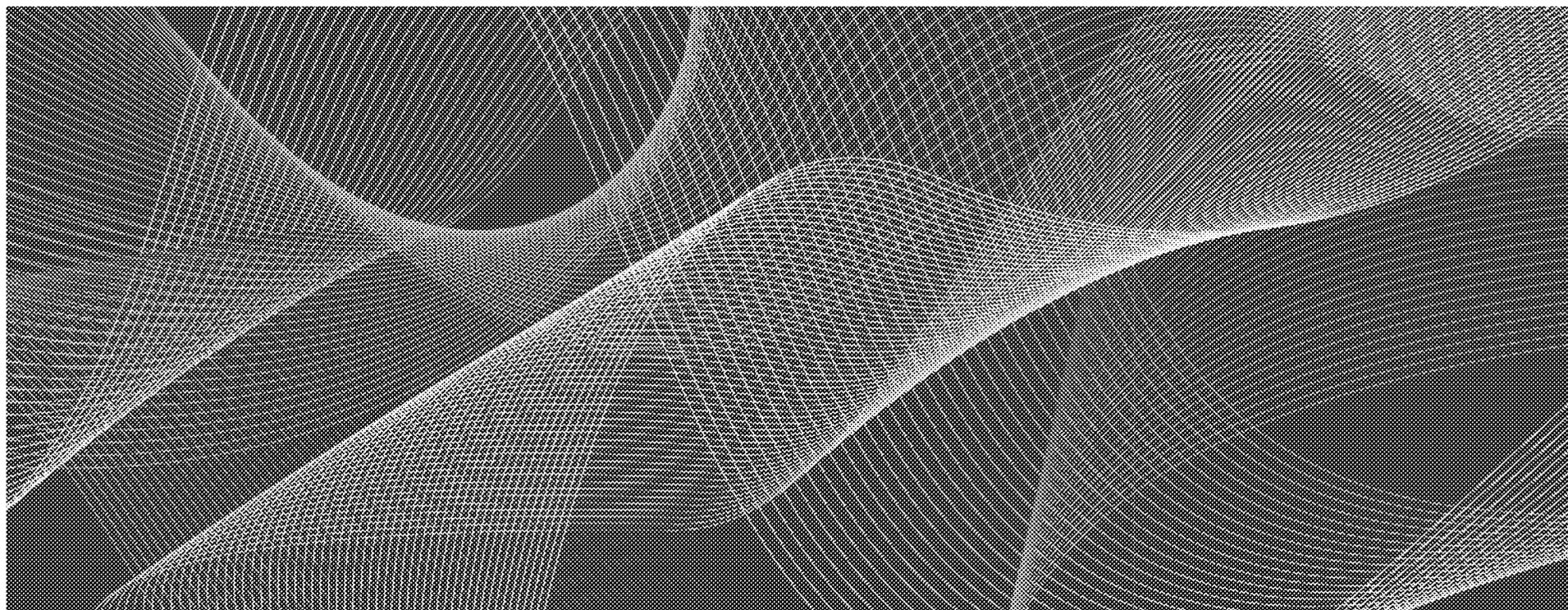


Equity Adequacy Framework



Confidential Presentation

Overview

- ◆ Equity capital is one of the most important resources of the Firm. Rapid growth and increased complexity of the Firm place heightened demands on the efficiency of the capital utilization

- ◆ Equity Adequacy Framework (EAF) is the Firm's primary economic capital model
 - Risk/liquidity-based model that accounts for the different characteristics of the Firm's businesses and exposures
 - Designed to protect the Firm's ability to restructure without resorting to bankruptcy in the face of severe, prolonged crisis
 - Supplements the existing Risk Appetite, Risk Equity, and Funding Frameworks

- ◆ EAF is both fundamentally robust and practical
 - Appropriately conservative due to additive charges for risks (i.e. does not reduce charges for negative correlation benefits between risks classes)
 - Testing of the model indicates its close alignment with the CSE model
 - Relatively transparent and easy to implement on both Firm-wide and business levels

