## MEMORANDUM

March 8, 2006

TO: Robert L. D. Colby, Acting Director
Herbert F. Brooks, Chief of Operations
Michael A. Macchiaroli, Associate Director
Thomas K. McGowan, Assistant Director
Division of Market Regulation

THROUGH: Matthew J. Eichner, Assistant Director

FROM: Financial Economist
Financial Economist
Accountant
Financial Economist
Financial Risk Analyst
Financial Economist
Financial Economist
Accountant

RE: Risk Management Reviews of Consolidated Supervised Entities

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

There were several common themes in discussions with firms:

- **Housing markets slowed in December but risk appetite in the mortgage space remains high.** Although the US housing market appears to be softening in December, many firms are still optimistic that mortgage securitization will remain highly profitable. So much so that senior management at several firms has approved increases in the relevant risk limits. Two firms, in addition to increasing the risk capital allocated to mortgage trading, are undertaking strategic initiatives to vertically integrate the business, replicating the model that has been successfully developed at Lehman Brothers. Currently, these firms purchase loan assets, the raw material for securitization, from third party originators, exercise the option to sell back any undesirable loans, securitize the remaining collateral, and distribute the resulting product. Having a vertically integrated business that includes an origination platform allows the firm greater control over underwriting and loan terms, shortens the time required to bring the deal to market, thereby reducing the duration of exposure to changes in interest rates, and assures an adequate supply of raw material into the pipeline. In addition to expanding activities within the US markets, firms are seeking opportunities in Europe and in Asia where housing markets remain strong.

- **Risk managers remain focused on non-investment grade corporate lending commitments, but express differing views on the strength of deal flow in the coming months.** With the persistence of strong investor demand for non-investment grade or leveraged loans, firms have continued to successfully reduce through syndication concentrated positions built up throughout the last quarter of 2005. However, risk managers express conflicting views on prospects for 2006. Some have stated that financial sponsors seeking financing for leverage buy-outs and dividend recapitalizations, the key driver of the leveraged loan market in recent years, continue to pitch new projects with unchecked enthusiasm. One firm noted that, in addition to current commitments of $33.7 billion in the pipeline, it currently has 15 new deals developed by financial sponsors awaiting review by the capital committee. Others have stated that the pipeline has diminished due to the inverted yield curve and a broad decline in investor demand for corporate credit products. In either case, risk managers remain focused on the leveraged loan area with its concentrated exposures.

- **The outlook for GM is dim and for GMAC uncertain.** Currently, many firms have large single name concentration in General Motors and even larger positions in GM's financing arm, GMAC. Despite and perhaps because of growing negative sentiment, trading in these names has remained brisk, which has provided substantial positioning opportunities to dealers as well as revenues from customer facilitation trades. But in light of the uncertainty surrounding both GM and GMAC, risk managers remain focused on several issues. First, there is concern, in the event that GM declares bankruptcy, that there will not be enough bonds in the market to settle all credit default swaps that require physical delivery. If there are not enough bonds in the market, firms hope trades will cash settle through an auction mechanism similar to one held last May for Collins and Aikman bonds, but this process remains ad hoc with the particulars decided after each default event. The second issue is GMAC's ability to maintain its investment grade status. GMAC securitizes a wide variety of assets, including residential mortgages and automobile loans. Should GMAC's credit rating fall, due either to GM's inability to sell the unit or because GM itself is further downgraded, there is potential for some disruption to its securitization activities. For example, its ability to obtain interim financing for assets awaiting securitization may be impacted. Given GMAC's size, such an event could have broader ramifications for the asset-backed market. Lastly, firms are concerned that they have accurately and completely aggregated their total exposure to GM and its subsidiaries. Since GM exposure resides in many different businesses within the firms, including issuer exposure in a number of debt and equity businesses as well as counterparty credit exposure on several derivatives desks, aggregation can be challenging. In light of these concerns, risk managers are monitoring exposures across the firm carefully and, in some cases, pushing for reductions.

