

**PROJECT MILAN**  
**August, 2008**  
**Prepared by: GB FIG**

**TRC Group: Lehman Brothers Holdings Inc                      CBID: SLBH**

**OBJECTIVES**

- 1) Identify exposure “mitigating actions” that may implemented by HSBC in case of progressive credit deterioration of Lehman Brothers, as opposed to immediate collapse/default. This implies a “controlled and managed” exit from Lehman Brothers in order to:
  - Holistically protect the HSBC organization’s interests, thereby limiting total losses.
  - Avoid crystallizing committed credit and/or precipitate a collapse of the regulated businesses or subsidiaries of Lehman Brothers.
  - Avoid market signaling or externally transparent actions (to extent possible) that could precipitate the exit of other creditors, counterparties &/or clients thereby undermining the franchise and potentially crystallizing our losses on hard to exit/mitigate exposure, as well as lender liability and reputational considerations.
  
- 2) Quantify reduction in exposure and improvement in security that may be achieved from such “mitigating actions”, along with projected timeline to achieve same.

**BACKGROUND**

- The July 14, 2008 insight report of global exposure for Lehman serves as basis data point for the assumptions and recommendations arrived at in this exercise.
  
- To the extent possible (driven by MIS available), our analysis is segmented along the following functional HSBC business lines: GB, GTB, Global Markets and Private Banking/Asset Management.
  
- It is assumed that HSBC business lines may not share the same interests, nor would be driven by same concerns in taking actions that could adversely affect other Group exposures or entities.
  
- This exercise is codenamed Project Milan due to its sensitivity and potential market impact. At this time, a short list of insiders is privy to its objectives, and it is recommended that further additions are tightly controlled.

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

**SCOPE**

1. Identify exposure or limits that would be considered at greatest risk of loss due to structural subordination (i.e., extended to holding company), tenor, lack of security, nature of obligor/counterparty (i.e., unregulated subsidiary), legal domicile and underlying nature of transactions.
2. Identify hard limits granted by HSBC private banking and asset management units as are associated with less economic and market sensitivity (i.e., transparency) to the Group, thus less knock-on effect to other exposures is implied.
3. Appropriately segment the roles of HSBC as a lender, professional counterparty, buy-side client, and clearing and settlement bank since each has distinct drivers (i.e., business, contractual or otherwise) and influence or impact on the client's stability, thus affecting our recommended actions.

## **GLOBAL FACILITY PROFILE**

**See attached spreadsheet**

## **SUMMARY & RECOMMENDATIONS**

- Advise Lehman Treasury management of HSBC exit decision so can work with FIG on implementation and limit disruption to Lehman's operations.
- The full exit over time of the client relationship across Global Banking (GB) & GTB, with directly related Cat A and PSL to be reduced, hedged or collateralized pursuant to the proposal below
- With the exception of cash securities trading, exit the Private Bank buy-side relationship or its use of Lehman as a broker. Cease distribution of Lehman products through the Private Bank network. Allow existing Private Bank long-dated or non-cash trading exposures to run off in ordinary course or novate to HSBC units with CSA.
- Allow Global Markets to continue trading with Lehman as a professional counterparty in cash trading and OTC derivatives, with latter subject to CSA coverage.
- Do not communicate any outright change in HSBC approach or appetite with respect Lehman to interdealer brokers or change control parameters in electronic trading platforms used by HSBC.
- Continue OTC give-ups and assignments to Lehman in order to avoid 3<sup>rd</sup> party transparency of HSBC position and potentially influence market behavior. It is important to note that aforementioned are transacted under CSA facilities.
- Continue agency securities lending inclusive indemnified, possibly under higher margin requirements, in order to avoid 3<sup>rd</sup> party transparency.
- In ordinary course, engage in tear-ups with dealer community through TriOptima that achieve RWA/exposure reduction, particularly with respect to non-modeled trades.
- With the exception of markets where provide GTB services to Lehman &/or transactional activity is backed by a CSA, cease OTC trading with Lehman. In markets that do provide GTB services, limit tenor of non-CSA backed OTC trading (i.e. forex) to 6 months.
- At Global Markets discretion, entertain appropriate hedging (or sale) of investment/portfolio held under NII limits. Solely HSBC Trinkhaus carries such positions.
- Remove Lehman from matrix issuer trading methodology at HSI & HBEU.

