MEMORANDUM

September 7, 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 July market and credit risk packages.

There were several common themes in discussions with firms:

- **Investors in non-investment grade leveraged loans have become more discerning.** Non-investment grade corporate lending remains a major focus for risk managers at the CSE firms. Clients have continued to seek such financing for acquisitions and recapitalizations, thus maintaining CSE firms' loan commitment pipelines at record levels. Early in the summer, borrowers had successfully pressured for better terms from originators and, ultimately, loan purchasers along many dimensions. But more recently, the market has become more discriminating and investors have pushed back decisively against some of the most aggressive deals, including so-called "covenant-lite" structures where the protections traditionally accorded to lenders (e.g. leverage ratios) are weakened or eliminated. Even some deals with more traditional covenant protections have been successfully syndicated into the market only after the use of so-called "flex terms". Price flex allows the originator to adjust the pricing of a deal based on investor demand. For example, a loan yielding Libor plus 250 basis points can be "flexed up" to Libor plus 300 points to clear the market. Structural flex allows the lender to change the capital structure funding the deal. For example, the size of different tranches can be adjusted relatively late in the process to produce a mixture that will be well-received by investors. Since investor appetite for leveraged loans has become more discerning, some originators, including one CSE firm, responded by seeking to include more conditionality in agreements with borrowers such as business material adverse change ("MAC") clauses. Business MACs or similar contingencies would theoretically permit originators to walk away if the borrower's financial condition deteriorates so that the deal no longer appears economically viable. These increased rights theoretically protect the banks from being contractually obligated to originate loan products that they will not be able to easily syndicate to investors and, therefore, would either be forced to hold on their own balance sheet or sell into the market at deeply discounted prices.

It is not clear, however, that banks would be willing to invoke the MACs and risk damaging critical relationships with deal sponsors. But even if these are not acted on, they may provide the originator with increased negotiating power when modifications to deal structure, pricing and timing beyond what is strictly permitted by the flex terms become necessary.

- **The potential for internal conflicts is growing as CSE firms actively make private equity investments with their own capital.** In acquisition deals, the CSE firms may provide a variety of services, including advisory work, origination and syndication of leveraged loans, and over-the-counter derivative hedges, in addition to taking an equity stake. As the size and thus potential profitability of these deals continues to grow, banks are seeking to become "one stop shops" with multiple touch points on these types of transactions. For example, during July, Hospital Corporation of America ("HCA") announced it agreed to be acquired by an investor group for $21.3 billion. The investor group includes Bain Capital, Kohlberg, Kravis Roberts & Co ("KKR"), and Merrill Lynch Private Equity. Factoring in HCA's existing debt of $11.7 billion, this transaction will be considered as the largest buyout in existence; previous record was held by the RJR Nabisco transaction which was valued at $31.3 billion. In this transaction, Merrill agreed to make a $1.5 billion private equity investment in HCA, to underwrite one-quarter ($5.5 billion) of the debt financing, and to become the lead arranger for the deal. These multiple roles, however, raise questions related to potential internal conflicts and information barriers. These matters have become a key focus for senior governance committees and risk managers at the firms most active in this space.

- **Proprietary interest rate trading has recently proven a difficult business.** Over the past several years as the Fed often telegraphed its intentions quite clearly, the propriety trading desks at the CSE firms often took directional views on interest rates that produced large gains. Recently, however, several CSE firms have had more difficulty trading within the interest rate space. In several instances, they were positioned for continued moves by the Fed to raise short term rates that did not materialize. When the Fed paused, several firms incurred losses on their directional bets. Although the exposures that produced the losses were well understood, and resulting losses were well predicted by the measured risk going into the events, risk managers are nonetheless focused on interest rate exposures which reside in a variety of places across the firm.

- **Risk taking in the airline sector increases.** Trading in the distressed loan space, particularly in the airline sector, has been profitable over the last few months. Therefore, several firms have increased risk appetite in this area. The business entails purchasing aircrafts with distressed leases and either renegotiating with the current lessees, re-leasing the aircrafts to other carriers, or selling the aircrafts for parts or as a whole. Risk managers are focused on this business as in-depth understanding of both aircraft valuation and the bankruptcy process is required.

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

<u>Bear Stearns</u>

- Bear's efforts to vertically integrate its mortgage securitization business continue to progress, as the business is sourcing a larger portion of the loans for its MBS deals from its newly formed (2005) U.S. residential mortgage originator, Bear Stearns Residential Mortgage Corp ("Bear Res"). For the first time in July, Bear brought several deals to market that were collateralized 100% with Bear Res originated loans. Prior to July, all Bear Res product had been securitized along side loans purchased from third party originators.

- The CRO noted that risk management is working to improve the production line suite of risk reports made available to the firm's senior management, so as to allow individuals to view the firm's risk from a high level and then drill-down into particular areas of interest. This entails not only work from an analytical modeling perspective, but making off-line reports available in a more automated and controlled environment. In addition to requiring investment by risk management, such enhancements should be facilitated by the front office IT initiatives, such as the upcoming front-to-back office platform "Calypso". As risk management works to enhance the risk reporting provided to senior management, we will discuss and incorporate into our monthly process.

