him, and he never called. His data is slightly inaccurate

If I have all of my assets at JPMorgan, I can trade with Goldman Sachs, Merrill Lynch, or anyone as long as I have an agreement with them that they will deliver the money. That's the way that the prime brokerage business works. You domicile funds in one or two places and trade with everyone.

With over-the-counter (OTC), the same thing happens, but no physical asset gets delivered to you. An OTC contract is just a contract between you and the counterparty. Say you have a contract with Bear Stearns: it's literally just a piece of paper that agrees that we will pay you this if an entity goes one way; you will pay us if it goes the other way.

If you have a bunch of contracts with a bunch of firms, and you want to close a contract, if you try to close it at the firm that it sits at, they can take advantage with you with the pricing.

If my firm keeps all of our money at JPM and have an ISDA agreement with them—we can trade OTC derivatives with them. If I go to them to ask for a price for something, and if they know that they're the only outlet, and they'll bid you above the market--\$92 instead of \$90. If we have the ability to move that contract and trade OTC with another dealer, that's called a novation.

When we transact, we go into the market with all of our counterparties, and say that we have a contract and who will pay me the best. Get them bidding against each other.

When we talk about GS or any firms, they have \$100 M trading days. It's not because they're risking their capital. Because of OTC derivatives, they have captive clients, and GS can make \$100 M riskless. We need to get these things Exchange traded so everyone knows the price and they don't fleece their clients.

KREBS: we have a derivatives hearing coming up, I'll suggest your name.

BASS: I'm happy to provide background information. I just want the system fixed, so I'm happy to give you all of the data.

I have a transaction on—I had a transaction with GS that I wanted to close. I went to 10-12 dealers and asked who wanted to pay for this. BS said that they would pay the most, I said “deal.” My back office notifies when I have a trade on, and when I close, we step out of the agreement. There's a Novation Protocol Network, you can find through ISDA—those people are automatically available to be counterparties with one another. Trades have to settle.

Stepping out and stepping in are terms of settlement.

What has to happen by 5:30 or 6:30 central, all of the parties have to consent that that's the way that they see it—agree to price and transaction, who's stepping in and out. That happens 100 times every day.

KREBS: What happens when one office gets hammered with these requests?

BASS: I think that's what happened back then.

I was closing a transaction. Another thing you can do, if I have a transaction with GS and I don't want it anymore, I ask them to novate it to another firm, like JPM. The book says that you're moving something, but you're actually closing it out.

SIMHAI: If you're closing it out, Hayman Cap is done with position?

BASS: Yes, we're done. It's not on our books anymore. That's the only way you can close an OTC position.

If the old counterparty was GS and the new counterparty was Barclay's, Barclay's has to take GS's risk. What happened during BS and L was that people who had credit agreements with them knew that their credit worthiness was deteriorating. People were trying to move credit agreements away from them.

That evening, there was a non-consent. People were running from BS at that point in time. The next morning, my COO said that GS said that they don't consent. I said make sure that the price is right, there's no error. They came back and said that we will not consent to this trade. In my history that's never happened before. They sent me an email and said that GS would rather face Hayman as a counterparty for credit risk than BS, and we don't consent.

The SEC looked at this in depth.

GS was being inundated with clients who wanted to move positions away from BS; they wanted GS to take the risk. GS said enough is enough, we can't take more risk. Their prerogative is to prudently take risk. That's what I understood happened.

When I got that email, markets are all based upon trust and confidence. That was the market saying we're done, we can't take BS risk anymore. The cap structure is levered 38 times. They're out of biz in a week.

I was explaining the CDS market to the SEC a week before L came down. I said that L's cap structure is inverted, and I said that they had about a week to stay into biz. They didn't really understand how that financing worked.

KREBS: Were you long in L because if they bailed Bear...they would bail L out.

BASS: I was long L's debt, because they had a lot of money market funds, and if they let it fail they would break the buck.

Our credit trader trades with the trader on the street. Many times we don't have salespeople, we deal directly with the desk. Sales person is one more person. We would agree on a price and a transaction, and it would go to the back office. The trader would say, this is what we did, go settle. All three back offices would talk and submit the information to ISDA, and it would settle by the end of the day. That happens all day every day.

Every single one of these transactions we have to sign. It is paper trading. If this financial reg reform goes through and 90% of stuff gets exchange traded, we don't have most of these problems.

KREBS: Was the inability to settle out through the back offices and keeping track of BS and counter party transfers the problem?

BASS: I think they (Goldman Sachs) were over their credit limit with respect to BS. WS and banking is a game of confidence. Everyone knows how BS was levered to mortgages and MBS. BS experienced a loss of confidence. The Street knew that these guys were in a precarious

position that they should have lowered their credit risk. But at the same time, all of the investors were trying to pass off their credit risk on the WS investment firms. WS is in the business of risk. The moment people won't take your risk, it's over.

The whole situation was unusual. It had never happened before.

If you read Fortune Magazine, Cayne said it was GS, Paulson, Bass that caused it all. I worked at BS for 6.5 years. I have many friends there, we lost money when it went down. We had no positions against them when they went down. I called Ace (Greenberg) about the article and said that

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36CFR1256.56: Privacy They will go to their graves thinking that someone else caused the problems. They shouldn't hate the mirror because they're ugly. Rumors can't put you out of biz if they're false. This wasn't a rumor; this was a fact. Did it propagate in the marketplace? Of course. Me as a fiduciary, I'm paid to understand what's happening and to not lose the money I'm managing. The damage was done when BS levered their balance sheet 38 times to these crappy mortgages. WS not novating deals was a big deal, but it was the end.

SIMHAI: You said that Hayman was trying to close out a mortgage position, and BS was willing to pay the most.

BASS: They were the best bid in the marketplace on that day. The original transaction was between HC and GS.

SIMHAI: You had a derivative with GS, and BS would pay the most for it, and you wanted to close out the position and have BS and GS face each other on the trade, and GS wasn't comfortable with this.

BASS: At this time, the whole Street was trying to novate away from BS. This is just a \$5 M example. You can see what was happening.

The next morning, we called again and said, "are you sure you don't want to consent to the novation, and they said we're sure." It got escalated up to the highest ranks of GS, and the CFO of BS called the CFO of GS, and said if you don't consent to this, we're out of business. GS didn't want them out of business. Later that morning, they call out of thin air and said that they would do it.

That's the culmination of the complete loss of confidence in the marketplace.

SIMHAI: It didn't really matter that at the end of the day, GS did step in and face BS. It was that there was so much hesitation, correct?

BASS: How can you fault someone who's being inundated with requests for the riskiest assets out there. They have to throw up their hands and say enough.

KREBS: The fact that BS is back office was unable to keep up with this was not the issue. The issue was BS's credit.

BASS: That's correct in my opinion. You have to ask BS and GS to get the real answer. I'm just presupposing.