- ◆ EAF has many applications
 - Determine whether the Firm is appropriately capitalized
 - Allocate equity to businesses and charge for its usage
 - Assist businesses in making, shareholder accretive, marginal trade decisions
 - Measure businesses' performance on an economic value add basis

The Role of Equity Adequacy Framework

Along with Risk Appetite, Risk Equity and Funding frameworks, the Equity Adequacy Framework is designed to protect the Firm against adverse events. It reflects the estimated amount of capital required to allow the Firm reorganize and restructure without resorting to bankruptcy in case of severe and prolonged crisis

Multi-tiered Defense Structure

Severity and duration of adverse event	Line of defense / Components	Function / Protected stakeholders
Severe but limited duration	Risk Appetite Framework <ul style="list-style-type: none"> • Earning power • Diversification • Flexible cost structure 	<ul style="list-style-type: none"> • Ensures minimal acceptable level of earnings • Maintains the Firm's ability to recover while continuing to meet its obligations, including paying common dividends
Severe and extended duration	Risk Equity Framework <ul style="list-style-type: none"> • Common Equity 	<ul style="list-style-type: none"> • Ensures the Firm's ability to meet all financial obligations in distressed environment without restructuring
Severe but limited duration	Funding Framework <ul style="list-style-type: none"> • Liquidity pool • Reliable funding 	<ul style="list-style-type: none"> • Ensures the Firm's ability to meet all financial obligations without relying on asset sales for one year and with no access to debt markets • Protects secured and short-term unsecured lenders
Severe and long-term	Equity Adequacy Framework <ul style="list-style-type: none"> • Common equity • Hybrid equity 	<ul style="list-style-type: none"> • Ensures the Firm's assets, even in case of liquidation following extended crisis, are sufficient to meet its obligations to counterparties and lenders • Protects long-term senior unsecured lenders

Focus on Lehman-Specific Events

The focus of the Equity Adequacy Framework is on a Lehman-specific event, rather than systemic meltdown. Our Liquidity Framework ensures that we have sufficient time (one year) to arrange for disposition of assets or restructuring of liabilities. We assume that during this period liquidation of financial assets is possible, albeit at reduced valuations

Scenario

A major loss stemming from events linked to either Lehman or/and one of its major counterparties.

Damage is large-scale and enduring (over one year), necessitating sale of assets and/or restructuring of liabilities. The Firm's rating is severely impaired (below IG)

Overall, economic environment is unfavorable, resulting in severe losses on trading positions, however financial markets are functioning



Implications

Tangible assets can be liquidated or refinanced, albeit at significantly reduced valuations.

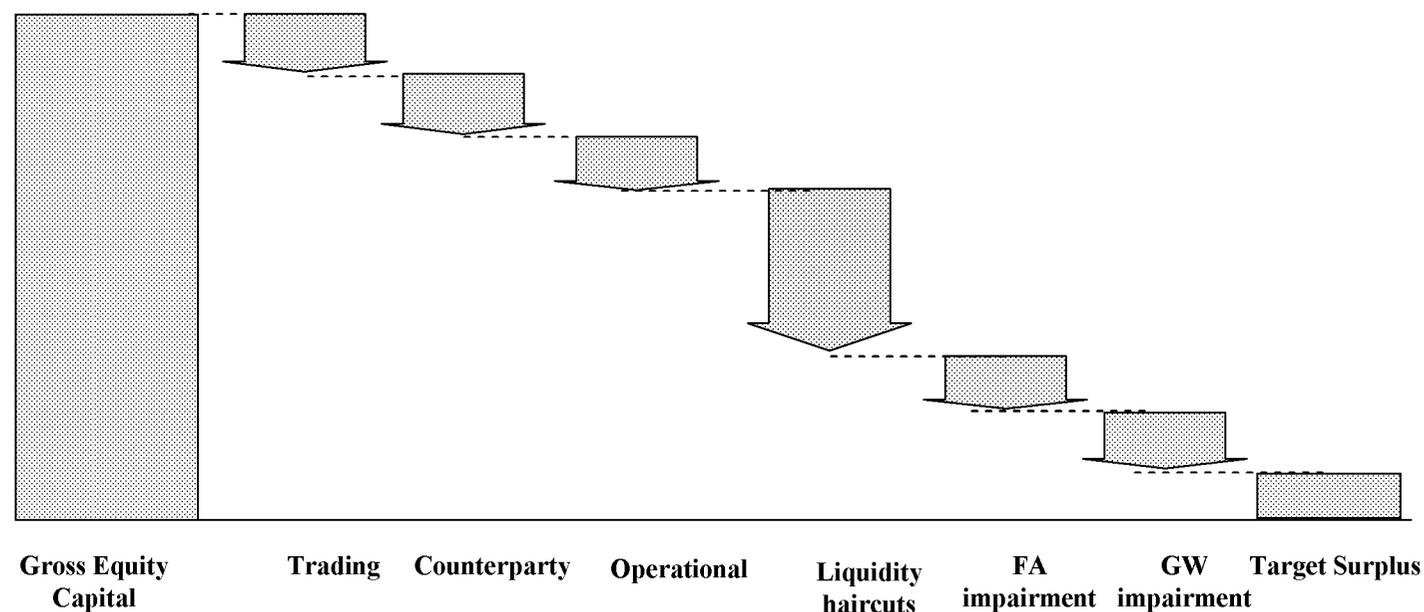
The value of intangible assets is materially impaired or lost

