MEMORANDUM

August 2, 2006

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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 June market and credit risk packages.

There were several common themes in discussions with firms:

- **Corporate credit investors push back against "covenant-lite" agreements.** Last month, risk managers had highlighted the growth of "covenant-lite" deals in the leveraged lending space. In such deals, the lenders agree to a reduced set of covenants that provide less protection than has in the past been associated with bank loans and similar credit extensions. More recently, investor appetite for loans with these aggressive terms has diminished - meaning the banks that arranged the financing packages had difficulty in distributing certain covenant-lite loans to their institutional customers. In these cases, the banks either walked away from the deals or used their pricing flex to re-negotiate covenants, incorporating more traditional protections. As a result, as one chief risk officer stated, "covenant-lite deals are no longer getting done."

- **Credit risk management and loan portfolio managers remain focused on the risk of credit spreads widening in the bank loan area.** Credit spreads on bank loans, including leveraged lending facilities, remain at historically tight levels. Given the continued high level of exposures from the corporate lending pipelines at many of the CSE firms, some credit risk and loan portfolio managers have taken additional steps in risk managing these portfolios. Over the past couple of months some of the biggest players in this market have begun to more actively hedge commitments with index products, seeking protection from a general widening in credit spreads. In addition, at least one firm has recently implemented an additional scenario-based risk metric for determining the potential loss given a credit spread widening event. While CSE firms generally have scenarios that measure the impact of a Fall 1998 series of events on the lending portfolios, this firm has supplemented its standard analysis to consider a wider range of potential market events.

- **After a rocky start, hedge fund performance in June appears to have stabilized from the losses experienced in May.** Preliminary results show that performance in June was generally much better than during the previous month. The risk managers noted no significant issues related to outsized margin calls, missed margin calls, redemptions or rapid de-leveraging by their hedge fund clients. In fact, several risk managers noted that many hedge fund clients (from both the OTC derivative business as well as prime brokerage platform) are exhibiting considerable caution, and in some cases appear willing to sit on the sidelines for the time being despite in many cases being only flat for the year to date.

- **Market risk as measured by VaR has decreased across the CSE firms.** Most firms have shown moderate to significant drops in their Firmwide VaR numbers from the prior month. Risk managers have noted that many businesses have reduced positions as customer activity has shown signs of weakening. One risk manager noted that customer activity is dropping further in July, which may foreshadow further reductions in the risk profile of the CSE firms. The universal exception to this decrease in exposure has been the core mortgage securitization and leveraged lending businesses where exposures remain high.

- **Increased correlations and volatilities in equities markets impact VaR measurement.** While the absolute VaR for equities at many firms stands below levels during the late spring period when position taking was significantly higher, VaR measures have increased recently as firms have rolled forward the time series of market moves used in the modeling. The two biggest reasons for the increase relate to (1) the increase in volatility in the equity markets and (2) recent increases in correlations in equity markets, which result in the reduction of the diversification benefit inherent in a portfolio based risk measure.

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

Bear Stearns

- After a month characterized by high profitability and high turnover of inventory, the net market value of positions in Bear Stearn's residential securitization pipelines increased almost $4 billion during June. The risk manager highlighted the lower turnover this month as well as a significant increase in aged inventory, a key metric in managing a securitization business that serves as a warning that production may be outstripping distribution. We will follow up with risk management on both the levels and aging of inventory in the securitization pipeline at the next monthly meeting.

- The problems at Rooftop Mortgages Limited, Bear Stearns' UK subprime mortgage originator, discussed two months ago, have continued. As a result of the continued poor performance of the two deals already in the market, Bear Stearns has decided not to bring another Rooftop deal to market for the time being and hopes to sell the current inventory of originated loans through bulk whole loan sales. We will continue to monitor this situation as the amount of loan inventory, including commitments, is approximately $1.5 billion.

- During the July meeting, the risk manager discussed plans to switch the firm's approach to marking bespoke Collateralized Debt Obligation ("CDO") tranches. The firm historically would mark bespoke tranches using index implied spreads. The decision had been made when many of the single name CDS were not as liquid as the indices. With the increase in liquidity and transparency in the single name CDS market, they have changed their approach and will now mark the bespoke CDO tranches using single name spreads from CDS as inputs into the pricing model. We will follow up on the implementation of this methodology change.

