MEMORANDUM

November 6, 2007

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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 current market and credit risk packages.

There were several common themes in discussions with firms:

- **Firms breathed a sigh of relief about the leveraged loan market but are not completely out of the woods yet.** As anticipated, the primary leveraged loan market re-opened after Labor Day and loan syndications slowly resumed. Demand remains far below pre-summer levels, but investors are willing to purchase loan products backed by sound credits, with the right terms and at the right price. Hence CSE firms are actively selling down their loan inventory to both CLO buyers and a variety of fund types, including high-yield bond mutual funds and hedge funds. However, challenges remain in distributing the larger commitments.

  As a result of renewed investor demand and decreased loan inventory balances, CSE firms are contemplating reopening their leveraged buyout financing pipelines. With lessons learned from the recent market disruption, firms are rejecting financing proposals involving questionable credit quality, high leverage ratios, and large commitment sizes, as these were the major characteristics associated with deals that failed to clear the market during the late summer. CSE firms are now requiring higher fees to commit to lend, as well as, wider price and structural flex terms. Covenants are also back for deals involving financial sponsors. Thus far, only two CSE firms have entered into new non-investment grade commitments, all of which are less than $5 billion in size.

- **Firms increased market risk across the board.** After reducing positions in July and August, most CSE firms are again active across all products and regions. For instance, equities desks have increased directional (delta) equities exposures, interest rate desks have gone longer rates, particularly in Euros and Sterling, and FX desks have built back up their emerging market positions. This significant increase in risk-taking, combined with the impact on risk models of the recent volatility in many markets, has resulted in some firms breaching limits at the firm-wide and divisional levels. Thus many desks have requested and been granted VaR limit increases. However, risk managers are closely monitoring traders lest they be inclined to take outsized risks after a weak summer, as bonus calculation season approaches.

- **The securitization market for credit sensitive residential mortgages products remains in a "deep freeze."** The securitization market remained essentially closed to new deals involving subprime collateral as rating agencies announced repeated waves of downgrades on 2006 and 2007 subprime deals. While risk managers report some trading in Alt-A backed securities, liquidity remains largely limited to prime products. As one risk manager summed up the events in September, "the best thing about it was that it wasn't August."

- **As concerns regarding ABCP persist, will M-LEC be a long-term solution or a quick fix?** Driven by investor aversion to asset-backed commercial paper ("ABCP") programs which issue short-term commercial paper secured by mortgage-backed securities and other assets, Citigroup, J. P. Morgan Chase, and Bank of America are creating a super structured investment vehicle ("SIV"). Their hope is that by purchasing the assets held through dozens of existing bank-affiliated programs that might otherwise be forced to unwind, the super SIV will prevent a mass liquidation of mortgage-backed securities into the market at fire sale prices. Such a fire sale could further depress prices, causing other institutions to incur additional mark-to-market losses on existing inventory. The super SIV, which is called Master Liquidity Enhancing Conduit ("M-LEC"), will be partially backstopped by the three commercial banks and will be largely funded by new issues of ABCP.

  There is no consensus regarding what M-LEC's market impact will be. Proponents of the initiative believe that M-LEC will stave off a broader credit crunch in the financial markets and foster ABCP investor confidence. Skeptics believe it is just an attempt to delay reckoning with the inevitable thus far. The CSE firms have been approached to participate as investors in the project but have made no commitments. They continue to examine the proposed structure.

- **Maturities of high grade corporate commercial paper are extending back to normal lengths.** The lack of liquidity in leveraged loan and mortgage markets spilled over to affect the maturities on newly issued unsecured high grade corporate commercial paper. Under normal conditions, average maturities were around 30 days but, by late summer, maturities shortened to an average of 8 days. Average maturities have slowly extended back to around 20 days, and seem likely continue to extend out further as investors regain confidence in the market.

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

<u>Bear Stearns</u>

- Bear has experienced a recent spike in mark disputes with dealer counterparties to swaps referencing RMBS and ABS CDOs - products which have been very illiquid the last several months. We will continue to discuss with risk managers the firm's progress in resolving these disputes.

