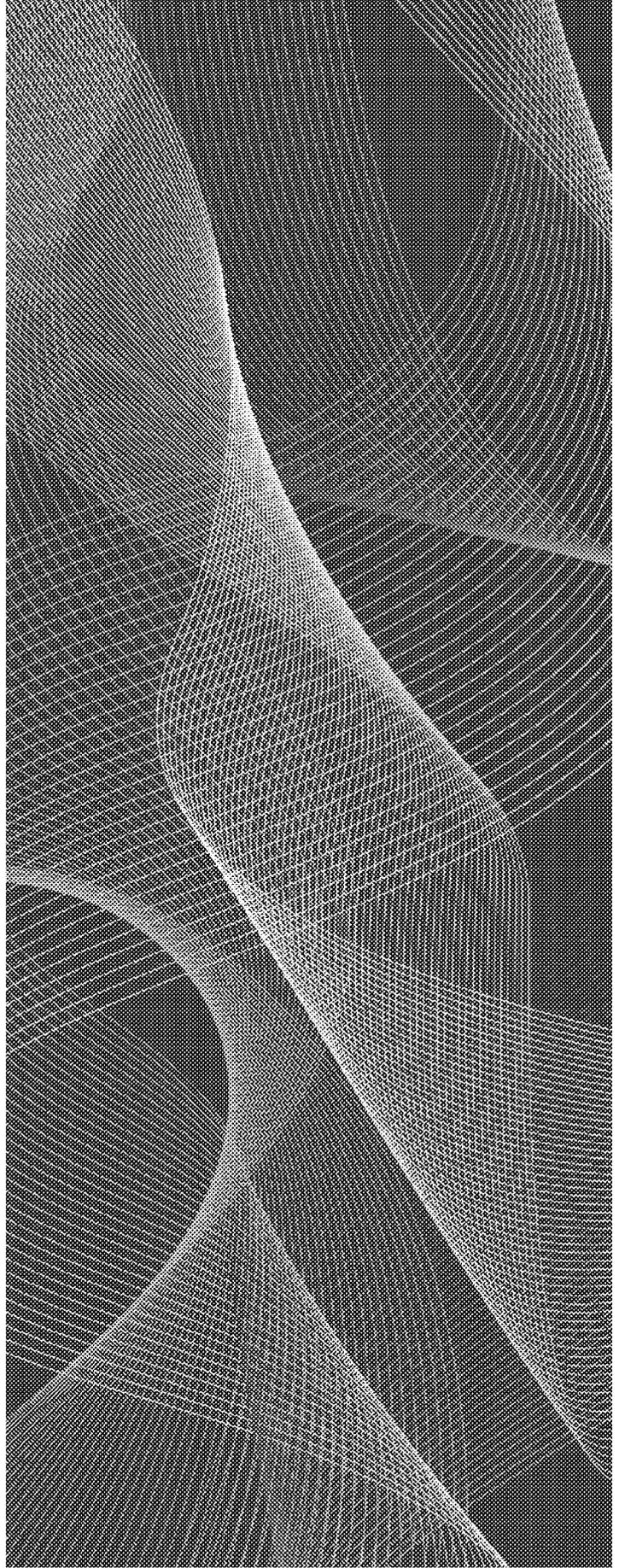LEHMAN BROTHERS

JPM Chase Triparty Repo

LBEX-AM 001399

Summary

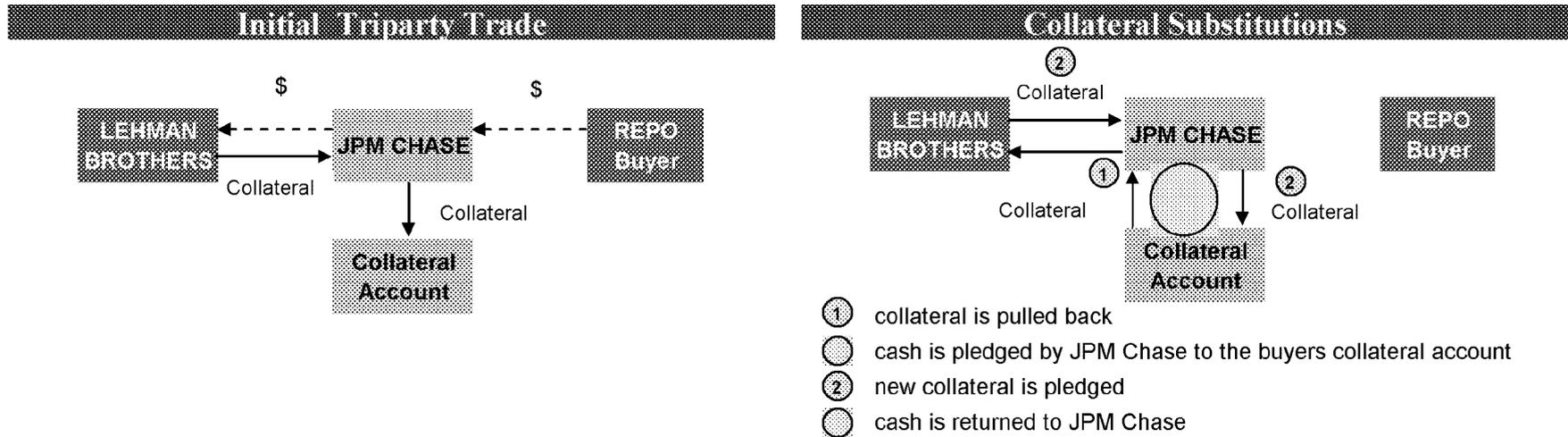## JPM Chase have requested a meeting to discuss triparty repo. The likely focus of the meeting will be credit exposure.

