Just a reminder, today's conference is being recorded.

Erica: Okay, so who wants to start?

Rob: Let me start with a preface. So we're live on the air now?

Erica: Yes.

Rob: Okay.

Erica: All systems go, Rob.

Rob: Okay, all right. Here at New Deal 2.0 today we're pleased to be able to talk with the guest, Jim Chanos, famous hedge fund manager and a short-seller, who's been very involved in market developments for the better part of three decades and has – how would you say, played a very interesting role in public policy as well.

The Enron situation which Alex Gibney covered in his film, "The Smartest Guys in the Room." Is, I want to say, a portrait of social discovery of financial misdealings. And Jim played a very, very large role in the developments that led to the book and the film.

He's been a very successful investor for many years. I've known him since the days that I worked with George Soros. And in recent days through a series of press articles in the United Kingdom following a radio interview that he did, we are seeing a very, let's say a bit of uproar directed at Gordon Brown, who seeks reelection this fall.

And it suggests that policy officials, Gordon Brown among them, did have information that our financial system was highly unstable and that Jim Chanos, and other hedge fund managers had given a briefing in Washington in April of 2007 suggesting that they should take decisive action.

According to the press accounts and the radio interview Jim describes that he and others who gave testimony or evidence on that day were ignored.

Jim, thanks for being with us today.

Jim Chanos: Thanks, Rob. I'm glad to be here.

Rob: Gillian Tett speaks about this episode in her book, *Fool's Gold.* And she talks about a whole cadre of high level ministers; the people who were responsible were there. Can you set the stage for us? Can you tell us essentially the context? Why were you invited to Washington and what was it that you were talking about that day? Thanks.

Jim Chanos: Yes, Gillian did a very good job chronicling this episode in her book, *Fool's Gold.* I was invited along with one other hedge fund manager as well as hedge fund industry representatives to represent the industry at the G7 Finance Ministers Conference in Washington which was being held at the World Bank in mid-April of 2007.

We were invited to present to the Ministers and Central Bankers on Sunday, the last day of the session, basically the hedge fund industries view point as to why hedge funds would not be, or perhaps would be, these source of future systemic risk.

If you recall at that time, the Europeans, particularly the Germans, were concerned that hedge funds would be the source of future market systematic upheaval if it occurred. And the Germans happened to be chairing that spring session. So they set the agenda.

And the Under Secretary of the Treasury at the time, Bob Steel, invited myself and another manager to basically make presentations as to why we thought that would not be the case.

And both the other manager, who has been identified as Paul Singer, that's public, and myself, took the opportunity to make presentations pointing out something a little bit different from what the Germans thought.

Rob: So in essence you came in to present a view not only that was representative of the hedge fund industry, but also a portrait of where the Achilles heel might lie in contemporary financial markets and financial structure?

Jim Chanos: Right. If you recall, before April of '07 there were some very, very ominous cracks in the walls of finance that occurred. You remember that the Bear Stearns hedge fund blow up occurred in June. So that was still two months away. But we had had in the fall and winter of '06-'07 the first falterings of some U.S. non-bank financials in the subprime area, New Century and others, that had begun to stumble with large amounts of default in recent loans.

If you recall the peak in loan issuance, I believe, was late-'05 and early-'06 for this area. And then you had in February, late-January and February of '07, HSBC, the big global banking giant, which had bought Household International, a U.S. subprime lender, began to – through experiencing severe deterioration in its U.S. subprime portfolio.

So there was not just conjecture at this point. There was some sign posts along the road already. Finally, for anybody who was tracking it, the sort of artificial market indices that were set up to track these esoteric debt instruments like collateralized debt obligations, CDO's, and so on and so forth, had begun to crack pretty hard in February, March from par to somewhere, as I recall, par being 100, down to the high 70's or low 80's.

So already a market indicator of subprime health had already become to deteriorate rather dramatically by the time this meeting occurred.

Rob: And you also mentioned in other conversations we've had about this episode that SEC releases, the 10K reports, were indicating some very, very substantial vulnerability among the major financial institutions.

Jim Chanos: Well, that's what got me very concerned. In the two week period between the end of March '07 and my presentation mid-April, my staff had begun to review the SEC 10K filings, which are the annual reports that companies file at the SEC.

And they usually do in March for the year ending in December; some of the entities were November entities. So they already reported their 10K's in February.

But what was interesting for the 2006 10K's which were filed in early '07 was that for the first time the banks were fessing up under this new accounting regime to get esoteric FAS 157 which was the so-called mark-to-market accounting rules.

And for the very first time we were getting a glimpse under the hood like we never had. And which big banks and brokers were telling us how many of their financial assets that were securities were either Level 1, Level 2 or Level 3.

