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Sam Molinaro Follow Up From Wendy Edelberg

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Eric Goldstein

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Wendy Edelberg
Executive Director

August 9, 2010

Via Email & Mail
Mr. Samuel Molinaro Jr.
c/o Brad Karp
Paul, Weiss, Rifkind, Wharton & Garrison
1285 Avenue of the Americas
New York, NY 10019

Re: Financial Crisis Inquiry Commission Hearing on May 5, 2010

Dear Mr. Molinaro:

Thank you for testifying on May 5, 2010 in front of the Financial Crisis Inquiry Commission and agreeing to provide additional assistance. Toward that end, please provide written responses to the following additional questions and any additional information by August 23, 2010.[1]

1. Leading up to and during the "run" on Bear Stearns in March 2008:

    a. Was Bear Stearns' OTC derivatives dealing business affected? If so, please describe.

    b. Did potential counterparties refuse to enter into contracts with Bear Stearns? If so, please provide specific examples.

    c. Did existing counterparties try to terminate their contracts with Bear Stearns through novation or other means or did they try to reclaim collateral posted with Bear Stearns? If so, please provide specific examples.

    d. Did Bear Stearns's derivatives business contribute to the "run"? If so, please describe.

[1] The answers you provide to the questions in this letter are a continuation of your testimony and under the same oath you took before testifying on May 5, 2010. Further, please be advised that according to section 1001 of Title 18 of the United States Code, "Whoever, in any matter within the jurisdiction of any department or agency often United States knowingly and willfully falsifies, conceals or covers up by any trick, scheme, or device a material fact, or makes any false, fictitious or fraudulent statements or representations, or makes or uses any false writing or document knowing the same to contain any false, fictitious or fraudulent statement or entry, shall be fined under this title or imprisoned not more than five years, or both."

2. At the hearing, Commissioner Keith Hennessey shared his rendition of what happened at Bear Stearns leading up to its collapse, the text of which is located below. Please provide us written responses regarding how the narrative is incomplete and/or incorrect.

"Bear Stearns was not one of the biggest investment banks. Bear Stearns tried to grow quickly to be much bigger. They did this by increasing their leverage to be in the range of 35 to 1, or 40 to 1, compared to tangible common equity. They did this largely by betting on housing-related assets. Their bet was therefore largely concentrated in one sector. Mr. Friedman, you were heavily involved in the implementation of these housing-related investments and this concentration of risk. Like many other banks, Bear Stearns relied on overnight financing, short-term financing for liquidity. Short-term financing is significantly cheaper than long-term financing, allowing Bear to earn higher profits. Short-term financing is also riskier than longer term financing because of counterparty risk. Now, Mr. Molinaro, you led a shift from unsecured commercial paper as a short-term financing mechanism toward secured overnight repurchase agreements. The idea was that the added counterparty risk of relying on overnight financing was outweighed by the reduced risk from having secured financing.

For awhile this strategy, combining extremely high leverage, concentrated bets in the housing market, and reliance on short-term financing worked well. Bear Stearns grew and was profitable. Even after the housing market peaked, Bear continued to make highly leveraged bets on the housing market. They did not de-lever significantly, in effect doubling down on their prior bets. This strategy of big, concentrated bets financed by overnight financing failed even though that overnight financing was secured. While Bear Stearns argued they were profitable and solvent at the time, some investors made judgments that Bear Stearns was a credit risk and refused to roll over repurchase agreements even though those borrowing needs would have been secured.

Whether those judgments were substantiated or not, legitimate or not, a liquidity run began against Bear Stearns. Bear Stearns argues that the liquidity, the tightened liquidity, was system-wide rather than firm-specific, but we know there was something that differentiated Bear Stearns from other similarly situated firms because Bear Stearns failed first. Either Bear Stearns's firm leaders were wrong and the problem was firm-specific credit risk, more than system-wide liquidity risk, or Bear Stearns was more vulnerable than other firms to a system-wide liquidity shock. Whichever reason is true, Bear Stearns was not prepared for a scenario in which they could not get secured overnight financing.

