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Internal Correspondence    New York Office

January 25, 2008

To: Files

From: Wyatt de Silva

Re: Commercial Real Estate Testing Approach

This memo serves to summarize the Mortgage Capital Team's approach to testing the U.S. commercial real estate ("CRE") area for the fiscal 2007 audits of Lehman Brothers Holdings Inc. ("LBHI") and Lehman Brothers Inc. ("LBI") (collectively "Lehman").

Pricing

Lehman's CRE portfolio is held at fair value based on front office marks. With respect to securities, the Product Pricing Team is responsible for validating current and accurate prices of securities, and identifying, resolving and reporting on exceptions. Securities that have 3<sup>rd</sup> party available pricing data are priced via feeds from the vendors. In addition to vendor pricing feeds, the Product Pricing Team also obtains prices from Lehman's product desks. Real estate collateralized loans and equity investments in real estate vehicles are also carried at fair value and marked by the traders. Real estate held for sale is carried at the lower of cost or market.

On a monthly basis, Product Control performs price verification or price testing procedures to determine the reasonableness of the inventory marks. The population to be price tested is downloaded from GQuest. GQuest is a global system for tracking profit and loss and facilitates data collection, adjusting journal entries, and reporting. It provides Lehman with the ability to report P&L from an individual security level up to a consolidated divisional level. GQuest is used to identify the positions to be price verified because it includes all positions on Lehman's balance sheet as well as off-balance sheet commitments (e.g. commercial loan commitments, REIT unfunded balances).

Note: IT general controls for GQuest are tested by the EY TSRS team. Application controls to verify GQuest has the complete and accurate population of inventory is also tested by the EY TSRS team.

GQuest allows for the download of critical information of the inventory for analysis. Finance extracts the inventory booked in GQuest as of the valuation date to Excel. The data contained in the extract includes the following:

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Profit Center	Maturity Date
Position Size	Coupon
Issuer	Price (referred to as "Inventory Price")
Account Number	3 <sup>rd</sup> Party Prices (i.e. – EJV, IDC, etc..)
CUSIP	Trader

The third party prices in GQuest are derived from the ESM system (pricing system tested by EY TSRS as part of the Lehman Type II SAS 70).

Product Control then performs its price verification on the extract. The price verification approach is determined based on product type and level of price transparency. Per Jonathan Cohen, SVP CRE Product Control, the price testing hierarchy is generally: 1) recent trades, 2) external marks, 3) models with consideration of liquidity.

The following section describes the types of mortgage products and the price verification procedures performed by Product Control as well as procedures re-performed by E&Y on a sample basis as part of our audit of the valuation assertion.

#### 1. All products

##### ***Completeness of price testing population***

E&Y tested the controls intended to verify completeness of the price testing population by testing the CRE pricing reconciliation to GQuest, and independently downloading the GQuest extract for 2 testing months. We then compared the totals from the downloaded population to those from Product Control's pricing package.

E&Y also selected a sample of positions across various pricing models over 2 testing months to agree to MTS, Lehman's mortgage trading ledger.

##### ***Price testing variances***

With respect to variances in price testing we performed the following:

- Reviewed Product Control's procedures for positions with price variances above scope and concluded on the results.
- Obtained Product Control's monthly analysis of pricing variances for 2 testing months. Assessed whether satisfactory explanations were provided for a sample of material variances.
- Reviewed positions, if any, which are not price verified by Product Control and determined whether additional procedures are required based on the level of materiality.

##### ***Other***

- For each significant product area, we performed a walkthrough of the price testing process, made inquiries of product control, and performed analytical review procedures on the balance sheet values and related P&L. The inquiries made of Product Control include those in response to the results of our detailed testing, data analyses, and other procedures.

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2. Liquid Listed asset-backed securities with price transparency (Type A)

Within the CRE portfolio, Lehman holds Commercial Mortgage Backed Securities “CMBS”. All securities in this category are carried at fair value. Product Control price verifies these products by comparing the average 3<sup>rd</sup> party prices against the inventory marks at the security level.