Level 1 being something that had a very active market, for example, shares of IBM which trade every day on the New York

Stock Exchange. You know what the closing price is, it is what it is.

Level 2 assets being a little bit more problematic because they are assets that are priced off of something else. So if I owned an esoteric debt instrument that historically has traded at some spread or gap to U.S. Treasury Bonds, I would attempt to value that debt instrument at some spread based on market conditions on where U.S. Treasury Bonds were.

So there was an observable input, the Treasury Bond price, that accounted for where you valued that asset. But yet, there was still some judgment involved, obviously. There was not necessarily a day-to-day liquid market price.

Finally, we have Level 3 assets which some have dubbed toxic or radioactive. And this had the oxymoronic phrase attached to it – these were assets for which there were no observable inputs. So the inputs were all to value these assets in ______ were all judgmental.

Management would make certain assumptions about various different things that might apply to the valuation of this asset and plug it into their computer; the computer would spit out a model – a number.

And Level 3 assets, as we now know, were the most problematic in the crisis to come because often they were the pieces of paper that could not be sold to third-parties when deals were done.

So the banks and brokers retained them on their own balance sheets, but as we now know did not reserve enough for any unforeseen circumstances. They certainly didn't appear to be in their models.

Those numbers, Level 2 and Level 3, were off the charts when my staff looked at them in April of '07. And I think there was a growing sense on the street in that two week period among some reporters that were writing about it and other hedge fund managers that looked at the same things we looked at, that my God, these numbers were far worse than we thought, and the banks were far more leveraged to the most hard to value illiquid assets than we thought.

Rob: We actually even saw, as the crisis unfolded, many of them used the mystery of Level 3 assets to mock up valuations to hide their

losses elsewhere. I would say we really were in an area that was what you might call pregnant with the possibility of hiding things or misreporting things, but the overall context that you're describing is a system that's way overburdened and very, very vulnerable and potentially gonna drop a big, big bill on the taxpayers shoulders.

Jim Chanos: Ironically, to tie in the Enron situation, it's exactly that type of accounting that got Enron in trouble. These mark to model accounting for what would now be called Level 3 assets. The energy derivatives that we're creating.

And since there were no liquid markets in those energy markets and Enron dominated the trading in those markets, Enron had the ability to make whatever assumptions it wanted to long-term about the value of energy, prices of energy, volatilities, you know, credit counter party risk and so on and so forth, and really derive whatever it wanted to when it booked the deal.

In many cases we now know that bank proprietary ______ did exactly the same thing that Enron was doing in energy derivatives with its derivatives, with its financial derivatives.

And so the lessons that we thought we had learned in 2001 and 2002 from the Enron debacle, which led to Sarbanes-Oxley shortly thereafter, you know, less than three or four years later were being repeated in the banking sector. It's quite remarkable if you think about it.

Rob: Yeah. Now, let's look at this again in the context of this G7 briefing. You have just painted a very vivid portrait of something that's happened before in the case of Enron, that policy officials should, how we say, they should at least see the parallels.

Jim Chanos: Right.

Rob: Very, very concrete numbers, large bank, like HSBC, talking about the U.S. subprime exposure, derivative indices like the CDL index cracking. These are not what you might call conjectures. These are not portraits that you're painting, these are analytical facts. How did the G7 ministers at the time react to your presentation?

Jim Chanos: Well, I'll preface it by saying that the other manager, Mr. Singer, went first, and I'm sort of glad he did because his firm was actively monitoring some of these esoteric instruments in his hedge fund.

He traded in them. And his presentation involved the instruments themselves and what I – these structured finance products were sold as AAA safe securities to a large number of people because of their structure and because of the various natures of the accounting and the insurance behind them, which we now know in many cases was written by AIG, by the way.

And that these were not AAA securities and that the toxic tranches were at this point almost worthless despite what banks might be carrying them on, and that if there's any more deterioration in the residential real estate market, which we now know, of course, there was, that large amounts of securities that people thought were going to be AAA were not going to be.

And all the assumptions behind this giant structured finance system were suspect, and he gave some examples and then he referred to the HSBC, he referred to these indices cracking. So he sort of set the stage for my presentation which followed his. And mine simply was, "Well, if you believe Mr. Singer, and I do, the problem is not going to be with us, i.e. hedge funds. It's going to be with institutions that you already heavily regulate, the large banks and brokers. Because that's where this stuff resides."

And I began to recount the numbers that we just talked about a few minutes ago in this call, the Level 2 and Level 3 assets to tangible equity, the stunning amounts of leverage involved in the system, the nature of the accounting of these pieces of paper that was highly subjective, the growth in those Level 2 and Level 3 assets in the past two years, and why this all could easily, if there was any distress in residential real estate or subprime spread to other areas, could cause a crack up in the world's largest financial institutions.