Goldman Sachs

- Goldman's exposure in the bank loan space remains high, particularly to non-investment grade borrowers. It appears that all levels of the firm's management are highly focused on this business and continue to monitor the associated risks. We will also continue to follow Goldman's risk appetite in this area closely.

Lehman Brothers

- Senior management at Lehman has instituted an initiative to increase their risk taking activities across a number of areas. Their current Risk Appetite, an aggregate measure of risk across the firm that incorporates market, credit, and event risk, is at $1.8 billion versus a limit of $2.3 billion, and thus senior management feels there is room for additional risk-taking. Notably, they plan to increase their exposure to non-investment grade counterparty credit risk through increased cross-selling of derivatives to leveraged lending clients. We will closely monitor the risk governance issues that arise as these initiatives are implemented.

Merrill Lynch

- Trading value-at-risk ("VaR") has recently been in the $60-70 million range, compared with $40-50 million in the past. The firmwide VaR limit is currently $80 million, and Dow Kim, head of GMI, has expressed a desire to increase this limit to accommodate further business growth, specifically within credit trading, commodities, and currencies. The Executive Committee would need to approve this change, and Market Risk anticipates the business will make the request in the next few months. We will follow this process and any adjustments to risk appetite, as expressed through the firmwide limit.

- GMI recently reorganized its business structure, creating a Fixed Income, Currencies and Commodities (FICC) division headed by Osman Semerci. Market risk managers have been discussing risk metrics with the new management team, and the business has expressed a desire to roll down VaR limits to desks at a more granular level. This increased focus on VaR for governance purposes has led to pressure for some adjustments to the measures. While the ostensible motivation is a more "accurate" VaR, the result in practice is usually a reduction in measured risk. Increased interest in setting VaR limits has also placed new demands on the Portfolio Analytics Group that is responsible for VaR implementation. We will closely monitor the increased interest in VaR "accuracy", as well as implications for the adequacy of the Portfolio Analytic Group's resources in light of the movement toward more extensive use of VaR limits.

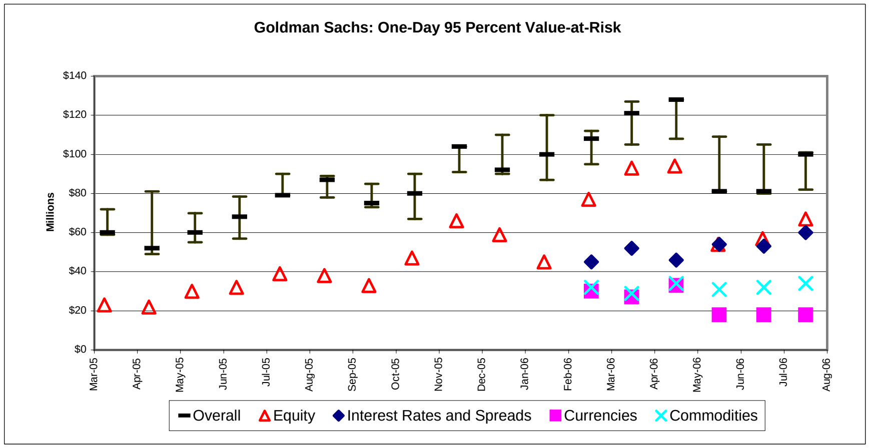
- MLCI recently completed a large power swap with British Energy which caused commodities VaR to spike to $22 million from an average in the $10 million range. As discussed in previous months, we continue to closely monitor the business profile and risk metrics used in this business.

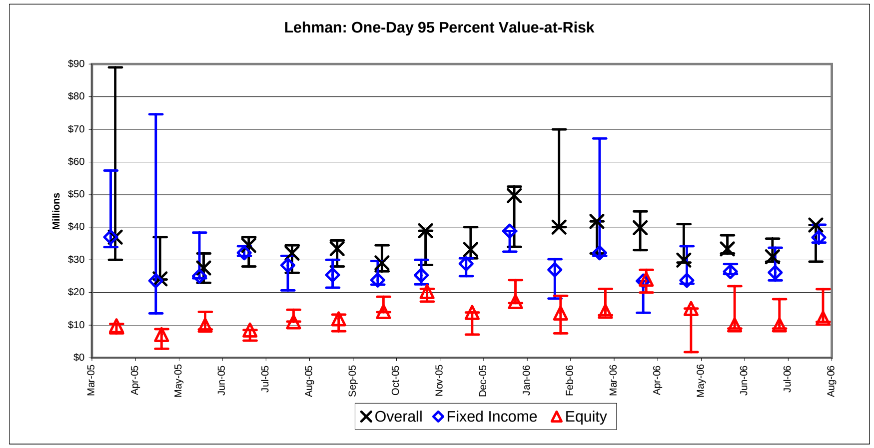
- To expand and vertically integrate its mortgage platform, Merrill Lynch recently announced its acquisition of National City Corp's subprime mortgage unit for $1.3 billion. This unit includes a wholesale originator of non-prime residential mortgages, a mortgage servicing company, and an online retail residential mortgage lender. We will closely monitor this acquisition as it is integrated into Merrill's existing platform.