- An equities trader in Hong Kong incurred approximately $100 million in losses as a result of a trading strategy that was "doomed from the beginning". The strategy involved the purchase of warrants on large cap equities, hedged with short positions in OTC options referencing the same underliers. Because the warrants trade at a premium to the OTC options, these positions would inevitably generate loses if held to maturity. It appears the trader's view was that the implied volatility spreads between the warrants and options would temporarily widen (before eventually collapsing to zero), allowing him to trade out profitably. However, because this individual had purchased the majority of outstanding warrants for some of the underliers, such a spread widening was virtually impossible. Thus far, Bear's investigation into this matter has not uncovered any fraud. Given that this loss is not the result of a classical "rogue trader" problem, risk management has been assessing what steps it could have taken to identify and address this "uneconomic activity" sooner. The positioning commenced in July but it was not until September that the trader was forced to liquidate the book. Because this particular implied volatility spread was never conceived by risk managers to be a material risk factor to the business, there was no risk reporting around the exposure. Therefore, one lesson learned from the incident is that risk managers must have more frequent and detailed dialogue with traders and desk heads regarding trading strategies, in order to ensure the risk managers are "on the right page" with respect to risk measurement and reporting.

Goldman Sachs

- Intra-month, Firmwide VaR and standalone Equities VaR reached all-time highs of $181 million and $167 million respectively. In addition, senior management has extended temporary Firmwide and Equities VaR limit increases in order to accommodate perceived trading opportunities. We will continue to monitor this large equities exposure, and next month we will discuss with risk management whether a permanent shift in risk appetite has occurred.

Lehman Brothers

- Risk Appetite ("RA"), Lehman's holistic risk measure, reached an all-time high value of $4.3 billion versus its limit of $3.5 billion. While many businesses are running close to their limit, the increase in firmwide RA was primarily driven by an increase in equities exposure and retained positions from the First Data leveraged finance deal. The Executive Committee approved the limit excession, noting that a new limit which would accommodate current risk levels will be developed shortly, upon completion of the 2008 budget process. However, given the naming of a new Chief Risk Officer effective December 1, we will follow up on the governance issues surrounding the increase in risk-taking.

Merrill Lynch

- We have been in close contact with all the control functions at Merrill with regards to the management and valuation of the Super Senior ABS CDO position. We have implemented daily calls with Treasury personnel to discuss liquidity risk, including contingency plans for funding off-balance sheet assets that may return to the balance sheet. Discussions were also held with Finance personnel on the marking methodology employed at quarter-end and the governance process surrounding the marks. Market and credit risk personnel has also kept us abreast on potential strategies to mitigate the risk of the positions.
- Merrill has purchased CDS protection on Super Senior ABS CDOs from several financial guarantors as part of its risk mitigation strategy. Although financial guarantors insure other debt obligations and structured finance products, such as municipal bonds and Corporate CDOs, their businesses are sensitive to the large amount of protection sold against subprime structured products. As several financial guarantors recently reported GAAP based losses for their third quarter, Merrill is beginning to question their ability to perform under all scenarios; a concern we also share. Credit Risk Management is currently analyzing and monitoring total

financial guarantor counterparty exposures across all desks at the firm and seeking to mitigate exposures.

Morgan Stanley

- In the summer, the Securitized Product Group's proprietary trading desk established a large synthetic position in Super Senior ABS CDO tranches to compliment an existing, and highly profitable, set of short positions in bespoke subprime mezzanine CDOs. The desk sold CDS protection on $14 billion notional of Super Senior ABS CDOs. As of September month-end, the position had suffered trade to date losses of approximately $1.5 billion. Further significant losses in October are likely. There have been no control issues around this exposure. We have been in close discussion with the independent Valuation Risk Group and are comfortable with the current methodology used to price verify the position. The Market Risk Department has also discussed with us the market risk profile of the position for the last several months and we are scheduled to perform a detailed review of the P/L drivers at the next monthly risk meeting.