

*Confidential Presentation to:*

Finance and Risk Committee of the Board of Directors

# 2007 Financial Plan

*January 30, 2007*

LEHMAN BROTHERS

# Agenda

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Agenda

- I. Introduction
- II. 2007 Budget
- III. 2007 Funding and Capital Plan
- IV. Risk Update

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# Introduction

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## Three key objectives for today's meeting:

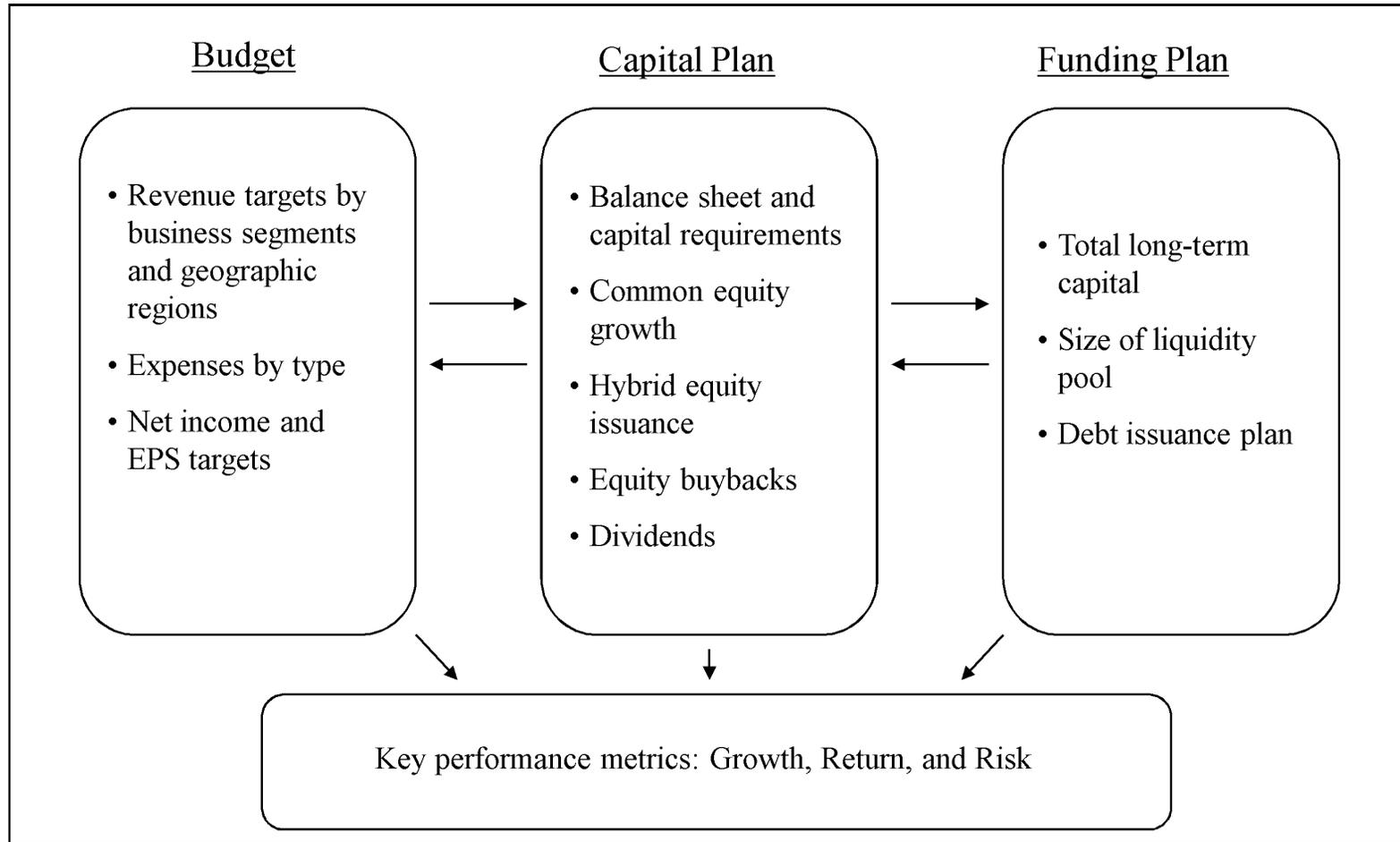
- ◆ Review the Firm's 2007 Budget
  - Revenue of \$19.65 billion, up 12% versus 2006
  - EPS of \$7.41, up 10% versus 2006 operating results, on net income of \$4.3 billion
  - ROE of 21.7% versus 23.4% in 2006
  
- ◆ Review the Firm's 2007 Funding and Capital Plan and obtain the Board's authorization for share repurchases and an increase in common dividends
  - Repurchases of up to 100 million common shares for the management of the Firm's equity capital, including offsetting dilution from employee awards
  - Annual common stock dividend of \$0.60 per share, an increase of \$0.12 or 25% versus 2006
  
- ◆ Review proposed changes in Risk Appetite limits
  - Risk Appetite limits to increase from \$2.3 billion to \$3.3 billion

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*1. All 2006 comparisons exclude the one time gain of \$47 million from FAS 123R accounting standard adoption.*

# Components of the Financial Plan

- ◆ The Firm's Financial Plan consists of three interlinked components: Budget, Capital Plan, and Funding Plan.



