

From: Frost, Alan
Sent: 02/16/2006 12:20:41 PM
To: Forster, Andrew; Teasel, Sheridan; McCormack, Sinead; Park, Gene; Gorton, Gary; Fewings, Tom; Robinson, Peter; Martin, Andrew; Budnick, Adam
Subject: RE: Subprime Thoughts

Does 20% of subordination mean 3% of a deal that has a 15% SS AP? Also static deals are obviously a very limiting factor and I'm not sure of what you mean by useless managers as it relates to static deals. I do agree that we should disallow CDO by crap managers generally, but I'd have more tolerance for managed deals by good managers. Then still know them down and stress. Also what about HG deals that we aren't involved in. They will certainly be able to buy mezz CDO's. This is now a tertiary exposure, but nonetheless possible. Are we going to have any rules there?

From: Forster, Andrew
Sent: Thursday, February 16, 2006 12:13 PM
To: Frost, Alan; Teasel, Sheridan; McCormack, Sinead; Park, Gene; Gorton, Gary; Fewings, Tom; Robinson, Peter; Martin, Andrew; Budnick, Adam
Subject: RE: Subprime Thoughts

I agree we may be able to live with some small bucket with appropriate stress, the question is how big is that bucket. If you make it anymore than about 10% in my view then we will end up losing huge amount of our subordination in the doom and gloom scenario. How about we allow a bucket no more than 20% of our subordination to be in AAA and AA static tranches of CDO's but in addition we haircut them and disallow useless managers and crap deals that are very low quality.

From: Frost, Alan
Sent: Thursday, February 16, 2006 4:37 PM
To: Teasel, Sheridan; McCormack, Sinead; Forster, Andrew; Park, Gene; Gorton, Gary; Fewings, Tom; Robinson, Peter; Martin, Andrew; Budnick, Adam
Subject: RE: Subprime Thoughts

On point I'd like to clarify is that I wouldn't treat AA tranches of mezz CDO's as that high in credit quality. In some ways, I liken them to CDO², although that does give it a particularly toxic feel. But I would advocate a small bucket of AAA or AA tranches and then treat them like BBB's with stress. (Also arbitrary, but again just for starting points anyway.) I think there's a pretty good degree of circularity (is that a word?) in the market, and just buying AA's off of HG CDO is not that easy. I also think there's a big difference between allowing a small bucket with penal treatment and not allowing them at all. In the former, they might find other things to improve upon to offset the treatment of that collateral so that the deal still works (such as shortening the ave life, etc.), and we get a bit of an option that the CDO's in question do not default. To the extent that you write them off completely, that becomes a free option (like we've done in some other asset types), but that might be too harsh. I also think there's a difference between writing SS on a mezz deal and have the AA of that mezz CDO as a tiny piece of an otherwise acceptable HG portfolio, particularly if we are haircutting it and there are other compensating characteristics of the portfolio.

From: Teasel, Sheridan
Sent: Thursday, February 16, 2006 11:05 AM
To: McCormack, Sinead; Forster, Andrew; Frost, Alan; Park, Gene; Gorton, Gary; Fewings, Tom; Robinson, Peter; Martin, Andrew; Budnick, Adam
Subject: RE: Subprime Thoughts

My vote on the 2 main points are that a A category bucket of 10-15% (and maybe even a small bit of that in A3 too) is OK but we should haircut all the A collateral to some degree. Maybe run A3 bucket as BBB and 50% stress on the rest of it. Arbitrary yes but we have to draw a line somewhere.

On the AA and AAA tranches of Mezz CDOs I say we should not do them. If we are not happy taking the SS bits of those deals it is very inconsistent to believe the lower tranches are genuinely that high in credit quality. I see no reason why managers cannot fill those buckets with AA and AAA tranches of high grade deals instead.

From: McCormack, Sinead
Sent: Thursday, February 16, 2006 1:25 PM
To: McCormack, Sinead; Forster, Andrew; Frost, Alan; Park, Gene; Gorton, Gary; Fewings, Tom; Teasel, Sheridan; Robinson, Peter; Martin, Andrew; Budnick, Adam
Subject: RE: Subprime Thoughts

..... going through these deals the WARF of the mezz deals do vary quite considerably showing the "sub tiering" of these deals (if that's a word) which is another way of thinking of this. . ranging from low 400s (sub Baa2) to low 200s (between A3/Baa1)

From: McCormack, Sinead
Sent: Thursday, February 16, 2006 9:59 AM
To: Forster, Andrew; Frost, Alan; Park, Gene; Gorton, Gary; Fewings, Tom; Teasel, Sheridan; Robinson, Peter; Martin, Andrew; Budnick, Adam
Subject: RE: Subprime Thoughts

We all seem to agree that the US market fundamentals and increase in new low cost mortgage products (neg am, 40 years, los, etc ..) are the main concerns in the subprime market As rates rise, the lenders seem to continuously find ways to leverage in response, so I guess the concern is whether ultimately rates will rise to a point where they all get hit or whether there will be a soft landing as Alan says. I'd tend to agree with Andrew that if we don't really have strong feeling - then it is a punt in any case and we would be more prudent to stay higher in the capital structure given our large exposure.

