8-9-2010

Paul Friedman Follow Up From Wendy Edelberg

Wendy Edelberg

Eric Goldstein

August 9, 2010

Via Email & Mail
Mr. Paul Friedman
c/o Brad S. Karp
Paul, Weiss, Rifknd, Wharton & Garrison
1285 Avenue of the Americas
New York, NY 10019

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

Dear Mr. Friedman:

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. 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."

1717 Pennsylvania Avenue, NW, Suite 800 • Washington, DC 20006-4614
202.292.2799 • 202.632.1604 Fax

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

PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP

1285 AVENUE OF THE AMERICAS
NEW YORK, NEW YORK 10019-6064

TELEPHONE (212) 373 3000

LLOYD K GARRISON (1946 1991)
RANDOLPH E PAUL (1946 1956)
SIMON H RIFKIND (1950 1995)
LOUIS S WEISS (1927 1950)
JOHN F WHARTON (1927 1977)

WRITER S DIRECT DIAL NUMBER

212 373-3204

WRITER S DIRECT FACSIMILE

212 492-0204

WRITER S DIRECT E MAIL ADDRESS

egoldstein@paulweiss.com

UNIT 3601 FORTUNE PLAZA OFFICE TOWER A
NO 7 DONG SANHUAN ZHONGLU
CHAO YANG DISTRICT
BEIJING 100020
PEOPLE S REPUBLIC OF CHINA
TELEPHONE (86 10) 5828 6300

12TH FLOOR HONG KONG CLUB BUILDING
3A CHATER ROAD CENTRAL
HONG KONG
TELEPHONE (852) 2846 0300

ALDER CASTLE
10 NOBLE STREET
LONDON EC2V 7JU U K
TELEPHONE (44 20) 7367 1600

FUKOKU SEIMEI BUILDING
2 2 UCHISAIWAICHO 2 CHOME
CHIYODA KU TOKYO 100 0011 JAPAN
TELEPHONE (81 3) 3597 8101

2001 K STREET NW
WASHINGTON DC 20006 1047
TELEPHONE (202) 223 7300

500 DELAWARE AVENUE SUITE 200
POST OFFICE BOX 32
WILMINGTON DE 19899 0032
TELEPHONE (302) 655 4410

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 Paul Friedman. Below we provide Mr. Friedman'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.

(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.

Response: Mr. Friedman's main responsibility at Bear Stearns was to oversee the Fixed Income Repo Desk. Mr. Friedman lacks sufficient personal knowledge regarding Bear Stearns' OTC derivatives dealing business to answer the Commission's questions on this topic.

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: Mr. Friedman does not adopt Commissioner Hennessey's rendition of the events leading to Bear Stearns' sale to JPMorgan, and does not agree with several of the statements contained in Commissioner Hennessey's narrative.

For example, Mr. Friedman does not agree with the statements that Bear Stearns relied on short term financing for liquidity and that Bear Stearns made "big, concentrated bets financed by overnight funding." As Mr. Friedman set forth in his May 2010 testimony before the Commission, until late 2007 and early 2008, Bear Stearns used short term financing, including overnight funding, largely to finance highly liquid assets, such as United States Treasury securities and agency mortgage-backed securities. Until the repo markets began to experience instability in the summer of 2007, the firm generally funded its other, less liquid assets with long term financings that were typically 6 months in duration or longer. Throughout the second half of 2007 and early 2008, Bear Stearns undertook extensive efforts to obtain and even increase the amount of long term financing that the firm used. Accordingly, Bear Stearns did not, as a general practice, use short term funding to finance less liquid assets until the instability in the funding markets in 2007 and 2008 made longer term financing unavailable for certain of those assets.

As reflected in Mr. Friedman's written testimony, he does not believe that Bear Stearns pursued a flawed funding model or one that was fundamentally different from its investment banking competitors. Mr. Friedman maintains that system-wide illiquidity and an effort by lenders to reduce their overall exposure to Bear Stearns caused the liquidity crisis at Bear Stearns. Just a few months later, every other major investment bank experienced similar difficulties.

Mr. Friedman further notes that several of the topics addressed in Commissioner Hennessey's narrative are beyond his personal knowledge. For example, while the narrative asserts that Mr. Friedman was "heavily involved" in Bear Stearns' purported decision to increase its leverage through housing-related investments and its alleged "concentration of risk" in such investments, in fact, Mr. Friedman was not involved in any such decisions, if they occurred.

* * *

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 disclosure under various provisions of FOIA; the Privacy Act; the Trade Secrets Act, 18 U.S.C. § 1905; and/or other applicable provisions of law, regulations, and statutes.

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/MDC

Eric S. Goldstein

cc: Ms. Sarah Knaus