“Separable” assets can be sold (at reduced valuations) allowing some recovery of Goodwill

Equity Adequacy Framework (EAF)

The equity allocation framework (EAF) calculates the equity required to enable restructuring in crisis outside of bankruptcy without access to unsecured debt. The model incorporates both risk and liquidity considerations and can be applied at different levels of granularity: the Firm, the Divisions, BPMs, and even trades

Equity Compression in Crisis



$$\underbrace{\left\{ \begin{array}{l} \text{Common} \\ \text{Equity} \end{array} \right\} + \left\{ \begin{array}{l} \text{Hybrid} \\ \text{Equity} \end{array} \right\}}_{\text{Available Equity}} - \underbrace{\left\{ \text{Trading} + \text{Counterparty} + \text{Operational} + \text{Less-Liquid} + \text{Impairment} + \text{Target Surplus} \right\}}_{\text{Required Equity}} \geq 0$$

Parameters of Model

Component	Includes	Approach
Trading Loss	<ul style="list-style-type: none"> Market Risk Credit Risk 	<ul style="list-style-type: none"> VaR-driven Reflects maximum loss over 1 year holding period with 99.97% confidence level
Counterparty Loss	<ul style="list-style-type: none"> Financing and derivative exposure 	<ul style="list-style-type: none"> MPE (Probability of default and expected recovery in default)
Liquidation Loss	<ul style="list-style-type: none"> Liquidity Haircuts on LLA's Devaluation of Fixed assets Devaluation or loss of intangible assets 	<p>Triangulated based on</p> <ul style="list-style-type: none"> Estimated discount in fire sale Haircut for non-recourse financing Equity requirement in CDO structure <p>Estimated by marking to market, then taking same haircuts as on illiquid assets</p> <p>Estimated by marking "Separable" assets to market, then taking same haircuts as on Corporate Investments</p>
Operational Loss	<ul style="list-style-type: none"> Operational loss Litigation loss 	<ul style="list-style-type: none"> Percent of revenues
Target Surplus	<ul style="list-style-type: none"> Protection against unexpected Reserve for tactical opportunities 	<ul style="list-style-type: none"> \$1.5 B

Capital Allocation, Liquidity Haircuts

Illiquid assets are assigned an equity component driven primarily by the difficulty of their funding in a stressed environment. Hedging (where done reliably) leads to reduced assessment. A collaborative effort is under way to further refine the assignment factors based on the relative size and other specific characteristics of the assets