# 2007 Budget Summary (I)

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- ◆ The Firm achieved another record for financial performance in 2006. We generated record revenues in each of our businesses and regions
  - Revenue and Net Income were up 20% and 22% respectively versus prior year operating results
  - Third year in a row in which Revenues have grown by approximately \$3 billion
  
- ◆ In 2007 we are budgeting the following:
  - Revenues of \$19.65 billion, up 12% versus 2006
  - EPS of \$7.41, up 10% versus 2006 operating results and ahead of First Call Estimate of \$7.30, on net income of \$4.3 billion
  
- ◆ 2007 Revenue growth is projected to come from all main business segments and geographic regions
  - Investment Banking Segment up 14% versus 2006
  - Capital Markets Segment up 10% versus 2006
  - Investment Management Segment up 16% versus 2006
  - European Region up 14% versus 2006, and
  - Asian Region up 30% versus 2006

# 2007 Budget Summary (II)

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- ◆ Total expenses are budgeted to increase by 13% (or \$1.5 billion)
  - Maintain personnel expense to revenue ratio at 49.3%
  - Non-personnel expenses are budgeted to increase by 16% to \$3.5 billion from \$3.0 billion in 2006 primarily due to:
    - Increase in Real Estate / Occupancy charges as Firm expands globally
    - Increase in variable expenses (brokerage and clearance) related to volume growth
    - Technology initiatives including building out new business lines, improving existing business systems, strengthening infrastructure, and costs related to capacity growth
    - Full year effect of Firm growth in 2006
  
- ◆ Pretax margin of 32.9% versus 33.6% in 2006
  
- ◆ ROE and ROTE of approximately 21.7% and 26.3%, respectively (versus 23.4% and 29.1% in 2006)
  
- ◆ Book value per share estimated to grow to \$38.29, up 13% from \$33.87 in 2006

# 2007 Overall Financial Performance

Budget

- ◆ The 2007 business plan projects double digit revenue growth from all segments.

## Financial Performance

<i>\$ millions, except per share data</i>	2005	2006	2007B	vs. 2006
Investment Banking	2,894	3,160	3,600	14%
Capital Markets	9,807	12,006	13,250	10%
Investment Management	1,929	2,417	2,800	16%
<b>Net Revenues</b>	<b>14,630</b>	<b>17,583</b>	<b>19,650</b>	<b>12%</b>
Personnel Expenses	7,213	8,669	9,687	12%
Non-Personnel Expenses	2,588	3,009	3,500	16%
Special Charges	-	-	-	
<b>Total Expenses</b>	<b>9,801</b>	<b>11,678</b>	<b>13,187</b>	<b>13%</b>
<b>Pretax Income</b>	<b>4,829</b>	<b>5,905</b>	<b>6,463</b>	<b>9%</b>
Income Tax	1,569	1,945	2,133	10%
Impact of Accounting Change	-	47	-	
<b>Net Income</b>	<b>3,260</b>	<b>4,007</b>	<b>4,330</b>	<b>8%</b>
<b>Performance Indicators</b>				
EPS	\$5.44	\$6.73 <sup>1</sup>	\$7.41	10%
First Call Estimate			\$7.30 <sup>2</sup>	
ROE	21.6%	23.4%	21.7%	(1.6)pp
ROTE	27.8%	29.1%	26.3%	(2.8)pp
Average Common Equity	14,741	16,876	19,611	16%
Diluted Share Count	587.2	578.4	574.8	-1%
Compensation / Revenue	49.3%	49.3%	49.3%	-
NPE / Revenue	17.7%	17.1%	17.8%	+0.7pp
Pretax Margin	33.0%	33.6%	32.9%	(0.7)pp
Book Value Per Share	\$28.75	\$33.87	\$38.29	13%

1. 2006 EPS excludes \$0.08 from one time accounting gain from the adoption of FAS 123R

2. First Call estimate as of January 24, 2007

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# 2007 Revenue Details

◆ Revenue growth is projected to come from all main businesses and regions.

## Revenue Detail

<i>\$ millions</i>	<b>2005</b>	<b>2006</b>	<b>2007B</b>	<i>vs. 2006</i>
Fixed Income	8,531	9,029	9,800	9%
Equities	3,117	4,032	4,500	12%
Banking	3,135	3,338	3,700	11%
Asset Management	1,217	1,653	1,950	18%
Global Trading & Principal Strategies	55	577	800	39%
Banking Elimination / Other	(1,425)	(1,045)	(1,100)	<i>nm</i>
<b>Total Revenues</b>	<b>14,630</b>	<b>17,583</b>	<b>19,650</b>	<b>12%</b>
<b>Regional</b>				
Europe	3,157	4,066	4,650	14%
Asia	1,532	1,659	2,150	30%

1. Baseline based on 2006 year-end headcount.  
 2. New Initiatives include incremental resources

# 2007 Budget – Business Segments

Budget  

## Fixed Income

- ◆ Revenue increase of 9% in 2007 versus record performance in 2006
- ◆ Key 2007 strategic initiatives include:
  - Extending origination and securitization businesses (insurance, middle market, infrastructure and non-performing loans)
  - Building out energy and commodity business globally
  - Growing the derivatives business
  - Building presence in emerging markets

## Equities

- ◆ Revenue increase of 12% in 2007 versus record performance in 2006
- ◆ Key 2007 strategic initiatives include:
  - Grow derivatives and convertibles business
  - Expand Prime Services
  - Continue to expand electronic trading platform
  - Leverage expertise in research

## Banking

- ◆ Revenue increase of 11%, with global fee share expected to increase to 5.3% from 4.6% in 2006
- ◆ Key 2007 strategic initiatives include:
  - Increase in M&A market share in both Europe and Asia
  - Increased wallet share among large financial sponsor clients
  - Sale of derivative products to corporate clients
  - Focus on hedge fund opportunities

## Asset Management

- ◆ Revenue increase of 18% versus 2006, with 23% AUM growth by year-end
- ◆ Key 2007 strategic initiatives include:
  - Achieve strong net flows from higher fee-generating products
  - Roll out new alternative investment funds
  - Minority stakes in alternative asset managers
  - Build out European asset management platform

# 2007 Budget – Geographic Regions

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Budget  

## Europe

- ◆ Increase in revenues of 14% versus prior year with strong outlooks for all divisions
  
- ◆ Key 2007 strategic initiatives include:
  - Build scale and capacity into existing businesses
  - Capitalize on newly established businesses (e.g., Energy and Asset Management)
  - Expand geographically, including Western Europe and Middle East

## Asia

- ◆ Increase in revenues of 30% versus record performance in 2006
  
- ◆ Key 2007 strategic initiatives include:
  - Build franchise in India
  - Continue to develop Asia Capital Markets client franchise
  - Grow mortgage platforms in Japan and Korea
  - Increase focus on prime services (hedge funds)
  - Grow IBD market share

# Balance Sheet

- ◆ To support the 2007 Business Plan, we intend to deploy approximately \$58.7 billion of additional net balance sheet
  - Significant growth is expected in the proprietary businesses, as well as investments in the asset management business

