

LEH Ratings Strategy in '08: Ratings Advisory Group Discussion

FP&A met with LEH's Jeff Fritzingler to broaden its market intelligence on the rating agencies' views of Lehman Brothers and other broker dealers and to discuss how to enhance Treasury's dialogue with the Rating Agencies...

- ◆ Given the unprecedented current market environment, the rating agencies are especially “cautious and negative” in their tone
 - Generally tough, but fair
 - Increasingly unpredictable and quick to trigger downgrades based on perception (rather than reality) or an increased focus on one particular area of interest (e.g., liquidity)
- ◆ Lehman Brothers has been able to maintain its credit ratings better than many of its peers
 - Lehman's strong ERM/Risk management policies have had a very positive impact on Lehman's ratings at the margin
 - Lehman's management has also done a fantastic job of managing the rating agencies and has clearly established a high degree of credibility that is reflected in its ratings
 - Avoidance of catastrophic asset writedowns (particularly when compared to peers) has been a positive
 - “whatever recipe Lehman is using, we should keep it up”
- ◆ At the same time, there are a number of potential factors that could easily push the agencies “over the edge”, thereby causing a rating downgrade for Lehman
 - Continuing asset writedowns are a sore spot for rating agencies and could jeopardize the excellent dialogue Lehman has established with the agencies, particularly given the market's perception that Lehman is still “hiding something”
 - Liquidity remains a primary issue and any incremental concerns regarding liquidity would unquestionably result in negative ratings action
- ◆ When considering Lehman relative to other broker dealers, Fritzingler noted the following:
 - Size and diversification do and will always matter in the ratings process, putting Lehman at a distinct disadvantage
 - The presence of a national deposit franchise for several of our competitors is a particularly positive factor in credit ratings that should not be underestimated

Note: FP&A met with Jeff Fritzingler (who covers FIG, previously worked at S&P and still maintains close contacts and relationships) from the Ratings Advisory Group on Apr 23 '08

LEHMAN BROTHERS

LEH Ratings Strategy in '08: Ratings Advisory Group Discussion

...where his views provided useful action points Lehman should consider, including: emphasizing our strong Risk Management and senior management presence, working with the agencies to refine their rating criteria and methodology, and continuing to strengthen Lehman's liquidity profile – all of which would help to mitigate any uncertainty / subsequent surprises / negative perceptions in the minds of the agencies

- ◆ Although open to new ideas regarding rating criteria, the agencies are “stodgy and slow” to act
 - View is that the agencies will start to focus more attention on qualitative criteria that are supported by quantitative data
 - Risk management and liquidity in particular are likely to garner more weight in the ratings process going forward
- ◆ We also addressed a number of other topics including:
 - Risk-Adjusted Capital Framework (RACF): S&P has distributed a Request For Comment (RFC) for its RACF that proposes to utilize economic capital models in the ratings process.
 - Fritzingler believes that this initiative will eventually be implemented although it could be a slow process
 - Lehman should be helpful and develop a dialogue with S&P on its initiative but should avoid providing any formal comments that could be viewed negatively by Lehman clients
 - Similarly, Lehman should avoid any formal comments regarding regulatory oversight of the rating agencies
- ◆ Based on our discussion, it becomes clear that capitalizing on Lehman's core competencies are critical to maximizing our credit ratings:
 - Highlighting Lehman's effective Risk Management policies and how they enable the firm to not only minimize risk but also to identify and exploit business opportunities (albeit, this might be difficult to prove)
 - Strong management quality and culture
 - Ability to produce solid fundamental results relative to peers in an unprecedented challenging market
 - Primary basis for a potential upgrade once the cycle starts to turn around
- ◆ Fritzingler believes that the purchase of a strong deposit-based franchise (e.g., Sovereign Bank) would have a significantly positive impact on Lehman's credit rating by reducing any perceived threat of liquidity impairment
 - Could be paired with a “piggyback” transaction that would allow Lehman to restructure its asset portfolio by selling “troubled assets” to another party (i.e., a financial sponsor)

LEHMAN BROTHERS