

Eileen A. Fahey/CF/CHI/F-I
06/09/2008 08:44 AM

To Stephen Joynt/EXECUTIVE/NYC/F-I@F-I, Nancy
Stroker/CF/NYC/F-I@F-I
cc Charles Prescott, james.moss@fitchratings.com
bcc
Subject Fw RAC for LEH is in the QUEUE



LEH RAC 6.9.2008.doc

FitchRatings

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----- Forwarded by Eileen A. Fahey/CF/CHI/F-I on 06/09/2008 07:43 AM -----



"Tonucci, Paolo"
<paolo.tonucci@lehman.com>

06/09/2008 07:40 AM

To <Eileen.Fahey@fitchratings.com>

cc "Thatcher, Kevin" <kevin.thatcher@lehman.com>, <Leslie.Bright@fitchratings.com>, "Azerad, Robert" <RAzerad@lehman.com>

Subject RE: Fitch Appeal

Understood.

Dick is very strong on there being a chance to speak to Steve before anything goes out. He is going to call shortly.

His preference is to have a more formal appeal as I mentioned earlier, but I have noted your view that it need to be material information that is being submitted.

Paolo

-----Original Message-----

From: Eileen.Fahey@fitchratings.com
[mailto:Eileen.Fahey@fitchratings.com]
Sent: 09 June 2008 08:34
To: Tonucci, Paolo
Cc: Thatcher, Kevin; Leslie.Bright@fitchratings.com; Azerad, Robert
Subject: Re: Fitch Appeal

Again, I do not think that this information is anything new - we will continue to process our press release as I indicated.

(Embedded image moved to file: pic61997.jpg)

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Fitch Downgrades Short- and Long-Term Ratings of Lehman Brothers; Outlook Remains Negative

Fitch Ratings-NY-June 9, 2008: Fitch Ratings downgrades the short and long-term Issuer Default Ratings (IDRs) of Lehman Brothers Holdings Inc. (Lehman) and its subsidiaries as indicated below. Fitch maintains Lehman's Rating Outlook of Negative. Approximately \$145 billion of long-term debt is outstanding including current year maturities of \$18.5 billion with \$8 billion of commercial paper.

Ratings

Lehman Brothers Holdings Inc.

- Long-term IDR to 'A+' from 'AA-';
- Long-term senior to 'A+' from 'AA-';
- Short-term IDR to 'F1' from 'F1+';
- Short-term debt to 'F1' from 'F1+';
- Senior unsecured debt to 'A+' from 'AA-';
- Subordinated debt to 'A' from 'A+';
- Preferred stock to 'A' from 'A+';
- Individual to 'B/C' from 'B'.
- Support Rating of 5.

Fitch's ratings action results from increased earnings volatility, changes in its business mix due to contraction in the securitization and structured credit markets and the level of risky assets exposing earnings to challenges in hedge effectiveness. Earnings volatility has increased and is expected to remain elevated in the near term. The level and variability in future profits are expected to be consistent with companies carrying a high 'A' rating.

Fitch believes management has made strides in reducing its aggregate leverage and risk profile through asset sales, preferred capital issuance and reduced trading positions. Liquidity has been bolstered to over \$40 billion by debt. Capital position has been strengthened this year by \$5.9 billion of preferred issuances, including \$4.0 billion mandatory convertible preferred stock, and \$2.0 billion of 30-year subordinated debt. While Fitch recognizes the permanency of the preferred issues, maximum equity credit of such hybrids has been reached in Fitch calculated leverage ratios. The numbers above exclude the capital raising transaction announced this morning.

While Fitch recognizes the permanency of the preferred issues, maximum equity credit of such hybrids has been reached in Fitch calculated leverage ratios. The cost of carrying this incremental funding will also negatively impact profitability.

The Rating Outlook remains Negative because profitability is expected to be challenged with continued fixed income volatility. Despite asset sales, Lehman's exposure to higher risk asset categories as a percent of Fitch core capital is higher than peers. Lehman's has been active hedging its exposure in these asset categories. However, its hedging strategy, while generally reducing earnings volatility, has not always been effective.

The Outlook may be changed over the next year pending modifications to business mix and profitability. Lehman's equity sales and trading and investment banking businesses experienced increases in market shares. Additionally, management has reduced overhead and will continue to adjust its business strategy as the environment changes. Fitch believes Lehman will continue to sell riskier assets and reduce its overall risk in specific asset classes, particularly residential and commercial mortgages. However, Fitch is concerned that such sales may remove the most attractive assets, leaving a concentrated level of least desirable or more problematic assets on the balance sheet.

Lehman's liquidity position solidly covers its short-term needs and was recently bolstered by the introduction of the Federal Reserve's Primary Dealer Credit Facility, and greater use of its bank entities to fund less liquid assets.

