

MEMORANDUM

January 6, 2006

TO: Robert L. D. Colby, Acting Director
Herbert F. Brooks, Chief of Operations
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Division of Market Regulation

THROUGH: Matthew J. Eichner, Assistant Director

FROM: Financial Economist
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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 five weeks with senior risk managers at the CSEs and at Credit Suisse First Boston to review November market and credit risk packages.

There were several common themes in discussions with firms:

- **Equity risk continues to rise.** Equity risk continues to be a major driver of the firms' overall measured risk, with outright directional views on the rise. The firms continue to be particularly bullish on Japan, a view that is expressed through long index positions in the Nikkei. In addition to exposures resulting from directional plays, firms have engaged in a number of block equity trades that have contributed to increases in equity-related value-at-risk ("VaR").
- **Calpine declared bankruptcy, which came as no surprise.** Calpine, a domestic power producer, filed on December 20. Calpine was one of the largest companies to file in US history, with \$17 billion in outstanding debt. The CSE firms were well aware of this possibility, and transacted with Calpine only on a fully collateralized basis. Therefore, counterparty exposure was very low. However, most firms have a significant amount of market, or inventory, exposure to Calpine, as their debt is actively traded by various businesses across the firms. Distressed desks tend to trade the general parent company debt, while other issuances are fully collateralized with revenues from particular power plants and actually traded above par right up until bankruptcy. Calpine's default will also require the credit derivatives market to efficiently manage a significant default event, which entails buyers of credit protection on Calpine (and indices containing Calpine) delivering eligible securities to sellers of protection in return for cash. But the CSE firms are confident this will proceed smoothly, despite Calpine having a fairly large variety of debt instruments with differing seniority and collateralization outstanding. The cash settlement protocol that has now been tested repeatedly, most recently with Delphi, will be used again for index trades, while single-name trades will most likely settle physically.

- **Non-investment grade lending continues to contribute significantly to firms' measured risk, and efforts are underway to develop new varieties of credit derivatives as hedges.** Leveraged loans are often a key component of financing packages assembled for non-investment grade borrowers. To the extent that these exposures were hedged in the past, instruments tied to high-yield bond indices were used. While such hedges protected the firms from a general widening of corporate credit spreads, the borrower specific risk remained. In an effort to deal with the rapid growth of leveraged lending, one firm created credit default swaps referencing specific loans in early 2005. The use of these swaps all but eliminates the basis risk that results from hedging specific names with an index. While this type of hedging is not yet widespread across the firms, there appears to be a general consensus that this market will continue to grow. Hedge funds and other market participants that are interested in selectively assuming the credit risk associated with high yield loans are frequently eager to take the other side of these contracts and serve as the sellers of credit protection.
- **The number of outstanding credit derivatives trade confirmations is beginning to fall.** In October 2005, all of the CSE firms participated in an industry-wide initiative that was coordinated by the New York Fed with the active involvement of the SEC and was intended to reduce the large number of outstanding trade confirmations associated with credit derivatives. At that time, the firms established an industry-wide target of reducing the volume of confirmations outstanding for more than 30 days (relative to the backlog on September 30, 2005) by 30 percent before January 31, 2006. The firms have been submitting monthly metrics tracking their progress towards meeting this goal, and we have conducted monthly calls with each firm to discuss their progress. Based on current data, it appears that all five firms will meet the target by January 31.
- **The housing market slowdown discussed extensively in the press has not yet had a significant impact on firms' mortgage businesses, which continue to be very active and profitable.** One firm with a large mortgage origination platform mentioned that origination activity had fallen slightly, but not by enough to indicate a significant slowdown in the housing market. Another firm, which is active in the mortgage securitization market, noted that it had not seen any material declines in mortgage activity. They did, however, mention that with a flattening yield curve traditional mortgages might become more attractive in comparison to adjustable-rate mortgages that have recently driven much of the securitization activity.

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

Bear Stearns

- The net market value of the adjustable rate mortgages ("ARMs") desk's positions increased to \$12.4 billion, its second highest level ever. It is noteworthy that Bear's ARMs securitization deal volumes have remained strong despite a continually flattening yield curve. However, the ARM loan portfolio has recently become more heavily skewed towards Option ARM products. The net market value of the Option ARM loans held by the desk grew from \$2.7 billion to \$4.6 billion, or by 70%, from the previous month. We will continue to monitor activity in the ARMs space, including this movement towards what are potentially less well understood and more credit sensitive products.

Credit Suisse First Boston

- Due to increased position taking in collateralized debt obligations ("CDOs") and other tranching credit products, we will follow up on CSFB's activities and risk management pertaining to CDOs and structured credit in general next month.

- Similar to other firms, CSFB's pipeline of leveraged lending commitments has increased significantly. At next month's meeting, we will follow up on the credit risk profile of the portfolio, trends in the market, and developments on the distribution side, such as the sale of leveraged loans through the creation of collateralized loan obligations.

Goldman Sachs

- Firmwide VaR reached \$104 million, its highest level for the year. In addition, the Firmwide VaR limit was increased from \$95 million to \$105 million. These increases in risk usage and risk appetite have been driven primarily by the equities business, which has gotten longer delta through options positions and several large block deals, and uncharacteristically had a higher standalone VaR than fixed income this month. Senior management is contemplating further limit increases to accommodate further opportunities in the equities space. We will continue to discuss with risk management any further shifts in risk appetite.
- As leveraged lending activity continues to grow, the Firmwide Risk Committee more than doubled the limit for the credit spread widening scenario, the primary risk metric used to manage this business. In addition, an enhancement to the scenario methodology, designed to capture risk mitigating credit terms such the ability to adjust the terms of a debt issue during the underwriting process, resulted in an overall reduction in measured risk and further increased origination capacity. We will continue to monitor changes in risk appetite in this space.

Lehman Brothers

- Lehman has begun to trade commodities on the exchanges, but has not yet completed a trade with an individual counterparty. We will be meeting with the relevant business and market personnel at the end of January to discuss plans and risk management for the overall energy business.

Merrill Lynch

- Risk managers described Merrill Lynch's new derivatives prime brokerage business, which involves Merrill Lynch entering into credit derivative swaps on behalf of their prime brokerage clients, i.e. hedge funds. We will continue to follow the growth of this business, which poses certain risk management and operational challenges.

Morgan Stanley

- We will follow up with the credit risk managers regarding their use of the more recently developed CDS on leveraged loans to reduce credit risk in the leveraged lending business.
- The credit risk manager discussed Institutional Credit's initial thoughts concerning moving away from Potential Exposure at the 99% confidence interval as the internal credit risk limiting metric for the derivatives, repo, and securities financing businesses. We will continue to follow progress on this initiative.