E&Y performed the following procedures to address the valuation assertion for these products:

- Selected a sample of positions across 2 testing months and compared the average third party marks per pricing file to the average prices obtained via Bloomberg/E&Y-ISP and investigated significant variances.
- Reviewed positions, if any, which are not price verified by Product Control and determined whether additional procedures are required based on the level of materiality.
- Performed data analysis to check for material, unexplained fluctuations in the marks assigned to the securities from period to period.
- Obtained recent trade history and evaluated CMBS prices relative to observable trades executed by Lehman near the valuation date.
- For certain “more-liquid” portfolios, E&Y performed an entire portfolio pricing upload into E&Y ISP and assessed reasonableness of the client’s marks compared to the external prices in E&Y ISP.
- Evaluated the age of quoted prices from third party sources in evaluating the relevancy of the quoted price used for Liquid Listed products.
- Leveraged EY TSRS’s testing of the ESM system with respect to the Lehman SAS 70 to cover the feeds from third party vendors to Lehman’s systems via ESM.

3. Liquid Listed asset-backed securities with no (or very little) price transparency (Type B)

All securities in this category, including retained interests and IOs are carried at fair value.

Product Control price verifies this category by comparing the inventory marks to:

- a. Recent trade prices, where available;
- b. The carrying value of other tranches which have price transparency (for securities; not used for Residuals);
- c. Prices generated by a yield table analysis via Intex (third party model) using assumptions that are validated by information available from the Intex database, collateral performance parameters from Bloomberg or using remittance reports; or

We note that CRE Product Control did not use the CMBX to value CMBS bonds during the year as bond trading and securitization activity near year end was deemed not to be closely related to CMBS . Discussions with Product Control indicated that movements in the CMBX index were not representative or strongly correlated to the movements in the value of the underlying CMBS bonds (unlike residential mortgage backed securities, where the ABX index has been used to price MBS positions), or spreads primarily due to

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speculation on increased credit risk in this space. As of year end, the credit impact on the bonds was minimal.

E&Y selected a sample of positions across 2 testing months and performed the following:

- For samples that are marked using recent trade prices, obtained reasonableness of assigned marks by comparing them against recent trades per Quest trade details
- For samples that are model-priced in Intex, reviewed the yield table analysis prepared from Intex for reasonableness (see additional Intex testing below)

E&Y also performed the following:

- Performed inquiries of Front Office to understand traders' approaches and methodologies to pricing securities.
- Utilized the assistance of E&Y Structured Finance Advisory Services (SFAS) to independently value certain positions via the independent identification of comparable securities
- Performed data analysis to check for material, unexplained fluctuations in the marks assigned to the securities from period to period and to examine trends of marks throughout the year in light of developments in the capital markets.
- Performed data analysis of assumptions used in price testing to examine trends observed throughout the year relative to developments in the capital markets and to changes relative to peers, as appropriate.
- Performed inquiries of Product Control in response to the results of our detailed testing, data analyses, and other procedures.
- For traded positions, we agreed a sample of positions to Bloomberg historical price page.
- Observed Product Control run the yield analysis table in Intex for selected samples, noting that Product Control only has read-only access to the Intex collateral database.
- Performed testing around the Intex database and related inputs such as:
  - Compared the deal and collateral information per Intex to collateral performance and deal information in Bloomberg.
  - Agreed deal information to deal prospectus for accuracy.
  - Agreed collateral-specific curves from Loan Performance Inc. to industry data.
  - Selected sample of positions to ensure that the deal and collateral information in the Intex database reflect accurate and current industry information for the underlying deal structure/collateral.

Note: see Intex Testing Memo for additional procedures performed

#### 4. Principal Transactions Group ("PTG")

PTG positions include investments in commercial real estate, and can be in the form of debt, equity or real estate owned ("REO"). Typically, these investments take the form of mezzanine financing or financing subordinated to debt provided by senior lenders such as banks. Mezzanine financing can be viewed as a hybrid of debt and equity financing as the lender is typically able to convert debt capital to an ownership or equity interest.

