<u>Merrill Lynch Specific</u>

<u>Exposure to MBS / ABS CDOs:</u>

- In the fall of 2006 is when we had the first glimpse on the extent of Merrill Lynch's potential MBS and CDO exposures. In hopes of replicating the similar mortgage models in which Lehman and Bear Stearns have, on September 6th 2006, Merrill announced its acquisition of National City Corp's nonprime mortgage unit for $1.3 billion. The unit purchased includes First Franklin (12th largest wholesale originator of non-prime residential mortgages), Home Loan Services (14th largest servicer), and NationPoint (online retail residential mortgage lender). The three businesses will expand Merrill's vertically integrated mortgage platform within the US. The addition of the California based wholesale originator will double Merrill's wholesale origination volume and has the potential to further increase the volume when Merrill introduces Alt-As into the product mix. At the time, we did not have any major concerns but had begun to closely monitor the growth of this business.
- In February 2007, signs of stress emerged in the subprime market as several subprime mortgage originators begun to fail. Merrill, who had just recently finished vertically integrating its subprime mortgage originator, had begun to accumulate an abundant amount of subprime mortgages. To quickly dispose the assets off of its books, Merrill had packaged the mortgages into asset backed securities collateralized debt obligations ("ABS CDO"), sold the riskier part of the capital structure, and retained the higher rated portion (a.k.a. "super senior"). The underlying assumptions to retain the super senior were there was a limited amount of buyers for the product and that it was considered less risky. During the first quarter of 2007, Merrill printed 19 ABS CDO deals and had $32 billion of gross notional super senior exposure. The usual amount of deal issuances per quarter was 5 to 6 deals. The greater concern for the firm at the time was the amount of subprime residuals; the lower rated retained portion of the ABS CDOs deals. The size of the subprime residuals was at $1.6 billion market value.
- During the spring and summer of 2007, Merrill continued to accumulate a substantial amount of super senior ABS CDOs. As the size grew, we begun to turn our attention on the price verification process and methodology surrounding the product space. Starting in May 2007, we had monthly discussions and meetings with the firm's finance department to get an understanding on their evolving nature of the methodology and pricing process. By September 2007, Merrill had accumulated $55 billion of gross notional amount of super senior ABS CDOs.
- On October 5, 2007, ahead of their third quarter earnings release, Merrill announced that challenging credit market conditions will have an adverse impact on its net earnings for the quarter, particularly with respect to its ABS CDOs and US subprime positions. The impact was estimated to be a write-down of $4.5 billion, net of hedges.
- On October 24, 2007, Merrill reports a net loss of $2.3 billion for its third quarter. The primary driver was a write-down of $7.9 billion across its CDOs and US subprime positions, almost double the estimated amount reported two weeks ago during the pre-earnings release. The increase was due to an internal change of the price verification methodology.
- In December 2007, the firm decided to create Price Valuation Group that will focus on price verification process and methodologies for the firm. They have hired David Braun to head the group. We provided David with our suggestions as he built out the group.
- We continue to monitor the area closely over the next year until the firm sold $30.6 billion of gross notional ABS CDOs to Lonestar in September 2008. The sale transaction brought the firm's exposure down to $1.6 billion, net of hedges.

Credit Derivatives:

We began closely monitoring the firm's credit derivative exposures due to two occasions.

1. Ramp up on credit derivative product company ("CDPC") applications: During early 2007, there was an increase in the number of applications to create CDPCs with Merrill Lynch being one of them. CDPCs specialized in selling credit default protection on highly rated corporate borrowers. CDPCs are rated AAA and in exchange for quarterly premiums, they provide counterparts with an insurance against the bankruptcy of issuers through credit default swaps. CDPCs are constructed to be bankruptcy remote. However, the fall of Bear Stearns two hedge funds in May 2007 and later Bear Stearns stepping in as the counterparty for all the hedge funds' transactions made us question the firm's reliance on the bankruptcy remote clause on their soon to be created CDPC. The firm later canceled their plans on creating a CDPC.
2. In July 2007, due to the inability to distribute its super senior ABS CDO exposure, Merrill Lynch began to increase the amount credit default protection purchased from financial guarantors to offset its long exposure. We began to become concerned with the financial guarantors' viabilities as rating agencies began to downgrade their ratings in early fall 2007. We brought up our concerns with the firm as it had purchased $95.9 billion of notional credit default protection from financial guarantors. We also have stated that if the firm intents to purchase additional credit default protection from financial guarantors, we will impose a punitive capital charge. The firm has cease buying additional CDS protection and is currently working their exposure down.

Material Findings about Risk Management

1. With respect to the risk management of the commodities business, we were particularly concerned with the adequacy on the flow of information and the weakness of the head commodities risk manager during late 2006. While the commodities business is conducted out of Houston, TX, the risk management of the business is administered in New York. Although we gained comfort with the competence of the staff located in Houston through our on-site visit, we were unimpressed with the knowledge and strength of the head commodities risk manager in comparison to his counterparts of other areas. The situation lead us to believe that there was a possible disconnect on the flow of information relayed to senior management. When confronted, senior management was very responsive to our concerns and remedied the situation by hiring a global head for commodities risk management who will be based in Houston. He is expected to start by the end of March 2007.
2. Summer of 2007, we became dissatisfied with the governance and procedures surround the firm's price verification methods, in particular with the firm's super senior ABS CDO exposures. We worked closely with the firm's finance department to gather an understanding of the constant changing price verification process and methodologies. Our constant discussions led the firm to create a separate group called Price Valuation Group ("PVG") in late 2007. PVG focused on the price verification process and methodologies for the firm's assets. We continued our discussions on price verification of the super senior ABS CDOs with PVG and were greatly satisfied with their work. However, senior management did not take PVG's recommendations on remarks of the book for several months. We had elevated our dissatisfaction on the governance process, in particular with the Q1 2008 results. Erik Sirri, Bob Colby, and Matt Eichner arranged a meeting with the firm's audit committee in July 2008 to address our concerns. The audit committee had taken note of our concerns. From Q2 2008 and forward, we have seen improvements (e.g. traders attest to their marks, PVG's recommendations were taken, etc.).
3. At the beginning of its second quarter of 2006, Merrill's Treasury Department implemented several new changes in polices and practices in funding the firm. The most concerning change related to its plan to reinstitute a more active commercial paper program. The concern was not on the reinstitution

of the plan per se but the significant amount of commercial paper that was issued and maturing within a 30 day period. In conjunction with the commercial paper plan, the Treasury Department substantially reduced the long-term funding for the liquidity pool, as well as, decreased the size of the liquidity pool. From the time of Merrill's approval as a CSE to present, the size of its balance sheet assets has grown tremendously, particularly in the space of illiquid assets. Hence, we expected the size of the liquidity pool to grow in the same respects.

Again, when confronted, senior management was very responsive to our concerns. Merrill had immediately scaled backed its issuance of commercial paper and issued much longer dated paper. Furthermore, the Treasury Department provided a detailed discussion and presentation on other sources of funding of the liquidity pool and preliminary models to size the pool.