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Goldman Sachs

- As Goldman's exposure in the bank loan space has continued to grow, credit risk management and senior business heads have looked for additional risk metrics to capture the possible losses associated with a deal pipeline that regularly hovers around $40 billion. To accomplish this, credit risk management has recently rolled out a metric to supplement the standard credit spread widening scenario. The standard scenario increases spreads by a percentage of their current level, with this percentage shock derived from the Fall 1998 spread widening event. As credit spreads are at historically tight levels, the effect of relative shocks has been dampened. Credit risk management is now providing two senior risk committees with an Absolute Fall 1998 scenario, which takes the spreads to the actual levels realized in 1998 and effectively doubles the loss impact, further highlighting the risk associated with this business.

Lehman Brothers

- A new proprietary group, managed by the former head of high grade credit, has commenced trading. The proprietary positions formerly housed in the franchise high grade business have been moved under their auspices, and they expect to put on new positions as well. It is our understanding that this group will focus mainly on credit trading strategies, but is not limited to a particular asset class. We will continue to monitor the growth of this business.

Merrill Lynch

- Merrill Lynch has changed the time series used in the historical VaR calculation for traded leveraged loans resulting in a decline in average firmwide VaR of 15% over 2Q06. The affected book consists of approximately 130 distressed and high yield names with an aggregate market value of $1.5 billion and has been growing for the past year. While the portfolio is diversified, there are a high proportion of loans from the airline and energy sectors. Instead of mapping to a single-B corporate bond time series, the positions will be mapped to the S&P Leveraged Loans time series. The new series is less volatile, and better represents the risk of the positions. Since VaR limits were implemented last year, there has been a push by some businesses to refine the VaR calculation, which had been characterized as conservative in this case because of the higher recovery rate and lower volatility of loans versus bonds. Market Risk Management is sensitive to the optics of a decreasing VaR for a growing business and has restated VaR going back to January 2005 in addition to employing other risk metrics. We will follow up on the backtesting results for this book with the revised methodology, and we will continue to monitor the implementation of VaR limits and other VaR methodology changes as this issue surfaces elsewhere.

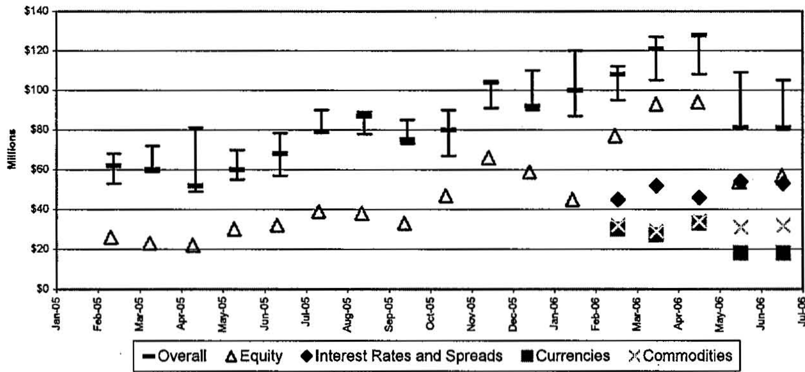
- Senior management has expressed a desire to grow the foreign exchange and commodities businesses. Merrill acquired an energy trading business specializing in gas and power in November 2004. Recently that business has expanded into trading complex oil products, presenting new risk management challenges. We will continue to monitor the risk management of this business and senior management's risk appetite in this space.

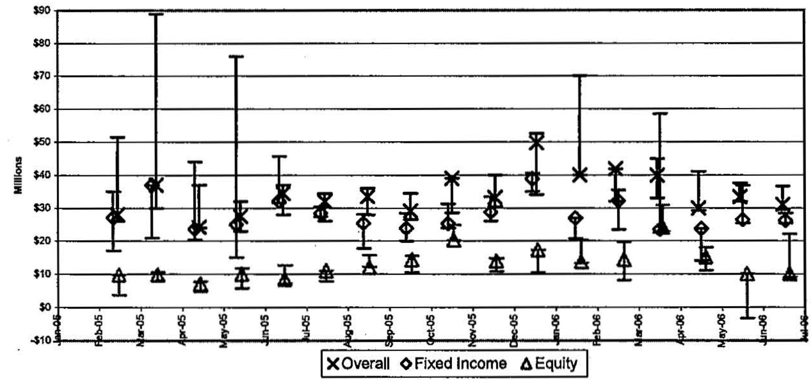
- On July 24th, Hospital Corporation of America ("HCA") announced its agreement to be acquired by a buyout group including private equity firms Bain Capital, Kohlberg, Kravis Roberts ("KKR") and Merrill Lynch Private Equity. Including the assumption of $11.7 billion in debt, the transaction would represent the largest leveraged buyout ever. In addition to the tremendous size of the deal, this transaction represents a trend in deals where Merrill plays multiple roles in a transaction. In this deal Merrill is providing one-quarter of the debt financing ($5.5 billion) for the deal as well as making a $1.5 billion private equity investment in HCA. During the month, we discussed with senior risk management both the specifics of this deal as well as the challenges involved in the risk management of deals were Merrill has

