Lehman Monthly Risk Review
Package dated 6/27/07, meeting held 7/19/07

MONTHLY RESULTS (ED GRIEB)

- June was another strong month, with net revenues of $1.978 billion. Capital markets are running at 20% over budget – FID made $874 million, while equities was slightly lower this month at $452 million. IB saw strong origination and M&A activity, while IM saw AUM up by $5.9 billion, and picked up $27 million in DE Shaw fees, versus $39 million for all of Q1. It is worth noting that these fees could be volatile, as DE Shaw (and therefore Lehman) accrue incentive fees monthly.
- Securitized products earned revenue in part through short ABX positions, and while securitization volumes remained low margins began to tick up. Originations were in line with average month 2007 levels. Credit products were down slightly, as was real estate (timing issues). The sales credits within equities were on par with recent months, although as mentioned above revenues were down, in part because the desk made less money trading around customer flow.
- Within equity origination, the Blackstone IPO and Hertz secondary offering contributed to a good month. Debt origination was down 35% versus average month, seeing a big drop-off in leveraged finance. (Lehman ate through all fees on the Dollar General deal, but lost less than $1 million. At the time of the meeting, they were holding around $100 million of the junior subordinated piece, which contained a PIK-toggle. Subsequent to the meeting, they have sold down the position to $20 million). The pipeline remains strong at $1.6 billion (with 1/3 of that being leveraged finance and therefore somewhat uncertain).
- LBIE received excess capital for the yield-enhancement business.
- LBSF was a big winner this month, as it was short swaps against long agencies in LBI (which is the market maker for Lehman debt). Ed also noted that Lehman had earned $100 million in revenue from Lehman's own spreads widening – not sure if that accrued within LBI. Lehman is looking at doing an inter-company swap which would be funded with 100$ cash capital, and margined daily (like with LOTC).
- The OTS is kicking off its exam on August 6, and appears to be focusing on more than last year (including prop trading and private equity). Also, E & Y wants to speak with us (Matt had little appetite for this), and it seems that a decision has finally been made with respect to Neuberger's broker-dealer – Lehman is going to withdraw the BD license and move positions into the LB BD. Neuberger will become (continue as?) a registered investment adviser. Apparently, withdrawing a BD license is a very lengthy process, involving the SEC and NYSE.

RISK APPETITE

- Risk Appetite usage increased to $3.062 billion, up from $2.938bn last month. Usage peaked at $3.17 billion, with a low of $2.8 billion.In the July 16 risk snapshot, risk management notes that if they have to fund a number of LBOS, RA could increase by up to $320 million on an incremental basis, which would bring its to the $3.3bn limit.

UPDATE ON AURORA/BNC MERGER (LAURA VECCHIO, LANA FRANKS, TOM WIND, PAUL SVEEN)

- Aurora and BNC are being consolidated under Tom Wind, who is CEO of Americas Residential Lending (and reports to Ted Genulis, who is head of MCD, which also includes Europe, Asia, Campus Door, etc). The entities will likely be called Lehman Mortgage Capital, but that is still under discussion.

- Integration is expected to take 1 to 1.5 years, with Quality Control and other controls already being merged. In terms of merging the two cultures, Tom Wind hopes to take a "best practices" approach and pick the best features from each entity, and develop one-culture (which I understood to be more Aurora-like than BNC).

- See org chart for specifics, but basically Steve Skolnik (former CEO of BNC) will be responsible for wholesale lending (BNC was 95% wholesale), Jeff Schaefer will head correspondent lending (he was the head of sales for Aurora, which is a mix of retail, wholesale, and servicing), Jeff McGuiness will head Direct Lending (he is an Aurora person and will be in St. Louis where there is a call center – different from Scotts Bluff). Terry Gentry (Aurora, we met him) will be loan administration, Craig Wildrick (Aurora) will head Ops, Catherine Eckert (new to Lehman, worked with Tom Wind previously) will head business development and risk management (i.e. credit policies), and Paul Sveen will be CAO (we met him at Aurora, former Lehman NYC). Employees will report both to their function head and to a senior, on-site person (such as Steve Skolnik in Irvine).

- BNC is shifting from the branch model to a more centralized model where 30 branches will become 5 regional operating centers (ROC). These include Atlanta, Philadelphia, Chicago, and CA (Concord and Irvine).

- Catherine Eckert will be looking at the underlying credit policies to ensure consistency, and will be responsible for the management of third party relationships and approval of these across both entities. She is also responsible for fraud management. Cheryl will still run QC and Jim Park will head appraisals/collateral valuation. Dimitrius will still be responsible for independent risk management and report to Jeff Goodman.