## **GTB SERVICES/PRODUCTS PROVIDED**

### *Payments & Cash Management (PCM)*

HSBL BKH	Overdraft
HSBL HKH	Overdraft re HKD Clearing
MMBI MNY	Payment Settlement Limit (day loans)
	Liquidity Products (\$1bn MMCA deposit)

MDBK MIL

Payment Settlement Limit, Overdraft re GBP Clearing & CREST settlement  
Liquidity Products (\$250m-\$500m MMK fund deposit)

Custody & Clearing (CNC)

Lehman Brothers International (Europe)	Bangkok, Mumbai, Hong Kong, Manila, Lebanon, Kazakhstan, UAE, Vietnam
Lehman Brothers Investments Pte Ltd	Bangkok

**IMPLEMENTATION PLAN**

The following covers:

- Communication Strategy
- Recommendations & timeframes for exposure reduction of Global Banking & GTB

**Communication**

- AUGUST ??- Global FIG Securities Head communicate to Lehman Treasurer/CFO HSBC exit decision and strategy for orderly implementation.
- Both parties should agree on global project team, which would coordinate and implement the exit plan in each region with minimal leakage to rest of organization.

## AMERICAS FACILITIES

The table below outlines all credit lines approved in the Americas:

HBUS limits as of 8/14/08 COUNTERPARTY (all limits in \$ thousands)	CBID	CAT A	Traded Products		SETTLEMENT LIMIT	Comments
			CAT B Limit	Description		
Lehman Brothers Holdings Inc.	SLBH					Cat A: Holdco 3 year unsecured RCF (\$20m hedged)
Lehman Brothers Finance SA	LMFI		36,000	XPR (CSA)		
Lehman Brothers Commercial Corp.	SLCC		46,000	XPR (CSA)	200,000	TSL: forex & metals inclusive options
Lehman Brothers Inc.	EFHC	300,000	46,000	BOND, FMC, REPO	1,000,000	Cat A: MPL used for LCs. \$1bn PSL for day loans.
			45,000	XPR (CSA)	300,000	TSL for forex.
Lehman Brothers Special Financing Inc.	SLBF		236,000	XPR (CSA)	150,000	TSL for currency swap settlements
			5,000	Swaps		Cayman Branch, Delaware
Lehman Brothers International (Europe)	SLIL		15,000	XPR (CSA)	5,000	TSL for forex.
			18,750	REPO, QRT, BON		Cayman Branch
Lehman Commercial Paper Inc.	LCPI	82,215				Cat A: GTR/Fronting
Lehman Brothers Bank FSB	LBBK	14,000				Cat A: GTR/Fronting
Lehman Brothers Financial Products Inc.	LBFP					Contingent CSA
<b>TOTAL HBUS</b>		<b>446,215</b>	<b>549,751</b>		<b>1,655,000</b>	
<b>HSI limits as of 8/14/08</b>						
			<b>Traded Products</b>			
Lehman Brothers Inc.	EFHC		25,000	BOND, REPO, FLS	5,000	
			500	FFI		
<b>TOTAL HSI</b>			<b>25,500</b>		<b>5,000</b>	

Committed Cat A: 446,215      490,000 CSA-backed Cat B  
 GTR: 96,215      83% percentage of total Cat B  
                                  90,250 Cash trading limits  
                                  16% percentage of total Cat B

The following plan of action is recommended:

### CATA

- Committed USD 50m participation in Holdco 3 year RCF maturing March 2011 – \$20m of the RCF is currently hedged, with recommendation to hedge remaining balance via 2 year CDS. Approximate cost \$1.4m per annum.
- Uncommitted USD 300m facility – This 6 month facility is used for MMK loans and SBLCs. At 8/14/08, total outstandings of USD 129m, of which \$11m used by holdco. We hold \$6m of cash collateral against holdco usage.

Recommendation: Immediately advise Lehman withdrawal of facility and allow outstandings to roll off at expiry (within 6 months) or in ordinary course. Once LC reduced via amendment, bank will not allow further increases. Hedge remaining evergreen LC exposure (\$5m) via 2 year CDS at approximate cots of \$500k.

- \$95.2m of fronting risk – Various maturities through 2012.

Recommendation: Allow to roll off. Review treatment under contracts for defaulted syndicate participant.

### CAT B

- \$5m swap line granted by HSBC Delaware – Facility is used by Delaware BSM/Treasury for hedging portfolio positions. This facility is not subject to a CSA.

Recommendation: No further trading to be conducted and allow exposure to roll off.

- 88% of HBUS/HSI Cat B limits are subject to CSA, with balance for trading of cash products (spot/DVP). At this time, HBUS is in a net out of the money position with Lehman across its CSAs and posting collateral in excess of \$400m to Lehman.

