MEMORANDUM

June 7, 2006

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THROUGH: Matthew J. Eichner, Assistant Director

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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 April market and credit risk packages.

There were several common themes in discussions with firms:

- **Risk managers remain focused on non-investment grade corporate lending activities, and provided varying accounts of commitment pipeline events.** In terms of both commitment requests and investor demand for bank debt, reports varied from observing things cooling off somewhat to activity being extremely hot during the month. Along the lines of the latter, one firm noted great success recently in syndicating exposures quickly and stated that, due to increased investor demand, new loans were closing at spread levels that were tighter than stated in the initial deal terms (i.e., "price flexed" downwards). Separately, while risk managers over the past year have continually observed corporate buy-outs occurring at increasingly aggressive leverage levels, one firm noted some recent success on the banks' part in pushing back against financial sponsors on deal terms.

- **As of April hedge funds are performing well and counterparty credit risk managers describe a fairly benign environment.** In addition, prime brokerage business unit personnel, who extend leverage to hedge funds in the form of margin and securities lending, appear to be spending relatively little time fielding requests for additional leverage. At the same time, however, there is increasing client demand for prime brokers to provide clearing and financing services on a broader range of financial products. In other words, hedge funds appear relatively less concerned with negotiating lower margin requirements on securities traditionally financed by their prime brokers, but are determined to consolidate more types of instruments into fewer clearance accounts. In addition to realizing operational efficiencies, this provides funds relief/offset from a margining perspective, especially between cash securities and OTC derivatives. Clearly as funds ask prime brokers to intermediate and provide leverage through more complex and less standardized instruments, credit, operational, and legal challenges arise.

- **Several firms active in the Residential Mortgage Backed Securities (RMBS) space experienced a slowdown in new deal issuance in certain sectors.** One firm described adjustable rate mortgage collateral turnover in April as being down considerably from the previous month. Another firm depicted a more broad and gradual trend downwards in RMBS activity. Meanwhile, reports indicate that pipelines remain strong in the commercial mortgage space, in terms of new loan origination as well as the pace of collateral securitization/distribution.

- **Large movements in the dollar and commodities prices led to increases in unsecured exposures to some counterparties, although no immediate credit concerns resulted.** With the dollar depreciating over 5% and crude oil and metals (especially copper) prices rising significantly, some derivatives contracts inevitably moved further into the CSE firms' favor. On the commodities side, one would expect dealers' counterparty exposure to increase as prices rise, as the producers and refiners often seek to forward sell their production. Further, it is common for dealers to trade without variation margining in place in this space (i.e., without the right to call for additional collateral following market moves), given the liquidity constraints of many commodities counterparties and historical market convention. However, the lack of such collateral agreements is often mitigated by the "right way" nature of the credit exposures generated - e.g., an oil exploration company owes the dealer money as the price of oil is rising.

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

Bear Stearns

- During the prior month, OPSRA heard of difficulties that some subprime mortgage originators were having in the U.S. This month, the risk manager stated that Bear Stearns' UK subprime mortgage originator subsidiary, Rooftop Mortgages Limited, had suffered losses on remaining BB notes and residual tranches from two securitizations of Rooftop collateral originated in April 2005. The mark-to-market losses resulted from the trust having a shortfall in cash due to extremely poor performance. Bear Stearns has moved to replace the current UK servicer of these loans. Rooftop currently has collateral accumulated (and growing) for the next deal. Given the performance of the earlier securitizations, the ability to bring the next deal to market will be severely challenged. We will follow up on any additional plans regarding changes to the underwriting standards at Rooftop as well as any further P&L resulting from remaining securities and accumulated loans.

- During the May risk meeting, the risk manager discussed the risk profile and the year-to-date performance of the risk arbitrage desk. He discussed the fact that the main trader had already exceeded last year's profit and thus was allowed to grow his positions. As of the end of April, the desk was long $1 billion which was the largest position seen since last fall. The risk manager noted that the desk incurred some material losses during the market volatility in May. We will follow up on the performance and risk management of this desk at the upcoming meeting.

