MEMORANDUM

February 1, 2006

TO: Robert L. D. Colby, Acting Director
    Herbert F. Brooks, Chief of Operations
    Michael A. Macchiaroli, Associate Director
    Thomas K. McGowan, Assistant Director
    Division of Market Regulation

THROUGH: Matthew J. Eichner, Assistant Director

FROM: Financial Economist
       Financial Economist
       Accountant
       Financial Economist
       Financial Risk Analyst
       Financial Economist
       Accountant

RE: Risk Management Reviews of Consolidated Supervised Entities

Office of Prudential Supervision and Risk Analysis ("OPSRA") staff met over the past five weeks with senior risk managers at the CSEs and at Credit Suisse to review December market and credit risk packages.

There were several common themes in discussions with firms:

- **Non-investment grade corporate lending commitments were down across most CSE firms.** While the pipeline of future deals remains strong, unfunded commitments, typically provided by banks and securities firms as part of a financing for an acquisition, fell markedly as firms successfully syndicated high-yield loan commitments during December. The continued strong appetite for non-investment grade loans allowed the firms to reduce several outsized exposures generated in the previous few months. Risk managers, however, remain focused on the leveraged loan area, which has grown sharply and steadily over the past several years, and on the possible impact of a decline in investor demand for these corporate credit products.

- **New, and in many cases larger, limits are coming.** Firms are currently completing their annual budgeting processes, which include revisiting market risk, credit risk and balance sheet usage limits. Senior management considers risk appetite in the aggregate and conducts risk/return analyses to support the allocation of limits to specific product areas. Significant growth in the capital base during the past year is expected to lead to an overall increase in risk appetite, and thus limits, at most firms.

- **Firms reacted swiftly to news that a trader at Deutsche Bank had mismarked structured credit products, leading to a loss of approximately $53 million.** While the exact nature of the problem at Deutsche Bank remains unclear, the CSE firms immediately conducted their own reviews in response to the press reports regarding the loss at Deutsche Bank. While the amount of additional investigative work varied across firms, all firms undertook an examination of marks in the synthetic collateralized debt obligations ("CDO") books, with special attention being devoted to trades with Deutsche Bank. In all cases, risk
managers and product controllers felt comfortable with the results. Nonetheless, everyone recognizes that price verification in much of this product space, particularly with respect to bespoke tranches of synthetic CDOs, is challenging given the level of model complexity and lack of transparency for certain model inputs such as base correlations. Like us, risk managers are extremely interested in better understanding the events at Deutsche Bank and the extent to which there are lessons regarding controls in the structured credit area that may be more broadly applicable across the industry.

- **Correlation risk is not just about corporate credit anymore.** Much of the innovation in corporate credit markets in recent years, which led to the establishment of active markets in corporate default correlation products, is now being replayed in the mortgage- and asset-backed space. Several firms have begun to structure CDOs comprised of residential and commercial mortgage assets, as well as other collateral such as credit card and auto loan receivables. In addition to accumulating cash collateral, firms source the exposure for these CDO structures through credit default swaps written on existing asset-backed securities. Like with corporate CDOs, credit tranching is performed to create securities designed to appeal to a variety of investors. To the extent that all of these tranches are not immediately distributed, the firm structuring the deal is exposed not only to losses from widening credit spreads, but to changes in the correlation of defaults of the underlying collateral for the deal. This risk is difficult to measure and hence to manage. Yet the development of ABS/MBS derivatives markets has also provided new opportunities to manage risks from other businesses within the firm, notably by hedging mortgage securitization pipelines. Complicating matters further, with the recent launch of a synthetic ABS index, the trading of standardized tranches is likely to develop soon in the MBS/ABS space, presenting new correlation trading opportunities (both in terms of market making and proprietary trading).

- **All eyes are on the Financial Accounting Standards Board (“FASB”).** Under current accounting standards, the CSE firms are all required to defer recognition of some profit and loss (“P&L”) on certain derivatives trades. Where certain inputs to the models used to price the contracts are unobservable, firms may not recognize first days gains from those trades under the post-Enron EITF 02-03. Some firms have unrecognized income (or deferrals) in excess of $1 billion. Following industry complaints that these deferrals are problematic, and impose a wedge between P&L and risk management, FASB is now revisiting EITF 02-03 with a proposed new standard that would increase the circumstances under which P&L could be recognized on the basis of a “mark to model”. While the possible modification of EITF 02-03 is generally eagerly awaited, risk managers remained concerned about the transition rules that would apply to the current deferrals. Under some scenarios, the firms would never be able to record this economic profit into net income. Instead the deferrals would be eliminated through adjustments to the equity accounts on the balance sheet. However, traders are generally compensated based upon their contribution to net income. Risk managers have expressed concerns that this could provide incentives for traders to put on uneconomic trades for the sole purpose of creating transparency and releasing the deferrals. Such behavior would raise significant risk governance issues.

