MEMORANDUM

December 5, 2006

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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 October market and credit risk packages.

There were several common themes in discussions with firms:

- **CPDO issuances may have compressed credit spreads.** Many observers believe that the emergence of a new credit derivatives product, constant proportion debt obligation ("CPDO"), has caused spreads on investment grade credit derivatives indices to tighten to all time lows. CPDOs are leveraged credit structures that sell credit default protection on US and European investment grade credit default indices while offering investors in the structure attractively high fixed coupons. CPDOs generate these returns by using a dynamic hedging strategy that entails increasing leverage when credit markets are selling off and decreasing leverage when credit markets are performing well. In other words, a CPDO will take on more risk as it is incurring losses and reduce risk as it is incurring gains. Rating agencies have rated instruments that utilize this "trading strategy" as AAA, although the exact basis for this determination remains unclear. Firms are scrambling to provide CPDO products to satisfy the demand of investors searching for yield in the current low interest rate environment.

  Some risk managers are concerned not only with the immediate impact on the credit trading market. They are also concerned with the effect on the market during the rebalancing that is required when the composition of the credit indices changes semi-annually. Rebalancing occurs on the index roll dates (March 20th and September 20th) when credits that have been downgraded or whose spreads have deteriorated significantly are replaced in the indices. Risk managers are concerned about the potential crowding in the market during these periods. In addition, risk managers also can foresee situations where CPDOs would hit certain unwind triggers if credit spreads widened substantially. Should this occur, the CPDO structures would liquidate positions, leading to losses for investors and, at least potentially, market volatility.

- **Firms are pressed to go long on investment grade credits.** Normally, many credit traders would take bearish directional views on spreads in an environment where spreads are at historically tight levels. But given the recent tendency of spreads to continually grind tighter (perhaps helped by CPDO issuance), mark-to-market losses have thinned the ranks of the shorts to almost nothing. Risk managers observe that almost no traders or desks are currently short, and express concern that a wide range of financial institutions are now exposed to an unexpected deterioration in credit markets.

- **Investors' demand for leveraged loan products has increased.** Several months ago, risk managers were concerned about the market's capacity to absorb the volume of leveraged loan products entering the market, particularly the outsized issuance related to Hospital Corporation of America's ("HCA") $33 billion leveraged buyout deal. In fact, investors were eager to purchase the HCA deal and, as a result, loan products priced better than expected.

- **Covenants are again under pressure, but now in the investment grade loan market.** Last spring, the covenants that traditionally protect lenders were weakened or eliminated as appetite for leveraged loans on the part of investors appeared insatiable. During the summer, however, there was a clear pushback against this erosion from the purchasers of leveraged loans and such deals vanished from the market. Now there are new indications that some lenders are willing to dispense with the traditional protections, but the current issues are in the investment grade space. Recently, more investment grade counterparties have been using borrowed cash, rather than their equity, to finance acquisitions. Given the current appetite of loan market investors, they have also become more aggressive in negotiating for less restrictive covenant terms. Risk managers are monitoring investors' reactions as these investment grade "covenant-lite" issuances enter the market.

- **Several firms are using CSE capital requirements as a basis for internal allocation of risk capital.** The attribution of CSE capital to individual businesses, and computation of resulting returns on CSE capital, has become part of the governance process at several firms. The risk return analysis assists the firms in setting limits, and evaluating requests from businesses for adjustments between formal budgets. One risk manager noted that applying the CSE capital framework has motivated some business units to more actively hedge risk exposures. Furthermore, application of this risk-return framework has moved some business units to estimate CSE capital for potential trades prospectively.

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

Bear Stearns

- Bear's Distressed Debt business made a record $50 million profit in October, which represented a rather extraordinary 5% monthly return on the desk's inventory. More than half of these gains came from Enron trade claims. Given the illiquid nature of this position, we intend to follow-up with risk managers and controllers regarding the cause of the October mark-up, and discuss the challenges regarding the marking-to-market of such positions.

- As also evidenced last month, Bear's appetite for large lending commitments has expanded significantly. Most recently, Bear is the co-arranger for a private equity firm's acquisition of a $20 billion REIT. We plan on discussing with risk managers in December the evolving business, including any increase in risk appetite and senior management's current involvement in gaining comfort around these outsized commitments.

Goldman Sachs

- The commodities business executed a large European emissions transaction and the risk manager indicated that such trading is poised to grow. We will have a detailed discussion of this business and associated risks in the near future.

- Market and credit risk managers have conveyed a very strong internal business focus on growing operations in emerging markets countries. Businesses have begun to hire additional staff to focus on emerging market areas and discussions around limit increases have seemingly begun. We will continue to discuss these initiatives with risk management, including the internal dialogue surrounding new limits or the approval of particular activities.

Lehman Brothers

- The energy business recently executed a large power trade in Texas, resulting in a standalone deal value-at-risk of $12 million and maximum potential exposure of over $170 million. This is by far the largest trade that the business has engaged in since its inception earlier this year, and we will continue to discuss the market and credit risk management of this position.

- We met with the relevant business, product control, and market risk personnel to discuss the increases in subprime and prime mortgage residuals held on the balance sheet since June. The increases reflect greater difficulties in selling these riskier pieces of the securitization as well as a shift in business philosophy to invest in more third-party sourced residuals. We will continue to discuss this trend, and the mortgage securitization space in general.

Merrill Lynch

- Market risk managers are currently focusing attention on the commercial real estate space. Merrill Lynch is actively growing in this area in both conduit financing activity and equity principal investments. Several recent transactions have caused the firm to take concentrated positions, particularly within the European and Asian region. We will continue to monitor the business and the means by which the concentrated risks are managed.

- We met with the business, market risk, and product control personnel about Merrill's recent and projected issuances of CPDO products. Although market risk managers expressed comfort with these instruments, they will be watching closely the impact of the firm's credit spread exposures on the next indices roll when these instruments will need to be rebalanced. We will continue to monitor developments in this market closely over the coming months.