Goldman Sachs

- Goldman has recently approved a hedge fund share lending program, enabling private wealth management clients to borrow against their hedge fund shares. For now, the total loan notional amount is limited to $100 million and the business may only lend against Goldman-managed funds, or Goldman-advised fund-of-funds. As this business model allows borrowing against non-standard and illiquid collateral, we will continue to discuss the growth and risk management of this activity going forwards.

- Increases in directional equity exposures continue to drive aggregate risk upward. The period-end Firmwide VaR of $128 million tied the all-time high, with the largest Equities

Division desk (GSPS) running slightly over its stand alone VaR limit of $45 million. Risk management continues to discuss with senior management potential refinements to the limits scheme, in terms of the granularity of the metrics used. Subsequent to our meeting, equities and commodities markets volatility led to losses and a VaR excession at the holding company level. Consequently risk positions were sharply reduced, especially directional equities exposure. Firmwide and Equities VaR measures were reduced by roughly 25% and 35% respectively. We will discuss these developments in more detail next month.

Lehman Brothers

- New milestones in energy trading this month include the conversion to a more robust trading system and the first physical power trade. Legal documentation has been established with more counterparties, including merchant energy companies who are lower rated than typical Lehman counterparties. Credit risk management has hired a senior analyst to cover these counterparties, and we will continue to monitor their exposures and risk management surrounding them.

Merrill Lynch

- Merrill Lynch has increased their private equity investments in equity long-short hedge funds over the past month. More generally, Merrill is increasing their allocation of capital to principal investments such as hedge funds and funds of funds which have traditionally had good returns in addition to high risk. Separately, the hedge fund lending business (which uses hedge fund complexes and fund of funds as collateral) has received increased internal attention lately. OPSRA has closely monitored activity in this space, as this type of lending clearly poses wrong way risk for the lender. In the coming week, senior management plans to discuss the viability of the business. We will continue to monitor developments in this area, as well as, follow up on the outcome of these discussions at our next monthly meeting.

Morgan Stanley

- Current exposure in the Commodities OTC derivative space reached its highest level in the past twelve months due to large market moves in commodities, particularly crude oil. This increased the firm's credit exposure to non-investment grade names as many of the counterparties in the Commodities business are lower rated. While the total exposures across the Commodities portfolio increased substantially, the credit risk manager noted that these increases were spread across multiple names and thus did not currently cause any particular concerns with respect to individual counterparties.

- Morgan Stanley's commercial mortgage business continues to run significant exposures from both its CMBS securitization pipeline as well as secondary trading through both cash and derivative product. This business has been a major driver of increased hypothetical losses in the Market Risk Department's Financial DistressI scenario over the past couple of months and has also shown up on the Credit Department's reports to Management. In addition to the growth in its overall exposure, the business has significant exposures to European and Asian real estate markets where hedging of credit spreads is not as developed as in the corresponding U.S. markets. We will continue to monitor the risks stemming from this business.

- Morgan's Market Risk Department rolled out a new corporate credit trading VaR methodology. Although the basic approach remains the same and is therefore based upon a factor model, the new model uses a larger set of factors and captures name-specific risk without imposing as many distributional assumptions. The impact on measured risk and thus regulatory capital has been negligible at the top level, although the allocation of risk under the surface between desks shifted predictably from diversified, higher-rated portfolios to concentrated, lower-rated portfolios. We intend to follow-up on the performance and risk management impacts of the model over the next several months. On a separate but related note, MRD is taking a closer look at refining its scenario/stress tests, where senior management has focused its attention lately given increased risk appetite for securitized products, emerging markets and principal investments. We will continue to monitor the direction and impact of these developments.

- We are planning to meet with Morgan Stanley's Credit Department to discuss recent adjustments made to the internal credit rating process to facilitate the Department's ability to review derivative counterparties on an annual basis. During the CSE review, the Credit Department policy called for formal annual reviews of its ratings on all lending counterparties, but on a less frequent basis for derivative only counterparties where the timing of reviews was based on a sliding scale according to the counterparties rating.