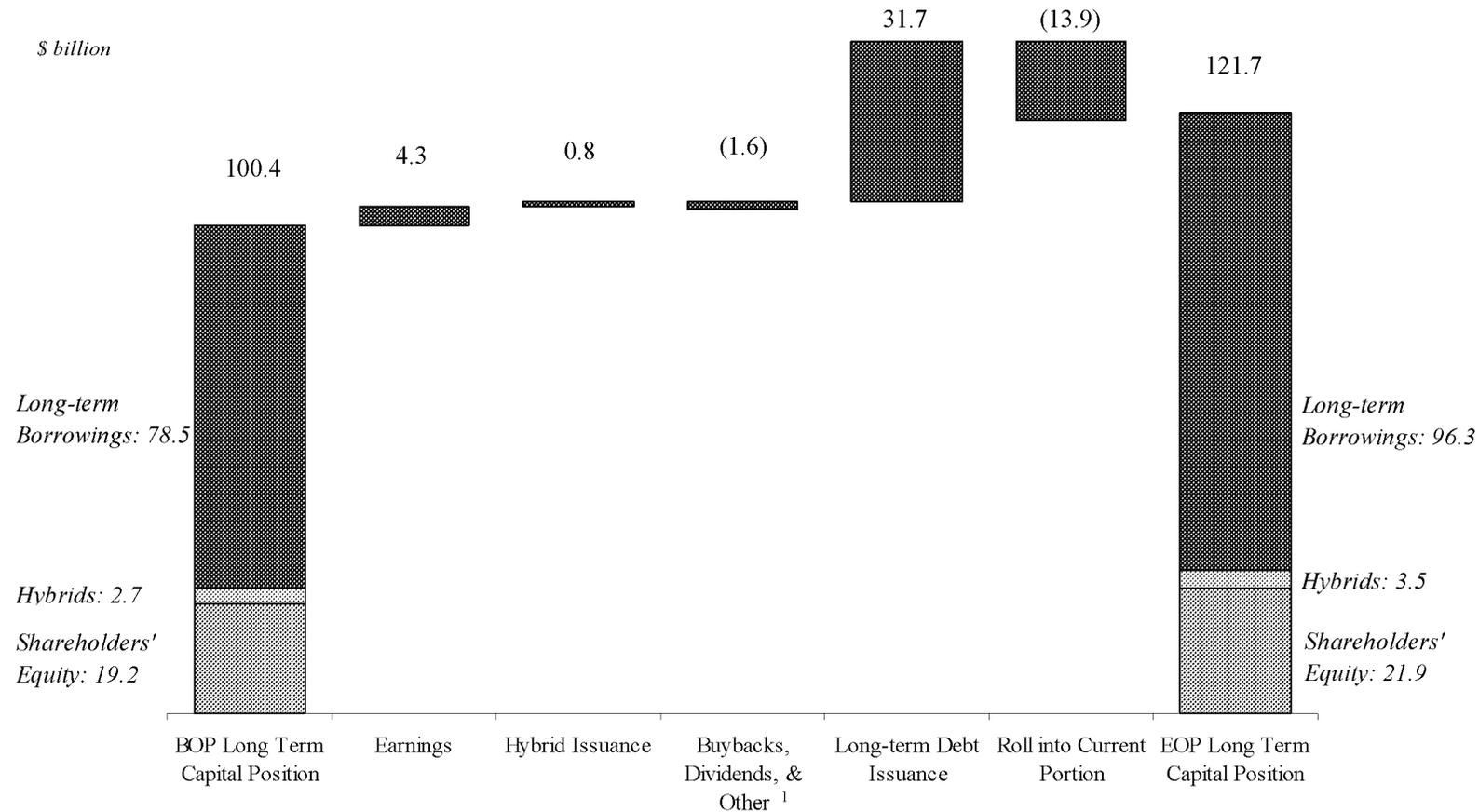
## Year-End Balance Sheet Summary

(\$ Billions)	2005	2006	2007B	2007 Growth	
				\$	%
Fixed Income	133.0	174.3	198.4	24.1	14%
Equities	53.5	67.8	84.3	16.5	24%
Global Trading & Principal Strategies	2.6	7.4	15.0	7.6	103%
Other	22.4	19.5	30.0	10.5	54%
<b>Total Net Assets</b>	<b>211.4</b>	<b>268.9</b>	<b>327.6</b>	<b>58.7</b>	<b>22%</b>
Financing and Other	198.6	234.6	285.1	50.5	22%
<b>Total Assets</b>	<b>410.1</b>	<b>503.5</b>	<b>612.7</b>	<b>109.1</b>	<b>22%</b>
Other Liabilities	339.4	403.2	490.9	87.8	22%
Long-term Borrowings <sup>1</sup>	53.9	81.2	99.8	18.7	23%
<b>Total Liabilities</b>	<b>393.3</b>	<b>484.4</b>	<b>590.8</b>	<b>106.4</b>	<b>22%</b>
Common Equity	15.7	18.1	20.8	2.7	15%
Traditional Preferred	1.1	1.1	1.1	-	0%
Stockholders' Equity	16.8	19.2	21.9	2.7	14%
<b>Total Liabilities and Stockholders' Equity</b>	<b>410.1</b>	<b>503.5</b>	<b>612.7</b>	<b>109.1</b>	<b>22%</b>
<b>Total Long-Term Capital</b>	<b>70.7</b>	<b>100.4</b>	<b>121.7</b>	<b>21.4</b>	<b>21%</b>

1. Long-term Borrowings includes Hybrid Equity

# 2007 Issuance Requirement (I)

- ◆ Although the balance sheet growth for 2007 (approximately \$59 billion) is expected to be similar to 2006, issuance is expected to be \$11 billion lower than prior year. This is due to more assets being funded in Lehman Brothers Commercial Bank (\$3 billion) and Bankhaus (\$3 billion). Additionally, bank sourced and other secured financing is expected to increase by \$5 billion.