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The PTG population is price verified by Product Control using 6 different models, depending on the type of investment structure:

- i) Single Asset Debt Pricing Model
- ii) Single Family Debt Pricing Model
- iii) Single Family Equity Pricing Model
- iv) Strategic Equity Pricing Model
- v) Single Family REO Pricing Model
- vi) Strategic REO Pricing Model

Each model uses a Net Present Value (“NPV”) analysis based on individual investment characteristics. These NPV calculations for debt positions are driven by discount rates based on based on LTV’s calculated using recent property values reported by the servicers (primarily, Trimont) and property types (e.g. retail, office, industrial, hotel, multifamily). These LTV’s are then applied to spreads published in real estate industry periodicals and interpolated for an appropriate discounting factor. For equity positions, Lehman verifies equity partnership interests individually by examining the deal waterfalls under a current partnership liquidation scenario based on current values (as reported by the servicer). There are four components: a) return of capital; b) cumulative preferred return; c) current year preferred return; d) Lehman’s share of the excess profits (if at all). For REO positions, Lehman’s compares its basis to the properties’ current values (as reported in the servicer tapes). Discount rates for Equity and REO positions are based on property types. Product Control will investigate any significant variances between traders’ and calculated marks.

E&Y performed the following procedures to address the valuation assertion for these products:

- Performed inquiries of Front Office to understand traders’ approaches and methodologies to pricing securities.
- Reviewed the average age of the portfolio of loans by category and evaluated any implied illiquidity or impairment in the portfolio.
- Evaluated changes in Product Control’s price testing assumptions and methodology in light of developments in the capital markets.
- Tested Product Control’s price verification models for 2 months and performed the following:
  - Agreed sample of key external data, such as discount rates and property valuations, to 3<sup>rd</sup> party real estate publications and servicer files.
  - Agreed a sample of key fields such as the coupon, original face and marks per model to Lehman’s systems (i.e. MTS)
  - Recalculated the underlying formulae in the model (e.g. PV, LTVs, capped receipts, etc.)
- Investigated any pricing variances above Product Control’s testing threshold (during 2 months controls testing and subsequently at year end) and obtained evidence as to why the position was appropriately marked and whether any valuation adjustment was necessary.

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- We performed data analysis to check for material, unexplained fluctuations in the marks assigned to the securities from period to period and to examine trends of marks throughout the year in light of developments in the capital markets and in comparison to similar categories of assets and their relative marks.

E&Y also utilized the assistance of E&Y Real Estate Advisory Services (REAS) to independently value a sample of property valuations to test the key basis of the underlying PTG valuation. Included in REAS's procedures is an assessment of the valuation methodology of the servicer, Trimont, to determine that an appropriate process is applied across the entire PTG portfolio.

#### 5. Conduit/Large Loans – Fixed Rate

In general, price transparency on fixed rate conduit/large loans ("CLL") is limited to recent sales and indications from recent securitizations. As the exit strategy for these loans originated by Lehman is typically securitizations, the inventory is carried at critical mass fair value until a securitization is imminent. At this time, a portfolio would be written up to observed securitization value.

For price verification purposes, Product Control compares the carrying value of loans to the last securitization of that particular class of loan collateral. This methodology is referred to as the "Mock Securitization Model". Product Control estimates the potential gain or loss upon securitization based on the credit structure and profit spreads from similar deals. Since mock securitization identifies the forecasted securitization gain that would be recognized today if the loans were securitized at their current carrying value, Product Control ensures the potential P&L effect from the securitization of deal is within a reasonable range of the spreads from prior securitization deals.