Recommendation: No further action is recommended at this time.

- Outside of US, limits in region total \$14.7m for cash trading, \$31m for short-dated FX trading and \$12m for swaps. The latter limit is granted by HBMX and is unused.

Recommendation: Cancel HBMX facility. No further action recommended at this time, but remaining limits will be reviewed with each unit on case-by-case basis.

## **DSL**

- Uncommitted \$1bn Day Loan PSL facility - This intraday facility used to front cash to settle fixed income & equity 3<sup>rd</sup> party capital markets issuances, where Lehman is lead underwriter. The underlying debt or equity instruments are used as security.

Recommendation: Cancel

- \$660m of TSL used by Global Markets @ HBUS principally for foreign exchange trading, inclusive CLS eligible transactions.

Recommendation: No further action is recommended at this time.

- Outside of US, \$177m of TSL in region used by Global Markets principally for foreign exchange trading.

Recommendation: No further action is recommended at this time, but will be reviewed with each unit on case-by-case basis.

## **OTHER ISSUES**

- As relates to GTB, Americas does not maintain any clearing or custody arrangements with Lehman.
- Lehman maintains a \$1bn client segregated funds deposit on the HBUS PCM platform and HBUS CTLA provides trustee/paying agent services. Both aforementioned GTB relationships do not require or use any credit limits.
- Similar to Bear experience, it is likely Lehman will withdraw \$1bn deposit upon advice from HSBC that exiting relationship. HBUS ALCO senior management representative should be advised in confidence.

## **EUROPE FACILITIES**

### **CAT A**

- Committed Exposure USD 50m expires in April 2010 - Recommend a one year hedge, cost c \$2m
- MMK Line USD 150m – Recommend reduce to Zero – see PSL recommendation
- Review USD 15m of OD Lines in Kazakhstan and cancel if possible.
- Fronting Risk of USD15m – relatively low risk and cannot be cancelled until run-off. Action – ensure syndicate shares this risk in extremis.
- Global Markets to report holdings of Lehman paper (we know we have \$30m in Germany) and sell/hedge as they see fit.

### **CAT B**

- Total CAT B of USD 1.2bn.
- 46% covered by CSA or equivalent
- Other limits are an amalgam of FX/Swap lines in overseas branches, plus Private Bank.
- Key issue is – how visible do we want to be to the market ie give-ups, broker business ?
- Recommend move to a CSA only policy as far as possible. Allow short term FX if custody or transactional related. Focus on major centres ie cut as many lines in European branches as possible.
- Other banks (we hear) have refused give-ups on Lehman – we could state our lines are full and do same.
- Run-off equity finance over a 3 month period to reduce impact.

### **DSL**

- Major settlement risks are CREST and PSLs for UK clearing. Crest limits are USD2.2bn secured and USD1.1bn unsecured. PSL is USD 800m. TSLs total USD1.1bn – 75% in UK and France.
- CREST unsecured appears unused and could be cancelled.
- CREST secured can be enhanced with tighter haircuts, we have looked at this already for the wider market – cannot implement on a name by name basis.
- PSL cannot be reduced by much without impacting payments flow – not desirable for us, Lehman's or the UK market – Recommend asking for cash cover of min \$500m (already in Liquidity fund) to placed in account. Residual risk can be managed as any crisis develops. Cash cover also means MMK will not be required to cover failed trades,
- Key issue is that it will not be easy for them to find a new bank to take the clearing or CREST on. We are locked in and must make management aware of this.
- TSLs to be reviewed and focused on major centres only.
- CTLA lines to be reviewed

### **Other Issues**

- Control of information – as more people are aware of our stance ie Markets and European branches the greater the risk of our stance becoming public and damaging for them.
- Check legal status of 'missing' crest deed.
- Check what amount of Lehman's paper we lending against in Markets.

## Appendices

### TYPE OF FACILITIES:

FNII	Line for holding Bonds/Debt instruments used by Treasury (investment) and/or Markets (customer market making, hedging & underwriting)
FB/S/FLU	Fluctuation Risk Limit (contingent market risk) for trading securities in the cash markets (usually DVP settled)
FFEX	FX
FSWP	Swaps (interest rate and currency)
FTSL	Treasury Settlement Limit (FX, Metals, non-DVP instruments) –spot to 1 week tenor of risk
FPSL	GTB payment settlement limit - intraday tenor of risk
FCTB	Used by CCF to identify as an XPR (Crisped) line
FOPT	Options (contingent market risk)
FRPO	Repos (reverse & repurchases)
FSBL	Stock Borrowing and Lending