If we believe that older deals are more tightly underwritten (if slightly offset by tightening in rating agency criteria in the past year) and benefit from strong HPI, there may still be a space for us to write super senior on the (growing??) market of synthetic deals if we believe managers are truly 'cherry picking' the strongest deals over the past few years and we will have some HPI built in. Several managers we have spoken to have said this - indeed PIMCO exited the CDO of ABS space in Nov 2004 for all the reasons we are talking about but say they are considering re-entering via the CDS market. Alan - I don't know what the collateral was like in the Ischus deal - whether it was all 2004 vintage or just CDS on the normal mix.

From: Forster, Andrew
Sent: Thursday, February 16, 2006 9:03 AM
To: Frost, Alan; Park, Gene; Gorton, Gary; Fewings, Tom; Teasel, Sheridan; McCormack, Sinead; Robinson, Peter; Martin, Andrew; Budnick, Adam
Subject: RE: Subprime Thoughts

The issue for me is that I think there is a big difference between what we think is perhaps most likely - that being a softer landing in the housing markets and deals getting stressed and downgraded while not totally blowing up - and what we think is a sensible approach to a SS business. The notionals involved in SS and the fees we get paid do not make it a place in my book to take trading risks and punts on views. I doubt too many people take \$30bn punts on the speed of decline in the housing market. If we think there is more likely to be a softer landing I would prefer we took that view directly by investing in the underlying deals and then earning some real spread since we are taking pretty much the same view in my mind since we lack any feel for correlation across deals so we have no idea if the subordination we have is worth much.

We can consider some single A exposure but I think it needs to be A1 or A2 and a small bucket as Gene suggests. As for allowing mezz CDO tranches I think that totally defeats the object and we are just taking exactly the risk in a different format so that has to be removed.

I am happy to hear everyone's views so that we can come to a consensus. I fully appreciate the ramifications but I want to be sure we are making the right decisions for the SS business as a whole and so our starting point has to be what risks we like not what deals we think that may stop us doing. Again I would emphasize that this is a SS business and we need to be confident we have independent risks that are reflected by an accurate rating.

From: Frost, Alan
Sent: Wednesday, February 15, 2006 10:29 PM
To: Park, Gene; Gorton, Gary; Forster, Andrew; Fewings, Tom; Teasel, Sheridan; McCormack, Sinead; Robinson, Peter; Martin, Andrew; Budnick, Adam
Subject: RE: Subprime Thoughts

I came away from that call thinking that we were all in general agreement with the fundamentals that are present in the sub prime market. After thinking about it some more, I decided (perhaps no shock to many of you) that I think we are being a bit extreme about these risks and the consequence of the changes in our approach will fundamentally shut us out of the entire market very quickly. I didn't realize that our threshold for rating on sub prime was single A (I thought it was BBB). In addition to disallowing highly rated tranches from mezz CDO's, killing single A tranches of sub prime resi deals themselves will certainly eliminate too much of the collateral universe even for HG deals for us to be a participant in any real form. I don't think we can just look at this as just exiting the mezz subprime CDO market, even though that's the driver. Maybe we should spend some more time working out some revised rules, so that we don't shut it down completely. Having said all that, I do not have a very robust rebuttal for the concerns that people have, although I am probably more of a buyer of the soft landing expectation. So I agree these rules will be somewhat arbitrary, but I think we can be sensible about it.

I still go back to being most concerned at this stage with how we deliver the message. I think we have some chance of instilling some change to the market, as we have before, but there's no certainty of that. I think we still have a little bit of a call option on this business, by virtue of our strength and reputation, and I don't want to unnecessarily squander it. I also think we should be aware of the ripple effects that this could have on other business that we may do with street. Yes, we're all professionals, but we will probably lose our "most favored nation" status with some dealers (obviously also something I am very sensitive to).