- **Derivative trading commenced on the newly created asset-backed indices.** On January 17, 2006, CDS IndexCo and Markit Group Limited launched the first series of asset-backed indices referencing U.S. residential mortgage backed securities. This product, which represents a move towards standardization in terms of asset-backed security derivatives trading, should allow market participants to more cheaply and easily adjust broad exposure to the sector. Previously, hedging an existing exposure or creating a synthetic exposure required a customized product referencing an existing asset-backed security. Risk managers believe that the new index products will simplify the management of exposures in the securitization businesses that have grown rapidly in the past several years. Following the successful launch of the residential asset-backed indices, CDS IndexCo plans to expand their product line in the future to include a series of indices that will reference commercial mortgage backed securities[1].

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

Bear Stearns

- OTC trading has commenced in CalBear, Bear Stearns new commodity business. Thus far only "a few" counterparty trades have been done, and only with large counterparties such as Exxon. March 20 is the current deadline for the bankruptcy court to affirm the CalBear

[1] News released on http://www.markit.com/cmbx.jsp

Agreements, a requirement for the continued use of the entity. Should the agreement not be affirmed, Bear's risk is basically limited to time/resources lost in establishing the venture. From a market risk perspective, trading remains limited to the $1 million daily Value-at-Risk ("VaR").

Credit Suisse

- Over the past year plus, Credit Suisse has built a commodities trading business focusing primarily on the natural gas and power area. On February 8, Credit Suisse announced its new joint venture with Glencore International, one of the world's largest non-integrated oil suppliers, for oil liquids derivatives trading. We had a preliminary discussion of this new business during this past month's risk meeting. We will continue to monitor the activities in this space as trading in the joint venture begins.

- While VaR decreased for the firm during January, many businesses were approaching or exceeding their economic capital limits. The risk manager noted that exposures were likely to grow further in February as the businesses were granted temporary limit increases in anticipation of the Board approving much larger economic capital limits at its March 6 meeting in response to a mandate to grow businesses and profitability. We will follow up on the allocation of these increased limits across businesses.

Goldman Sachs

- Total VaR increased by $8 million from the previous month to a level of $100 million. In addition, there was an intra-month VaR spike of $120 million, which is the largest Firmwide VaR total to date. The largest single contributor to this increase in measured risk was the commodities business, which did a large customer power trade. While much of the market risk for this particular trade was easily hedged, large structured transactions have recently driven increases in Goldman's commodities risk. In response, the Firmwide Risk Committee, as part of a broad limits reassessment process, increased the stand alone Commodities VaR limit from $35 to $50 million to allow the business to continue to capitalize on these large transaction opportunities without crowding out the daily franchise business. Given the relatively illiquid nature of many of these positions as well as the large amount of counterparty credit risk generated, we will continue to discuss Goldman's approach to risk managing these outsized commodities exposures.

Lehman Brothers

- The head of credit risk management retired effective February 17. We will follow up with the Chief Risk Officer about staffing plans and, in particular, coverage of the newly established energy trading business.

- The energy group is growing, with two key recent developments: First, the signature of ISDA documents with several counterparties during the past month will allow for more trading activity. Second, the group intends to go to the New Product Committee in the next few weeks to seek permission to trade physical power and natural gas products in addition to the financial products they are currently allowed to trade. We will continue to closely monitor developments with this group.

Merrill Lynch

- On February 15, 2006, Merrill Lynch announced the purchase of a large minority stake in money manager BlackRock for $8 billion. BlackRock and Merrill Lynch agreed to merge Merrill Lynch's investment management business with BlackRock to create a new independent company that will be one of the world's largest asset management firms. With the merger, Merrill Lynch will receive a 49.8% stake in BlackRock. We will continue to closely monitor developments as the merger unfolds, including the treatment of the investment for capital purposes.

- Trading in multiple asset classes has increased in recent months. For example, an equities prop trader currently has a mandate to trade credit products and commodities. This leads to several potential risk management issues, including the possibility of unintended concentrations in specific names. Senior management is examining issues related to the governance of trading in multiple asset classes, and we will follow up on in the coming months.

Morgan Stanley

- Risk as measured by VaR has trended upwards significantly for the Repo desk. Although the market risk department acknowledges risk taking is up, they believe VaR is overstating the actual risk. As such, the market risk department is contemplating some modifications to certain inputs in the VaR calculation (e.g. how volatility of interest rates is best represented) to more accurately reflect risk. We will monitor any developments in this area.