> Bear quickly ran out of cash and faced impending liquidation. JPMorgan expressed interest in buying Bear Stearns, but only if the transaction was subsidized. The Fed provided that subsidy, and JPMorgan bought Bear Stearns."

The FCIC appreciates your cooperation in providing the information requested. Please do not hesitate to contact Sarah Knaus at (202) 292-1394 or sknaus@fcic.gov if you have any questions or concerns.

Sincerely,

Wendy Edelberg
Executive Director, Financial Crisis Inquiry Commission

cc: Phil Angelides, Chairman, Financial Crisis Inquiry Commission
Bill Thomas, Chairman, Financial Crisis Inquiry Commission

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*NOT ADMITTED TO THE NEW YORK BAR

September 10, 2010

By Email and Federal Express

Wendy Edelberg
Executive Director
Financial Crisis Inquiry Commission
1717 Pennsylvania Avenue, NW
Suite 800
Washington, DC 20006-4614

Financial Crisis Inquiry Commission ("Commission") August 9, 2010 Letter

Dear Ms. Edelberg:

On behalf of JPMorgan Chase & Co. ("JPMorgan"), I write in response to the Commission's August 9, 2010 letter to Samuel Molinaro. Below we provide Mr. Molinaro's response to your questions, to the best of his recollection.

* * *

1. During the "run" on Bear Stearns in March 2008:

(a) Was Bear Stearns' OTC derivatives dealing business affected? If so, please describe.

Response: Mr. Molinaro personally was not involved in Bear Stearns' day-to-day OTC derivatives business. Nonetheless, he understands that the Bear Stearns OTC derivative business experienced unusual trading activity during the week of March 10, 2008, in that certain existing non-dealer derivatives contract counterparties of Bear Stearns (primarily hedge funds) novated to third-parties a substantial number of their open trades with Bear Stearns. Novations would require Bear Stearns to settle collateral with the novating party, by either returning collateral to the novating party or seeking the return of collateral that Bear Stearns may have posted to the novating party. In turn, Bear Stearns would be required to settle collateral with the party accepting the novated trades. The fact that as the week went on an increasing number of novations were occurring also meant that dealer entities to whom the contracts were being novated were experiencing increases in the number of their open positions with Bear Stearns. Some dealer entities made margin calls against Bear Stearns during that week based on what Bear Stearns believed were unjustified valuations of open derivatives transactions. Such margin calls were disputed.

(b) Did potential counterparties refuse to enter into contracts with Bear Stearns? If so, please provide specific examples.

Response: Starting early in the week of March 10, there were rumors that some large financial institutions were refusing to accept Bear Stearns as a counterparty, but after investigation Bear Stearns was unable to find any basis for these rumors. Mr. Molinaro is unaware of and unable to provide specific examples of potential counterparties who refused to enter into derivatives contracts with Bear Stearns during the week of March 10.

(c) Did existing counterparties try to terminate their contracts with Bear Stearns through novation or other means or did they try to reclaim collateral posted with Bear Stearns? If so, please provide specific examples.

Response: Please see Mr. Molinaro's response to Question 1.a, above. He is unable to provide specific examples of existing counterparties who tried to terminate their contracts with Bear Stearns through novation or other means or who tried to reclaim collateral posted with Bear Stearns.

(d) Did Bear Stearns's derivatives business contribute to the "run"? If so, please describe.

Response: Mr. Molinaro believes that, particularly during the latter half of the week of March 10, 2008, certain unusual trading activity in Bear Stearns' OTC derivatives business did contribute to the run on Bear Stearns. In a normal market, novations are neither unusual nor significant, but in the context of a panicked market the number of novations Bear Stearns was experiencing later in the week did appear to Mr. Molinaro in hindsight as having contributed to the panic by fueling the rumors of the week of March 10 that Bear Stearns was facing a liquidity crisis.

2. At the hearing, Commissioner Keith Hennessey shared his rendition of what happened at Bear Stearns leading up to its collapse, the text of which is located below. Please provide us written responses regarding how the narrative is incomplete and/or incorrect.