◆ JPM Chase provides a $2bn line of unsecured credit to facilitate triparty repo in Europe. JPM Chase has indicated that they want to change the line from unsecured to secured.

◆ JPM Chase wants to apply a intraday haircut on collateral designed for overnight triparty financing. The charge would be applied to Lehman's secured line of credit also referred to as Net Free Equity. The amount of the charge and its impact has yet to be determined but is estimated to be in the range of $3-$5bn.

◆ JPM Chase wants to revise the collateral schedule for overnight box loans. This would include the exclusion of certain asset types and an overall increase in haircuts.

Unsecured Credit

JPM Chase provides $2bn of unsecured credit to LBIE to facilitate triparty repo in Europe.

- ♦ LBIE's securities clearance and triparty clearance activities reside at different clearing agents which results in increased pressure on intraday credit
  - The decentralized clearing structure prohibit the extension of secured credit by JPM Chase, as JPM Chase is not in possession of LBIE's excess collateral intraday
- ♦ The timing of collateral substitutions creates intraday credit shortfalls at JPM Chase which is remedied by an unsecured line of credit
- ♦ Lehman will occasionally request an increase to the $2bn unsecured line of credit due to heavy settlement volume.
  - On May 29th, Lehman requested an increase of 3$bn for a total of $5bn.

| Initial Triparty Trade | Collateral Substitutions |

② collateral is pulled back
cash is pledged by JPM Chase to the buyers collateral account
② new collateral is pledged
cash is returned to JPM Chase

Secured Credit - Net Free Equity

JPM Chase provides secured intraday credit in the form of Net Free Equity (NFE) to facilitate clearing activities in the US.

◆ The calculation of NFE is as follows:

+ WDDA Balance	Value given for cash in accounts outside the BDAS.
+ Cash Balance	Net money for all transactions processed by BDAS.
+ Security Value	Total market value, including accrued interest, of all securities held in lienable accounts for the account group. No haircut is taken intra-day.
- Collateral Pledged	The total value of all shells that have been loaded into BDAS + 2%
- SLD Cash Lien	The value +2% of all securities outstanding on loan from JP Morgan/SLD. This value is reduced by shells securing SLD.
+ Intra-Day Credit	Credit line granted by JPM Chase's Wall St. Credit area. ($200mm)
- Approved Risks	The sum of the risk component off all trades which are currently in a pending state. Reduced as transactions settle.

= Credit Position is considered to be the NFE

◆ Insight and understanding of NFE is limited. Access to real-time and historical NFE data does not exist making analysis and management nearly impossible.

   ― Requests for access to NFE data have been largely ignored, although recent conversations have indicated JPM Chase is now willing to provide this information.

Changes to Net Free Equity

For purposes of calculating NFE JPM Chase wants to apply a haircut to the collateral held intraday in lienable accounts.

◆ According to JPM Chase a deficiency in the NFE calculation is creating an unacceptable level of credit risk

  – The existing NFE calculation credits the repo seller (Lehman) with the full value (no haircut) of collateral returned from the prior nights repo unwind.

  – As current days triparty repo 'shells' are transmitted to JPM Chase, the contractual haircut on the repo trade is debited from the NFE calculation.

  – The period between the maturity of the prior nights repo trade and the transmission of the new trade is where the exposure lies.

  – JPM Chase has proposed that the total amount of prior day triparty repo haircuts be debited from the start of day NFE position and gradually reduced as new repo trades are transmitted.

  – The proposal will apply to all JPM Chase triparty clients.

◆ Effective March 17th 2008, JPM Chase began debiting Lehman's NFE for 20% of the proposed haircut amount with the expectation of gradually increasing to 100%

  – At Lehman's request JPM Chase has not increased the charge beyond the 20%.