Management has conservatively structured its funding strategy and is currently running with large surpluses of long-term funding sources relative to its level of illiquid assets and other long-term funding requirements. Average life of long-term debt is approximately 7 years. Its liquidity pool amply covers cash outflows generated by unsecured debt maturities over the next twelve months. Commercial paper has modestly expanded with minimal indication of credit sensitivity at current levels. Lehman maintains its emphasis on match funding credit sensitive and liquid investments with like sources.

Market risk measures indicate Lehman has increased its risk to market volatility over historic levels. Lehman's disclosed VaR, Fitch stressed VaRs as a percent of tangible equity and the volatility of principal trading revenues reflect the more volatile environment and heightened levels of risk to capital. Positively, position risk has declined visibly through Lehman's disclosure of un-weighted Value at Risk on an average and end of period basis. Risk contribution continues to remain fairly balanced between interest rate/credit and equity based exposures. Principal trading losses in fixed income are expected to result in earnings volatility particularly in the next few quarters.

Earnings volatility increased with Lehman pre-announcing substantive losses for the second quarter as dislocations between cash and derivatives pricing behavior severely limited the effectiveness of hedges. Some of these losses were realized as Lehman sold assets, particularly in sales of residential mortgages and leveraged loans. Two proprietary positions designed to be risk reducing in nature also suffered losses due to unexpected price behaviors during the quarter. Both have been largely sold. The basis risk between the cash and derivatives markets may result in further realized losses since the reduction in basis may be ongoing for some time.

Revenues in investment management and investment banking remain stable. Despite Lehman's improvement in M&A announced market share, Fitch expects revenues to be limited with materially reduced levels of activity in the near term.

Costs are expected to be reduced over the next several quarters with the impact of recent staff reductions. Management is expected to reduce capital investments reducing the run rate of non-compensation expenses. Reductions in compensation may be below Fitch's expectations since pressures for retention bonuses and franchise protection may increase in the near time.

The firm announced a capital raising transaction to offset the negative impact of earnings on capital and leverage. A successful common equity raise should help mitigate potential future erosion from continued asset sales in residential mortgages and corporate and commercial real estate loans. The amount and composition of the capital

raise will be evaluated and included in the resolution of the Negative Outlook.

Fitch has downgraded the following ratings. The Outlook Remains Negative

Lehman Brothers Holdings Inc.

- Long-term IDR to 'A+' from 'AA-';
- Long-term senior to 'A+' from 'AA-';
- Short-term IDR to 'F1' from 'F1+';
- Short-term debt to 'F1' from 'F1+';
- Senior unsecured debt to 'A+' from 'AA-';
- Subordinated debt to 'A' from 'A+';
- Preferred stock to 'A' from 'A+';
- Individual to 'B/C' from 'B'.

Lehman Brothers Inc.

- Long-term IDR to 'A+' from 'AA-';
- Long-term senior to 'A+' from 'AA-';
- Short-term IDR to 'F1' from 'F1+';
- Short-term debt to 'F1' from 'F1+';
- Subordinated debt to 'A' from 'A+';
- Individual to 'B/C' from 'B'.

Lehman Brothers Holdings PLC

- Long-term IDR to 'A+' from 'AA-';
- Long-term senior to 'A+' from 'AA-';
- Short-term IDR to 'F1' from 'F1+';
- Short-term debt to 'F1' from 'F1+';
- Subordinated debt to 'A' from 'A+';
- Individual to 'B/C' from 'B'.

Lehman Brothers International (Europe)

- Long term IDR to 'A+' from 'AA-';
- Short term IDR to 'F1' from 'F1+';
- Individual to 'B/C' from 'B'.

Lehman Brothers Bank, FSB

- Long-term IDR to 'A+' from 'AA-';
- Long-term deposits to 'AA-' from 'AA';
- Individual to 'B/C' from 'B'.

Lehman Brothers Commercial Bank

- Long-term IDR to 'A+' from 'AA-';
- Long-term deposits to 'AA-' from 'AA';
- Individual to 'B/C' from 'B'.

Lehman Brothers Holdings Capital Trust III - VII
--Preferred stock to 'A' from 'A+'.

Lehman Brothers UK Capital Trust LP, II and III
--Preferred stock to 'A' from 'A+'.

Lehman Brothers E-Capital Trust I
--Preferred stock to 'A' from 'A+'.

Fitch Affirms the following Ratings
Lehman Brothers Holdings Inc.
--Support '5'.

Lehman Brothers Inc.
--Support '1'.

Lehman Brothers Holdings PLC
--Support '1'.

Lehman Brothers International (Europe)
--Support '1'.

Lehman Brothers Bank, FSB
--Short-term IDR 'F1+';
--Short-term deposits 'F1+';
--Support '1'.

Lehman Brothers Commercial Bank
--Short-term IDR 'F1+';
--Short-term deposits 'F1+';
--Support '1'.

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