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Financial Crisis Inquiry Commission
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Re: Merrill Lynch

Dear Gary:

Please see Attachment 1 for additional information regarding Merrill Lynch's CDO business.

Sincerely,

/s/ Reginald J. Brown

Reginald J. Brown

Attachment

Attachment 1

Merrill Lynch CDO Business

To assist the Financial Crisis Inquiry Commission with its work, this document provides additional details and context regarding the evolution of Merrill Lynch's CDO business.

As you know, beginning around 2003, in an effort to stay competitive with its peers and to meet the investment objectives of its clients, Merrill made a strategic decision to increase its participation in the residential real estate and CDO markets. With historically low interest rates during this period, CDOs and other structured products became increasingly popular among investors throughout the world as a means of satisfying their demand for higher yield.

Merrill was careful and deliberate in moving toward an "originate to distribute" model, spending over a year engaged in internal and external discussions and extensive due diligence regarding several mortgage-originator targets, culminating in the December 31, 2006 acquisition of First Franklin. As the late date of this acquisition shows, Merrill believed that any signs of decline in the housing market in 2006 were a temporary, cyclical phenomenon. Merrill remained committed to its CDO business as a long-term part of its overall business strategy, and it sought to position itself for continued success once the market stabilized.

Merrill's view that the weakness in the housing sector in 2006 and 2007 would not lead to a national recession reflected the opinion of many sophisticated market observers, regulators, and credit rating agencies at the time. Federal Reserve Chairman Bernanke¹ and then-Treasury Secretary Paulson² each publicly expressed their belief in mid-2007 that problems in the subprime sector would be contained and would not impact the broader economy. Treasury Secretary Geithner³ and former Federal Reserve Chairman Greenspan⁴ have both explained that the dominant assumption at the time was that housing prices would continue to appreciate, and that at worst the market would suffer only gradual declines.

Market participants continued to price and close transactions through the first half of 2007, and secondary market trading activity remained active in Q1. While secondary trading slowed in Q2, trading was still occurring, reflecting confidence in the long-term viability of the CDO market and continued strategic importance of the housing market for Merrill.

¹ See, e.g., *Hearing Before the J. Economic Comm.*, 110th Cong. 1–2 (Mar. 28, 2007) (testimony of Ben. S. Bernanke, Chair, Fed. Reserve); Ben S. Bernanke, Chair, Fed. Reserve, Address at the Federal Reserve Bank of Chicago's 43d Annual Conference on Bank Structure and Competition, at 6 (May 17, 2007).

² See, e.g., Fox News Sunday, Interview with Henry Paulson (Sept. 21, 2008).

³ See *Housing Finance—What Should the New System Be Able to Do?: Hearing Before the H. Comm. on Financial Services*, 111th Cong. (Mar. 23, 2010) (statement of Timothy F. Geithner, Secretary, U.S. Dep't of the Treasury).

⁴ See ABC News This Week, Interview with Alan Greenspan (Apr. 4, 2010).

Throughout this period, Merrill remained focused on risk management.⁵ In 2006, as its CDO business expanded, Merrill implemented specific strategies intended to reduce its exposure to the riskiest pieces of the assets it was holding, including working with collateral managers to include retained tranches from previous Merrill-originated CDO deals in new CDOs underwritten by Merrill. A byproduct of this strategy was retention of seemingly safe, AAA-rated super senior tranches.⁶ While Merrill was initially able to distribute the super senior tranches, as the market deteriorated, it became progressively more difficult to sell or hedge these positions, and Merrill increasingly retained the risk at closing.⁷ Merrill felt comfortable with this risk because it did not build CDOs that it thought were likely to fail. In fact, Merrill was frequently the single largest “long” investor in the CDOs it sponsored, giving it a strong incentive for the transaction to succeed, and meaning it had the most to lose if a transaction failed.

Like other CDO underwriters, Merrill worked with a variety of collateral managers in an effort to put together deals that satisfied investor demand. Despite some media reports, we are not aware of any formal programs or initiatives implemented by Merrill to put new CDO managers in business. In the 2006–2007 time period, Merrill used approximately 32 different collateral managers with varying levels of experience.⁸ Moreover, in a competitive market, there is nothing extraordinary about a CDO underwriter encouraging collateral managers to purchase the underwriter’s own assets, rather than those of a competitor. Merrill reasonably preferred assets from its own CDOs because of its comfort evaluating and pricing its own products, as well as its familiarity with and confidence in the underlying collateral.⁹

Ultimately, the collateral managers owed fiduciary duties to the CDO and bore sole responsibility for the portfolio’s composition. Merrill’s approval rights terminated when the deal

⁵ Risk management is a necessary element of any financial business. Merrill employed—and its risk management group was at the table in discussing—trading strategies such as hedging that were commonly accepted throughout the industry as effective methods for managing risk. Merrill also closely monitored its positions and evaluated its risk exposure through commonly used risk measures such as DV01, Value at Risk (VaR), and Stress Event Scenarios (SES).