  – Lehman requested that JPM Chase provide an impact analysis of the proposed change so that Lehman could respond accordingly

  – To date this information has not been provided.

Box Loans

JPM Chase wants to revise the collateral schedule for overnight box loans in the US.

◈ JPM Chase currently accepts a broad range of collateral for overnight box loan financing, including non-rated and other low grade assets.

◈ While not part of the daily funding strategy, overnight box loans play an important role in allowing LBI fixed income to run with near zero funding cushions.

 — The majority of box loans are caused by a mismatch between financing trades and available collateral

  ❋ Lower grade collateral is pledged to JPM Chase for cash and cash is then pledged to the repo client as collateral

 — Box loans will also be used when a shortfall in secured financing occurs, although this is an infrequent event and usually of small value.

◈ JPM Chase has proposed the following key changes to the box loan collateral schedule but has indicated a willingness to negotiate.

 — Exclusion of private label cmo and pass-through collateral

 — Multiple tranche exclusions for remics and cmo and asset backed collateral

 — Increase in haircuts:

  ❋ Corporates up to 130% for BB-
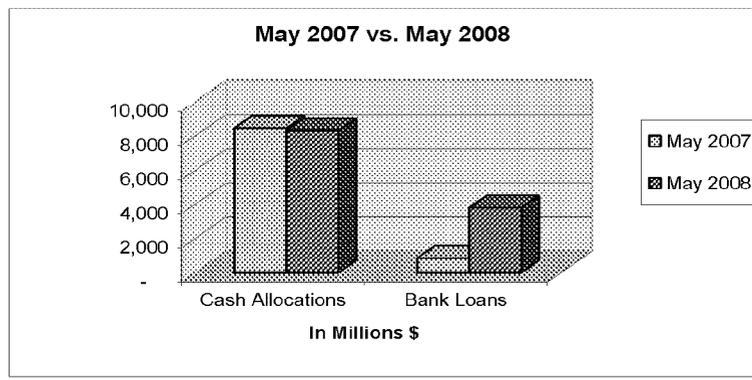
  ❋ Converts 120%

  ❋ Muni's 110%

LEHMAN BROTHERS   5

Appendices

Proposed Box Loan Collateral Schedule

US TREASURIES	MARGIN
TREASURY BILLS, BONDS, NOTES up to 5 years	101
TREASURY BILLS, BONDS, NOTES > 5 years	102
TREASURY STRIPS	102
PRIVATE LABEL TREASURY BACKED (LION, TIGER, etc)	102

GOVT SPONSORED ENTERPRISES (GSE) & AGENCIES	MARGIN
FEDERAL NATIONAL MORTGAGE ASSN (FNMA)	103
FEDERAL HOME LOAN BANK (FHLB)	103
FEDERAL HOME LOAN MORTGAGE CORP (FHLMC)	103
FEDERAL FARM CREDIT SYSTEM (FFCS)	103
FEDERAL AGRICULTURAL MORTGAGE CORP (FAMC)	103
FINANCE CORP (FICO)	103
RESOLUTION FUNDING CORPORATION (REFCO)	103
STUDENT LOAN MARKETING ASSOC (SLMA)	105
TENNESSEE VALLEY AUTHORITY (TVA)	103
WORLD BANK (IBRD)	103
SUPRANATIONAL INSTITUTIONS (Asian, African, Interamerican Development Banks & International Finance Corp)	103
SMALL BUSINESS ADMINISTRATION (SBA)	103
OTHER GSE & AGENCY ISSUES	105
AGENCY STRIPS (NON-MBS)	103
AGENCY STRUCTURED NOTES	103
AGENY CALLABLE SECURITIES	103

GOVERNMENT BACKED SECURITIES	MARGIN
GOVERNMENT TRUST CERTIFICATES (GTC)	105
AID BONDS	105

GSE & AGENCY MORTGAGE BACKED SECURITIES	MARGIN
GNMA PASS THROUGHS - Fixed Rate	103
GNMA PASS THROUGHS - Adj. Rate	103
GNMA REMICS	105
FNMA PASS THROUGHS - Fixed Rate	103
FNMA PASS THROUGHS - Adj. Rate	103
FNMA REMICS	105
FHLMC PASS THROUGHS - Fixed Rate	103
FHLMC PASS THROUGHS - Adj. Rate	103
FHLMC REMICS	105
FAMC PASS THROUGHS	103