- Lana Franks is moving from her trading role as head of non-prime mortgages to become the CAO of MCD (I think working directly for Ted Genulis). Eric Hibbert, who is the CCO of the bank and was our liason during our on-site MCD discussions at Lehman earlier this year, will now report to Rich Kinney, who will head both prime and non-prime mortgage trading, instead of to Lana. Eric's role is mostly limited to policy (he is the CCO of LB Bank), while Catherine will focus more on the implementation of that policy.

- Internal Audit: Beth had wanted central oversight and direction prior to the merger, and feels that this move has hastened that process. She has big expectations around seeing processes become consistent. Also, with the BNC movement towards ROCS it will be easier to be confident about the consistency of management. Both Ed and Kevin will have functional roles, as opposed to just geographic ones.

CREDIT RISK (VINCE DIMASSIMO, STEVE SIMONTE)

- Vince briefed us for the first time in his new role as Global Head of Credit. Since he has only been at Lehman for less than a month, he was not completely up to speed about the status of each of the commitments, but he spoke generally about the markets. As we've heard at other places, a lot of the pipeline is slated to hit the market in the fall, including two potentially troubled deals TXU and First Data. New deals are getting tighter with pricing and flex, thus the trouble is with deals Lehman has already committed to that are coming up. (Vince will be reworking the pipeline reporting package, to separate out real estate deals at a minimum.)
- Specific deals discussed and/or highlighted on the Firm-wide Risk report include:
    - Home Depot - $7.5bn conditional deal (Lehman is committing to $5bn)
    - Imperial Tobacco ($5.611bn) is now mandated
    - Houghton Mifflin Riverdeep ($874m in the package) was announced
    - Dollar General - $108m remains of PIK toggle debt
    - Thompson – hold level is down to $100m
    - Sisal ($198m commitment) is an Italian gaming company. The deal has been pulled from the market and Lehman has funded it, so it looks like a bridge commitment.
    - Applebee's is a $2.15bn acquisition financing for IHOP's purchase of Applebee's. Lehman is providing financing as a bridge to a whole business securitization where the assets being securitized are franchise receivables (the Dunkin Donuts model). The AAA tranches are being monoline wrapped.
    - Global Santa Fe is a $5bn bridge financing commitment to fund a dividend distribution in connection of a merger. Lehman is also M&A advisor to Global Sante Fe. They do not expect to fund as they will syndicate the commitment or execute permanent financing prior to close. Financing terms are still being negotiated but will likely include flex, financial covenants and a business MAC.
    - Lehman has a $1.9bn commitment to Blackstone as part of the Hilton acquisition. Loan is 3 year maturity with 3 one year extensions at a rate of L+185, with 60bps of flex and 1% upfront fee.Up to $2bn of the most subordinate portion of the loan may PIK interest if insufficient cashflow.
- KwikSave was a $162m senior loan and $13m joint venture equity financing completed in November 2006 to finance the sale of KwikSave from the

Somerfield Group. KwikSave went bankrupt in July (which was not completely unexpected). The vacant possession value is $180-196m, compared to the total acquisition cost of $178m. The plan is to obtain vacant possession and re-let remaining stores, then dispose of the portfolio.

- Specific hedge fund names in the news include:
  - Lehman has approx. $150m of loan amount vs $240m of market value on reverse repo with United Capital. That is, they have $90m or 40% of buffer and the positions are marked where Lehman would be happy to own the assets. Assets are mostly MTA resids (option ARMs) and a smaller amount of Alt-A and Alt-B bonds. The MTAs are prime borrowers, not sub-prime, and they have performed well. He has met all margin calls to date and is not in default. Lehman always considered these funds very risky so they gave them no leeway (they "hate him").
  - Basis Capital missed a margin call on July 12 and a default notice was sent quickly. In the Basis Yield Alpha Fund, they were lending $138m against collateral of $216m, $31m against $77m of ABS CDOs and CLOs, and $106m against $139m of various EM sovreign and corporate bonds. In the Pac-Rim Opportunity Fund, they were lending $133m against collateral of $224m, $80m against $124m of CDOs and CLOs, and $53m against $100m of EM soverign and corporate bonds. All loans are overnight and they have a cross-netting agreement across agreements in the Funds. As of the date of our meeting, the risk has been eliminated and they were selling down the portfolio. The EM bonds had all been sold off as well as some of the CLOs. They had paid off all debits and still had some collateral.
- The Eagle energy acquisition closed June 26th, which brough 224 active clients with $317m in CE and $848m in PE, mostly in short dated gas trades. Eagle had one credit analyst who managed the cash risk, and Credit is thinking about putting someone in Houston. Lehman is looking to re-negotiate terms with the existing clients now that the clients are facing off to a higher-rated counterparty (Lehman versus Eagle).
- CE was up from $32bn to $34.2bn mainly due to FID/CDS exposure to broker dealers. Noteworthly names on the top exposures lists include:
  - Freebird Energy Marketing (CE and PE $50.9m) was Eagle's largest client. Exposure is from Lehman's purchase of natgas storage (i.e., Lehman's gas is in their facilities).
  - TXU (CE $10.4m, PE $565m) exposure is coming from hedge of 9,855 NYMEX natgas contracts through 2013. Credit views this as right-way risk.

