MEMORANDUM

January 2, 2008

TO: Erik R. Sirri, Director
    Robert L. D. Colby, Deputy 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
       Financial Economist
       Accountant

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:

- **There has been little improvement in the mortgage markets and losses continue to mount at several CSE firms.** Morgan Stanley and Bear Stearns incurred fourth quarter mortgage-related losses of $9.4 billion and $1.9 billion respectively.¹ In both cases write downs significantly surpassed estimates that were pre-announced by the firms in late October and mid November, reflecting the continued erosion of asset values as well as the underperformance of hedges. While the story for subprime products was essentially more of the same, higher credit quality assets such as near prime (Alt-A) fixed rate loans and adjustable rate mortgages (“ARMs”) of all sorts exhibited deteriorating performance into November. Along these lines, risk managers at several firms noted that traders were struggling to devise effective hedges for long Alt-A and ARM exposures, as there are no indices available for directly shorting these underlying asset classes. In addition, subprime index (ABX) hedges have been very volatile and their spreads have often not moved in accordance with spreads for cash securities. As one risk manager explained, the firm is “actively restructuring its hedge program”. November was also a challenging month for commercial mortgages in terms of diminished liquidity (investor demand), spread widening and mark-to-market losses.

There were some positive market developments in November and early December, leading to a modest rally in the ABX indices. Namely, numerous central banks took further actions to provide liquidity to banks heading into year end and several commercial banks announced

¹Both firms reported negative income for the quarter ending in November. Merrill Lynch’s quarter ends in December.
plans to fully support the structured investment vehicles ("SIVs") they sponsored, rather than allowing the mass liquidation of mortgage assets financed through those structures.\(^2\)\(^3\) Despite these developments, however, overall mortgage market liquidity remained quite poor. Furthermore, troubles in the U.S. have spread overseas, with firms reporting a complete “freezing” of European residential and commercial securitization markets.

- **CSE firms are still working to syndicate the “insufficiently distributed” event-driven lending commitments from the summer deal pipeline; however, the leveraged loan market had largely closed for the year and progress was measured.** Some firms were able to chip away at their lending portfolios, mostly due to borrower specific events, but month-over-month exposure reduction was modest as leveraged loan buyers such as hedge funds and high yield mutual funds had “gone home” for the year. Credit risk managers conveyed optimism that the market would reopen in January, noting however that the total deal calendar is still quite large. Consequently, January should be “fascinating to watch”.

In the instances when CSEs were able to sell loans, proceeds were generally in line with or greater than the prevailing marks, providing some comfort with the processes in place for marking these positions to market. Very few new non-investment grade commitments were made, and the ones that were mostly occurred in the context of strategic acquisitions as opposed to in a financial sponsor or leveraged buy-out related context. Furthermore, new commitments have entailed superior pricing flex and covenants compared to the “old tainted deals”, allowing for more immediate distribution.

- **Credit risk managers remain focused on financial guarantors, but for now losses will likely be contained to ACA.** As discussed last month, the CSE firms are exposed directly and indirectly to financial guarantors through a variety of channels. These insurers provide default protection on a variety of fixed income asset classes – most notably municipal debt but also RMBS, ABS CDOs, and corporate debt. Credit risk managers are optimistic that direct counterparty losses of any material size will be contained to ACA, a guarantor that was unique in terms of its willingness to enter into collateral agreements with protection buyers, its level of capitalization and resulting A rating (most financial guarantors carry a AAA rating), and its relatively concentrated ABS CDO exposure. In addition, risk managers feel a financial guarantor induced municipal market dislocation, while possible, is unlikely. Several guarantors, most notably MBIA, were successful in raising new equity during the month. While there is a clear sentiment that capital raising will need to continue, the fact that the guarantors (with the exception of ACA) are relatively insulated from liquidity driven failures provides hope that events in this sector will unfold in a manageable manner.