"Bear Stearns was not one of the biggest investment banks. Bear Stearns tried to grow quickly to be much bigger. They did this by increasing their leverage to be in the range of 35 to 1, or 40 to 1, compare to tangible common equity. They did this largely by betting on housing-related assets. Their bet was therefore largely concentrated in one sector. Mr. Friedman, you were heavily involved in the implementation of these housing-related investments and this concentration of risk. Like many other banks, Bear Stearns relied on overnight financing, short-term financing for liquidity. Short-term financing is significantly cheaper than long-term financing, allowing Bear to earn higher profits. Short-term financing is also riskier than longer term financing because of counterparty risk. Now, Mr. Molinaro, you led a shift from unsecured commercial paper as a short-term financing mechanism toward secured overnight repurchase agreements. The idea was that the added counterparty risk of relying on overnight financing was outweighed by the reduced risk from having secured financing.

For awhile this strategy, combining extremely high leverage, concentrated bets in the housing market, and reliance on short-term financing worked well. Bear Stearns grew and was profitable. Even after the housing market peaked, Bear continued to make highly leveraged bets on the housing market. They did not de-lever significantly, in effect doubling down on their prior bets. This strategy of big, concentrated bets financed by overnight financing failed even though that overnight financing was secured. While Bear Stearns argued they were profitable and solvent at the time, some investors made judgments that Bear Stearns was a credit risk and refused to roll over repurchase agreements even though those borrowing needs would have been secured.

Whether those judgments were substantiated or not, legitimate or not, a liquidity run began against Bear Stearns. Bear Stearns argues that the liquidity, the tightened liquidity, was system-wide rather than firm-specific, but we know there was something that differentiated Bear Stearns from other similarly situated

firms because Bear Stearns failed first. Either Bear Stearns's firm leaders were wrong and the problem was firm-specific credit risk, more than system-wide liquidity risk, or Bear Stearns was more vulnerable than other firms to a system-wide liquidity shock. Whichever reason is true, Bears Stearns was not prepared for a scenario in which they could not get secured overnight financing.

Bear quickly ran out of cash and faced impending liquidation. JPMorgan expressed interest in buying Bear Stearns, but only if the transaction was subsidized. The Fed provided that subsidy, and JPMorgan bought Bear Stearns."

Response: As Mr. Molinaro no longer has access to the "complete" set of facts about Bear Stearns, he can respond to the question based on his own perspective on events and can say that he does not adopt Commissioner Hennessey's narrative, which he believes creates a misleading impression of what happened to Bear Stearns in a number of ways. For example, the suggestion conveyed in the first paragraph of the narrative that Bear Stearns adopted a reckless business plan of leveraging up its balance sheet to generate greater return on equity through a concentrated "bet" on housing-related assets is incorrect. Bear Stearns was a diversified investment bank (with operating business lines in research, sales and trading of institutional equities and fixed income, investment banking, global clearing services, asset management, and private client services) that had a wide variety of balance sheet assets and sophisticated hedges. As he testified on May 5 of this year, Bear Stearns' 2006 revenues of almost $9.5 billion were generated throughout the firm. The fixed income division (which included the residential mortgage business, as well as several other profitable businesses) accounted for $4.19 billion in revenues.

In addition, Bear Stearns' funding strategy, which sought to reduce use of unsecured short term funding and materially increase use of term secured financing, was designed to make Bear Stearns' funding less credit sensitive and thus more stable due to the collateralized nature of the borrowing – not to earn higher profits, as the first paragraph states. In fact, Bear Stearns' shift to secured financing made its financing more expensive, but this funding strategy was implemented nonetheless because Bear Stearns believed it would protect its balance sheet from tightening in the credit markets or other market stresses.

Moreover, the use of secured repo in implementing this funding strategy was not focused on overnight financing, as the first paragraph also states. Rather, the tenor of Bear Stearns' repo facilities matched the perceived liquidity of the assets that they were intended to finance. So, for example, in general short term overnight repos were used for the most liquid securities, longer-term repos for less liquid assets, and long term debt and equity financed those assets that could not be rehypothicated in the repo and bank loan markets.

