MEMORANDUM

December 5, 2005

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THROUGH: Matthew J. Eichner, Assistant Director

FROM: Financial Economist
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RE: Risk Management Reviews of Consolidated Supervised Entities

Office of Prudential Supervision and Risk Analysis ("OPSRA") staff met over the past four weeks with senior risk managers at the CSEs and at Credit Suisse First Boston to review October market and credit risk packages.

There were several common themes in discussions with firms:

- **Non-investment grade corporate lending activities hit record highs, again.** As M&A and leveraged buy-out volumes remain strong in the US and Europe, firms continue to grow their leveraged lending businesses. Banks provide financing, including higher-risk bridge loans, to facilitate acquisitions, leveraged buy-outs and similar deals, and then generally shed the exposure through loan syndication. Over the last year, the total investment and non-investment grade notional lending commitments have increased two to three fold at several firms while measured risk, based on various metrics such as value-at-risk (VaR) and credit spread widening scenarios, has increased as much as ten-fold. As this activity has become a more important component of the overall businesses, measured both by risk and net revenues, senior management at several firms has repeatedly reevaluated appetite for lending risk, with limit increases and temporary excessions a fairly common outcome. In fact, one risk manager suggested that risk taken via lending has become as important as counterparty credit exposures incurred through derivatives trading. Given this pronounced growth, along with the firms' reliance upon investor demand for non-investment grade debt to mitigate risks through syndication, leveraged lending remains among the most significant areas of focus for risk managers.

- **Spreads temporarily widened on the lower rated tranches of structured mortgage products.** Spreads on BBB rated residential mortgage-backed securities (RMBS) backed by subprime loans widened intra-month, although minimal pain on the part of investment banks and other market participants was apparent. Interestingly, spreads for credit default swaps referencing MBS widened considerably more than the cash bond spreads, suggesting the mortgage credit derivatives market may still have only limited liquidity. While accounts varied somewhat, these CDS spreads reportedly widened by as much as 125 basis points, representing a near doubling in level. Meanwhile, there was little-to-no impact in the commercial mortgage backed security (CMBS) space.

- **Investor demand for synthetic asset-backed collateralized debt obligations (CDOs) appears to be growing.** Consequently, several firms have increasingly been accumulating synthetic exposure to subprime MBS as well as other assets such as auto loan asset-backed securities for eventual securitization. This is accomplished by selling credit default swap protection on existing mortgage and asset-backed securities and repackaging the risks into new securities (or "tranches") for sale.

We also expect to discuss the following firm-specific issues during the next round of meetings:

Bear Stearns

- The risk managers reiterated that the joint venture with Calpine was structured assuming a real possibility that Calpine might enter bankruptcy proceedings at some point. The risk managers noted that their exposure to a Calpine bankruptcy was limited to "sunk costs" associated with getting the joint venture up and running (i.e., there is no market or credit risk solely as a result of a Calpine bankruptcy). As of our discussion, Bear personnel were still working on operational and logistics issues related to CalBear, but the trading of energy contracts through the joint venture had not yet commenced. We will continue to monitor this situation.

- The risk manager noted that, as investor demand for synthetic mortgage CDOs has increased, the business model for the Residential Subordinates desk has expanded. Historically, this desk held and distributed the residual tranches from both Bear Stearns' ARM and Non-Agency CMO securitizations. But in addition to this activity, the desk has now begun to accumulate risk through derivatives referencing existing MBS to facilitate these synthetic deals. We will continue to monitor the growth of these new activities, and related risk management.

Synthetic CDOs

Credit Suisse First Boston

- At the next monthly meeting, we will discuss the leverage loan business at CSFB with a focus on risk management of these positions, including differences between U.S. and European syndications. This business continues to be a large contributor the high level of ERC limit usage within the Fixed Income Division.

Goldman Sachs

- The loss impact of the Sovereign Stress Test for Russia reached $194 million, well in excess of the $70 million limit. We will continue to monitor the magnitude of this exposure, which is driven by foreign exchange positions.

- The loss impact of a credit widening event for the leveraged loan origination business continued to increase during October and now stands above $900 million, or more than twice the relevant limit. We will continue to discuss with risk managers the size of this business and the relevant limits.

Lehman Brothers

- Equity VaR continued its recent increase, exceeding the relevant limit at the end of October. Lehman is in the process of recalculating equity risk appetite and limits in conjunction with its annual budget process, and we will continue to follow this process.

Merrill Lynch

- Last month Merrill restated its total August trading VaR, resulting in a reduction of $19 million to $76 million. The restatement was broadly related to changes in the benchmark mapping of various credit sensitive instruments. We intend to discuss in detail the enhancements leading to this material adjustment next month.

- The head of credit risk modeling confirmed Merrill's intention to migrate all product areas to a simulation-based potential exposure methodology in the near future. We will examine these new techniques in the upcoming months.

Morgan Stanley

- Next month, the credit risk group is going to present its plans to transition to EPE for the Basel II counterparty credit risk charges for the Stock Loan business. In addition, they will be presenting their revised Loss Given Default ("LGD") framework for their warehouse facilities, secured lines of credit extended to mortgage banks and finance companies to fund residential mortgage loans being amassed for eventual securitization.

- We discussed with the credit risk managers the firm's large counterparty exposure to the Republic of Italy. Morgan Stanley has a large portfolio of long-dated interest rate and cross-currency swaps with the Republic of Italy which currently generate a gross potential exposure of approximately $7 billion. While the firm does have over $1 billion of single name credit default swaps as hedges to help mitigate this exposure, the performance of these hedges is tied to the Republic of Italy defaulting on its bond obligations (not on derivative transactions). With this level of potential exposure, the risk of selective default (i.e. defaulting on derivative transactions but not on its bonds) is of concern. The credit risk manager re-iterated that pressure has come from senior management to reduce this risk. He stated that they are looking for creative ways to reduce this risk. We will continue to monitor this exposure – and any evidence of creativity -- going forward.

- Leveraged loans have once again driven the gross notional commitment of the corporate lending portfolio to a new record level of over $44 billion against a newly increased limit of $40 billion. Two new, very large non-investment grade acquisition-driven facilities, totaling over $8 billion, were the main cause of the sharp increase in exposure. We will continue to monitor the overall size of the corporate lending portfolio, and these two outsized transactions in particular.