1. \$(1.6) billion represents: Buybacks of \$(0.8) billion, dividend payments of \$(0.4) billion, and Other is a one time adjustment of \$(0.4) billion arising from Pension accounting changes

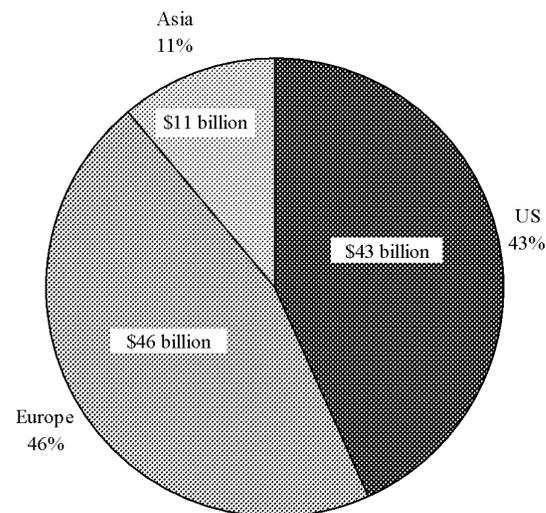
# 2007 Issuance Requirement (II)

- ◆ We continue to put an emphasis on diversifying our debt investor base. This has the additional benefit of increasing brand awareness in new issuance markets, as well as being a cost effective source of financing.
- ◆ We plan to continue to diversify our debt investor base in 2007, without compromising our pricing standards
  - Reviewing possibility of entering the debt markets in India (INR) and Sweden (SEK)
  - Looking to expand in Australia (AUD), Canada (CAD), Switzerland (CHF), and Mexico (MXN) that we entered for the first time in 2006
  - Aiming to broaden our presence in Samurai (JPY) market

**FY 2007 Long-term Borrowings Issuance (Projection)**  
(\$ millions)

Types	Volume	Tenor (yr)	US	Europe	Asia
Vanilla	14,600	6	8,600	5,000	1,000
Structured	13,100	3	2,100	7,000	4,000
Subordinated	4,000	13	2,000	2,000	-
Hybrids	800	5	800	-	-
<b>Total Long-term Debt:</b>	<b>32,500</b>	<b>6</b>	<b>13,500</b>	<b>14,000</b>	<b>5,000</b>
<b>Regional Breakdown</b>	<b>100%</b>		<b>42%</b>	<b>43%</b>	<b>15%</b>

**FY 2007 Projected Outstanding Long-term Debt by Region**



# Equity Adequacy and Equity Allocation

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**When deciding on the appropriate level of the Firm's equity capitalization we use a conservative approach intended to satisfy the Firm's management, the regulators, and the rating agencies.**

- ◆ Our primary tool is the Firm's internal Risk Equity model
    - Reflects the Firm's internal assessment of risk consistent with the need to protect the franchise
    - Most sophisticated, uses the most up-to-the-minute inputs, well regarded by rating agencies and regulators
  
  - ◆ We supplement Risk Equity model with requirements of two additional models: CSE Regulatory Equity model and Rating Agency Capital Charge model
    - CSE regulatory model reflects capital adequacy standards established by SEC. We target capitalization level comparable to the large international banks
    - Rating Agency Capital charge model reflects the requirements applied by the leading rating agencies to AA broker/dealers
  
  - ◆ In addition, we have established overall limits on the size of the Firm's Gross Assets, Net Assets, and Less Liquid Assets
    - These limits are primarily based on the rating agencies' key credit metrics relative to the peer group
  
  - ◆ Capital is allocated to the businesses based on risk equity, and supplemented by regulatory and rating agency requirements where these exceed risk equity
    - Capital requirements are first calculated using the Risk Equity model and are supplemented if Regulatory or S&P models require more equity
    - All three requirements are tracked
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# Equity Composition

- ◆ The net balance sheet growth is supported by a 19% increase in leverageable equity, made up of a \$2.7 billion increase in common equity and \$0.8 billion of hybrid equity issuance.
- ◆ Net leverage is projected to increase to the 14.5-16.0x range, in line with the peer group.

## Equity Trend

(\$ Billions)	2005	2006	2007F	2007 Growth	
				\$	%
Common Equity	15.7	18.1	20.8	2.7	15%
Perpetual Preferred	1.1	1.1	1.1	-	0%
<b>Shareholders' Equity</b>	<b>16.8</b>	<b>19.2</b>	<b>21.9</b>	<b>2.7</b>	<b>14%</b>
Junior Subordinated Notes	2.0	2.7	3.5	0.8	29%
Goodwill & Intangibles	(3.3)	(3.4)	(3.4)	-	0%
<b>Leverageable Equity</b>	<b>15.6</b>	<b>18.6</b>	<b>22.1</b>	<b>3.5</b>	<b>19%</b>
Net Balance Sheet	211.4	268.9	327.6	58.7	22%
Gross Balance Sheet	410.1	503.5	612.7	109.1	22%
<b>Net Leverage</b>	<b>13.6x</b>	<b>14.5x</b>	<b>14.9x</b>	<b>0.4x</b>	<b>NA</b>

# Hybrid Equity Issuance

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- ◆ As discussed before, we view hybrid equity as an important component of the Firm's equity
  - Given their long-dated (or perpetual) maturities and deep subordination, regulators and rating agencies include hybrid equity alongside common equity in the calculation of Tier 1 Capital and Leverageable Equity
  - From our perspective, these instruments, used within regulatory limits, help support growth and optimize the Firm's equity structure in cost-efficient way
  - They represent very low cost equity and are comparable cost to straight 30 year debt: tax-deductible net cost of under 4.00%, and non-tax-deductible at 6.50%
  
- ◆ In 2006, we had \$3.8 billion of hybrid equity outstanding consisting of
  - \$1.1 billion traditional non-tax-deductible securities (perpetual preferreds), and
  - \$2.7 billion tax-deductible trust preferred securities
  
- ◆ The amount of allowable hybrid securities is limited by our own view of acceptable levels, CSE regulations and guidance from rating agencies. In 2007, based on projected common equity growth, we have capacity to issue up to \$1.8 billion of these securities
  - We intend to issue \$0.8 billion of tax-deductible securities and may issue up to additional \$1.0 billion of other preferred securities, subject to market conditions and the need to support the Firm's growth
  
- ◆ The objective is to maximize tax deductible issuances through innovative development of structures.