	MARGIN	RATINGS* S&P	RATINGS* MOODYS	F T
BANKERS ACCEPTANCES	100	Min A- issuer	Min A3 issuer	
CERTIFICATES OF DEPOSIT	100	Min A- issuer	Min A3 issuer	
CORPORATE BONDS and MEDIUM TERM NOTES	103 / 106 / 109	AAA / AA / A	Aaa / Aa / A	
CORPORATE BONDS and MEDIUM TERM NOTES	112 / 115 / 118	BBB+ / BBB / BBB-	Baa1 / Baa2 / Baa3	
CORPORATE BONDS and MEDIUM TERM NOTES	122 / 126 / 130	BB+ / BB / BB-	Ba1 / Ba2 / Ba3	
CONVERTIBLE BONDS	120			
MUNICIPAL SECURITIES, excl. AB MTM	110	AAA	Aaa	
PRIVATE LABEL CMOS	NO			
PRIVATE LABEL PASS THROUGHS (PTA)	NO			

TRANCHE EXCLUSIONS FOR REMICS & CMOS (Use X to indicate exclusion)	EXCLUDE
INTEREST ONLY (IO)	X
PRINCIPAL ONLY (PO)	X
SEQUENTIAL	Accept @ 105
Z TRANCHE	X
RESIDUAL	X
FLOATING RATE	Accept @ 105
COMPANION	X
IOETTE	X
SUPER FLOATER	X
SCHEDULED	X
PAC	X
TAC	X

TRANCHE EXCLUSIONS FOR ABS (Use X to indicate exclusion)	EXCLUDE
INTEREST	X
PRINCIPAL	X

	MARGIN
CASH	100

Box Loans and Cash Allocations – May 2008

Monthly Total May '08 (In $MM)		Cash Allocations		Burn $		Bank Loans		Burn$	Trust Deposit
Causes	Freq.	$MM	8,339	(54,278)	Freq.	$MM	3,802	(38,183)	1,750
Bad Mix Of Collateral / Collateral Shortage	5	2,091	25.1%	(13,610)	6	2,181	57.4%	(21,903)	0.0%
Late T/P trade increase	3	355	4.3%	(2,311)	4	388	10.2%	(3,897)	0.0%
Co. G to Co. P funding swing	3	485	5.8%	(3,157)	1	160	4.2%	(1,607)	0.0%
Unapplied cash	5	320	3.8%	(2,083)	0	0	0.0%	0	0.0%
SCS cash late receipts	6	551	6.6%	(3,586)	2	190	5.0%	(1,908)	0.0%
Late customer pairoff receipts	2	160	1.9%	(1,041)	1	70	1.8%	(703)	0.0%
Sales Related Discrepancies	2	610	7.3%	(3,970)	2	517	13.6%	(5,192)	0.0%
Trades not Accounted For.	0	0	0.0%	0	0	0	0.0%	0	0.0%
Failed Trades	3	499	6.0%	(3,248)	1	50	1.3%	(502)	0.0%
CCM Posting Error	0	0	0.0%	0	0	0	0.0%	0	0.0%
MISC	0	0	0.0%	0	0	0	0.0%	0	0.0%
Intercompany receipt from Broker Dealer	9	909	10.9%	(5,916)	2	158	4.2%	(1,587)	34.3%
Intercompany receipt from LCPI / LBHI	1	6	0.1%	(39)	0	0	0.0%	0	17.1%
Intercompany Financing	1	1,100	13.2%	(7,159)	1	100	2.6%	(1,004)	0.0%
CCM Funding Decision	2	240	2.9%	(1,562)	0	0	0.0%	0	14.3%
Treasury Funding Desk Decision	3	1,021	12.2%	(6,645)	0	0	0.0%	0	51.4%
Explained		8,347	100%	(54,327)		3,814	100%	(38,302)	
Un-explained		(8)	0%	50		(12)	0%	120	

# of Cash Allocations		17
Daily Average: (per occurance)	$ 437	MM
# of Box Loans		8
Daily Average: (per occurance)	$ 475	MM

May 2007 vs. May 2008

☒ May 2007
☒ May 2008

Cash Allocations   Bank Loans

In Millions $

Date	Cash Alloc.	Bank Loan	Co. G Box	Co. P Box	Free
1-May	373		349	4,512	(2,530)
2-May	144		2,131	3,983	(2,563)
5-May	626		1,575	3,981	(2,259)
6-May	245		448	3,979	(2,343)
7-May	253		466	3,951	(2,128)
8-May	201	428	256	3,961	(2,498)
9-May	565	523	166	3,949	(2,537)
12-May	1,030	466	278	3,944	(2,540)
13-May	473	90	278	1,544	(2,351)
14-May	485		1,111	1,544	(2,046)
15-May		533	614	1,555	(2,382)
16-May	95		279	1,557	(2,987)
19-May	415	450	167	1,559	(2,732)
20-May	464		551	1,501	(2,688)
21-May	135		279	1,493	(3,086)
22-May		452	253	1,485	(2,468)
23-May	392		253	1,485	(2,739)
27-May	253		308	1,492	(2,743)
28-May	1,273	861	535	1,485	(3,587)
29-May					
30-May					