E&Y performed the following procedures:

- Performed inquiries of Front Office to understand traders' approaches and methodologies to pricing securities.
- Reviewed the average age of all portfolio loans by category and evaluated any implied illiquidity or impairment in the portfolio.
- Verified that the current mock securitization used in the model represents the most recently completed deal and documented Product Control's rationale for using that securitization.
- Evaluated changes in Product Control's price testing assumptions and methodology in light of developments in the capital markets, including an evaluation of securitization as the primary market for CLLs.
- Tested the subordination of transactions used as the "base" transactions for creating the mock securitization to Bloomberg/Prospectus for each transaction.
- Reviewed changes in interest rates from the date of the last securitization
- Agreed a sample of key fields such as the, Class/Tranche, CUSIP, coupon, original face and marks per model to Lehman's systems (i.e. MTS)
- Verified whether the underlying loans have the same risk characteristics as the current mock securitization used in the model.

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- Agreed sell price for a sample of tranches per mock securitization to MTS.
- Recalculated the underlying formulae in the model (e.g. PV, weighted average coupon, mock securitization price, deal P&L/spread from last securitization deal, etc.)
- We performed data analysis to check for material, unexplained fluctuations in the marks assigned to the securities from period to period and to examine trends of marks throughout the year in light of developments in the capital markets and in comparison to similar categories of assets and their relative marks.

## 6. Large Loans – Floating Rate

Floating rate large loans are originated by Lehman, with the principal exit strategy being securitizations. However, unlike fixed rate loans (discussed above) there is limited volume of floating rate securitizations. Therefore, these loans are price verified on an individual basis, using a Net Present Value analysis based on individual loan characteristics, such as expected cash flows. The model prices these loans like bonds, using a Moody's spread matrix for floating rate securities in order to create a shadow rating for these loans.

Note: Lehman will evaluate the floating rate loans and strip out positions which are deemed unsecuritizable, and price verify this population using the same model used for Lehman's PTG debt positions – see above for further discussion.

E&Y performed the following procedures:

- Performed inquiries of Front Office to understand traders' approaches and methodologies to pricing securities.
- Reviewed the average age of all portfolio loans by category and evaluated any implied illiquidity or impairment in the portfolio.
- Evaluated changes in Product Control's price testing assumptions and methodology in light of developments in the capital markets.
- Tested Product Control's price verification models for 2 months and performed the following:
  - Agreed sample of key external data, such as discount rates and ratings, to 3<sup>rd</sup> party real estate publications.
  - Agreed a sample of key fields such as the coupon, original face and marks per model to Lehman's systems (i.e. MTS)
  - Recalculated the underlying formulae in the model (e.g. PV, LTVs, capped receipts, etc.)
- Investigated any pricing variances above Product Control's testing threshold (2 months controls testing and subsequently at year end) and obtained evidence as to why the position was appropriately marked and whether any valuation adjustment was necessary.
- We performed data analysis to check for material, unexplained fluctuations in the marks assigned to the securities from period to period and to examine trends of marks throughout the year in light of developments in the capital markets and in comparison to similar categories of assets and their relative marks.

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## 7. B-Notes

B-Notes are positions carved out from large loans as a means of credit enhancement. Financial institutions will take a loan and separate it into two pieces, the senior loan (A-Note) is typically securitized, while the junior piece (B-Note) is typically retained by Lehman. Lehman's exit strategy for these loans has been sales of the individual positions or hold to maturity. In general, price transparency on B-Notes is limited to recent sales.

B-Notes are price verified on an individual basis, using a Net Present Value analysis based on individual loan characteristics, such as expected cash flows, and prices these loans like bonds for comparative purposes against their respective bases. Product Control creates a spread matrix for fixed and floating rate securities based on spreads published by Moody's, in order to create a shadow rating for these loans and also establishes discount rates for what would have been for the combined whole loan (the senior plus the junior notes), based on the LTV at time of underwriting. Product Control will investigate any significant variances between traders' and calculated marks.