# Share Repurchase Plan

- ◆ Share repurchases is one of our main levers in managing the Firm's equity. By increasing the size of repurchases we can reduce the size of common equity, and increase ROE. Conversely, by delaying repurchases we can deploy incremental equity to support the Firm's growth.
- ◆ We have been able to offset dilution, grow dividends and meet the growth needs of the firm. By periodically front loading repurchases, we have been able to both minimize costs and manage EPS shares.
- ◆ In 2006, we bought 11 million shares more than required to fully offset dilution. This primarily represents front loading of purchases for 2007.
- ◆ We request the Board to approve repurchases of up to 100 million common shares for the management of the Firm's equity capital, including offsetting dilution due to employee awards, subject to market conditions. This allows us flexibility to repurchase shares to offset future year dilution, when market conditions are suitable. This authorization supersedes the previous share repurchase authorization.

## Share Repurchase Plan

(# of Shares In Millions)	2005	2006	2007 Change		
			2007F	# of Shares	%
<b>Equity Award Dilution</b>					
RSU Amortization	25	19	34	15	77%
Option Exercises	51	22	30	8	35%
<b>Total Dilution</b>	<b>76</b>	<b>42</b>	<b>64</b>	<b>23</b>	<b>54%</b>
Repurchases to Offset Current Year Dilution	76	42	55		
Repurchases of 2007 Dilution		9			
Other Repurchases	4	2	-		
<b>Total Repurchases</b>	<b>81</b>	<b>53</b>	<b>55</b>	<b>2</b>	<b>4%</b>
<b>Basic EPS Shares</b>	<b>556</b>	<b>543</b>	<b>544</b>	<b>1</b>	<b>0%</b>

# Impact of Share Repurchases and Equity Awards on Equity

Capital Plan

- ◆ We project the net impact of share repurchases and equity awards on equity to be approximately \$830 million. The actual cost will be affected by the number of options exercised in 2007 and the share price dynamics.

## Net Impact of Equity Awards and Share Repurchases On Equity

*(\$ millions)*

Impact on Stockholders' Equity	2005	2006	2007F	2007	
				Δ	%
RSU Amortization / Option Expense	1,054	923	1,895	972	105%
Options Exercised (Proceeds)	1,245	637	877	240	38%
Tax Benefit on Options Exercised	537	385	387	2	0%
Tax Benefit on RSU Issuances	467	451	667	216	48%
<b>Increase in Equity from Employee Awards</b>	<b>3,304</b>	<b>2,396</b>	<b>3,826</b>	<b>1,430</b>	<b>60%</b>
<b>Cost of Share Repurchases</b>	<b>(4,157)</b>	<b>(3,681)</b>	<b>(4,656)</b>	<b>(975)</b>	<b>26%</b>
<b>Net Impact on Equity</b>	<b>(853)</b>	<b>(1,285)</b>	<b>(830)</b>	<b>455</b>	<b>-35%</b>
Number of Shares Repurchased, millions	81	53	55	2	4%
Average Purchase Price Per Share, \$	\$52	\$70	\$85	\$15	22%

# Equity Overhang

- ◆ In 2006, our equity award overhang declined to 8.5% from 11.3%.
- ◆ In 2007, we project our equity overhang to be 7.0%; this is driven by the continued reduction in option awards.

## Equity Overhang

<i>Shares in millions, \$ millions (except per share)</i>	<b>Actual 2005</b>	<b>Actual 2006</b>	<b>Forecast 2007</b>
RSUs Outstanding	120.4	100.4	117.0
Options Outstanding	101.8	81.4	50.5
Gross Shares in Overhang	222.2	181.8	167.5
Shares in RSU Trust	(69.1)	(64.7)	(79.4)
Net Shares in Overhang	153.1	117.1	88.1
Option Proceeds	(50.6)	(36.8)	(20.2)
Tax Benefit from Options	(20.4)	(17.8)	(12.1)
Tax Benefit from RSUs	(18.8)	(16.5)	(18.0)
Total Adjustments	(89.9)	(71.2)	(50.3)
<b>Adjusted Shares in Overhang</b>	<b>63.1</b>	<b>46.0</b>	<b>37.8</b>
Basic EPS Shares Outstanding	556.3	543.0	543.6
Gross Overhang	39.9%	33.5%	30.8%
Net Overhang	27.5%	21.6%	16.2%
<b>Adjusted Overhang</b>	<b>11.3%</b>	<b>8.5%</b>	<b>7.0%</b>
Exercisable Options	52.6	54.6	35.6
W avg Strike Price	\$27.65	\$30.12	\$28.00

# 2007 Dividend Increase Recommendation

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- ◆ Similar to previous years, we propose to continue our approach of maintaining our strong record of dividend increases while preserving financial flexibility to support business growth and offset dilution by keeping a low payout ratio
  - Signal management’s confidence in the financial health of the Firm.
  - Position Lehman Brothers as a “growth” stock.
  
- ◆ We recommend increasing Lehman Brothers’ annual common stock dividend from \$0.48 in 2006 (\$0.12 per quarter) to \$0.60 in 2007 (\$0.15 per quarter), a 25% increase. The proposed dividend would return approximately \$320 million of retained earnings to shareholders
  - Projected dividend payout ratio<sup>1</sup> of approximately 7.5%, amongst the lowest in our peer group where the average payout ratio is 10.2%.
  - Projected dividend yield of 0.7% is the lowest, with the peer average of 1.1%.
  - Dividend growth consistent with revenue and income growth.

