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Financial Crisis Inquiry Commission Interview With David Einhorn of Greenlight Capital

November 9, 2010

INTERVIEWER:
So it's November 9, 2010. We are interviewing Mr. David Einhorn at Greenlight Capital. Mr. Einhorn, thank you for taking the time to talk to us today. My name is Chris. I'm with the Financial Crisis Inquiry Commission. With me today is Clair. We were created by a statute enacted last year called the Fraud Enforcement and Recovery Act of 2009 that tasks us with figuring out the various causes of the financial crisis and delivering a report by the end of this year, actually in about a month. That statute includes many things for us to look at and we figure given your background at Greenlight and what you've been doing for the last several years, it made sense to talk to you. So with that, let's just dive right into it. My understanding is that you started Greenlight and have been there since 1996, right?

DAVID EINHORN:
Correct.

INTERVIEWER:
Okay, so let's just go right into the areas that we had talked about with your counsel before and that is I think just generally the first thing I want to ask you is, generally what were you looking at that made you short the companies that you did, both company specific and non-company specific factors?

DAVID EINHORN:
And this is like in the fallish of '07 time period?

INTERVIEWER:
Yeah, I mean you don't need to limit yourself to '07. I mean if you were noticing things for example in the housing market before then and that caused you to short housing related companies or otherwise, I'd be interesting in hearing that. But certainly we're also interested in '07 and '08.

DAVID EINHORN:
Okay. We short a lot of companies in a lot of different areas. It's just part of our ongoing business. We also long a lot of companies in a lot of areas. In fact we're always long more than we're short and our primary business is that we we're always sort of long-biased, if you would. So I think it's important, because we may talk a lot about the short selling and so forth, that you recognize or anyone who's listening recognizes that our primary business is with a long-bias towards things.

The first financial shorts that we shorted that pertained to the general topic that I understand that you're investigating were the monoline bond insurers, most particularly MBIA and then later Ambac. With the MBIA short, really commencing I think in 2002, by which point we had realized that their business model didn't make any sense. And later as we investigated that over a number of years, we became very concerned relating to how MBIA was relating to other participants in what later became

the financial crisis, most particularly the credit rating agencies, and later eventually the investment banks. We had got a much heightened sense of the coming credit crisis in August of 2007. The most clearly precipitating event in my mind was when BNP Paribas froze the money markets of some of their customers, which struck me as reflecting the complete failure of the securitizations. And that combined with a view that a lot of AAA-rated securities had been purchased by entities and people, including foreign people and entities that simply did not want to assess the credit worthiness of what they were buying and they bought it because it was AAA. I felt that the failure of the AAA securities was going to lead to a rejection of securitization and so in August of 2007, we did sort of a quick research project to identify companies where their business was reliant upon securitization. And when we found them, and I think we found approximately two dozen over the course of the weekend, that was the basis for instituting short positions pending doing additional work.

INTERVIEWER:
And so were those, the 24 companies that were dependent on securitizations, you don't need to list me all 24 by name, but generally what types of companies were they? Were they the I-banks and various mortgage companies and things like that?

DAVID EINHORN:
Yeah, they were investment banks. They were commercial banks. They were certain companies that were dependent on real estate. They were the rating agencies, the bond insurers, the mortgage guarantors and I might have missed a miscellaneous one or two but that's the gist of where they were.

INTERVIEWER:
I know from looking at some of the things you've written before, some of your speeches, at least in terms of MBIA, I think you wrote that in addition...that over time, 1: they were becoming more leveraged and 2: they went from just insuring municipal securities to insuring structured credit. Was there other facts besides those two things that got you concerned about MBIA and I take it by extension, Ambac and the other monolines?

DAVID EINHORN:
Yeah, I came to the idea that first of all that the business itself didn't make any sense. That the business was to take credit risk for a small fraction of what the market said the credit spread was. I mean that's the premise of the business. The market said credit spread is 200 basis points, we will insure it for 50 basis points, the insured bond will trade 100 basis points tighter so the issuer will split the savings with us, we'll keep 50 and they'll keep 50 and so forth. And we didn't understand why it would make sense to have a business that charges 50 basis points to take what the whole rest of the market says is 200 basis point of credit risk as a general proposition. And as we investigated it, we realized a couple of the things. The first was that the accounting was giving them reasonable economics because the accounting itself wasn't describing the economics. The company put up boss provisions that were by definition a percentage of premium as opposed to a measure of the actual risk that they had taken on. So literally if you were going to charge a dollar premium and you were to put up I think 10 per cent of that as a loss reserve, call it 10 cents, I forget what the exact figure was. If you came in the next day, reduced your price and charged 50 cents to take the same risk, now you would put up a loss reserve of only 5 cents. So the less they charge, the worse the deal was for them and the lower loss provision that they provided.

