

MEMORANDUM

May 8, 2006

TO: Robert L. D. Colby, Acting Director
Herbert F. Brooks, Chief of Operations
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Division of Market Regulation

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 five weeks with senior risk managers at the CSEs to review March market and credit risk packages.

There were several common themes in discussions with firms:

- **Equity risk taking remains high.** Several firms reported substantial increases in aggregate measured risk, driven largely by more risk taking in equities. Risk managers conveyed that higher equity exposure was due to increases in long directional position taking (much of which occurred in Europe and Asia), increases in block deals, and significant reductions in downside gamma protection. With respect to block deals, even firms such as Bear Stearns that have been comparatively small players in this space saw sizeable increases in equity exposure stemming from larger than usual deals. Risk managers also indicated that equity desks are increasingly willing to take on positions without purchasing downside protection. The purchase of downside protection leads to a "long gamma" profile, which generates gains if the price of the underlier moves in either direction. By not purchasing protection, firms save the cost of option premiums albeit at the expense of increased exposure to extreme market moves.

As a result of increased "purposeful risk" taking, equity desks at many of the firms have requested, and been granted, increases in equity VaR limits. In addition to limit structure discussions, risk managers, desk heads, and senior managers have been discussing the apportionment of equity VaR across desks, including non-equity desks, which incur equity exposures. Examples of non-equity businesses with significant equity exposure include global credit trading desks that, through customer flow business, transact across numerous asset classes, and macro proprietary trading desks that have mandates to trade across equity asset classes. Risk managers expect these discussions will lead to refinements in the way that risk limits are allocated across divisions.

- **Risk managers remain concerned about sub-prime originators.** Last month, problems surfaced at sub-prime originators with respect to "put backs," the return of purchased loans to originators when prepayment or default occurs within a specified window. Some CSE firms noted that recent events, such as the bankruptcy of Acoustic Home Loans, have increased their level of concern with respect to sub-prime originators. Acoustic Home Loans was a mortgage lender in Orange, CA, that specialized in loans for borrowers with poor credit or limited proof of income. Two of the CSE firms reported exposure to Acoustic stemming from put back claims. Both exposures were relatively small, approximately \$4.5 million total, but the potential losses highlight the challenging environment for independent mortgage originators, especially in the sub-prime space, as rising interest rates cut margins. Risk managers pointed out that they are responding to the Acoustic bankruptcy by increasing the monitoring of originators, by looking more closely for poorly underwritten collateral, and by conducting more detailed analysis on issues such as negative amortization that can impact sub-prime loan assets.
- **Deal flow in convertibles is up.** Three of the five CSE firms noted that there has been an increase in the size and number of convertible issuances in the market. As testament to the increase in deal flow, risk managers pointed to the recent Amgen convertible issuance of \$5.0 billion (comprised of two \$2.5 billion convertible senior notes) underwritten by Merrill Lynch with the involvement of Morgan Stanley and Lehman Brothers. Not only was this the largest convertible issuance to date, but it was also upsized by \$1.0 billion because of strong investor demand. Risk managers pointed out that convertible deals, such as the Amgen issuance, have been bundled with derivative contracts known as call spread overlays to meet client needs while stimulating investor demand. The structure essentially enhances the value of the option embedded in the bond to the investor, while creating the economics for the issuer of writing an option far out of the money.

From a credit exposure perspective, these synthetic deals raise questions about how to properly measure risk. Following the Amgen deal, Merrill Lynch showed a very large Current Exposure (CE) and Potential Exposure (PE) because of the call spread overlay. Risk managers said the firm believed that the convertible bond and derivative contract were not legally nettable, resulting in large CE and PE. While Merrill Lynch refrains from netting these exposures, some firms appear to be moving close to recognizing netting benefits in these situations.

Bear Stearns

- A small sub-prime mortgage originator that Bear purchased whole loans from declared bankruptcy in April. Bear had \$3 million in outstanding claims with this counterparty stemming from early default payment related to put back rights. Risk managers remain highly focused on potential operational and underwriting problems at sub-prime originators, not only from a counterparty credit risk perspective but also from the perspective of the collateral being securitized in Bear MBS deals. We will continue to discuss these issues and the work done to establish comfort in the sub-prime mortgage area.
- The equity business took down a \$300 million block deal, which is outsized by Bear's standards. The desk was able to reduce its position by roughly \$75 million on day one and \$170 million as of our meeting. We will follow up regarding the success in further reduction of this chunky exposure.