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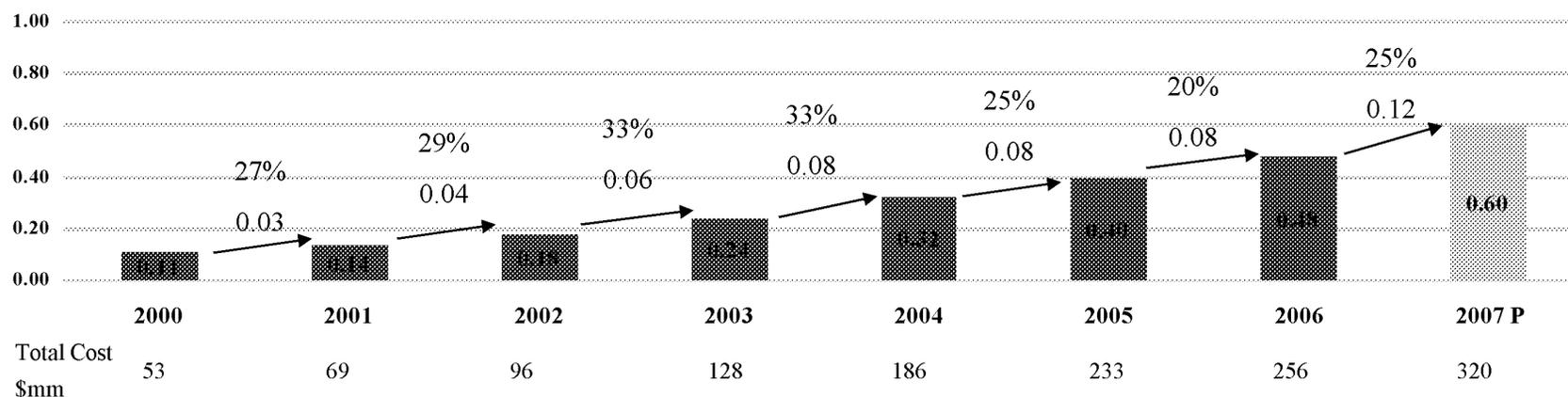
1. Payout ratio calculated as a ratio of common dividends to net income applicable to common. 2007 is \$320mm/\$4,294mm = 7.5%

2. Dividend yield calculated as a ratio of dividends per share / projected average stock price. 2007 is \$0.60/\$85 = 0.71%

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# 2007 Dividend Increase Recommendation (\$0.12 increase)

## Lehman's Dividend Trend and 2007 Recommendation, \$ / Share



## Peer Group Dividend Benchmarking

		Lehman Brothers	Goldman Sachs	Morgan Stanley	Merrill Lynch	Bear Stearns	
<b>Dividend per Share</b>	Last Announcement	January 19, 2006	March 14, 2006	December 19, 2006	January 18, 2007	December 14, 2006	
	Increase of	20%	40%	0%	40%	14%	
<b>Dividend CAGR</b>	5 Year 2001 - 2006	28%	22%	3%	9%	13%	<b>Average</b>
<b>Payout Ratio</b> <sup>1</sup>	2006	6.5%	7.2%	16.4%	13.9%	6.9%	10.2%
	Lehman 2007B	7.5%					
<b>Dividend Yield</b> <sup>2</sup>	2006	0.7%	0.8%	1.7%	1.3%	0.8%	1.1%
	Lehman 2007B	0.7%					

1. Calculated as: Common Dividends Paid / Net Income Applicable to Common. Since 2006 full year data is not yet available, 2006 data is Q3 2006 YTD.

2. Dividend Yield calculated based on average stock price during period.

# Lehman Brothers 2007 Equity Budget Summary

Capital Plan

- ◆ We plan to deploy incremental available equity as follows: 68% to support the Firm's growth, 16% to support our share repurchase program, and 6% and 1% to pay common and preferred dividends, respectively.
- ◆ The Firm's leverageable equity is projected to increase by 19%.

## Leverageable Equity

	2005	2006	2007F	2007 Change	
				\$	% <sup>1</sup>
<b>Leverageable Equity, BOP</b>	<b>12.6</b>	<b>15.6</b>	<b>18.6</b>	<b>3.0</b>	<b>19%</b>
Net Income	3.3	4.0	4.3	0.3	8%
Preferred/Hybrid Net Issuance	0.8	0.6	0.8	0.2	41%
<b>Total Sources</b>	<b>4.1</b>	<b>4.6</b>	<b>5.2</b>	<b>0.6</b>	<b>12%</b>
Net Impact of Share Repurchases	(0.9)	(1.3)	(0.8)	0.5	-35%
Common Dividends	(0.2)	(0.3)	(0.3)	(0.1)	25%
Preferred Dividends	(0.1)	(0.1)	(0.1)	(0.0)	4%
Other <sup>2</sup>	0.0	0.0	(0.4)	(0.4)	NM
<b>Total Uses</b>	<b>(1.1)</b>	<b>(1.6)</b>	<b>(1.7)</b>	<b>(0.1)</b>	<b>5%</b>
Net Change in Leverageable Equity	2.9	3.0	3.5	0.5	16%
<b>Leverageable Equity, EOP</b>	<b>15.6</b>	<b>18.6</b>	<b>22.1</b>	<b>3.5</b>	<b>19%</b>
<b>Composition of Leverageable Equity Sources</b>					
Net Income Growth	80%	87%	84%		
Preferred/Hybrid Net Issuance	20%	13%	16%		
<b>Composition of Leverageable Equity Uses<sup>3</sup></b>					
Net Impact of Share Repurchases	21%	28%	16%		
Common Dividends	5%	6%	6%		
Preferred Dividends	2%	1%	1%		
Other	0%	0%	9%		
Available Leverageable Equity for Growth	72%	65%	68%		

1. Percentage change calculated before rounding

2. Relates to an accounting adjustment on pension expected to be adopted on 11/30/07 (SFAS 158)

3. Leverageable Equity Uses as a percentage of Sources

# Risk Appetite Summary

◆ We propose to establish a 2007 Risk Appetite limit of \$3.3 billion. Our proposal is based on the following assumptions:

- The minimum performance hurdle is set at a 10.0% ROE. This translates into a compensation to revenue ratio of 58.7%, a pretax margin of 19.8%, and an ROTE of 12.4%
- The compensation expense is based on a severe downturn scenario: 10% headcount reduction (corresponding to approximately 2,600 people) and a 35% decline in compensation (may be mitigated by a change in the equity grid, which has not been factored in)
- NPE reduction of 20%
- Non-risk losses associated with client driven revenues of \$3.35 billion, or a decrease of 17% relative to 2007 budgeted revenues of \$19.65 billion, resulting in revenues before risk losses of \$16.3 billion

	<i>% Change in Revenues</i>	
	<b>2006A</b>	<b>2007B</b>
	<u>(10)%</u>	<u>(19)%</u>
Banking (Advisory, U/W)	(10)%	(19)%
Client Revenues	(8)%	(20)%
IMD Fees	(5)%	(15)%
Mortgage Origination	(5)%	(30)%