E&Y performed the following procedures:

- Performed inquiries of Front Office to understand traders' approaches and methodologies to pricing securities.
- Reviewed the average age of all portfolio loans by category and evaluated any implied illiquidity or impairment in the portfolio.
- Evaluated changes in Product Control's price testing assumptions and methodology in light of developments in the capital markets.
- Tested Product Control's price verification models for 2 months and performed the following:
  - Agreed sample of key external data, such as discount rates and property valuations, to 3<sup>rd</sup> party real estate publications and servicer files.
  - Agreed a sample of key fields such as the coupon, original face and marks per model to Lehman's systems (i.e. MTS)
  - Recalculated the underlying formulae in the model (e.g. PV, LTVs, capped receipts, etc.)
- Investigated any pricing variances above Product Control's testing threshold (2 months controls testing and subsequently at year end) and obtained evidence as to why the position was appropriately marked and whether any valuation adjustment was necessary.
- We performed data analysis to check for material, unexplained fluctuations in the marks assigned to the securities from period to period and to examine trends of marks throughout the year in light of developments in the capital markets and in comparison to similar categories of assets and their relative marks.

## 8. REIT Lines of Credit

Lehman provides lines of credit to REITs and operates on a basis similar to PTG (see discussion below). The key difference is that the REIT group lends to an existing trust that hold real estate assets, rather than lending to an entity (e.g. partnership) that is

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typically set up to finance a particular real estate asset. As such, the credit worthiness of the REIT must be evaluated in much of the same way as a corporate bank loan. Typically the exit strategy is to syndicate the loans with other investors and sales of the individual positions.

E&Y performed the following procedures:

- Performed inquiries of Front Office to understand traders' approaches and methodologies to pricing securities.
- Reviewed the average age of all portfolio loans by category and evaluated any implied illiquidity or impairment in the portfolio.
- Evaluated changes in Product Control's price testing assumptions and methodology in light of developments in the capital markets.
- Tested Product Control's price verification models for 2 months and performed the following:
  - Agreed sample of key external data, such as discount rates and credit ratings, to 3<sup>rd</sup> party real estate publications and servicer files.
  - Agreed a sample of key fields such as the coupon, original face and marks per model to Lehman's systems (i.e. MTS)
  - Recalculated the underlying formulae in the model (e.g. PV, LTVs)
- Investigated any pricing variances above Product Control's testing threshold (2 months controls testing and subsequently at year end) and obtained evidence as to why the position was appropriately marked and whether any valuation adjustment was necessary.
- We performed data analysis to check for material, unexplained fluctuations in the marks assigned to the securities from period to period and to examine trends of marks throughout the year in light of developments in the capital markets and in comparison to similar categories of assets and their relative marks.

## Results of Testing

### 1. Completeness

Based on our inquiries and observation of 2 months' Quest downloads performed by Product Control, E&Y noted no exceptions to procedures nor any indication that populations used by Product Control to perform price verification procedures are incomplete. E&Y concludes that procedures used to obtain complete populations of financial instruments for price verification appear reasonable.

### 2. All CRE Product Categories Above

Based on the results of our substantive procedures performed, including tests of details, inquiry, observation, and dual-purpose tests of controls, as outlined above, E&Y noted no material differences in CRE pricing, in any of the above product categories, that are above our thresholds or would result in a significant audit difference or adjustment or a material misstatement. Please see our workpapers supporting the details of our work, our analyses, and our conclusions in GAMx at the references outlined below for further reference.

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Workpaper Indices

<i>Product</i>	<i>Process/Account &amp; Procedure Reference</i>
1. Completeness Testing	BB19, BB22
2. Type A Liquid Listed Products	B28/H1
3. Type B Liquid Listed Products	B28 / H1, J5
4. PTG	B22 / J2
5. Conduit/Large Loans – Fixed Rate	B19 / J1
6. Large Loans – Floating Rate	B19 / J1
7. REIT Lines of Credit	B17 / J3

*Note: Workpaper Indices above reference the significant process as well as the significant account and related procedures for each product type as many of our substantive procedures are the result of tests of details and analysis performed and documented within documents obtained as part of our testing of controls related to significant price verification processes. In addition to these dual-purpose tests, all other substantive procedures, as outlined above, are documented separately in workpapers associated to the significant accounts and related substantive procedures.*

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