The second was they were front loading the revenue recognition relating to the premiums, particularly on the structured finance business. They had this convoluted way of saying that the risk was expiring on an accelerated basis, even though we believed that the accounting rules said that the risk needed to expire actually as the principal and interest payments were being made. In other words, if you had a bond that was just a single payment and it was in 10 years, after 1 year, you still were insuring the full value, none of the risk was expiring. But MBIA would have recognized 10 per cent of the profit on that. One year had passed. And we wrote various letters to the SEC and the accounting authority. What are those guys up in Connecticut called?

INTERVIEWER:
The FASB?

DAVID EINHORN:
FASB, yeah, on this topic. We met with FASB to discuss it.

INTERVIEWER:
Okay.

DAVID EINHORN:
So we thought that their accounting was bad. If you fast forward then there was the question of as it became clear that MBIA's business was actually impaired, why was it that the rating agencies were so reluctant to take away their AAA rating? And from that we identified a major conflict with the rating agencies, which was that the rating agencies loved having monoline bond insurers rating say municipalities and structured finance for that matter because once they were insured, they could be rated AAA and the rating agency didn't need to actually monitor the deals.

INTERVIEWER:
Well, I hear you saying that, but I mean if the rating agency sees a monoline insurer insuring a deal, presumably they're looking at the monoline insurer.

DAVID EINHORN:
That's right, that was the rationale. So the rationale was it was very effective for the rating agency to leave the monoline as a AAA because they didn't have to check whether XYZ municipality in California was screwing around with their pension. Because as long as MBIA had guaranteed it, they didn't have to worry about that bond, it was AAA.

INTERVIEWER:
Right.

DAVID EINHORN:
But the corollary to that was if they downgraded MBIA, they were going to have to review literally tens of thousands of credits.

INTERVIEWER:
Did you ever talk to the folks... I mean I think I've read you saying that before, that one of the reasons they had an incentive not to downgrade the monolines was because then they'd have to do more work on what the monolines were insuring. Did you ever have any discussions with the credit rating agencies about that?

DAVID EINHORN:
Yes I did. I went to Moody's office and discussed it with them.

INTERVIEWER:
And when did you do that and what did they say?

DAVID EINHORN:
That meeting had to have been approximately late 2007 or maybe even a little bit before that. I would have to check.

INTERVIEWER:
If it helps, they did the mass downgrades of the RNBS in July of '07 and then the CDO's in October of '07.

DAVID EINHORN:
Yeah, and when did they get around to actually downgrading MBIA?

INTERVIEWER:
That I don't know off the top of my head.

DAVID EINHORN:
Right, the answer is I'm not sure but I think it was late '07 and we could get back and give you an exact date because there's a record of it.

INTERVIEWER:
Okay.

DAVID EINHORN:
Okay, but in any case, when I met with them, their basic attitude was – they had half a dozen people in the room including their most senior people – was that they were on a listening tour. They weren't going to react to anything that I said. And so I would say I got no reaction, but the idea that there were… that the conflict that I identified and pointed out to them, it certainly didn't strike them as something…you could tell from the body reaction in the room, that I wasn't telling them anything they didn't already know.

INTERVIEWER:
Who did you meet with?

INTERVIEWER:
Yeah, do you recall who you actually met with at Moody's?

DAVID EINHORN:
There would be a record of that, I don't know off the top of my head.

INTERVIEWER:
Okay. Was that your only meeting with them?

DAVID EINHORN:
Yeah, it was just one meeting.

INTERVIEWER:
Did you meet with any of the folks at either S&P or Fitch?

DAVID EINHORN:
No.

INTERVIEWER:
Okay. Did you talk to the SEC or other folks about the concerns about the rating agencies?

DAVID EINHORN:
Not in this context, no.

INTERVIEWER:
What context did you, if that's what that meant?

DAVID EINHORN:
I'm not sure; I don't remember any conversation with the SEC.

INTERVIEWER:
Okay. I guess I want you to continue to sort of chronologically in August of '07, as you said you see BNP Paribas freeze redemptions and that gives concern and you're talking to the rating agencies among other things and you've identified the type of companies that you had concerns about. Can you just sort of take us through chronologically through the end of '07 and into '08 and how things changed, if at all, for you folks?

DAVID EINHORN:
Yeah absolutely. So this is sometime in August, we put on a bunch of positions and our team here basically divided up the names for sort of further work cause we wanted to figure out which were the ones that were the most exposed. Whereas the initial couple dozen was ticked off relatively quickly over the course of a weekend, which is not our normal amount of time to due diligence, but I felt that given what was going on, there may not be a lot of time. And so we began putting on those couple dozen positions a little faster than we ordinarily would if we were just researching an individual security.

