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FCIC memo of staff interview with Phil Seares, Citigroup

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**DRAFT
MEMORANDUM**

TO: File
DATE: February 3, 2010; 6:30 – 7:15pm
RE: Meeting with Phil Seares

This is not a transcript of the proceeding and should not be quoted as such.

Biography from Paul Weiss

Mr. Seares is a managing director in Mortgage Trading at Citigroup Global Markets Inc. His responsibilities include residential mortgage loan trading and hedging activities. Prior to joining Mortgage Trading in May 2006, Mr. Seares worked in the Capital Markets division of Audit and Risk Review—first at Salomon Smith Barney, later at Citigroup Global Markets Inc.—from 1996 through 2001, then in Mortgage Finance at Citigroup Global Markets Inc. from 2002 through 2006.

Paul Weiss

Susanna Buerger, Joyce Huang, Phil

Citi

Phil Seares, Mimi

FCIC

Brad Bondi, Tom Krebs, Dixie Noonan, Karen Dubas

KREBS: [Explanation of FCIC mission & details and requirement to be truthful]

You are a managing director of mortgage trading?

SEARES: I am in charge of residential whole loan trading as well as some other off-the-run (trade less frequently) residuals off of securitizations and deep credit subordinates off of prime or Alt-A.

KREBS: You worked in the Capital Markets division of Audit and Review Risk?

SEARES: I left in early 2002. It's been almost eight years. I did audits of different portions of the company. I started in audit in 1996 when it was Salomon Brothers.

KREBS: What interaction did you have with the securitization desk?

SEARES: The securitization desk was buying loans, structuring them into securities, and selling securities.

KREBS: What interaction did you have with the CDO desk?

SEARES: I didn't interact with them too much throughout almost that entire time. Buyers of a lot of the securities were CDO managers. The Citi CDO desk had CDO managers at a different desk that would position different bonds for them while aggregating them up into a structure. We sold the bonds to the CDO managers.

KREBS: By bonds are you referring to RMBS?

SEARES: They would take them and have a dealer aggregate them and make them into CDOs. That's what Janice Warne did at Citi.

KREBS: How many people report to you now? What was the largest number of people who reported to you?

SEARES: Two people are reporting to me now, and maybe ten reported to me at the peak.

KREBS: To whom did you report?

SEARES: I reported to Jim De Mare when I was at the trading desk. Jim resigned in 2008, and then I reported directly to his boss.

I marked my own positions to the extent that I owned any bonds. At some point we had to mark the underlying bonds of the CDOs. That was after market collapsed and we dismissed a lot of people from that group.

KREBS: How did you accomplish hedging?

SEARES: Up until mid-to-late 2006, there wasn't really an ability to do a credit hedge. Hedging primarily revolved around interest rate risk. We would have long-duration interest rate risk, so we would sell something the opposite of that or correlated to the opposite of that.

SEARES: A typical subprime would be a portion of fixed rate, so our exit execution is via floating rate bonds. We'd pay fixed in a swap and receive floating LIBOR.

NOONAN: You just switch the interest, not the underlying collateral?

SEARES: We understood mortgage credit risk. We didn't want to take interest rate risk, so we used a swap to remove the risk that we weren't comfortable taking.

NOONAN: Was this a big part of your job?

SEARES: Yes. If you buy a bid and find out that you win, then you hedge. If there's a key economic risk that you know is coming, then you want to hedge against that. Wherever LIBOR was, you're hedging against that.

NOONAN: Are you hedging whole loan interest rate exposure?

SEARES: Yes.

KREBS: How do you go about valuing MBS?

SEARES: It's like any asset with a cash flow. It's the net present value of that cash flow.

KREBS: Was there a time when you became apprehensive about the MBS market?

SEARES: I traded, so it was my job to be concerned every day.

KREBS: What about after the Bear Stearns hedge funds collapsed in mid 2007?

SEARES: Of course.

KREBS: Were you concerned prior to that?

SEARES: Sure. Every time you do a trade and you have a bid out there and you win, you become concerned. You worry that you overpaid or wonder why you won. If you don't think that way, you're going to get in trouble.

KREBS: What about when mortgage originators failed?

SEARES: When New Century failed, it was worrying, because we had a warehouse line with them. After their failure, credit spreads widened.

