MEMORANDUM

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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 April market and credit risk packages.

There were several common themes in discussions with firms:

- **Private equity: still a boom or now a bubble?** With "so many deals" occurring, leveraged buy-out ("LBO") activity is becoming an ever more important determinant of risk taking at the CSE firms. Moving beyond the corporate lending, loan securitization, and investment banking advisory businesses, which provide services directly related to LBOs, other trading desks are also seeking to earn revenues from these deals. For example, risk managers at several CSEs have reported increased positioning by equity as well as credit desks in the equity of companies that are perceived as likely buyout targets - a variant of the "merger arbitrage" strategy (which involves traders taking views on whether already announced acquisition deals will successfully complete). Traders and risk managers have also become more conscious of losses that can result from upward "jumps" in equity prices of target companies, whereas historically much more concern was focused on the potential of asset prices to gap downwards. As one risk manager asserted, everyone is "really afraid of writing (equity) call options" right now. And as many are attributing the recent buoyancy of US equity markets to the relentless pace of buyouts, several risk managers reported that trading desks are exhibiting very strong convictions in their desire to take additional long (directional) equities exposure, in some cases running against trading limits in the process.

- **As LBO and merger activity remained robust, event-driven lending pipelines grew again in April.** Pipelines reached record levels at several CSEs in April. One risk manager in particular noted that as many as twenty-five new deals were being presented to the firm's senior commitment committee for approval each week, and several discussed the substantial revenue growth exhibited by these businesses thus far in 2007. Also, the firms are continually willing to commit to larger loan amounts on the bigger (and often highly publicized) transactions. Investment grade strategic acquisitions still tend to drive the largest

CSE commitments, which can initially exceed $10 billion. However, private equity-related activity, which almost always involves non-investment grade borrowers, remains the increasingly dominant component of lending portfolios. In the process, risk managers continue to report deals closing at unprecedented leverage levels. Also, there continues to be strong activity in deals that involve some significant real estate component – i.e., where the buyout targets own significant commercial real estate assets.

- **Directional equities risk was a dominant risk driver during the month.** Increased long equities exposure largely explained changes in the aggregate risk profiles of several firms. As mentioned above, some traders became rather aggressive in their desire to take additional equities exposure, spurring market risk limit discussions in some cases. In addition, there was active equity block trading in April, which one risk manager noted was unusual for the time of year. One explanation for this phenomenon is simply that investors were selling on the heels of a healthy market rally.

- **Developments in the residential mortgage market are somewhat encouraging.** Market risk managers reported a modest market recovery in April. On the subprime front, there is still little profit to be made in originating and securitizing loans. However, the situation has improved from previous months (even if that only means margins becoming less negative). While deal volumes are down, new securitizations continue to be completed, successfully moving product though the pipelines. Also, accounts indicated that liquidity is returning to the subprime marketplace, but with investors discriminating more actively between heterogeneous collateral pools. The ABX BBB- index, which is often used as the reference underlier by market participants purchasing or selling credit default swap protection on the broad credit-sensitive mortgage market, has also recovered somewhat.[1] Finally, risk managers continue to watch closely the performance of the Alt-A loan sector. With the exception of second lien (or home equity) loans, the problems have as yet not spread beyond the subprime sector.

  CSE counterparty credit risk departments remain focused on exposure to mortgage originators. The general outlook appears to be "not really worsening, but not getting better either". During the month several new subprime originators were added to the list of firms with serious financial difficulties. However, these events are quite consistent with prior expectations. Risk managers have been predicting for some time that smaller, monoline players will continual to fail, and the firms have been reducing their risk accordingly. No new counterparty exposures of material concern were reported.

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

Bear Stearns

- Bear Energy announced on May 21st its agreement to buy the power trading business of Williams Power Company for $512 million. The portfolio consists of a set of physical power plant tolling agreements, power plant lease contracts, a set of full-requirements power supply contracts, and the associated hedge book. In addition, Bear Energy will acquire various information systems and personnel from Williams in the deal. This acquisition will significantly increase Bear Energy's risk profile. We will monitor this deal as it moves towards closing and plan to visit Bear Energy's headquarters in Houston, Texas in the fall.

- Bear's corporate lending pipeline reached a record high. The firm had multiple commitments in excess of $5 billion, including two in the $9 billion range. While the overall pipeline increased substantially, all the largest exposures remain unfunded, pre-closed commitments.