Equity Allocation for Illiquid Assets

Asset Class	EAF	CSE	Asset Class	EAF	CSE
Corporate Debt			Residential Real Estate		
HG Funded Loans	6%	VaR	Non-Prime Loans	13%	VaR
HY Funded Loans/Bonds	13%	8%	International Loans	6%	VaR
Lending Commitments	5%	4%	Non-Investment Grade Securities	26%	100%
CAF	6%	4%	Servicing Rights	8%	
Private Equity and Principal Investments			Commercial Real Estate		
Real Estate	32%	32%	Senior Debt	4%	9%
Private Fund Investments	32%	32%	Mezzanine/Other Debt	16%	10%
Merchant Banking	32%	32%	Equity	32%	11%
Venture Capital	32%	32%	Securities	8%	0%
Credit/Infrastructure	20%	32%	Other		
Partnership Account	32%	32%	Bridge Equity Commitments	8%	16%
Fund of Funds	20%	32%	Perm Equity Commitments	16%	16%
Corporate Investments	32%	32%	HY Derivatives Receivable	13%	> 8%
Asset Management Seed	20%	32%	HG Derivatives Receivable	6%	< 8%
Minority Stakes	32%	32%	Illiquid Equities E3 -OECD FX	5%	VaR
			Illiquid Equities E3 - Intermediate FX	10%	VaR
			Illiquid Equities E3 -Obscure FX	20%	VaR

Capital Adequacy

Equity Adequacy Framework

At the end of Q1' 08, the Firm has an equity surplus of \$4.4 billion or \$2.9 billion above its Target Surplus

Q1' 08 Equity Adequacy Framework Surplus/(Deficit)

<i>Variables in \$mm</i>		
Performance data		Q1' 08
	VaR 95% 1 day	122
	Counterparty Risk Appetite	367
	Less Liquid Assets	174,597
	Revenue (FY 2007)	19,257
	PP&E	3,861
	GW&I	4,127
	DTA	2,309
 <i>Variables in \$mm</i>		
	<u>Equity Required</u>	Q1' 08
	Trading	3,997
	Counterparty	772
	Less Liquid Funding Haircuts	
	{ <i>Less Liquid assets</i> ¹	17,671
	{ <i>Fixed assets</i>	2,902
	{ <i>Goodwill</i>	1,227
	{ <i>DTA</i>	1,847
	Total	23,647
	Operational	963
	Total Gross Equity Required Before Target Surplus	29,379
	Target Surplus	1,500
	Total Gross Equity Required	30,879
	 <u>Gross Equity Available</u>	
	Common Equity	21,839
	Hybrids/Preferred ²	11,969
	Total Gross Equity	33,808
	 Surplus/(Deficit) Before Target Surplus	4,429