So from there we began concentrating our work and trying to figure out well which were the better, more exposed companies and which were the less

exposed companies and over the course of the next couple of months, we focused the list down and we covered a number of the shorts and we increased a number of the shorts as we focused on the people that we thought were most vulnerable.

INTERVIEWER:
And generally, do you recall what companies you found to be most vulnerable? Of course we all know about Lehman.

DAVID EINHORN:
Yeah, I think the ultimate list would be something close to Lehman, Bear, MBIA, Ambac, Moody's, Wells Fargo, HSBC.

INTERVIEWER:
So the one to me anyway that sort of sounds curious out of that list is Wells. How come, do you recall why they were on the list? I didn't know that they had a big subprime or real estate mortgage exposure.

DAVID EINHORN:
Wells is actually the number one originator of subprime mortgages in 2006, according to the industry statistics. Now they subsequently denied that they ever originated a single subprime mortgage, which is interesting. It's inconsistent with what happened in 2006.

INTERVIEWER:
Right, okay.

DAVID EINHORN:
I knew this when I was on the board of New Century. I mean Wells was right there as a top competitor.

INTERVIEWER:
You know I know I have this but I just don't know off the top of my head, how long were you on the board of New Century? Do you remember when you joined it and when you left?

DAVID EINHORN:
Yeah, it was less than a year.

INTERVIEWER:
Okay. So, through August, September, October 2007, time permitting you continued to do due diligence and cover and increase shorts on this smaller universe of companies down from the two dozen. Continue, continue the chronological story please.

DAVID EINHORN:
Sure. As we concentrated on these particular ones, there was one thing that came out, that I thought was very interesting, was the rating agencies held conference calls supporting the credit worthiness of the investment banks. And each rating agency did it, it was apparent to me from listening to these conference calls, that the rating agencies had little idea what was really going on at the investment banks.

INTERVIEWER:
And why was that?

DAVID EINHORN:
Well for example, on one of the calls they had said that the investment banks had done a lot of hedging of their credit risk. And I asked on the call, I said, "Where did they do all this hedging?" Right, because the amount of exposures was enormous and it wasn't clear to me how a person could hedge such exposure. And the rating agency analyst who was on the call said, "Have you seen the volume on the Mercantile Exchange in Chicago?" Which kind of sent me into a research project of how do you hedge credit risk on the Mercantile Exchange in Chicago? And after doing research, we were able to determine that you can hedge interest rate risk there through various types of contracts, but there is no instrument in Chicago with the Merc that allows one to hedge credit risk. Which literally meant that the rating agency analyst was making up on the phone an answer to a question to justify maintaining confidence in these banks.

INTERVIEWER:
Now when you were hearing that from the rating agencies as an example of why the investment banks were just fine, my term not yours...I've seen in your writing that the concerns you've expressed over the past with the investment bank model was the ones that others have expressed and that at least now a lot of people understand: highly levered short term funding, not a whole lot of transparency on the balance sheet in terms of growth exposures and in terms of derivative exposures. Can you talk about that a little and whether or not you see that as any kind of contributing cause to the financial crisis?

DAVID EINHORN:
I don't know how to adopt what you just said. It seems to be commonly understood at this point. I would add that the investment banks are further handicapped by paying out so much of their revenue in compensation, which causes them to earn returns on their equity which is inadequate for the risk that they take, to also encourage them to take more risk because they pay out compensation as a percentage of gross revenue. So if you borrow an extra dollar and lend it and make a spread, or even that you're going to gross interest return, and you start paying that out in compensation, you've added leverage, you've added compensation but you may not have added anything to your earnings.

INTERVIEWER:
And I've seen in your writings a little more specifics on that, that there were concerns not only about the leverage, but about the composition, the capital, because of one, the net capital rule that the SEC adopted in '04 that allowed you to include hybrids and sub debt and deferred tax assets and all

that kind of fun stuff in capital. Do you have any opinions and I've read some of your opinions about the SEC, but more broadly do you have any opinions about why the SEC missed the boat, for lack of a better term, on the level of capital, the quality of the composition of capital, etcetera at the I-banks?

DAVID EINHORN:
Yeah, can I supplement my previous answer before I answer that question?

INTERVIEWER:
Of course.

DAVID EINHORN:
Okay, the other major thing with the investment banks that you didn't allude to, is the use of the value-at-risk models which made no sense from my judgment because they cut off the tail. And the whole point in my view with risk management is to prepare yourself for what happened in tail events. And second, because the people who are running the banks, or who were involved with the banks, understood that the risks in the tails were being cut off, they effectively were able to game the system by buying securities that in the model showed no tail risk and therefore required no capital or almost no capital.

INTERVIEWER:
Right, and so I guess I would add that to the same list of things that why do you think the SEC didn't understand that or if they did understand it, didn't do something like say, "You got to hold more capital. You got to hold more long term sources of funding. You got to hold more equity."