And, you know, the numbers were what they were. They were irrefutable. So whether you agreed with the conclusion or not was a different matter, but they were what they were. And that's why I sounded the alarm on the banks and brokers. And, I, of course, indicated that as a result of our work we had gone short for our clients, the largest institutions, most of them anyway.

So I made sure to obviously disclose that. But I felt that on the other hand, the public policy ramifications of pointing this out far dwarfed anything that was gonna happen to my fund or anybody else's for that matter. The fact we were looking at just a giant, giant canyon of capital losses.

Rob: Let me, before we talk about the response of the officials, underscore what you just said. You would be viewed by a policymaker as someone who's earning their livelihood from your portfolio, and policymakers are skeptical of listing to market participants because they think the investor is trying to cajole them in a direction that enhances their returns.

But in this case you're disclosing that you're short these institutions, and you're talking to them, warning them, in a way that could mitigate a crisis and diminish the returns that you would otherwise obtain.

So in essence, you are talking about public policy here very distinctly from what would benefit you, which would be – in your portfolio – which would be this calamity.

Jim Chanos: I do have four children and I sometimes put other things beyond any financial return, and the size of this problem was so large that, you know, if I wasn't going to sound the alarm bells certainly I figured someone else would, and I was being asked by the U.S. government to come and give a presentation and give my thoughts freely and I took that seriously.

I thought it was important if we had done this work that we pointed out at this point already some well respected members of the financial press. I'd already written columns about this Level 2, Level 3 assets relative to tangible equity. So it was, I felt, not the first, but it certainly I wasn't going to also abrogate my responsibility and not say anything. In fact, I thought it was that important.

Rob: I'm just trying to underscore that they should not see your message as conflicted.

Jim Chanos: Oh, if they had taken the right policy actions at that point I probably wouldn't have made near the amount of money that I made, nor would my clients. You're absolutely right about that.

Rob: Yeah.

Jim Chanos: But on the other hand, you know, I think that the system of – might have – on balance I still might have been better off for all the things that may happen in the future based on the policy prescriptions that they did have to make. So you can't ignore that.

Rob: Especially when –

Jim Chanos: When you bring your four children into the mix, there may be a long tail to the consequences of what –

Rob: They're very well ______ ______.

Jim Chanos: Be a long tail based on their delays and their slapdash policy responses.

Rob: Yeah, well, let's return to the context of the meeting. So you and following Mr. Singer have been kind of a double barrel presentation where you've shown ominous signals.

Jim Chanos: Yeah.

Rob: Let's talk about how people reacted to you then and then in the aftermath of the meeting. What – without picking on particular policymakers, what – how did they look at you? How did they react? Were they curious? Were they dismissive? How would you describe it?

Jim Chanos: Well, there was a lot of sort of – you have to keep in mind this was Sunday afternoon. You're at the end of the conference. But I think we were seen probably as much as an annoyance as anything else from people who wanted to catch a plane or get home.

But there was some uncomfortable paper shuffling. There was sort of, you know, that looking at the ceiling across the table. There was a bit of eye rolling. There's no doubt about that.

And at the end of my talk the fellow running the meeting asked if there was any questions. There were literally no questions and at that point the Chair of the meeting said, "Well, that's all very interesting and now what do you think about insurance."

And it was just that complete realization that we've got – it just didn't sink in, the import was not grasped, certainly by the Chair, that they were gonna move on to the next item on the agenda with nary a bit of discussion.

And then shortly after the meeting ended, a few hours later, there were two central bankers, both EU central bankers who came up to me and with their assistants and we exchanged contact information, and both said they thought that my presentation was very interesting and if I had anything additional please send it to them, and to keep in touch and blah, blah, blah.

And that was sort of it. I was thanked by the U.S. delegation and we went on our way. And both Paul Singer and I left the room sort of incredulous that the presentation, which was fairly ______ to everybody sort of some standards, really elicited no official questions or comments.

Rob: And let's take and now look at – we've had a crisis, we have many policy officials, including Gordon Brown, who will attest that there was no way they could have seen it coming, which I would say today's conversation contradicts rather violently.

And now they've made a series of proposals. You have the G20 reports, the Financial Stability Forum, which is now called the Financial Stability Board, and others are going to meet more. You're going to appoint the Federal Reserve as the systemic regulator.

It feels to me like we're kind of shuffling the deck chairs. It feels to me like the same people who ignored your presentation are the people who are trying to reassure the public that they have the expertise and if they just talk a little more on the phone or meet a little more frequently that somehow that's gonna solve the problem.

Am I being too cynical?