Finally, we also still need to consider what effect, if any, this will have on spreads and how we can most optimally position our short, if we do put it on. We probably get the biggest pop by more abruptly quitting the market, but I think that ultimately, there will be a decent amount of protection to take up the slack. (for example, we heard today that Bear is close to getting there with FSA on the Ischus synthetic mezz deal. ISCHUS, SYNTHETIC, and MEZZ. This combo strikes me as the kind of deal that Bear would choke on without us. If they can get this done, then a cash mezz trade for TCW should find a home.) I actually don't think that the short has a lot of down side, apart from the negative carry, but I'm not as bullish on it being a home run. At the end of the day, it is a hedge for our book and there's nothing imprudent about that.

I realize I'm looking at this from a big picture perspective and that is generally in minority of view. I hope it turns out that I was being to aggressive.

From: Park, Gene
Sent: Wednesday, February 15, 2006 4:09 PM
To: Gorton, Gary; Forster, Andrew; Fewings, Tom; Teasel, Sheridan; McCormack, Sinead; Robinson, Peter; Martin, Andrew; Budnick, Adam; Frost, Alan
Subject: RE: Subprime Thoughts

I agree about how we handle A rated tranches in HG deals. Maybe instead of saying no A tranches, instead we haircut them or say no A- or worse. I don't know if I agree with Gary on allowing AA and AAA tranches of Mezz deals being put into HG deals. I look at these tranches as having direct exposure to BBB rated securities (the underlying collateral) even with some subordination - since we all agree that there is a lack of diversification among BBB subprime securities.

With regard to deals done, what I am most interested in is seeing what underlying notional is linked to specifically subprime BBB tranches in mezz deals. Since the deal structures have changed significantly over the last couple of years, old mezz deals might not be nearly as risky as new mezz deals.

From: Gorton, Gary
Sent: Wednesday, February 15, 2006 3:21 PM
To: Forster, Andrew; Park, Gene; Fewings, Tom; Teasel, Sheridan; McCormack, Sinead; Robinson, Peter; Martin, Andrew; Budnick, Adam; Frost, Alan
Cc: Gorton, Gary
Subject: RE: Subprime Thoughts

I think we should think more about A rated tranches off subprime deals and also reconsider AA and AAA rated tranches from CDOs of Mezz bonds from subprime deals. I think the really bad scenarios have BBB rated bonds being hit and possibly suffering significantly. Are we being a bit paranoid about the other situations? This question is important because Think it determines whether we have any chance of staying in the high grade market. If the street is to come around to our point of view -- maybe -- we shouldn't slam the door.

From: Forster, Andrew
Sent: Wednesday, February 15, 2006 11:34 AM
To: Gorton, Gary; Park, Gene; Fewings, Tom; Teasel, Sheridan; McCormack, Sinead; Robinson, Peter; Martin, Andrew; Budnick, Adam; Frost, Alan
Subject: Subprime Thoughts

Ok, I have to rush out so this is not proof read and nor I suspect complete but here is my take on our call yesterday. We are in the process of pricing up a portfolio of BBB names. I would appreciate any comments and additions so we can come up with a final "cheat sheet"

What we do not like:

We are no longer willing to write protection on the mezzanine tranches of subprime deals. This means all exposures rated A and below. We are still happy to write protection on all types of CDO but only those without subprime exposure, such exposure coming either directly or via other CDO's. We can still do deals with subprime collateral but our haircuts will mean that only small buckets will make any sense in terms of the ultimate attachment points.

Why do we not like the market any more:

We feel that the market is increasingly witnessing a decline in underwriting standards and that the subprime deals of today are not equal to those of previous years production. We also feel that older deals have the benefit of some strong house price growth which will help them to avoid a lot of the rate increases that would otherwise have been caused. Going forward we are less constructive on the housing market and so no longer feel that this solution will be available to many borrowers. The underlying bonds are increasingly correlated in our view and we are no longer comfortable treating them as individual obligations.

What about what we already have done:

We have done several deals in this space and have exposure of about [xxx]bn. A large part of this however is high grade collateral which we feel will be much stronger in its performance. Of the remainder [xxx] is in static deals so

this is previous years production that will benefit from the recent house price appreciation and we expect all those deals to perform well and pay off quickly. The risk remaining in the book is likely to be those deals that allow for replenishment. Clearly we could see those deals replacing amortising deals with new production mezzanine subprime risk. This amount however will be limited by all of the structural features we have in our deals such as trading turnover caps and also very tight loss triggers that quickly prevent this type of replenishment. Bear in mind as well that we are not predicting a precipitous fall in the market, it is more that as standards have changed and the market environment has moved on that we are no longer comfortable treating these deals as independent risks for our modelling. We fully expect all these BBB's to be money good but the correlation has risen dramatically in our view.