

BRIEFING note – Project Milan
18 August, 2008

Purpose

- This note briefs the decision to manage an orderly withdrawal from the Lehman relationship globally. It is provided in the context of a likely call from Chairman Jeremy Isaacs or CEO Dick Fuld to either SKG or MFG respectively to appeal the decision.
- Our desire to withdraw was communicated to the client today in New York (Nicholas Taylor, Head FIG, Global Banking HBUS to Paolo Tonucci, Global Treasurer, LB).
- The meeting was constructive, cordial and cooperative. However, he expressed surprise, great disappointment and concern about :
 - their ability to replace us a core clearing and funding bank in certain geographies (UK and India in particular will be difficult),
 - the action being premature as likely to be announced measures to significantly de-risk the business will provide creditors with more than satisfactory comfort.
- Advised that we are the only major bank relationship to be taking this action and particularly worried that our action would leak to the market and cause contagion amongst other funding/liquidity providers.
- This is a real but manageable risk, provided we avoid early, highly visible actions to alert market (eg: communication to interdealer brokers or control parameters in electronic trading platforms).
- Next step is to form small project teams in both institutions to execute our exit plan. We will effect immediate cancellation of material Cat A and Cat S and look for collateralisation of others and further reduction in a short timeframe.
- Beyond this, we are expecting vast majority of Cat A/Cat S exposure to be cancelled/mitigated within 3 months.

Background

Global Facilities (USDm)	Present	Usage
Cat A (Direct)	796.9	
of which Secured	0	-
of which Committed	(100.0)	None
Of which FNII	(30.0)	27.7
Indirect Cat A (Fronting Guarantees/GTR)	137.4	137.4
Cat B	2,519	
Total Cat S	8,638	
of which TSL	(2,931)	
Of which PSL	(1,366)	
of which Crest secured	(2,205)	
of which CREST unsecured	(1,136)	
of which HBUS day loan PSL	(1,000)	
TOTAL GLOBAL LIMITS	12,091.3	

- We are a tier 2 bank to Lehman in terms of both credit provision and wallet capture. However, probably the biggest non US bank and certainly very important to them.
- Likely HORIS for 08 will be c\$65m, very significantly up on 07 due primarily to volume and volatility driven GTB business, new HSS mandates and a big uptick in Equity lending.

GTB business (both PCM and CNC) now in UK, Thailand, India, Hong Kong, Manila, Lebanon, Kazakhstan, UAE and Vietnam).

- The decision to withdraw is on the basis of deteriorating risk and business fundamentals, continuing performance/valuation uncertainty, capital erosion and significant Group exposure to Lehman in particular and the sector as a whole.
- On balance, Lehman is the weakest with less diversification and relatively more exposure to troubled fixed income classes. Also, arguably, with its business model terminally damaged, it is perhaps the least likely to be saved.
- It has \$50bn of risky real estate/mortgage assets including \$10bn of Alt A. It also retains \$11bn of leveraged loans. Many now predict further write downs and a consequent fiscal Q3 loss (ending August) c\$2bn instead of the \$250m profit previously expected.
- Since raising \$6bn in new equity in June, shares have slumped 43%. Market Cap is now only \$11.4bn and 1 year CDS spreads are at 650bps (Merrill at 385bps).

Likely discussion points

- Likely to seek a compromise. Concede very significant exposure reduction (by cancellation and collateralization) but retain some support in UK and India. Also, they will want to retain flexibility for Global Markets pro counterparty trading. They may offer cash collateral for short deals.
- Provide details of the de-risking plan. We know they are looking at a good bank/bad bank structure that will inevitably require more capital.
- Also a possible sale of Asset Manager Neuberger Berman. Valuation range \$6bn - \$10bn.
- Note as a Reciprocity play, they signed up for \$25m in HSBC Finance's syndicated facility only last Friday.
- Also advised today that after a long running RFP, we are preferred provider for a material new Brazilian HSS mandate.

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