MARKET RISK (JEFF GOODMAN)

VaR Update

- Firmwide VaR ended the month at $90.9 million, up from $81.9 million last month (and over the limit of $85 million). FID was the main driver of the increase, going from $43.9 to $56.5 million. Big drivers in FID were FX, which got shorter the USD and long the majors, and is slightly less long EM (VaR up by $5 million) and Credit, which saw its VaR increase by $7.8 million, driven by HY (commitments and positions) as both positions increased and volatility picked up in the time series. Equities actually fell, from $32 to $22.4 million (despite an intra-month high of $4 billion, delta was down by the end of the month to $2.8 billion – versus $4.2 billion last month). Both FID and Equities were below their global limits, but a drop in diversification benefit led to the firmwide overage. IM was at $15.4 million, over its limit of $12 million. This was due to warehousing of deals for MLP (I believe the Lehman MLP fund) and CDOS.

- Jeff and Mark Weber walked us through some detail on the VaR calculation, in order to understand the changes. While equities tend to move their positions around fairly regularly and quickly, other positions at the firm (especially in FID) tend to be more structural. Hence, it seems that sometimes time series volatility can move the VaR around significantly, irrespective of changes to positions. Also, there is no fixed diversification benefit, and therefore big changes in diversification in the data can move around the VaR, and the data tends to have significant volatility. Jeff showed us a 12 year graph of the correlation between S&P 500 and UST10 bond yields, and the correlation was all over the place, taking up much of the room between -1 and 1 (i.e. the swings weren't just over a small band). Jeff told us that because of this volatility, VaR is just one measure that Lehman uses, and is more of a speed bump/warning sign that a true, hard limit – that role falls to RA. That said, VaR is about ½ of RA, so the market risk component of RA is a key driver. In addition, the exponential weighting of the VaR amplifies this affect. Jeff mentioned that they are struggling with the weighting issues in mortgages (seasoned versus new issues). We again touched on the VaR limits, and Jeff said that there was a conscious decision to set the VaR limit below what it "should" be under RA, which is $100 million. He said that Madelyn, Dave, and the executive committee tend to look more at RA. As an aside, Madelyn came in after Jeff's explanation and gave virtually the same speech.

- We saw Eagle's positions included for the first time in the Energy VaR packet – marginal contribution was $1.5 million, and standalone Eagle VaR was $3.3 million. Ram is transitioning out of his role as head of energy risk management, and Lehman is looking for someone to replace him. Also, the report had a new page with VaR limit utilization that seemed to break down limits by the greeks – maybe this is from Eagle?

GPS and GTS

- We again received the risk reports for GTS, and we also began receiving the reports for GPS. GTS is relatively straightforward, but we should get walked through GPS at some point (esp the event risk calculations – I think this is the first time we've seen event risk contributions mapped out at such a granular level).

From Firm-wide Risk Snapshots

- We discussed the $2.7 billion non-recourse margin loan on Allianz shares – it's being done through an equity swap, with 25% margin and a 1.5% minimum threshold for variation margin. The loan is 50 bp over Libor, and Lehman is also making an additional 23 bps for yield enhancement. The most recent large move downwards in the stock is 26% over a 5 day period in 2002. Ostensibly, this position would not generate any credit exposure. Madelyn said there was a lot of sensitivity around this position – I'm not sure we know who was on the other side.

- The Applebees deal which was discussed in the credit risk section has an associated deal-contingent rate swap. I am almost certain that Paul said, during our 6/28 discussion on capital for leveraged loans, that Lehman does not do deal-contingent hedges but this appears to be most definitely NOT the case.

- Linn Energy – Lehman provided a hedge for Linn's acquisition of some natural gas and oil products. The hedges (swaps and puts on nat gas and oil) are deal contingent (expected deal closing in October 2007), with a MTM risk of $275 million. If the deal falls apart, Lehman will be short nat gas in October-November, which is the peak of the hurricane season. This adds another $25 million of risk. Banking puts deal probability above 95%. Standalone VaR on this deal is $7 million, and on an incremental basis this trade increased commodities VaR by 20%, to $12 million.