DAVID EINHORN:
My understanding is that the SEC was told that you had banks in Europe that were under these kinds of value at risk standards, that US banks could not compete if the SEC did not adopt similar rules to what was going on in Europe and so they bought into this whole analysis and recognized even at the time that it would lead to lower capital levels. There was a philosophy at the time that it was not in the bank's interest to blow themselves up, so therefore they wouldn't do that. And then there was the further deficiency that the SEC really allowed everybody to just do their own calculations and it's not at all clear that the SEC did anything to actually monitor the calculations or to test them the way like a bank examiner would. And so you had a lot of self-reported stuff which led to enormous abuse. And I can't account for why the SEC behaved this way other than it might have just been their political philosophy at the time to really allow the market to sort of sort all this stuff out.

INTERVIEWER:
And again, did you ever talk, I mean you've had issues with the SEC from reading stuff, but did you ever talk to them about your concerns about the investment banking model and all these specific points that we've been talking about?

DAVID EINHORN:
No, when these changes were being done, I was unaware of the topic. So I was not in any way involved in that conversation.

INTERVIEWER:
Well but, and I get back in '04 when the net capital rule was adopted back then, but in the '07, '08 time frame when you've identified a couple dozen companies and then narrowed it down to include at least two of the investment banks, Lehman and Bear, I take it that at that point you and your folks at Greenlight, sort of understood all these points we're talking about. Is that accurate?

DAVID EINHORN:
Yes, that's accurate.

INTERVIEWER:
And at that time, are you having any conversations, I guess not even just with the SEC, but with other folks, about what is the SEC doing? And I've read the April '08 and the May '08 speeches where you address it there, but I'm just wondering what kind of conversations you were having either with other market participants or the SEC itself or other regulators or government officials about what you folks had identified as a fair amount of uncompensated risk in the IB model.

DAVID EINHORN:
You know we had very little in terms of the external conversations aside from what I would say at the various speeches, but it doesn't mean I didn't talk to anybody about anything, but it was not something that was terribly prevalent. We certainly didn't talk to the SEC about it. I wouldn't even have known who to call.

INTERVIEWER:
Okay. So another thing that we've noticed that I sent to you Mike earlier in the week or over the weekend, I'm losing track of the days, was when we get into the first quarter of '07, there were a fair amount of early adopters of FAS 157 and now we've got level 1, 2 and 3 asset disclosures coming in 10K's and at least for the I-banks are being filed in I guess in the March time frame since they had a November year end back then. Did that kind of, and I've read in your speeches that you saw that as providing some more transparency and appeared to provide some concerns because you were seeing basically concentrations of Level 3 assets to tangible capital as opposed to GAAP capital, but could you talk a little about whether or not the disclosure in 1Q07 of the Level 1, 2 and 3 assets provided any additional information for you folks and more importantly, whether it provided concern to you folks?

DAVID EINHORN:
There were various times where we looked at that along with the all the other data, but I don't think…and so it was useful in certain circumstances, but I don't think broadly it was terribly important and frankly I think the more meaningful accounting change was the 159, which allowed to financial institutions to book gains based upon their own debt going down in value.

INTERVIEWER:
And did you see a big income statement impact from that, from 159?

DAVID EINHORN:
Yeah we did and you still do to today. There are still financial institutions showing big income statement aspects of 159.

INTERVIEWER:
Let me take you back to...we've been talking about the rating agencies a little and how they had problems. Do you have any views or opinions on…cause one of the things we've seen is that a lot of folks did simply appear to be relying on the ratings, particularly the AAA ratings. Any opinions about why a lot of investors simply relied on those as opposed to doing some additional due diligence?

DAVID EINHORN:
I think that the rating agency AAA was marketed on a global basis for a long period of time as meaning that there was substantially no credit risk.

INTERVIEWER:
And I understand that and my question is obviously it sounds like folks like you and the folks at Greenlight weren't saying, "Oh, it's a AAA, it must be great, let's go along," but it appeared a lot of people were. Again, any discussions with folks out there, any views on why at least it appears a lot of investors simply relied on the AAA rating without doing additional independent research?

DAVID EINHORN:
Yeah, I think the take on the opinion that a AAA entity was rated something less than AAA may have not been that controversial but the idea that a AAA entity would actually default was practically sacrilegious. This went on for a very long period of time. We had this with MBIA for five years running and it wasn't AAA in 2002 or 2007 or any of the years in-between and probably the 10 years before. But to take that point of view, I mean it was a little bit like being a member of the flat earth society. It's pretty far out there.