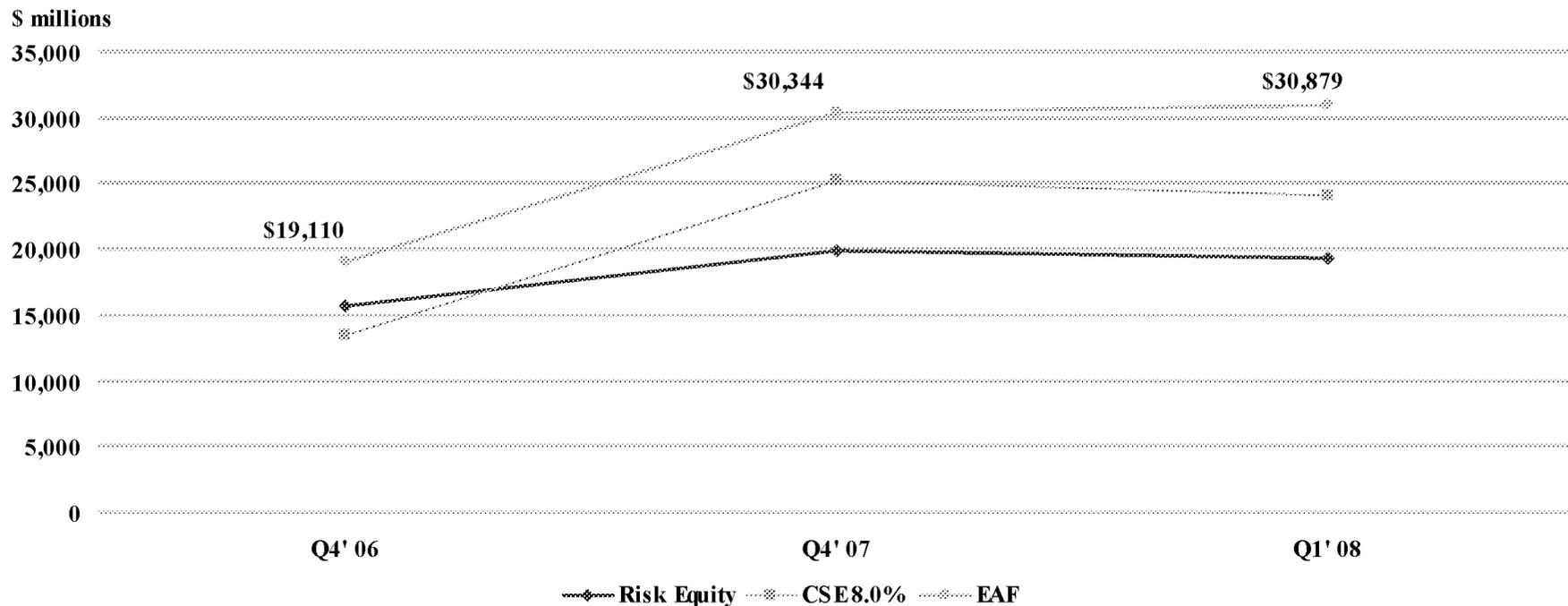
1. Less Liquid Assets include off-balance sheet items like commitments

2. Includes \$4.0B Non-cumulative Perpetual Preferred issuance in April

Comparing the Models: Equity Requirements

Comparison of Equity Adequacy Framework (EAF), CSE, and Risk Equity Models indicates close alignment between EAF and CSE. The difference between absolute requirements of the two models is driven by the fact that Tier 1 equity is, by definition, lower than Gross Equity.

Absolute Equity Requirements by Model



Capital Allocation

Using the EAF methodology the Firm allocates equity to the different businesses. Fixed Income is allocated over 50% of the Firm's gross equity

Equity Allocation by Division Q1' 08

in \$ Billions

Division	VaR	Counterparty	Liquidity	Other ¹	Total Equity Requirement
FIXED INCOME	1.8	0.5	12.0	2.7	17.0
EQUITIES	0.3	0.1	1.0	1.4	2.8
CAPITAL MARKET PRIME SERVICES	0.1	0.1	0.3	0.5	0.9
INVESTMENT MANAGEMENT	0.4	0.0	3.0	1.1	4.5
INVESTMENT BANKING	0.2	0.0	6.2	1.3	7.8
PRINCIPAL INVESTING	1.1	0.0	1.1	0.2	2.5
NON-CORE/OTHER	0.1	0.0	-6.0	1.2	-4.6
TOTAL FIRM	4.0	0.8	17.7	8.4	30.9

1. 'Other' includes requirements for operational risk, goodwill, DTA, fixed assets and the target surplus

Equity Usage Charge

Commencing in May, the Firm has begun charging the businesses for the use of equity. Each business will incur a charge for the use of equity attributed to liquidity. This charge is aimed at incentivizing behavior that preserves shareholder value and recognizes that equity capital is a scarce resource. Below is an illustrative example of how each business within FID would be charged with an offset to the division

Equity Allocation and Charge Fixed Income Division – Q1' 08 annualized

in \$ millions

FIXED INCOME	Equity Requirement for Liquidity	Charge @ 500bps
Global Rates	303	15
High Grade	859	43
Securitized Products	1,791	90
Real Estate	6,533	327
High Yield	1,760	88
Municipals	46	2
Foreign Exchange	45	2
CDO	405	20
Energy Trading	0	0
Fixed Income Corporate	274	14
<i>Offset</i>		(601)
Total FIXED INCOME	12,015	(0)