Jim Chanos: I don't –

Rob: How do you –

Jim Chanos: – think you're being too cynical at all. The ability of these organizations to move quickly and consult each other is glacial. So in markets that move so quickly and deteriorate so rapidly, you know, the need to call a G20 staff meeting or, you know, convene boards and get everybody together and then, first of all, you know, agree on protocol, and then agree on the principals and then agree on steps. You know, by that time the target in question of their interest might be in smoking ruins.

Rob: Yeah.

Jim Chanos: So from your days, I mean, you know full well how slowly these institutions move. They move – they are not – they're certainly not proactive and when they're reactive, they're reactive slowly.

So you have, you know, you have the classic, I call it the 20th Century French General staff problem. I mean, brilliantly fighting the – learning the lessons and fighting the last war.

And we're going to have this problem come up again and again, because, in fact, institutions like the large banks and brokers will do their best to both engage in regulatory capture and use whatever accounting rules are open to them legally to obfuscate any problem areas.

We've seen this time and time again in the banking industry and the brokerage industry in the 20th Century. I see no reason why that won't continue.

We've already seen a movement toward it in the move – the lobbying by the banks in the spring of '09, this year, to liberalize the mark-to-market rules and make more opaque balance sheets.

You should think, if anything, we've learned to tighten up the accounting and to make things more transparent so that the Jim Chanos', the Paul Singer's, can make these warnings in the future and point these things out.

Instead, they've made that job more difficult at the request of the banks. So you've already seen that this is not going to work.

Rob: That talk about markets and efficient markets in academic theory and they talk about how these markets need information and these very same – you might say collection, of PhD's and regulators when under stress of problems that involve bailouts and embarrassments vis-à-vis the taxpayers, do exactly what you're saying.

They're deteriorating the quality of information and hiding the problems and making it harder for the markets to act in an efficient manner, and sends what you might call proper signals for resource allocation.

Jim Chanos: Well, there's two important aspects of the efficient market theory and the capital asset pricing model, and that is number one, transparency of information. That all market participants have the same information and it's as detailed as convention allows. That's number one.

The second is a market place full of both interested and disinterested buyers and sellers, meaning that one can sell

something, if the price is too high, that one doesn't own, i.e. a short-seller, if he or she feels that the price is effective enough to make delivery in the future at a lower price.

And the presence of disinterested buyers and sellers, as well as interested parties, makes markets the most efficient in terms of pricing, in pricing discovery.

Well, let's look at what the banks lobbied the U.S. government from the spring of '08 to the spring of '09; they lobbied the U.S. government on two things, basically. To liberalize the economy and make more opaque bank accounting under the FAS 157 mark-to-market rules, and to try to outlaw short selling in their shares.

So the two tenets of the efficient market hypothesis that people hold dear, the banking industry lobbied the governments somewhat successfully to pull out from underneath it. It's absolutely Alice in Wonderland, Through the Looking Glass situation.

Rob: Now, I might add a third dimension to that which is in the realm of derivatives structure and market structure and regulation, they fought very hard to maintain the OTC structure rather than have things migrate to exchanges where pricing and –

Jim Chanos: Would be more transparent.

Rob: Yeah, are more transparent and what you might call societal or systemic integrity can be ______.

Jim Chanos: Well, go back to my point that if you actually have market prices that aren't posted through an exchange you no longer have the Level 3 problem because you have observable input.

Rob: Right.

Jim Chanos: And so – and we now know that that may be something the banks don't want. And having observable input makes it much easier for an auditor, who's got a spine, for example, to say, "Well, wait a minute. This thing is trading. We have trades at $0.40 on the dollar. Now, you know, we may argue that it's worth $0.35 to $0.45, but it's not worth $0.90 which is where you're carrying on your books for. So let's mark this down." And that's the last thing I think some of these institutions want.

Rob: Well, it seems my good friend Tom Ferguson said in an article recently that the irony was that Communism collapsed in the late-

'80s and then we allowed Wall Street to affect mark-to-model ______ type administered pricing for our financial assets.

And because those assets were so violently mispriced when the sun finally came out we experienced a tremendous crisis. We have market pricing in term –

Jim Chanos: Then don't forget the attempt to squelch critics. That has a very Soviet-style to it as well.

Rob: That's right, that's right.

Well, Jim, I don't know if we're ending on a particularly optimistic note here. I think the texture and the sensibility which you explore all of these issues is, I would say, actually very helpful to public policy.

And what I'd like to do is end for today, but invite you to come back and talk with us where the subject and the focus will be if you and I were putting together the regulatory regime, what would be the ingredients to put America and the world financial markets back on a more proper course.

Jim Chanos: Well, I would appreciate the opportunity to be here at New Deal 2.0 any time. So thank you.

Rob: Thank you.

Jim Chanos: Bye-bye.

Rob: Bye-bye.

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