INTERVIEWER:
Now what one area that I suspect you may have some comments on and that were asked to look at in the statute is the issue of short selling itself and whether or not that was any contributing cause to the financial crisis. And I've seen in some of your speeches and your writings where you've said that look, when companies start complaining about short sellers, that's a sign that perhaps they might be in trouble, one, and two, you're own personal experiences of why is the SEC spending time looking at short selling instead of looking at public disclosures by public companies that may not be what they should be? So I guess my first questions is, what role if any do you think short selling has as a contributing cause to the financial crisis? And my second question would be if you could, sort of give us a little more color on that tradeoff, on that curiosity that you've talked about in your speeches and your articles about companies that are complaining about short sellers or could be the ones that are in trouble.

DAVID EINHORN:
Yeah. I don't have any knowledge of short selling contributing to the financial crisis. I sort of don't think that it did. I think market participants reacted to the fundamentals and that's what causes security prices to move. The odd behavior of people shooting the messenger when they can't engage in a substantive debate, I don't think that that's controversial at all. I think that's sort of unfortunately standard warfare in today's playbook of what do you do if you got your hand caught in the cookie jar. You attack the messenger.

INTERVIEWER:
There's stories out there or at least anecdotes that oh, all these hedge funds get together and decide to target a company and drive its stock price down. And again, just the basic question, have you ever heard or seen of anything like that?

DAVID EINHORN:
Well I've heard the anecdotes. I'd like to know when these things happen and who's there. I heard there was a champagne brunch celebrating the fall of Bear Stearns, but I don't know anybody who was there. I don't think it existed, so this is folklore as far as I can tell, propagated by people who want to invent explanations for things that suit whatever their purposes are.

INTERVIEWER:
Well we do know that the SEC at least apparently investigated potential short selling of Bear and Lehman I think in the March '08 timeframe and the September '08 timeframe and did not find that there was any causal connection between short selling and those firms demise. So at least they've done that. So let me ask you about something else that is in our statute that I think you've spoken to before and that's the issue of mark to market accounting. I mean it's another area that folks ask us to look at and the argument on the one side is, look when you're in a period of declining asset prices, particularly with with illiquid securities, where there's not a lot of price transparency and you're in panic markets for lack of a better word, that mark to market accounting is a

problem because it requires firms to, particularly I-banks that are primarily mark to market books with trade securities, to mark their assets down to “fire sale prices”. It just becomes a vicious cycle. Do you have any views on that?

DAVID EINHORN:
My view is that if the rules by the accounting authorities are set up to require mark to market accounting, then the participants in the market ought to follow them. If the accounting authorities decide that we shouldn’t have mark to market accounting, then the participants in the market should follow those. But my attitude is that whatever the rules are, market participants should follow the rules.

INTERVIEWER:
Do you have an opinion on what the rules should be?

DAVID EINHORN:
I think it depends for different institutions, you know in different ways in what they’re doing and I think people need to set up their businesses in a way that accommodates the risk that they have. I mean the mark to market accounting was put in as I understand it at the instigation of the very same banks that wound up complaining about the mark to market accounting because they wanted to mark in the gains as soon as they happened so they could pay bonuses. So, look I think there’s good reasons for different types of things to either be mark to market or not be mark to market based upon the business purpose of why they assets are being held. I would not want to make a blanket statement as to what should and shouldn’t be mark to market.

INTERVIEWER:
Let me change the tracks a little and go back to the investment bank model and funding. One of the things that we saw both in Bear and initially in Bear, they had a fair amount of repos, I think $50 to $80 billion, I forget the exact amount, and when the run hit them, one of the things that apparently surprised folks at the SEC and the Fed was that there was a run on repo that was backed by agencies and treasuries. I guess that caught them a little by surprise. You know unsecured commercial paper is one thing, repos that are financing treasuries and agencies were another. Was that something that you were aware of at the time and that surprised you?

DAVID EINHORN:
I’m not aware of it even until you just told me.

INTERVIEWER:
Okay. When you were looking at companies, for example like Lehman and Bear in ’07 and ’08, what were you looking at on the funding side of the balance sheet if anything? I know you were looking at the asset side of the balance sheet.

DAVID EINHORN:
I was not looking at the funding side of the balance sheet. I was looking at the overall leverage and so forth, but there was not anywhere near the kind of disclosure I think you would need to make a judgment of the funding, so I took from a short seller’s perspective, the conservative point of view and just assumed that the funding was fine.

INTERVIEWER:
Okay.

DAVID EINHORN:
That way if it turned out to not fine, that would just mean that the situation was even worse than I realized.

INTERVIEWER:
Right, right. What were you looking at that was not company specific in ’07 and ’08? And obviously, let me just ask, I mean one of the areas that’s probably not surprising and that we’re looking at, is the housing market and just the whole level of the types and the composition of securities that were out there.

DAVID EINHORN:
Yeah, my attitude was that it was more of a credit bubble than just a housing bubble. And that you had all kinds of spreads at rates that didn’t make any sense mostly because of securitization, re-securitization, bad behavior by credit rating agencies.