If you bought loans assuming an exit strategy and came up with a price of how you'll be able to sell them—and then suddenly that is 100 basis points wider—then your loan is worth less.

KREBS: Did you talk with other traders about your concerns?

SEARES: Yeah, we talked all of the time about things. We sat in a row together.

KREBS: Did you talk to the structuring desk?

SEARES: The CDO desk was a different group but it was within Jim De Mare's lines. We were a business unit so of course we talked and worked together.

KREBS: Did you have lots of interaction with Susan Mills?

SEARES: Yes. I worked for her before I worked for Jim. We had lots of post-mortems after the fact—in 2008 and 2009—about what we saw and what should we do.

We did see very gradual worsening of the collateral over time. In 2005 the typical subprime pool would have 10% of the pool where income was stated. In 2007, the pool would have 40% stated income. It was very gradual though—it was a percent or two increase a month.

We saw that risky aspects of loans were increasing, so we started stressing our models more, and we started pricing in 5-6% losses where market was pricing 2-3% losses.

NOONAN: You would bid on and purchase the whole loans that then Susan would securitize?

SEARES: She had people who reported to her who created the securities. But I took risks based on certain assumptions about the security, so I was consulted in the securitization process.

People would put out a package of \$5 or 6 billion, and you had to buy them all.

NOONAN: Did you do carve-outs?

SEARES: Carve-outs didn't come about until 2008 or 2009. I tried to buy the ones with the best collateral. In 2006, we were #1 or #2 to Wells Fargo, and Wells Fargo was viewed as most conservative and the best underwriters.

NOONAN: Best in terms of what?

SEARES: They had the best quality in terms of being least likely to default.

NOONAN: So of pools that were offering the same yield, you looked for the best quality?

SEARES: We were trying to intermediate. There were plenty of people who wanted to buy bonds, and there were people with loans to sell. I was only trading subprime. So I'm talking about the best quality in terms of what I was allowed to do.

KREBS: Did you interact with the surveillance unit?

SEARES: I knew about it, but most of the information that they would get would come after the fact. We had Chinese walls up. I was on the public side, and I couldn't be in possession of material nonpublic information. Insider trading is scary—people go to jail for that. Surveillance reports were absolutely kept away from the trading desk. There's a secondary market to think about.

Susan would see early defaults, but she wouldn't share that information with me. I would eventually see them at the same time as the rest of the public.

KREBS: She talked about remittance reports and early payment defaults.

SEARES: That was in early to mid 2007. That was really alarming. To protect ourselves, when we would bid we would ask for more default protection. The standard request was one month of default protection.

KREBS: How quickly could you turn a transaction around?

SEARES: It took one to two months depending on the transaction.

KREBS: In the absence of an actual transaction, how do you mark a security?

SEARES: In general, it was easy to mark because there was a market. Once liquidity dried up, we would look for the few securities that were traded and try to find something analogous and mark it at as close as you could make an educated guess.

KREBS: When did it become difficult to obtain a good market value marks for securities?

SEARES: That was in late 2007 to mid 2008. There was some trading in the cash market or the CDS market.

BONDI: You described how you would hedge interest rate risk. How about credit risk?

SEARES: For awhile there wasn't really a good tool. Right around the turn of the year, between 2006 and 2007, ABX started trading a little more. I would attempt to hedge out some portion of the bottom of the capital structure. If I still had loans in my position that I felt were securitizable, we would buy protection on something we thought was similar. I tended to underhedge because there wasn't a lot of information about hedging ratios.

BONDI: When did you start to hedge credit risk?

SEARES: That was in January or February of 2007. I had wanted to do it earlier, but there were some concerns from my managers about the illiquidity of ABX. The initial hedging trades were in credit default swaps on RMBS bonds.

BONDI: Who were the counterparties on the CDS?

SEARES: I don't really know. There was another person who traded CDS, and he would tell me what was available, and I would put bids in.

BONDI: Did you ever short synthetic CDOs as a hedge?

SEARES: No, never. I couldn't price them. They were too complicated.

BONDI: Did you sell RMBS to the CDO desk at Citi?

SEARES: The guys that we had on the phone were CDO managers. They are external parties. Our CDO desk would aggregate the securities for the managers. As far as we knew, we wrote trade tickets to XYZ counterparty. It could be anyone.