◆ The result of the above assumptions is a 2007 Risk Appetite limit of \$3.3 billion – up \$1.0 billion from the 2006 limit

- Note that the 2006 limit calculated under the same methodology would have been in the \$2.5 to \$2.8 billion range. As our risk usage at the beginning of 2006 was relatively low at \$1.1 billion, the limit was set at \$2.3 billion
- During 2006, our risk usage gradually increased, fully utilizing our 2006 limit by fiscal year end and reaching a peak of \$2.7 billion in mid-December 2006

# Risk Appetite Limit

- ◆ We recommend setting a Risk Appetite limit of \$3.3 billion based on the following assumptions

## Downturn Scenario – Financial Performance

*\$ millions except per share data*

	<u>2007</u>
<b>Total Revenues</b>	<b>13,028</b>
Personnel Expense	7,650
Non Personnel Expense	<u>2,792</u>
<b>Pretax Income</b>	<b>2,585</b>
Income Tax	<u>776</u>
<b>Net Income</b>	<b>1,810</b>
Average Quarterly Revenue in Downturn Scenario	3,257

### *Performance Indicators*

Earnings per Share	\$3.03
PE / Revenue	58.7%
NPE / Revenue	21.4%
Pretax Margin	19.8%
Effective Tax Rate	30.0%
<b>Return on Equity</b>	<b>10.0%</b>
Return on Tangible Equity	12.4%

## Risk Appetite Results

	<u>2007</u>
<b>2007 Budgeted Revenues</b>	<b>19,650</b>
Client, Origination, Banking Revenue Loss	<u>(3,349)</u>
<b>Total Revenues Before Risk Losses</b> <sup>1,2</sup>	<b>16,301</b>
Minimum Revenue Level Required	<u>13,028</u>
<b>Proposed Risk Appetite Limit</b>	<b>3,273</b>
Average Qtr Revenue Before Risk Losses	4,075

### *Three Year Quarterly Revenue Trend*

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Q1	4,461	3,810	3,144
Q2	4,411	3,278	2,926
Q3	4,178	3,852	2,623
Q4	4,533	3,690	2,883

1. Revenues before risk losses reflects 2006 actual revenues stressed for estimated revenue losses in a downturn – lower origination, banking, and client flows  
 2. The \$16.3 billion represents an 17% decline versus 2007 Plan of \$19.7 billion and a 7% decline from the 2006 forecast of \$17.6 billion.

# Risk Appetite Limit Allocation

Risk

## Risk Appetite Limit Allocation

<i>\$ millions</i>	2004	2005	2006	2007 Proposed
Fixed Income	1,400	1,550	1,625	2,200
Equities	400	450	550	800
Capital Markets Prime Services <sup>1</sup>	-	-	100	150
Investment Management	250	325	325	650
Global Trading Strategies	300	450	450	600
Global Principal Strategies <sup>2</sup>	-	-	300	500
Principal Investing / IBD	-	-	-	100
Strategic Investing	-	-	-	150
India Operations	-	-	-	250
Diversification %	23.4%	24.3%	31.3%	38.9%
<b>Total</b>	<b>1,800</b>	<b>2,100</b>	<b>2,300</b>	<b>3,300</b>

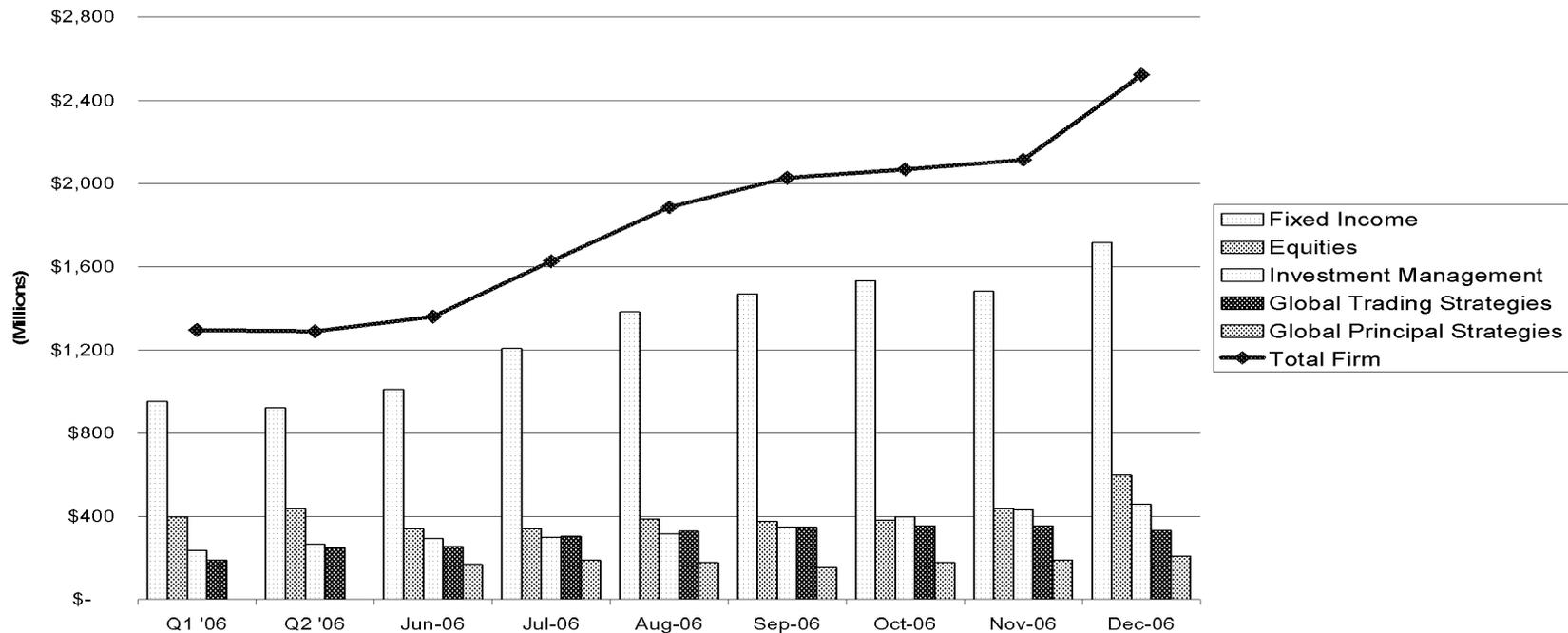
1. Prior to 2006 Capital Markets Prime Services were part of FID and Equities.

