MEMORANDUM

July 05, 2006

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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 four weeks with senior risk managers at the CSEs to review May market and credit risk packages.

There were several common themes in discussions with firms:

- **CSE firms sustained trading losses during the recent market turmoil, both from equity and emerging markets strategies.** Global equity markets fell during May, as did emerging markets currencies. Many firms had been long across equity markets and bullish on emerging markets, and therefore experienced trading losses. Firms also lost on restricted positions that they have not been able to hedge or sell, for example shares in the NYSE and other exchanges that recently went public. In some cases, firms' losses exceeded the value-at-risk ("VaR") bounds intended to describe a level of loss that should be exceeded on only a very small percentage of trading days, typically one of every one hundred. A few of these VaR breaches were at the firm-wide trading level, but more common were business unit exceptions. Risk managers felt that the risks had been well captured ex-ante, and none of these losses or VaR breaches came as a surprise given the positions and subsequent market movements. Almost across the board, equity and emerging market desks were able to significantly cut their positions as markets fell, indicating that markets remained liquid. At the overall firm level, losses were not material, as trading losses were generally mitigated either by trading gains in the following days, revenue generated by fee businesses such as investment banking, or both.

- **Hedge funds, despite facing losses resulting from market moves, continued to meet margin calls without incident.** Risk managers noted that although some hedge funds faced large margin calls in May, they had no problems meeting them, and there was no significant increase in contested calls (often the first indication of a problem). Emerging markets funds were hit particularly hard, with funds down over 4% during the month. As of May, these strategies were still profitable on a year-to-date basis, but risk managers suspected that continued market weakness into June would cause them to be flat for the year. After

sustained losses, some of the smaller funds have decided to close down, and have gone about doing so in a very orderly fashion.

- **The leveraged lending pipeline remains robust, and lenders continue to be pressured to make concessions on terms by acquiescing to "covenant-lite" agreements.** One firm noted that their loan commitment pipeline, which is defined broadly to include potential transactions at early stages that might subsequently fail to be completed, was at a record-high $60 billion. Risk managers again commented that the market is accepting non-investment grade acquisition finance deals at relatively tight spreads, and so-called covenant-lite deals continue to gain popularity, with 18 of these deals already completed this year (as compared to five during all of last year). Covenant-lite deals remove once-standard financial covenants such as those governing leverage (debt/equity ratios) and may lead to lower lender recovery, given that creditors may not be able to take action until a borrower's financial condition has deteriorated significantly. However, it is not certain that lenders will continue to accept these deals. One firm has walked away from a number of covenant-lite deals, only to have the borrowers come back and agree to include the traditional covenants, a sign that the market may be pushing back.

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

Bear Stearns

- The risk arbitrage desk incurred a $14 million monthly loss. Losses were particularly concentrated in a sub-strategy that involves speculating through long positions on potential acquisition targets, as opposed to taking more traditional long-short positions on announced merger deals. Following the May losses risk in this particular strategy was reduced "very much." However, the desk's aggregate long market value position remains at a relatively high $935 million, and we will follow up on activity in this space next month.

Goldman Sachs

- Certain trading businesses incurred large losses over a rather turbulent eight day trading period in mid-May, during which the trading division as a whole exhibited a daily loss in excess of $240 million on two occasions. Concentrated equity positions, especially in commodities-related firms and emerging markets, were the largest loss driver. There were also notable losses stemming from precious metals and emerging markets foreign exchange positions. Following (and during) these events, positions were reduced significantly, especially in directional equities and emerging markets. Market risk managers are broadly satisfied with the performance of their risk systems/metrics during this period, as they believe that exposures leading to losses were well measured and understood ex ante. Despite these large one-day losses, net revenue for the quarter was over $10 billion, just shy of the first quarter record.

- Leveraged lending commitments have recently hit a high of $60 billion. While this number refers to all commitments in the pipeline, including a substantial number of deals that will not be won by Goldman or the financial sponsor that they are backing, the high-water mark reflects the rapid growth of Goldman's risk appetite in this space. Along with the increase in overall commitment levels, the potential losses incurred by this business in a credit spread widening event rose substantially in May. We will continue to discuss Goldman's significant risk appetite in this space.

Lehman Brothers

- We were given an update on Lehman's Mumbai office. Currently, it employees 1000 people, who perform a variety of functions. Some of these are integral to the risk management

framework, such as model validation and counterparty credit reviews. We will continue to discuss the progress of this initiative, and the logistical challenges it poses.

Merrill Lynch

- We met with the head of QRM, the model validation group, to discuss the quarterly review prepared for the head of Market Risk Management. The quarterly review, completed for the first time in May, highlights significant changes in the inventory of models and volume of trades against individual models. In addition, a specific topic is chosen by QRM each quarter to be the subject of a more in-depth review. This quarter, that topic was equity volatility modeling. We will continue to meet with QRM quarterly to discuss their activities.

Morgan Stanley

- We discussed a very out-sized financing deal the firm was negotiating with a non-investment grade client. This transaction would create substantial credit risk exposure both from the lending perspective as well as significant counterparty credit risk from an associated hedging transaction entered into with the counterparty as part of the total financing solution. Based on the magnitude of the transaction we continued to maintain dialogue with the firm intra-month. However, we plan to discuss this transaction further at the next monthly meeting.