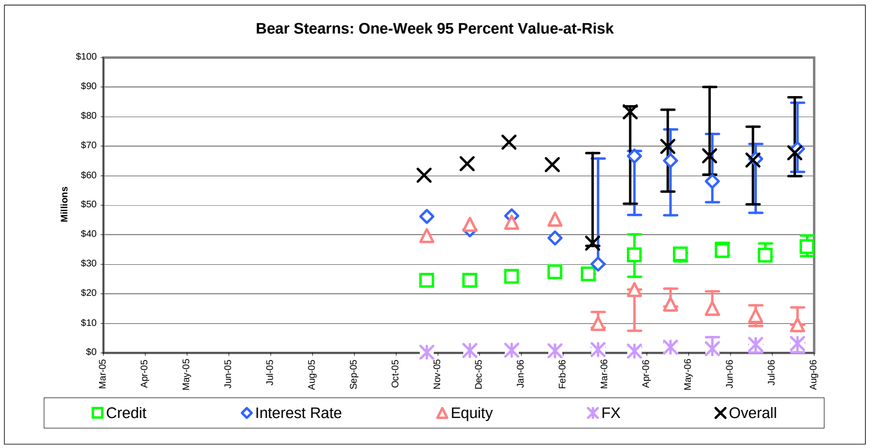
Morgan Stanley

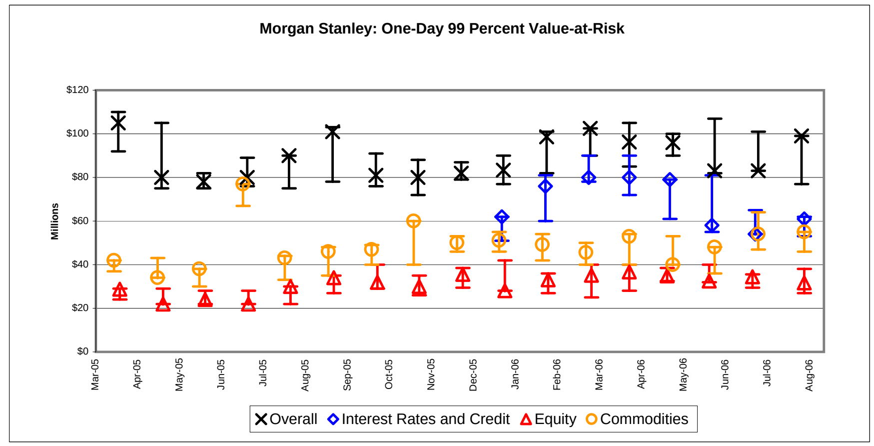
- The corporate lending portfolio has reached new heights as the leveraged lending pipeline has continued to push up against its limit. For the time being, senior management has decided not to increase the leveraged lending pipeline limit. We will continue to monitor this portfolio and any further discussions between the business and senior management regarding risk appetite in this area.

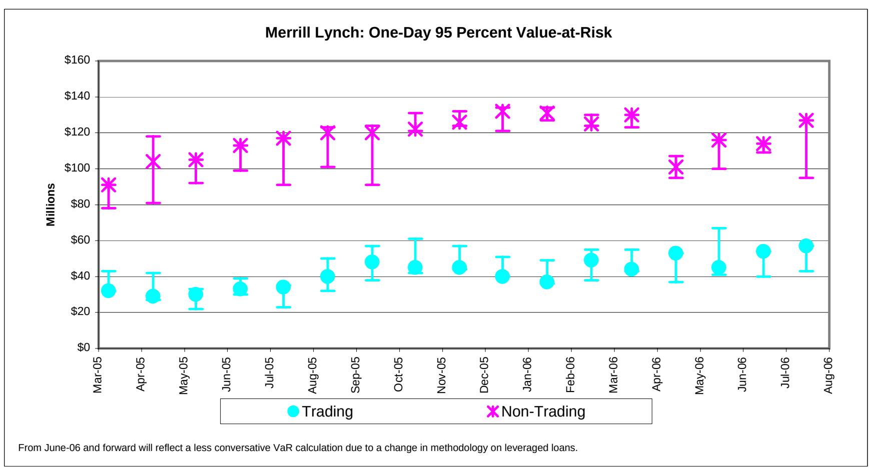
- The recent value-at-risk ("VaR") backtesting results for the equities proprietary trading businesses have shown an increase in the number of excessions at the 99th percentile. The results have prompted the market risk department to consider modifications to its equities VaR calculation. The impact at the firm-wide level is not material, and the businesses involved are those for which VaR is not generally an adequate measure. But we will follow-up on developments at next month's risk meeting.











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