[1] The "ABX-HE-BBB- 06-2" fell from its 2006 high of 102.19 to 63.16 in February of 2007, but as of mid-May had retraced to 77.05.

We will continue to monitor these large commitments as they move through the syndication process.

- Bear discovered that one of the traders working on its International Equities desk had been reporting fictitious short sales in an attempt to hide a significant long position. The trader was able to make his book appear flat in the trading system by continuously "canceling and correcting" the fictitious short positions with a one day lag. The activity was eventually discovered by the business due to the high funding cost, assessed/charged by the Treasury department, for what appeared to be a flat book. Since the incident, the firm has reviewed the permissioning rights of all traders, and discovered that the IT department had inappropriately granted similar rights to "cancel and correct" to a small number of other traders as well. The firm has subsequently revoked these rights where appropriate and is currently reviewing its policies and procedures around granting permissioning rights. In addition, the control functions are evaluating the reporting available to business heads for identifying such transaction modification activity. We will follow up on any further action taken by the firm.

Goldman Sachs

- GSS, Goldman's prime brokerage division, recently suffered a $21 million loss due to the failure of one client, a relatively small New York-based hedge fund, which had misrepresented to GSS the execution of significant short sales in a particular stock. This is the first loss of this magnitude for GSS and resulted from what one might deem as failures in GSS operations processes, and possibly fraudulent activity by the client. GSS staff immediately began to refine operational processes to minimize the chances of incurring a similar loss in the future.

- Continuing the trend of participating in so-called "marquee deals", Goldman had two new acquisition financing commitments in the $15 billion range. The business has recently expanded its hedging program, which will give significant benefit in the event of a broad credit spread widening but does little to mitigate the significant deal specific risk. Credit risk managers briefed us on the details of the hedging program. We will continue discussions about how Goldman manages both its spread-widening and idiosyncratic risk in this space.

Lehman Brothers

- Lehman is providing $23 billion of financing for its purchase, made with a co-investor, of Archstone-Smith, a large multi-family REIT. In addition to $19 billion in bank debt, the financing includes $2 billion in bridge equity and $2 billion in mezzanine bridge financing. While the initial commitment amount is unprecedented, Lehman plans to syndicate a portion of the bridges, sell properties to pay off bank debt, and to distribute the remaining debt exposure via CMBS securitizations. Post syndication and securitization, Lehman expects to retain only a $250 million equity stake in the new entity. Given the large size of the deal and Lehman's role as sole financing provider, we will closely monitor the business's progress in reducing its exposure.

Merrill Lynch

- Several organizational changes occurred within the control functions at Merrill Lynch in the past few weeks, following a re-organization in senior management at the group level, as well as within the Global Markets and Investment Banking ("GMI") division. Chris Hayward, formerly Merrill Lynch's treasurer, was named Finance Director for the holding company. He will also retain responsibility for key holding company supervision functions. Eric Heaton, the head of Investor Relations and Strategy and Business, was named as the new treasurer for the group, and a new corporate controller was named as well. In addition, several new CFOs were named for the major product groups within GMI. As we are continuing to focus on the price verification processes headed by the CFOs, we will work closely with the new team.

- The composition of risk reflected in the firm's Value-at-Risk ("VaR") has changed dramatically over the past few months. Credit spread risk has declined substantially while interest rate risk has increased. Market risk managers viewed this as a positive development, as interest rate products are generally more liquid. The increase in interest rate risk has been driven by proprietary positions in the Strategic Risk Group.

<u>Morgan Stanley</u>

- The commodities division suffered an $87 million loss on exposure to electricity transmission rights, which are auctioned just once a year. To put this in context, the 1-day 95th VaR for the division as a whole hovers around $25 million. We will get more detail on the nature of the position and the Market Risk Department's approach to risk measurement and management.

- The corporate lending portfolio reached a record level of $63.8 billion, with net commitments up approximately $9 billion from the previous record last month. This increase was driven primarily by financings of acquisitions by financial sponsors as well as some significant investment grade bridges used for corporate acquisitions.

- The firm's Chief Credit Officer noted that the Capital Commitment Committee ("CCC"), which approves the corporate lending commitments, has been working at a feverish pace due to the unprecedented volume of leveraged finance deals with financial sponsors. In the past, the CCC would meet two or three times a week. In April the committee began to meet daily, reviewing 20 to 25 deal proposals per week. Also, the CCC has begun to push back more on the "marginally profitable" deals that have weak terms (e.g., covenant-lite), increasing the percent of deals they reject at committee to between 20 and 25%.