INTERVIEWER:
And when you say the spreads didn’t make sense because of…I mean I get the credit rating agency part, but because of securitization and re-securitizations, what do you mean by that?

DAVID EINHORN:
This idea of carving up risk and then spreading it out would be securitizations, where you have a difference between the person who’s originating the loan and the person who ultimately will bear the credit risk if it doesn’t perform, or parts of the credit risk. And then re-securitization is taking already securitized, I guess bonds, and putting them into new securitizations. So then those would be generally called either asset backed CDOs or in some cases CDO squares.

INTERVIEWER:
Right and we’ve actually been looking at that and I wanted to ask about this, but did you see any change, and I don’t even know if you were looking at it, over time about who was actually purchasing the CDOs. I mean one of the things we’ve been looking at and I think we’re close to actually figuring out, is who were purchasing these things over time and it looks like in ’06, or at least the second half of ’06 and throughout I guess August of ’07 when it pretty much stopped, a lot the CDO tranches that were being purchased were being purchased by collateral managers that were simply putting them in other CDOs and the

hedge funds and pension funds and traditional buyers of CDOs were not really there anymore. Do you have any knowledge about that at the time or now?

DAVID EINHORN:
The thing that actually surprised me the most was how much of the stuff was kept at the banks.

INTERVIEWER:
So like the Merrill's and the Citi's of the world?

DAVID EINHORN:
Yeah, exactly. I was very surprised about that and in fact when we did our research in August and September time frame of 2007 to figure out which ones we wanted to increase our short positions in or cover, we made a number of conclusions that various of these financial institutions did not have large exposures after reviewing whatever filings and talking to whoever we could talk to and then those conclusions proved to be incorrect. They turned out that they had much more exposures than anybody could figure out, even from a careful reading of their filings and so forth.

INTERVIEWER:
Let me ask you about that, cause we've seen that too and in particular in the case of Merrill, that everybody started to find out in October of '07, and that is when you looked at the Q's and K's, you would always get net writedowns and net exposures, but you wouldn't get the gross numbers and I guess everybody at least understood, well there is a gross exposure and presumably the difference has to do with monoline hedges and things like that. But I haven't seen personally, at least prior to the 3Q07 either analysts on conference calls or analysts in their report saying, "We need to see the gross numbers so we can have a better idea of what the real exposures were." Was that something that you folks were trying to find out about or were seeing as a deficiency in financial reporting?

DAVID EINHORN:
Yes, and I would add that we read a number of false denials.

INTERVIEWER:
So like, and again I don't know how you guys and other hedge funds do their business, but I would assume that perhaps after looking at a Q or a K, you actually call us the company and say, "Hey we have additional questions. Can you answer them for us?" Was that kind of stuff going on at Greenlight?

DAVID EINHORN:
Sometimes, sometimes it was.

INTERVIEWER:
Of course we know about the phone call with Erin Callan on Lehman but more generally, were companies willing to provide additional information for example on gross real estate exposures?

DAVID EINHORN:
Different ones in different ways. I remember Morgan Stanley did a pretty good job in particular even though it then turned out they had some other loss relating to the AAA stock that we didn't detect. They at least were sort of aware of things. For example their financial supplement was relatively robust compared to their peers. You could contrast that with Citigroup which disclosed nothing; I mean thousands of pages but nothing that you could figure anything out from.

INTERVIEWER:
Okay, let's move to bigger picture stuff. Let me just go right to the biggest picture stuff that we're asking folks and that is: What do you see as the primary causes of the financial crisis?

DAVID EINHORN:
Right. My answer to that is kind of all of the above, you know. I've read a lot of stuff about people saying it was this thing or it was that thing and I think it was just all of those things coming together and I think each of them have some responsibility. I've heard very few of these theories that I would dismiss, whether it's relating to the regulatory behavior, the legal structures relating to the housing market, the oversight of the lending standards by the bank regulators, the capital requirements of the investment banks, the behaviors of the rating agencies, the failures of the securitization model, the incentives of bankers to game the risk management systems. I think all of that was prevalent and I think it all contributed.

INTERVIEWER:
What about one of the things we haven't talked about that's in our statute and that, at least in something I read, you had mentioned about before, or maybe this is one of the things you can just blame on Michael Lewis, but that is the whole role of a derivatives and I think what I saw, it might have been in the January '09 Op-Ed piece, was particularly credit default swaps. Any views on those being a contributing cause to the crisis?

DAVID EINHORN:
Oh absolutely. I think the prevalence of derivatives, concentrated derivative positions, where there's still really no disclosure in financial statements, whether they're interest rate derivatives or credit default like derivatives. I think all of these things contributed to the leverage in the system and really hidden in unanalyzable leverage in the system.