⁶ These highest-rated super senior tranches had historically been stable, and Merrill, like everyone else, believed its super senior holdings were effectively as good as cash. This belief was supported by the super seniors’ AAA ratings, as well as the prevailing market view, shared by regulators, insurers, and ratings agencies, that they carried a near-zero risk of default. Indeed, after a minor drop in February, the ABX index for AA and AAA subprime-backed CDOs remained stable through mid-June 2007. A March 2007 Moody’s analysis concluded that, even under the worst-case scenario, “the senior AAA tranche remains investment-grade.” John Park, “The Impact of Subprime Residential Mortgage-Backed Securities on Moody’s-Rated Structured Finance CDOs: A Preliminary Review,” Moody’s Investors Service Special Comment, at 7 (Mar. 23, 2007). Similarly, an April 2007 International Monetary Fund report declared that CDO “tranches rated A or higher” were not seriously threatened by the “deterioration in the credit quality of subprime mortgages.” Int’l Monetary Fund, *Global Financial Stability Report: Market Developments and Issues* 6–7 (April 2007).

⁷ This market dislocation pre-dated the late-2006 acquisition of First Franklin, which we do not believe contributed to Merrill’s increased retention of super senior tranches.

⁸ To the extent some investors in Merrill’s CDOs were collateral managers that Merrill worked with on other transactions, this only underscores Merrill’s confidence in the performance of its CDOs: it would make no sense for Merrill to structure a deal that was likely to harm its relationships with its long-term partners and clients.

⁹ We would also observe that CDO-squared deals were simply not in existence in 2003, so it is misleading to describe the increase from 2003 to 2007 in percentage terms.

closed, at which point the collateral manager even had authority to include an asset that Merrill had previously rejected during the pre-closing warehouse period. It was also common throughout the industry for the equity investor in a CDO, which had the riskiest investment, to have input during the collateral selection process. As mentioned above, however, the collateral manager made the ultimate decisions regarding portfolio composition. Like investors in any asset class, investors in a CDO's riskier, more-junior tranches, including the equity, would commonly attempt to hedge those positions either by shorting higher-rated securities in the capital structure or by purchasing credit protection on specific portfolio assets. This "long/short" strategy was well known by traders across the industry.

Members of Merrill's Board of Directors received updates on the CDO and subprime-mortgage businesses in early 2007, although management did not specifically discuss super senior exposure because it did not view super seniors as particularly risky. Indeed, risk measures and external sources like the ABX index, housing fundamentals, market indicators, and commentators did not suggest until Q3 2007 that super senior CDO securities posed substantial credit risk. As market conditions deteriorated, senior management made a presentation at the July 2007 Board meeting that highlighted changes in the firm's exposure, including reductions in warehouse lines, whole loan inventory, and the CDO warehouse, and increases in super senior positions.

Merrill made detailed disclosures concerning its subprime mortgage and CDO-related exposures earlier than its peer institutions. We are not aware of any financial institution disclosing losses or write-downs resulting from subprime mortgage or CDO-related exposures in the first half of 2007. In light of continuing deterioration in market conditions, however, Merrill did include enhanced disclosure in the second quarter 10-Q, noting that Merrill was a "major participant" in the affected markets, and there was thus a "significant risk" that the increased volatility and continuing deterioration in the market would have a negative impact on the company's financials. Merrill was one of the first institutions to provide detailed disclosure of its super senior positions, announcing a \$7.9 billion write-down in Q3 2007 related to subprime/CDOs, as well as net super senior CDO exposure of \$14.8 billion.

Merrill was also an early adopter of FAS 157, and its valuations of its CDO-related positions were consistent with applicable accounting rules. Merrill marked its positions to market whenever there were sufficient observable trading levels; when liquidity evaporated, it judiciously applied model-driven valuations as necessary. Merrill's valuation processes were always fully reviewed by independent Finance and Control staff and approved by its outside auditor, Deloitte & Touche.

Merrill's disclosures throughout 2007 were made after conducting analyses of the effectiveness of its hedges, including those with monoline insurers, in accordance with applicable accounting standards. These hedges were only one part of its overall risk reduction strategy, and Merrill actively managed counterparty risk, as necessary. During the fourth quarter of 2007, Merrill and other financial institutions were engaged in a dialogue with the SEC to develop a mechanism for determining the appropriate capital charges for securitized products. This dialogue was intended to be forward-looking, with the goal of developing and implementing a consistent approach across firms that could be applied to disclosures in the first quarter of

2008. This was a fluid issue, and discussions were still ongoing well after Merrill and other institutions disclosed their Q3 results.

We know now that the market consensus turned out to be wrong, and Merrill's good faith but mistaken belief in the safety of its CDO positions ultimately led to the sale of the company. After the June 2007 collapse of the Bear Stearns Asset Management hedge funds, liquidity in the CDO and subprime mortgage markets evaporated. Sudden downgrades by the rating agencies the following month further eroded investor demand and exacerbated the liquidity crunch. By late September, values of subprime securities had fallen dramatically, affecting even the highest-rated tranches. Even though Merrill had ceased executing new CDO transactions in August 2007, the collapse of the subprime market in the fall of 2007 resulted in Merrill taking a significant third quarter write-down related to subprime CDO positions.

In contrast to some institutions, which foresaw the subprime collapse and profited handsomely by shorting the market, Merrill remained bullish to the end. Merrill, however, paid a price for its optimism: \$40 billion in CDO-related losses and the collapse of the company. Merrill's experience resembles that of other large banks that held large positions in super senior CDO tranches—that is, more of what were perceived at the time to be the safest assets.

As you know, Bank of America stepped in to acquire Merrill in the fall of 2008—just days after Lehman's collapse—saving the financial system from the uncertain consequences of another major investment bank failure. The combined entity is no longer a participant in the CDO market.