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FCIC memo of staff interview with Bill De Leon, PIMCO

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MEMORANDUM FOR THE RECORD

Event: Interview with Bill De Leon, executive vice president of PIMCO's portfolio management group

Type of Event: Interview

Date of Event: Wednesday, March 24, 2010

Team Leader: Tom Krebs

Location: 1717 Pennsylvania Avenue NW, Suite 800, Washington, DC

Participants - Non-Commission:

- Bill De Leon, PIMCO
- David Flattum, PIMCO
- John Sopko, Akin Gump

Participants - Commission:

- Tom Krebs
- Mina Simhai
- Desi Duncker
- Troy Burrus
- Landon Stroebel

MFR Prepared by: Karen Dubas

Date of MFR: April 22, 2010

Summary of the Interview or Submission:

John Sopko arranged a discussion with Bill De Leon, the executive vice president of PIMCO's portfolio management group. Mr. De Leon is now head of portfolio risk at PIMCO.

PIMCO is a large money manager having 1200 accounts for 2100 separate fiduciary accounts. Each account is viewed as a separate legal entity, and PIMCO has a duty to manage each account individually. PIMCO does not invest its own money, rather it invest, the funds of its clients.

Some of its accounts are designed for leverage (this comprises less than 10% of all accounts) 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 strong credit.

Almost all of PIMCO’s transactions are bilateral in nature, and all of PIMCO’s trades are with documentation. PIMCO indicated that they get a better deal for their clients with bilateral (as opposed to trilateral) repos. This is because PIMCO has to confirm what was agreed to be done had been done, and typically these “forward transactions” are short-term, meaning that their duration ranges from overnight to one week to one month. Additionally, in the tri-party repo agreements the values are determined by the custodial banks. Those values are too low and the haircuts are not sufficient. PIMCO looks at fails on a daily basis.

Bear Stearns

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 the day after not much trading was occurring.” He further stated market participants were very worried about counterparty risk and the haircuts for borrowed bonds changed dramatically from 2 or 3% to 5% to 10%. He described these haircuts as “unsecured” and explained when he gave $100 worth of securities and received only $95 in collateral, the five dollars was unsecured. He also stated 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.”

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 some of the smaller players—like small hedge funds—had some problems and spreads were marginally higher, but they were not so high as to dislocate the market.

However, following Bear Stearns failure in the spring of 2008, things changed permanently. Investors were scared and picky about with whom they conducted business. Even though there was only about one day when people stopped doing business, haircuts went up to 10% and never returned to their pre-Bear Stearns 2% margin. Mr. De Leon said haircuts stayed at 4% to 5% on high quality securities. The haircuts on risky mortgage pools went up to 30%, and the quality of mortgage pools generally improved. The spreads to borrow securities increased. Firms were deleveraging, and the cost of doing a deal was higher.

Lehman Brothers

After Lehman's failure, there was pandemonium. There was great uncertainty in the market, and haircuts went way up, so much so that some paper could not be financed. An additional problem, he said, was a lot of Lehman paper was involved in fails to deliver because they could not find it. If you used Lehman as your prime broker, your securities were “lost” for a time because they were caught up in the bankruptcy. Lehman’s matched book “fell over.” Many matched books stopped being matched. No one could tell where the securities were located. It took more than six months to figure out where securities were.

Haircuts were very high and everyone felt counterparty risk was very high. Rates for borrowing went up. People became much less willing to do short-term trades. The commercial paper market stopped working, and the market was not functioning because there were no buyers for commercial paper. Treasuries traded at zero yield. SIVs, which had been under pressure, were now under extreme pressure.

PIMCO is very cautious and was one of the few firms whose positions with Lehman were all collateralized. David Flattum, PIMCO’s general counsel, said PIMCO rehypothecated securities acquired in its repo agreements into its clients’ separate accounts for cash. Once Lehman filed for bankruptcy, it had failed to perform, so PIMCO’s clients were entitled to keep the collateral. PIMCO’s clients did have exposure to the Lehman bonds. It was explained it is generally difficult to exit a large bond position and no one expected Lehman to fail.

The commercial paper market did not start to recover until the Fed put the Commercial Paper Funding Facility into place and Treasury provided a temporary guarantee of money market funds. Slowly, things got moving. It took 3 to 6 months for the market to recover, but there was a lot less commercial paper issuance. The SIVs had disappeared.

In July/August of 2007 the asset-backed commercial paper market tanked. It has not recovered and is not coming back because conduits do not exist anymore.