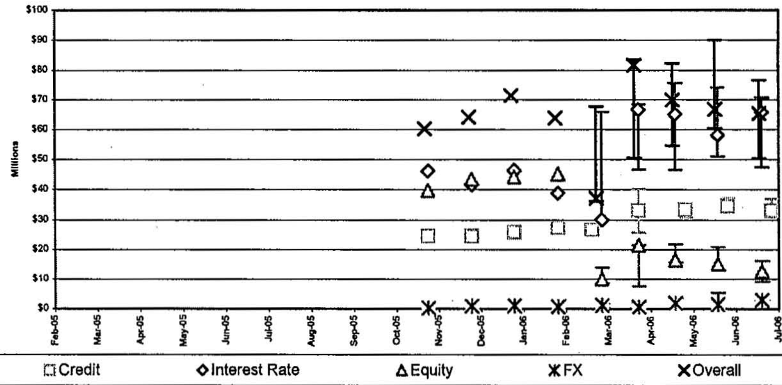
many "touch points". We will continue to monitor this deal as it moves toward closing late this year at which time the firm expects to have decreased substantially its loan commitment through syndication.

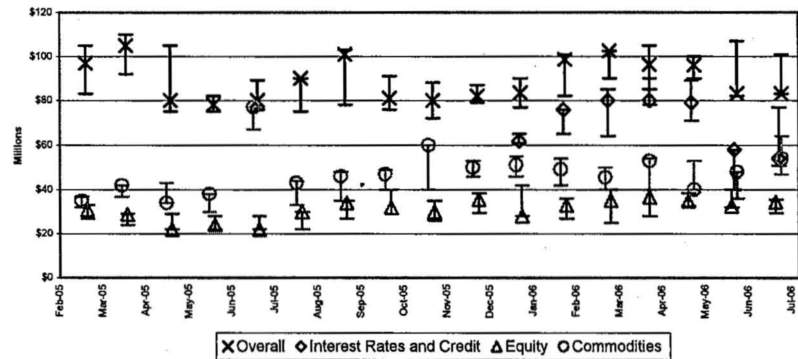
Morgan Stanley

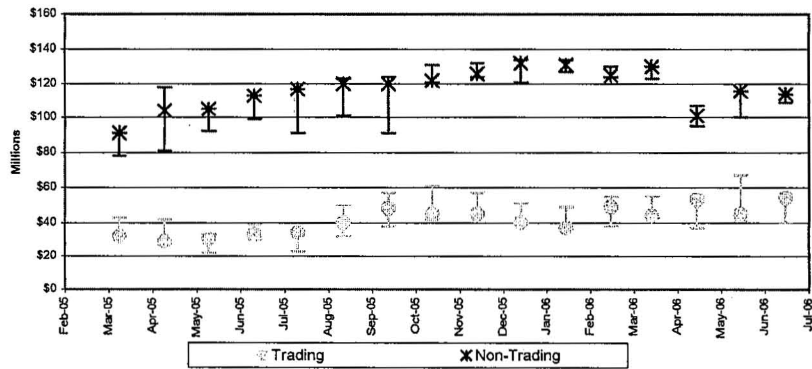
- In the prior monthly risk summary we discussed a very large financing deal that the firm was negotiating. The deal was with a newly created TXU subsidiary to finance the building of 11 new coal fired power generation facilities in Texas. The financing package was for a total of $11 billion to be funded in multiple stages. In order to achieve a stable debt rating on those facilities, Morgan also facilitated a large hedge transaction for the counterparty to mitigate the price risk of selling the future output of the plants. Prior to and during the current monthly risk meeting, we discussed the progress the firm had made in reducing the credit and market risk exposure coming from this transaction. On the credit risk side, two other banks joined the deal as expected and the loan commitment was reduced 60% to $4.5 billion. By the end of the summer, credit risk management expects the exposure to be further cut in half before a more broad syndication and closing of the loan takes place in the fall. On the market risk side, the large concentrated outright exposure discussed last month has been effectively converted into smaller, but still concentrated, basis risk positions via hedging. As a result, the Commodities VaR that spiked at the end of last month has come down substantially. We will continue to monitor this deal as it moves toward closing later this year.











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