INTERVIEWER:
There is some folks out there that have written that the whole increase in synthetic CDOs, which of course is just another way of saying credit default swaps, contributed to, if not primarily caused, spreads to not widen out on CDO tranches and perpetuated the prices those things selling at par and therefore perpetuated the housing bubble. Any views on that?

DAVID EINHORN:
You know the failure of the AAA rated securities, have brought, and the belief in the AAA rated securities prior to that, had broad implication. And the idea that you could have synthetic securities that were effectively rated AAA, that could therefore be given to any large bank, where they would essentially be assigned zero capital charge, meant that there was practically infinite demand for AAA rated stuff. And so that in effect was a subsidy that allowed all kinds of poor credit and lending decisions to continue.

INTERVIEWER:
Have you ever…let me go back to what we were talking about before about the value at risk model and how they don't predict what's going to happen if you have tail risk at the end of the distribution. Did you ever have any discussions with for example the chief risk officers of any of the I-banks or any of the other folks about these VaR measures that we see in your SEC filings are very helpful because they don't fundamentally do what risk managements folks are supposed to do, and that is see what's going to happen if you do, God forbid, have a tail risk event?

DAVID EINHORN:
I don't think I talked to any chief risk officers.

INTERVIEWER:
What about others?

DAVID EINHORN:
I don't think in any terribly serious way. I think I talked to some people somewhere along the line at both Morgan Stanley, Goldman Sachs about this. Not like in a formal presentation, more like a dinner or something like that.

INTERVIEWER:
So you mentioned earlier you were on the New Century board for about a year. Do you recall when you joined the board?

LAWYER:
Yeah, it was the spring of 2006 and just on this topic, I didn't know this was something that you were going to go into, there is a bunch of litigation related to New Century that David's been involved in, so because this is something unlike the typical type of interview, the government is going to go, as I understand it, on a website someday and be public. This is an area where I don't know that we're going to want to get into a ton of in-depth.

INTERVIEWER:
What my question was going to be was really just sort of a high level is, what happened? What were the problems that led to its bankruptcy? Is that something that Mr. Einhorn can address?

LAWYER:
No, I don't think that's a topic that… you need to give us a heads-up if that was the topic we were going to go into. I haven't discussed it with David before and the litigation.

INTERVIEWER:
Sure, what about just how…the circumstances of him becoming a director? Just you know, who contacted him, how it came to be.

DAVID EINHORN:
We've been shareholders for a good period of time and the company earlier on was an originator of loans, subprime loans, and they were selling the loans. And then somewhere in the years prior to me joining the board, they began to switch their strategy, where they began retaining the loans on their balance sheet. And I thought that that was a poor business decision and rather than sell the stock, because I did like the origination business, I lobbied with the potential proxy fight, which was eventually settled by me joining the board. I lobbied to do that because I wanted to see if I could encourage the company to retain less credit risk and just sort of unwind the decisions that they had previously made that I felt were diminishing the value of the business.

INTERVIEWER:
So you wanted them to go back to being a traditional mortgage banker?

DAVID EINHORN:
Correct.

INTERVIEWER:
Did they?

DAVID EINHORN:
No. I didn't have enough time.

INTERVIEWER:
Right. Okay. When you went on the board, did other folks go on the board with you?

DAVID EINHORN:
No.

INTERVIEWER:
Bear with me. Okay, let me just ask you, I know we're getting close, let me ask you some specific questions about Lehman. Again, I've read the April '08 and the May '08 speeches that you had and then I think even a speech after their failure in '09 talking about stuff. And we've of course heard the stories about the subsequent conversation with Erin Callan or I should say the interim conversation with Eric Callan. But you know we've looked at Lehman and we actually had a hearing on them in the context of too big to fail and I guess what I'd like you to do is just sort of give us any additional color that you can on what you saw at Lehman that made you short them. And like I said, I've read the speeches so I know the general story of the real estate positions, the failure to take what you thought were sufficient losses and the lack of transparency and the lack of good answers that you were getting

about changes between earnings disclosures and then the numbers in the Q, where it looked like they had written up stuff by about a billion dollars. But other than those things that we already know, what else were you seeing at the company that was giving you folks concern?

DAVID EINHORN:
Fundamentally Lehman was picked as one of the stocks in August of 2008 without too much work.

INTERVIEWER:
I take you meant August '07 right?

DAVID EINHORN:
That's right, August of 2007, without too much work, yeah, I'm getting old. I became particularly alarmed when I heard their subsequent earning conference call where they brought their earning release forward ahead of other investment banks. They had a number of items that they wanted people to exclude from their earnings and rather than disaggregate them, they lumped them together and refused to say what was what. That included a change in the fair value of their liabilities, which at the time I had never heard of and they were not clear about. But only later, maybe a few days later when Morgan Stanley announced earnings, I figured that was this FAS 159. And I felt that they were generally evasive on their conference call.