BONDI: We've mentioned the Bear Stearns hedge funds. Did you do trades with them?

SEARES: We sold them res bonds. Yes, I was involved with them.

BONDI: Did you ever stop sales to them?

SEARES: I think they stopped buying maybe a few months before they failed.

BONDI: What was Jim De Mare's role in your trading?

SEARES: He literally sat next me. There's not a lot that I was doing that he didn't know about. Did he ever direct me? I'm pretty sure that management is involved in setting risk limits, and I'm sure he helped define what the parameters were. I would have talked to him before I would invest \$1 billion of the firm's money. He talked with me about credit risk hedging. He was aware of what I was doing.

BONDI: Did he come up with this credit risk hedging strategy?

SEARES: We certainly didn't invent it. We talked about it and might have come up with it together.

BONDI: Did there ever come a time in 2006 or 2007 when he got more involved in your trading?

SEARES: No, it was the same level throughout.

BONDI: Did you ask him for his advice on trades?

SEARES: All of the time.

BONDI: Did you sell RMBS to Fannie, Freddie, or Ginnie?

SEARES: I sold to Fannie and Freddie, but not to Ginnie.

BONDI: Who was on the other side of the phone at Fannie and Freddie?

SEARES: Cheyenne was on the other side at Fannie, and Lori G. was on the other side at Freddie.

BONDI: What type of RMBS were sold to Fannie?

SEARES: They bought seniors and Aaa rated bonds. Same with Freddie. They were seniors on subprime.

BONDI: What was the volume of what you sold to Fannie and Freddie?

SEARES: Over a few years, we sold Fannie \$7-8 billion. Freddie would be a similar number. For awhile we did more trades with one, for awhile more with other, but I don't think we sold more to one than the other overall.

BONDI: Did you always do subprime with both GSEs?

SEARES: Yes.

BONDI: What happened in August of 2007 in the asset-backed market?

SEARES: Prices dropped quite a bit.

BONDI: When did the market freeze up?

SEARES: It froze sometime between June and September.

BONDI: What did you do after the asset-backed market froze up?

SEARES: I did my best to hedge the remaining assets that we had. I still tried to sell some things that we had. I had some success in both of those cases. I bought a few pools of loans at end of 2007 from firms going out of business.

BONDI: What type of hedging did you do?

SEARES: It was the same type of hedging. I used CDS and ABX, just at higher ratios.

NOONAN: Why would someone give you that protection?

SEARES: These are shorts, which go up in value as prices go down. If someone wants to buy it, then you sell it.

BUERGEL: The asset-backed commercial paper market froze in August of 2007. The asset-backed securities market did not freeze; there was still trading.

BONDI: How did buyers change after August 2007?

SEARES: They were mostly hedge funds and CDOs and came less frequently.

NOONAN: Could you describe the basic economics of RMBS for Citi?

SEARES: It's an intermediation business. You buy and you want to sell, and hopefully the price that you're selling is more than the price that you paid. There's a bid-ask spread.

NOONAN: So you didn't take a cut on deals?

SEARES: There's no cut to take. It's based on interest rate and spreads. You keep all of the risk. Instead of a spread, think about it as dollars.

BUERGEL: He is putting his bid on the pool based on what he expects to sell the bond for.

SEARES: You're structuring them as securities. You're breaking up these loans into bonds. We're a broker dealer. We're breaking up loans into different tranches with different risk values. They want to buy the bonds.

NOONAN: What would be the absolute value of what you pay when you buy of a pool of loans compared to the absolute value of the securitization?

SEARES: You can't know that. You can't price it in.

NOONAN: How were you incentivized?

SEARES: It was based on profit and loss. Hopefully profit. That's why I sell to make a profit.

NOONAN: How does it come back to you?

SEARES: There are certain reps in the deal. But also, if I sell someone a bad bond, they won't buy from me again. It's reputational.

The profit is anywhere between a quarter and a point. P&L in 2006 was about \$100 million.

BONDI: Have you given a deposition before?

SEARES: Yes, I gave a deposition to FINRA.

BUERGEL: It was on the record.

SEARES: I was interviewed by the SEC, OCC, and Fed while they were doing regular inspections. I was never by anyone in the enforcement division.

BONDI: [Explains requirement for confidentiality]