Further, the characterization of Bear Stearns' leverage as "extremely high" in the second paragraph of the narrative is an inaccurate retrospective judgment. In fact, Bear Stearns' leverage ratio during the relevant time was not materially different from that of its peers and Bear Stearns believed it was appropriate. In addition, it is incorrect to suggest that Bear Stearns somehow "doubled down" on its mortgage market investments due to its failure (together with its peers) to anticipate the precipitous decline it was about to experience in the mortgage market. With respect to its leverage levels, Bear Stearns closely monitored and controlled its market, credit, and liquidity risk throughout the period. Given the information that was available to Bear Stearns at the time, it believed its leverage levels were appropriate.

The third and final paragraph of the narrative is misleading in suggesting that Bear Stearns' failure was attributable to the manner in which it was financed. As he has mentioned, Mr. Molinaro believes Bear Stearns failed as a result of the system-wide crisis that subsequently claimed Lehman Brothers and other financial institutions as well. Through 2007 and into 2008, as the disruption in the securitization market generally was taking place, the market gradually lost confidence in any form of securitized financing that was not guaranteed by the U.S. government. In his opinion, Bear Stearns proved to be "more vulnerable," becoming the first of the major investment banks to fall, because it was the smallest of the five major independent investment banks and a leading participant in the mortgage-backed securities market and thus was perceived as being more exposed to the housing market than its peers. When the housing market unraveled with a speed and scale no one foresaw, a widespread panic relating to the lack of transparency in the value of mortgage-related assets and lack of confidence in credit ratings caused the loss of investor confidence in institutions that were perceived as having a large stake in the housing market, including Bear Stearns. These conditions created an environment in which rumors of a liquidity crisis could create a classic run on the bank.

* * *

Pursuant to our conversation with you, we understand that this letter and the information contained herein will be maintained in strict confidence by the Commission and be used solely for purposes of the Commission's inquiry. Accordingly, this letter has been marked "Confidential Treatment Requested by JPMorgan," and JPMorgan is providing the information herein pursuant to this understanding.

The letter concerns customarily non-public, confidential, and privileged business, commercial, and/or personal information regarding JPMorgan, and/or its personnel, as well as those with which JPMorgan has done or is doing business. The Confidential Materials are thus not "agency records" within the meaning of the Freedom of Information Act, 5 U.S.C. § 552(b) ("FOIA"), and/or the Privacy Act of 1974, 5 U.S.C. § 552a ("Privacy Act"). Further, the Confidential Materials are exempt from

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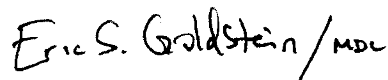
Any production of information herein that is subject to a claim of attorney-client privilege, attorney work product, or any other ground upon which production of such documents or information should not be made to the Commission, is inadvertent. JPMorgan requests that any such production in no way prejudice or otherwise constitute a waiver of, or estoppel as to, any claim of privilege, work product, or other ground for withholding production to which JPMorgan would otherwise be entitled. If a claim of inadvertent production is made with respect to information then in the custody of the Commission, JPMorgan requests that the Commission promptly return such information to JPMorgan and not use such information for any purpose.

If any person not a member of the Commission or its staff (including, without limitation, any government employee) should request an opportunity to inspect or copy the letter, or if you or any member of the Commission or its staff contemplates disclosure of the letter or its contents to any other person, JPMorgan requests that the Commission promptly notify Paul, Weiss, Rifkind, Wharton & Garrison LLP, 1285 Avenue of the Americas, New York, NY 10019 (attn: Brad S. Karp) and JPMorgan, 270 Park Avenue, New York, NY 10017 (attn: Stephen M. Cutler).

* * *

Please do not hesitate to contact me if you have any questions.

Very truly yours,



Eric S. Goldstein

cc: Ms. Sarah Knaus