2. Global Principal Strategies group was formed in 2006. It was part of FID prior to 2006.

# Risk Appetite Usage

- ◆ The Firm's overall risk usage trended up significantly since June 2006 and accelerated towards the end of the fiscal year, reaching \$2.3 billion by November 30<sup>th</sup>, 2006
- ◆ The upward trend continued as we entered our new fiscal year, peaking in late December at \$2.7 billion and averaging \$2.5 billion 2007 YTD
- ◆ While Fixed Income led the increase, other divisions have also increased their risk-taking activities, particularly Equities and IMD

**Average Risk Usage – Total Firm and by Division**



# Stress Testing

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Risk  

- ◆ Stress tests and scenario analyses are performed regularly to evaluate the potential P&L impact on the Firm's portfolio of abnormal yet plausible market conditions
  - Analyses of movements in interest rates, stock prices, FX, volatility, etc., are run over a wide range of possible scenarios to determine the impact on the current portfolio of these extreme instantaneous shocks
  - These analyses are conservative because they do not allow for re-hedging or selling down a position either actively or through the automatic execution of existing stop-losses
- ◆ Our stress tests are run regularly on a suite of scenarios, including:
  - Re-runs of historical episodes of extreme market moves, for example:
    - 9/11 terrorist attacks
    - Russia default contagion and LTCM
    - November 2001 volatile bond market
    - October 1987 stock market crash
  - Hypothetical scenarios due to shocks that have some probability of occurrence and are driven by macro fundamental shifts, for example:
    - Dollar declines due to the current account deficit
    - Oil price increase leading to cost-push inflation
    - Yield curve steepening due to potential inflationary expectations
    - Credit spreads widening due to an increase in the overall level of the curve
  - Other ad-hoc hypothetical scenarios
- ◆ We subject both our trading and counterparty portfolio to stress tests

# Stress Testing

Risk

## Revenue Impact on Trading Portfolio (\$ Millions)

Portfolio Date	Bull Steepening	Bull Flattening	Bear Flattening	Bear Steepening	EMG Crisis	Rating / Default & HF Risk	HY / LBO / Default Risk	Equity Crash (1987)	Parallel Move Down	Parallel Move Up	Black Monday	Oil Supply Crisis	Liquidity Crunch
Fixed Income	(320)	217	250	(647)	(864)	(690)	(823)	(717)	(539)	264	(537)	(407)	(884)
Equities	(349)	119	258	(88)	(323)	(119)	(360)	(427)	(344)	231	(317)	(349)	(304)
Global Trading Strategies	(229)	48	177	(108)	(229)	(92)	(238)	(468)	(241)	178	(338)	(245)	(196)
Investment Management	(139)	61	85	(103)	(166)	(104)	(159)	(316)	(143)	90	(222)	(184)	(197)
Global Principal Strategies	(74)	2	(12)	(105)	(68)	(84)	(107)	(109)	(70)	(33)	(72)	(25)	(89)
Prime Services	41	23	(52)	(19)	31	25	25	37	33	(34)	37	61	(52)
<b>Firm Total</b>	<b>(1,070)</b>	<b>471</b>	<b>706</b>	<b>(1,069)</b>	<b>(1,619)</b>	<b>(1,064)</b>	<b>(1,661)</b>	<b>(2,000)</b>	<b>(1,305)</b>	<b>696</b>	<b>(1,449)</b>	<b>(1,149)</b>	<b>(1,724)</b>
<b>11/30/06 Firm Total</b>	<b>(1,099)</b>	<b>306</b>	<b>1,035</b>	<b>(515)</b>	<b>(1,407)</b>	<b>(1,061)</b>	<b>(1,650)</b>	<b>(2,248)</b>	<b>(1,328)</b>	<b>951</b>	<b>(1,570)</b>	<b>(1,218)</b>	<b>(1,015)</b>
<b>10/31/06 Firm Total</b>	<b>(432)</b>	<b>198</b>	<b>736</b>	<b>(200)</b>	<b>(691)</b>	<b>(616)</b>	<b>(963)</b>	<b>(1,021)</b>	<b>(763)</b>	<b>767</b>	<b>(799)</b>	<b>(509)</b>	<b>(440)</b>
<b>9/29/06 Firm Total</b>	<b>(850)</b>	<b>147</b>	<b>951</b>	<b>(449)</b>	<b>(1,035)</b>	<b>(988)</b>	<b>(1,170)</b>	<b>(1,762)</b>	<b>(1,176)</b>	<b>934</b>	<b>(1,452)</b>	<b>(1,019)</b>	<b>(605)</b>
<b>8/31/06 Firm Total</b>	<b>(740)</b>	<b>(111)</b>	<b>1,117</b>	<b>(104)</b>	<b>(1,038)</b>	<b>(814)</b>	<b>(1,104)</b>	<b>(1,879)</b>	<b>(1,092)</b>	<b>1,076</b>	<b>(1,594)</b>	<b>(1,211)</b>	<b>(161)</b>
<b>7/31/06 Firm Total</b>	<b>(476)</b>	<b>34</b>	<b>919</b>	<b>(81)</b>	<b>(744)</b>	<b>(628)</b>	<b>(811)</b>	<b>(1,303)</b>	<b>(697)</b>	<b>903</b>	<b>(1,057)</b>	<b>(821)</b>	<b>(191)</b>
<b>6/30/06 Firm Total</b>	<b>(132)</b>	<b>164</b>	<b>610</b>	<b>(323)</b>	<b>(264)</b>	<b>(305)</b>	<b>(396)</b>	<b>(1,086)</b>	<b>(368)</b>	<b>623</b>	<b>(742)</b>	<b>(390)</b>	<b>(127)</b>

Note: These represent revenue losses associated with potential market moves occurring over a two-week period. These analyses are conservative because they do not allow for re-hedging or selling down a position either actively or through the automatic execution of existing stop-losses.