INTERVIEWER:
I'm sorry, just so the record's clear, I think you're talking about the call shortly after the Bear deal?

DAVID EINHORN:
No way before. I'm talking about at the end of their August quarter, so probably sometime in September.

INTERVIEWER:
Okay, okay thank you.

DAVID EINHORN:
This is all in September of 2007. I became sort of concerned by that, by all those kind of things. This was the time when Lehman was saying that they were hedged and the world still believed that Goldman and Lehman had hedged and nobody else hadn't. And I began asking questions like, "How do you hedge $30 billion of mortgages and $30 billion of commercial real estate, like where is that?" And that led to kind of questions I was asking of the rating agencies for example. And they told me about the Merc. And cause I knew there were these instruments like ABX and CNBX and I knew you could if you worked really hard, you could buy a billion of them or 2 billion, but I didn't see how anybody was going to be able to do 30 billion of each, which is probably what Lehman might have needed to do to be actually hedged. Then when they released their 10Q, I saw that they moved 9 billion of mortgage assets from level 2 to level 3 and it appeared that they had not written them down. But you couldn't tell for sure.

Then in November, I gave a speech about Lehman Brothers at the Value Investors Congress, where I highlighted the risks and the additional thing I did was I studied what Lehman did in 1998. And in August of 1998 the securitization market also stopped just as it did 9 years later. And people at the time, we weren't involved with trading the securities, but I remember the news accounts, people at the time generally thought Lehman Brothers might have been insolvent. And I went back and I reviewed their SEC filings from that time and saw they never even reported a loss, which suggested to me that they may have a game plan of just sort of denying things and waiting for them to get better. And it seems to be consistent with the language they were using in September of 2007 where they thought this was going to be a short term 1 or 2 quarter kind of problem. And so I came to become suspicious. So I gave a speech about all of this at the end of November in 2007. That prompted a conversation at Lehman's request, with their management where among other things, when Chris, what's his name, O'Meara, was on the call, I asked him about the 9 billion transfer of the mortgages, like, "When did you do that? Was it during the quarter, at the end of the quarter?" And he gave me the answer that, "Well we do this all the time. We mark these things every day. We transfer them back and forth all the time, just whenever. We mark our whole book every night." Literally in the middle of that call, he had to get off and they brought on a more junior person to continue the call and I asked the junior person the exact same question and I got the opposite answer, that they only mark this at the end of the quarter, that they only put these things on at the end of the quarter and then they hadn't written them down, which meant to me that this 9 billion of mortgages had been moved from level 2 to level 3 in part to avoid having to write them down.

So that kind of carried us through to the end of 2007 and into early 2008 when they started increasing their dividends and announcing enormous share repurchase promises. Meanwhile we were continuing to learn more about what was going on there, whether it was the Archstone-Smith deal or various other real estate oriented transactions that we knew them to be involved with that appeared to have huge problems. It didn't seem like there was a place for them to have written it down in their financials. And that's really sort of then what carried us into the Bear Stearns quarter, which was really two quarters later.

INTERVIEWER:
What about the, I know we're getting close, but other than Lehman of course, you had mentioned Bear, MBI, Ambac, Moody's, Wells Fargo and HSBC. Again, what were the main things you were seeing in those companies and you don't have to go to

the specifics of each one because we don't have a lot of time left, but if you could just generally tell us what you were seeing and you've already covered some of MBIA and Ambac generally since you know what the concerns of those monolines.

DAVID EINHORN:
Right, the monolines were the monolines. I thought that the rating agencies had huge problems as a result of their actions and I felt that securitization which was a big part of their revenue was going to go away. And I wondered whether there would eventually be legal liability for what they had done. Bear Stearns was, in my view, a less bad version of Lehman. They just had a balance sheet full of mortgages that it was pretty clear were just not likely to be able to be transacted in and it wasn't clear to me how it they were possibly marking them down enough.

INTERVIEWER:
Did you see the same…did you have concerns about the same kind of, what I'll term game-playing, you know switching stuff from level 2 to level 3 and that kind of thing?

DAVID EINHORN:
No, I don't know if it was as much game-playing as just simply not writing stuff down.

INTERVIEWER:
Okay. Well Mr. Einhorn I see we are at the end of the time. So thank you very much for taking the time to talk to us. We do appreciate it. I will tell you what I tell everybody at the end of these. I think we had everything we need. If we have any follow-up questions, I'll contact your counsel but I doubt that'll be necessary.

LAWYER:
Okay, do I need to do anything to request a tape or are you guys just going to send that to me?

INTERVIEWER:
Well you've just done it so now we will send you a copy of the audio file. It's actually a digital recorder, not a tape, so yeah, we'll have that sent to you.

LAWYER:
Great, I appreciate it.

INTERVIEWER:
All right, thanks guys.

DAVID EINHORN:
Thank you, bye.

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