In December ACA was downgraded to junk status by S&P. The firm also received a temporary forbearance from its counterparties, with each agreeing not to exercise rights to call for collateral as per existing agreements – an action which would surely cause ACA to default. As reported last month, the CSE firms that directly bought credit default protection from ACA are fully reserving the resulting exposures.

- **Emerging markets trading has remained robust throughout the credit crunch and exposures are growing moderately.** Liquidity has been strong throughout a variety of emerging market countries and across various product types (foreign exchange, local rates, credit, etc.), and trading volumes have been on the rise. Risk managers at almost all of the CSE firms reported this as a topic that was on the radar screen in some fashion. Several

\(^2\)The Federal Reserve, for instance, is providing secured term funding to U.S. depository institutions via a series of auctions. The first “Term Auction Facility” (TAF) of $20 billion has a 28 day term.

\(^3\)Citibank and HSBC committed to provide full liquidity support to over $90 billion in mortgage assets financed through SIVs, bringing those assets onto the banks’ balance sheets.
noted ongoing discussions regarding the appropriate limit structure and risk allocation (across businesses) for governing emerging market related activities going forward, which are targeted growth areas.

- **Things remained relatively quiet on the hedge fund front, but a few funds have hit NAV triggers.** Hedge funds continue to generate few specific concerns under current market conditions, with no CSE reporting counterparty credit losses for the month. However, there were several accounts of fund counterparties triggering trade termination clauses at November month end. OTC agreements with hedge funds often grant bank or investment bank counterparties the right to unwind existing trades should the fund exhibit a precipitous drop in NAV (the magnitude of such a drop is negotiated on a case-by-case basis). Consequently, this credit mitigant can be triggered not only as a result of negative returns, but also as a function of investor redemptions. In either case, credit risk managers typically respond to such NAV events by renegotiating for more conservative collateral terms, as several CSEs reported this month. Given market events in November and December, risk managers would not be surprised to observe more termination events following the reporting of year end NAVs.

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

**Bear Stearns**

- November was a “historically disappointing” month for Bear. The Mortgage business alone had losses of approximately $1.3 billion, and other desks incurring non-trivial losses included Credit Trading, Equity Derivatives, Risk Arbitrage, Emerging Markets, and Municipal Derivatives.

- Mortgage losses were attributed to continued erosion in asset values across subprime, Alt-A, ARM, and commercial collateral, as well as to the underperformance of hedges. Bear continues to actively reduce its mortgage exposures; however, the firm remains quite long Alt-A, ARM and commercial assets. Thus, as the desk is now net short subprime mortgages and securities through derivative hedges, and has a relatively small net long position remaining in ABS CDOs, the primary concern of risk managers is the long AAA exposure in higher credit quality loans and securities. Senior management has mandated the desk to further reduce risk. However, hedging is challenging given market liquidity and the lack of any indices for directly shorting Alt-A collateral. Risk management is therefore pushing the business to somehow devise shorts, even if it means paying a high price for purchasing protection or incurring significant basis risks, as “doing nothing doesn’t seem right”.

- A $17 million loss incurred by the Emerging Markets business brought the desk onto the radar screen for the first time during our monthly risk reviews. We agreed with the market risk manager to schedule a briefing on this desk in the upcoming months to discuss recent developments in the business and plans going forward.

- The new Model Control head briefed us on his plans for rebuilding the group in 2008. This included staffing plans and anticipated workload, changes to model review processes and focus, and plans for enhancing the regression testing used to control changes made to existing models. We will continue to track progress along these fronts and will reestablish our periodic reviews of current developments with model control personnel.

**Goldman Sachs**

- Goldman continues to work down its event-driven lending pipeline, but noted there was little opportunity for outright loan sales over the past month as the syndication markets had essentially closed for the year. The firm is still committing to new non-investment grade as well as investment grade loans. However, it is doing so at much more conservative pricing
and credit terms, and generally for smaller principal amounts than became common as the leveraged buy-out boom peaked in early 2007. As a result, the primary concern of credit risk managers heading into January is the ability of the business to distribute the backlog of older commitments, which could be challenging given the total amount of unsold loans in the market place.