- Although the deal has yet to close, in May the trading desk began hedging the anticipated market risk which would arise from facilitating the hedging component of the transaction noted above. This pre-hedging activity resulted in a large concentrated exposure, which drove a significant increase in the measured risk for the commodities division. We anticipate getting more detail on the exposure and the market risk management strategy at the next monthly meeting.

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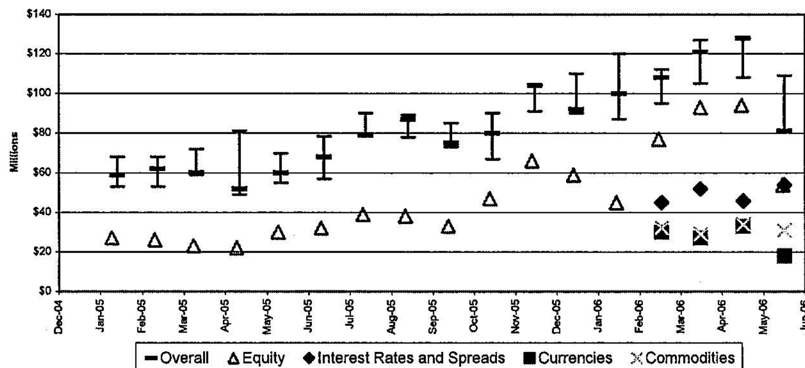

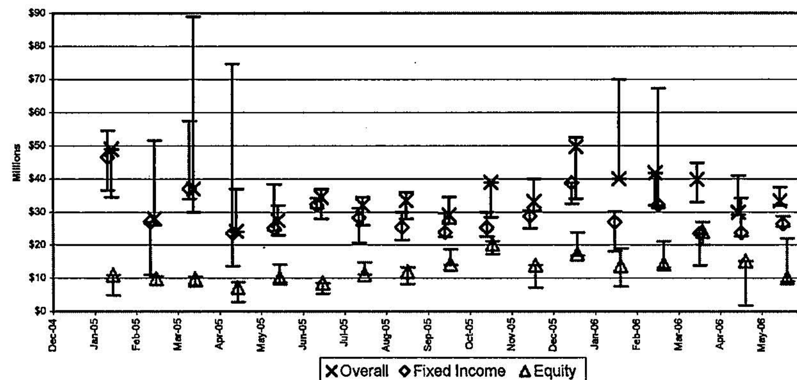

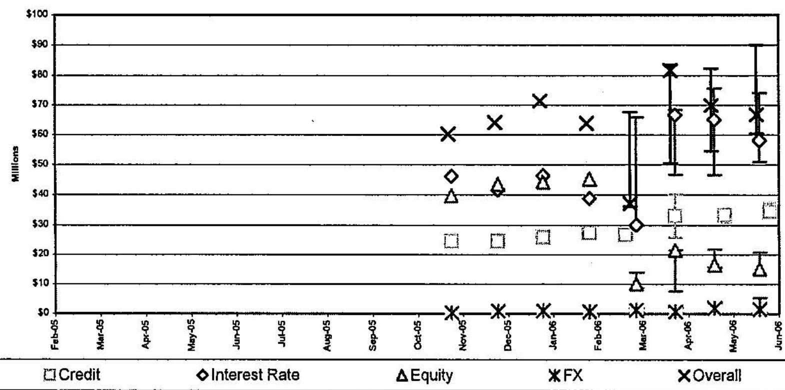

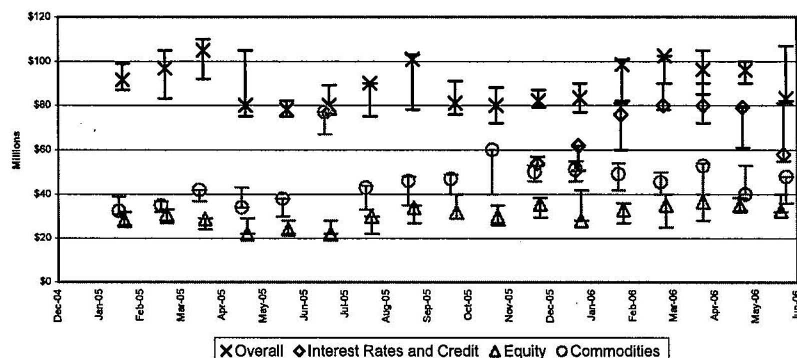

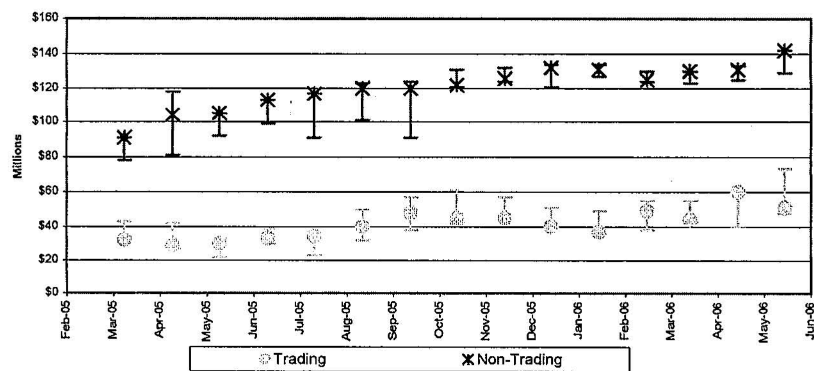

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