- **September 2001 risk factor changes “roll off” the time series used for VaR calculations.** Many firms that calculate a historical simulation based VaR using four years of data have noted the rolling off of the highly volatile September 2001 period from their time series of risk factor changes. Even holding positions constant, the rolling off of a volatile time period leads to less extreme observations in the tail of the portfolio loss distribution and thus generally results in a lower VaR. This type of change highlights the interpretation issues surrounding the use of VaR metrics.
We also expect to discuss the following firm-specific issues during the next round of meetings:

**Bear Stearns**

- Mortgage and asset backed inventories across Bear Stearns' securitization businesses grew during December. In particular, the net market value of the ARMs desk's positions grew $1.53 billion to another new record of $13.9 billion. Additionally, there was a sharp increase in aged inventory in the mortgage and asset backed area, which grew $900 million to $3.6 billion. The risk manager noted that this December was a particularly slow month for moving product, but that reducing the level of aged inventory is risk management's biggest focus currently. He also explained that the Head of Mortgages has instituted a target for reducing aged inventory by 50% (from December levels). We will follow up on the firm's progress in this area at the next monthly meeting.

- Limited trading has commenced in CalBear, Bear Stearns' joint venture with Calpine. Currently, the activity has been limited to exchange traded contracts in both the natural gas and power space and the market risk, as measured by VaR, remains below its $1 million limit. We will continue to monitor the evolution of trading activity in this business and any developments in bankruptcy court that affect CalBear's contracts with Calpine.

**Credit Suisse**

- The risk manager noted that the energy trading business has now implemented a new scheduling system that will provide the ability to do physical trading. While the firm does not intend to actually take physical delivery as part of its business operations, it needs this capacity to be able to engage in the full gamut of trading with clients and to take advantage of the volatility inherent in the settlement period of commodity contracts. During February, the firm is going to the EBK, its consolidated regulator, to get approval for physical trading. We will continue to monitor these developments and how they change the risk profile of Credit Suisse's energy trading business.

**Goldman Sachs**

- Goldman continues to syndicate down the $10 billion acquisition financing it provided to Telefonica, an investment-grade European company. The current position is approximately $1 billion, and syndication of the Telefonica commitment has gone according to ex-ante predictions. We will continue to discuss Goldman's increased risk appetite for deals of this magnitude.

**Lehman Brothers**

- Lehman has increasingly been involved in large block trades, especially in Europe. We will follow up on the risk management issues of these positions, including a specific block that resulted in a large loss in December.

**Merrill Lynch**

- Merrill is discontinuing its non-trading VaR disclosure effective with its 2005 10-K scheduled to be filed in the next several weeks. Risk from commercial loans, notes, and mortgages,
which were components of non-trading VaR, will be contained in enhanced credit disclosures. The exact form of the new credit disclosures as well as the representation of these products in the monthly risk package has not yet been decided, and we will follow up on this with Merrill at next month's meeting.

Morgan Stanley

- During this past month's meeting, the credit risk manager stated that the department is looking to change its potential exposure ("PE") methodology. The current PE simulation model, PERS, is a complex, econometric model that requires a high degree of manual calibration. The plan is to move to a model that yields results that are more transparent to the business units and that would be "self-calibrating". This transition, like the transition to a new credit risk metric (discussed in last month's memo), is not expected to happen overnight. We will continue to discuss these plans with the firm as they come closer to becoming operational.

- The credit risk manager stated that the prime brokerage business at Morgan Stanley is becoming much more of a multi-asset business, growing away from its roots in the Equities space. The Credit Department therefore plans to increase its reach to include all prime brokerage accounts in its credit risk systems over the course of this year. Traditionally, the prime brokerage business has been primarily risk managed internally, as business unit personnel would set the collateral requirements ("haircuts") for customer accounts, in effect determining the amount of leverage provided to prime brokerage counterparties. These requirements were set to provide the firm with an over collateralized position such that no current and very little potential exposure to prime brokerage counterparties would exist. We will continue to monitor developments in this area and plan to meet with the prime brokerage business risk management during an upcoming monthly meeting.

- During December, Commodities VaR usage remained at record levels. Recent senior level discussions about commodities have focused on deciding what the right "run rate" (VaR limit and usage) for the division should be. As part of these discussions, the market risk department is working with the business to bifurcate the Division's VaR into two parts: (1) "Core VaR" to reflect trading risk and (2) "new deal VaR" to reflect the risk from large structured transactions. P&L would be broken out in a similar fashion allowing management to discern the risk-return profile of commodities more clearly along these lines and help to efficiently allocate risk limits accordingly. At the next monthly meeting we will follow up on the outcome of these discussions.

- During the past month, there have been several significant personnel changes in the Credit Department at Morgan Stanley. First, the Chief Credit Officer, Steve Holcomb announced his retirement. Jon LaMountain and Chip O'Brien, highly tenured managing directors with whom we have met on a monthly basis for some time, were named as Global Co-Heads of Credit. Secondly, the risk methodology group within the Credit Department saw two departures, including the Head of Risk Methodology, Charles Monet, who announced his retirement from Morgan Stanley effective May 1st. Senior risk managers have expressed their intention to establish a single methodology group, charged with developing modeling approaches for both market and credit risk. We will follow up with the Chief Risk Officer regarding this initiative.