- Credit risk managers have been focused on Goldman’s contingent exposure to monolines (or financial guarantors) through the firm’s role as marketing agent for municipal auction rate securities ("MARS"). MARS, which are often insured by monolines, are essentially long-term municipal debt that is re-auctioned to investors periodically. Thus the financing cost to the issuing municipally varies over time as a result of the auction results. If an auction fails, existing investors are forced to hold the paper and the municipality is forced to make potentially onerous payments to those investors. Consequently, market participants (customers) would be looking to Goldman as marketing agent to provide liquidity during such an event. One reason risk managers are focused on this particular type of instrument is that MARS are largely bought by retail investors. To date Goldman has not experienced a failed auction, but the firm has assessed its appetite for purchasing this paper in such an event, and is developing plans to proactively restructure some of these issuances in a way that does not require monoline protection.

Lehman Brothers

- Globally, commercial mortgages held for securitization, B-Notes/Mezzanine loans, and CMBS total $31.5 billion at Lehman. The U.S. fixed rate loan and CMBS inventory, which totals about $5 billion, is largely hedged. However, there are no effective credit spread hedges for U.S., European, and Japanese floating rate commercial exposures, leaving Lehman exposed to spread widening. Market risk management remains very focused on the management of this pipeline.

- Risk managers highlighted the global Emerging Markets trading exposure to senior management in mid-December due to spread widening in the sector in November. By historic standards, however, spreads are still tight. Lehman’s exposure to large, correlated market shocks was estimated to be around $300 million, with concentrated exposure in India and Brazil. We will continue to monitor this risk.

Merrill Lynch

- Merrill has purchased $13 billion of notional protection from ACA, mostly against super senior ABS CDOs. Given ACA’s poor capital and liquidity position, Merrill began to fully reserve the net mark-to-market value of the resulting exposure, which currently stands at $900 million. Although the options are severely limited, Merrill is exploring possibilities for preventing the current exposure from growing further, including the purchase of replacement protection from other counterparties. We will follow up on the firm’s actions.

- Value-at-Risk ("VaR") continues to increase, reaching $129 million at the end of November. The increase was caused by the mapping of the large ABS CDO position to a volatile time series, as opposed to an increase in the position. Meanwhile, risk in other areas of the firm, including equities, rates, commodities, and residential real estate, continues to decline. As discussed last month, Risk Management is exploring the possibility of removing the ABS CDO position from VaR, as there are concerns that it is drowning other signals. We will continue to discuss this issue with Merrill.
Morgan Stanley

• Over the past several months we have discussed with credit risk management the status of a large defaulted commercial loan in Tokyo. The notional of the loan is slightly above $1 billion and is collateralized by Tokyo warehouse properties. It now appears that there has been a favorable resolution to this situation. After several months of trying to work with the borrower, Morgan has decided to sell the property in foreclosure and has a draft purchase agreement with a new buyer. The business expects to have the final purchase and sale agreement signed on December 18th and will receive a $100 million deposit that day. The closing is expected to occur by January 18th and Morgan should exit the position at a gain.

• The credit risk manager highlighted an outstanding issue with a Taiwanese bank from which Morgan purchased $275 million of default protection on super senior ABS CDOs. Morgan has the right to call collateral from this counterparty daily should its net mark-to-market exposure exceed $25 million. However, the risk manager noted that in this asset class, where marks have been adjusted dramatically and infrequently, the ability to call for collateral daily is not as strong a credit mitigant as when markets are liquid and prices readily observable. Morgan currently has a $75 million outstanding margin call with this counterparty. The bank has essentially asked for a “layaway plan” to meet the call. With that said, the risk manager has not identified issues with any other counterparty that has sold Morgan ABS CDO protection. We will follow up on this item at the next monthly meeting.