Goldman Sachs

- Aggregate risk continues to grow, with Firmwide VaR hitting a new all-time high of \$128 million intra-month. While various fixed income businesses, such as Commodities and Corporate Lending, were driving VaR increases in recent months, Equities trading has emerged as the key driver more recently. Furthermore, given the competition among the various trading desks for usage of the Equity Product Category VaR limit, as well as the types of positions being taken (e.g., long delta through options), risk management is considering refining its limits scheme. We will continue to discuss any changes in equity risk appetite as well as any changes in limit allocation practices.

Lehman Brothers

- Lehman's energy group received internal approval to begin physical commodities trading, and will begin trading physical power and gas as soon as their migration to a new technology platform is complete. We will continue to discuss the controls in place around this new area of business.
- A Global Head of Sovereign Risk Management was appointed last year. As Lehman is increasingly active in emerging markets and expands into areas such as the Persian Gulf, Korea, and India, we plan to meet with her to understand how she views and monitors this risk.

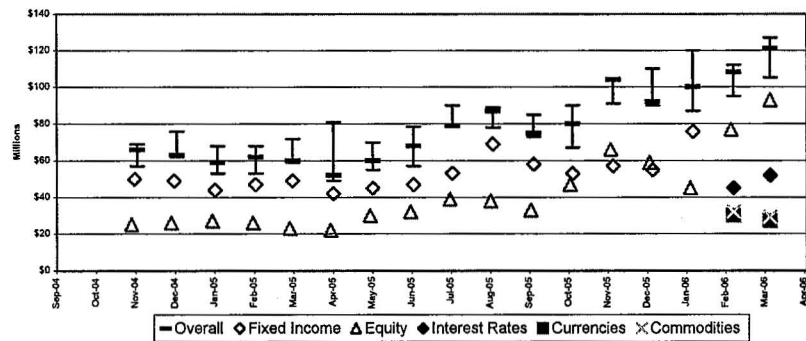
Merrill Lynch

- Merrill recently sold protection to a U.K. mortgage lender on an underlying pool of prime U.K. mortgages in advance of more permanent funding. The lender retained the first loss piece and Merrill bears the risk beyond that point. By buying protection from Merrill, the lender achieves a desired economic effect (i.e. capital relief via transfer of default risk) in advance of a permanent securitization arrangement. Should losses on the underlying portfolio exceed the first loss threshold, the lender can put the entire portfolio to Merrill at par, thus this raises potential liquidity risk issues. We will follow up on the management of this risk. Merrill expects to do more of these types of deals in the future, and we will continue to monitor their activity.

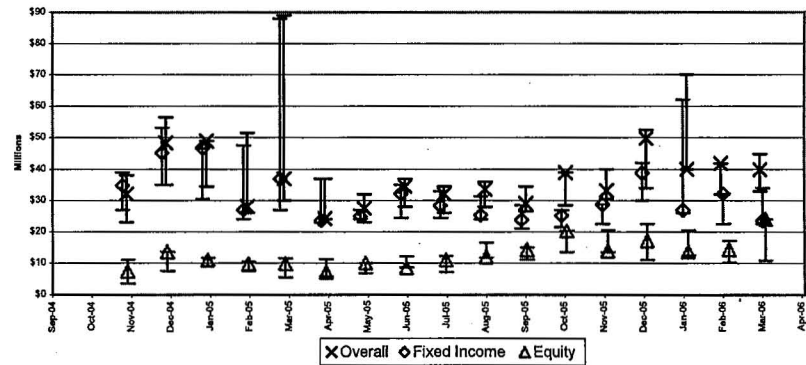
Morgan Stanley

- Because of the increase in "synthetic" convertible issuance and the questions surrounding the measurement of credit risk exposure, we plan to discuss the specifics of the equity derivative contracts which are components of the deals (i.e., the call spread overlays) at next month's risk meeting.