- Subprime market: The rating agency downgrades let to a substitution of 5% of the collateral in the Ballyrock synthetic mezz ABS CDO – the new collateral had wider spreads which led to improved equity returns. Losses incurred on selling that 5% will be split with Fidelity. LB has retained $85 million of this $500 million deal, which includes $17 million of equity and $18.25 million of Baa2. They have taken a reserve on these, and may get some of that money back. Jeff said that the downgrades were not a particularly big even for market participants, who had seen this coming.

Stress Tests

- Jeff pointed out Bear Steepening, Rating/Default and HF Risk, HY/LBO Deafult, and equity crash as all being up from the prior month, but not by huge amounts. He also noted that the IR business is always a net positive contributor, which provides some sort of macro hedge in a bad scenario. Rates actually cut their vega positions when they had a chance after a vol spike. However, increased positions in the credit business caused an increase in losses (as an fyi, they clarified that they use % moves rather than absolute spread level shocks). Jeff mentioned that they increased the stresses in mortgages (US and Europe) to make them more onerous - $150 to $200 million of losses were coming from this shock. It appears that in the mortgage space they have an absolute rather than % shock.

- Madelyn mentioned that the desk had asked that (with respect to the event risk calculation) risk management change the correlation between Ford and Ford Motor Credit. The event risk/JTD charge assumes perfect correlation, while the desk said that this was not the case and the names traded at a 40-50% correlation. Apparently Ford has the legal right to grab money from FMCC but incentives not to (it can't draw down its bank revolver if it takes money from FMCC, and the desk says that this is sufficient disincentive). Madelyn agreed to move the correlation down to 75% - she mentioned something about spread basis and implied correlations, but I can't help getting the feeling that 75% is basically splitting the difference between the desk (50%) and risk management (100%). In a subsequent email, Laura Vecchio confirmed that Ford/FMCC is the only pair with its "own" correlation – otherwise, "Generally, the Firm's methodology includes segmenting the population into 15 sectors with names within the same sector correlated at 20% and names in different sectors correlated at 10%. There are not, however, additional manual pairs." Ford and FMCC must have been considered to be the same name, then – otherwise it seems that they would have only received a 20% correlation as they would be names within the same sector.

- Something on my mind: what do you do when you take a write-down in the HY space that is much higher than anything implied by the stress tests? Does this lead to any kind of conversations?

<u>Backtesting</u>

- LMP had an exception at the end of the month on the back of a large rally in Treasuries (10 bps, a large move in terms of std deviation).
- Securitized Products had a large gain ($80 million) at the end of the month – $130 million gain from CDS offset by $50 million loss on ABX, and $25 million in fees on securitizations. I know that some of those CDS were on CDOs, something we've had questions about (particularly from a marking perspective)
- High Yield had an excession due to moves associated with an index versus single name trade on the Russell 2000. The VaR model underestimates this risk, and market risk is rolling out an CDX enhancement to VaR in August.
- Munis – muni/treasury basis
- GTS - $25 million loss on the back of LBO distress (First Data, Clear Channel)
- Equities cash strategies had two excession days, driven by drops in both HP and Dell
- Equities portfolio had an excession when RIM moved up by 21% - the desk was short calls going into an earnings announcement. Also quant strategies lost money as several stocks had small moves.

FOR THE MEMO

- Lehman's acquisition of Eagle Energy closed on June 26, bringing 224 active clients with $317 million of current credit exposure and $848 million of potential credit exposure from short dated gas trades. Commodities VaR (95%, 1 day) also increased from $6.5 million to $8.4 million. We will continue to monitor both credit and market exposures in commodities as well as the risk management resources devoted to this area.
- Lehman continues to have significant exposure to leveraged loans. While deals are currently getting tighter with pricing and flex, the question remains about what will happen to deals that have already been committed but not yet syndicated. TXU ($5.3 billion Lehman commitment) and First Data ($3.4 billion Lehman commitment) are both scheduled for syndication in the fall. We will follow the developments in this area closely.
- Firmwide VaR ended the month at $90.9 million (95%, 1 day), over the $85 million limit. Both Fixed Income and Equity VaRs were below their respective limits, and the increase in firmwide VaR was due to large moves in the diversification effect. However, Risk Appetite, a more holistic measure of risk, has not breached its limit yet. Senior management at Lehman is aware that VaR is over the limit, and continues to monitor multiple measures of risk.