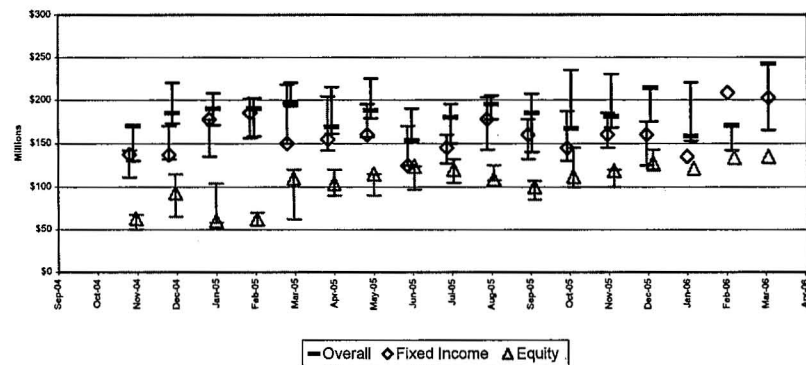
Goldman Sachs: One-Day 95 Percent Value-at-Risk



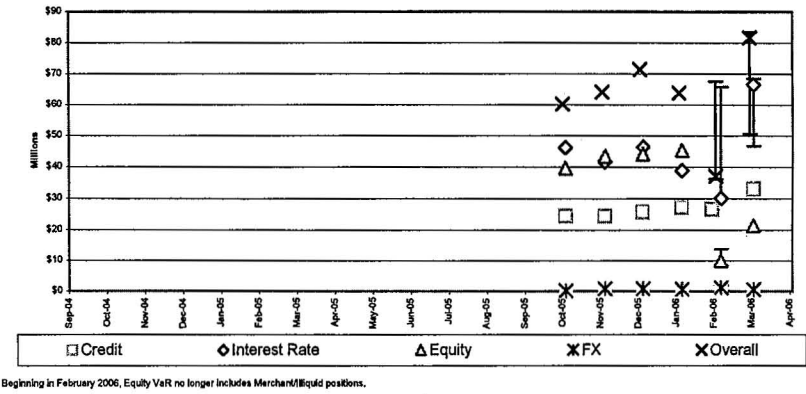
Lehman: One-Day 95 Percent Value-at-Risk



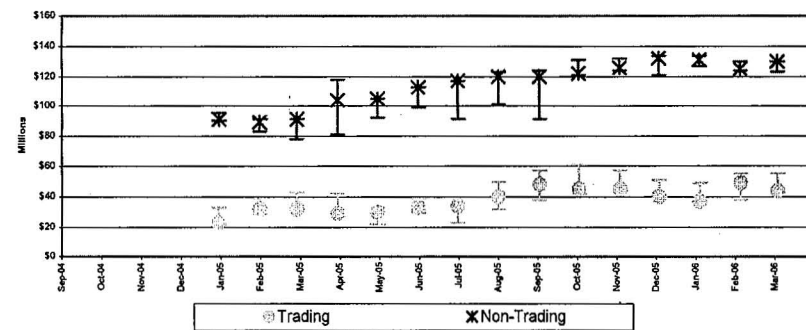
CSFB: Ten-Day 99 Percent Value-at-Risk



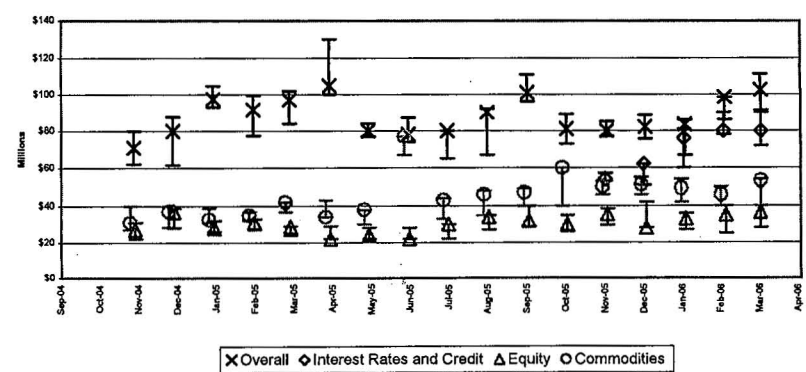
Bear Stearns: One-Week 95 Percent Value-at-Risk



Merrill Lynch: One-Day 95 Percent Value-at-Risk



Morgan Stanley: One-Day 99 Percent Value-at-Risk



For January 2006 memo, VaR has been restated for prior year as 95% 1-day, versus previous reporting of 95% 5-day.