

Confidential Presentation to:

Board of Directors

Risk Update

July 18, 2006

LEHMAN BROTHERS

Agenda

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- ◆ Conclusion

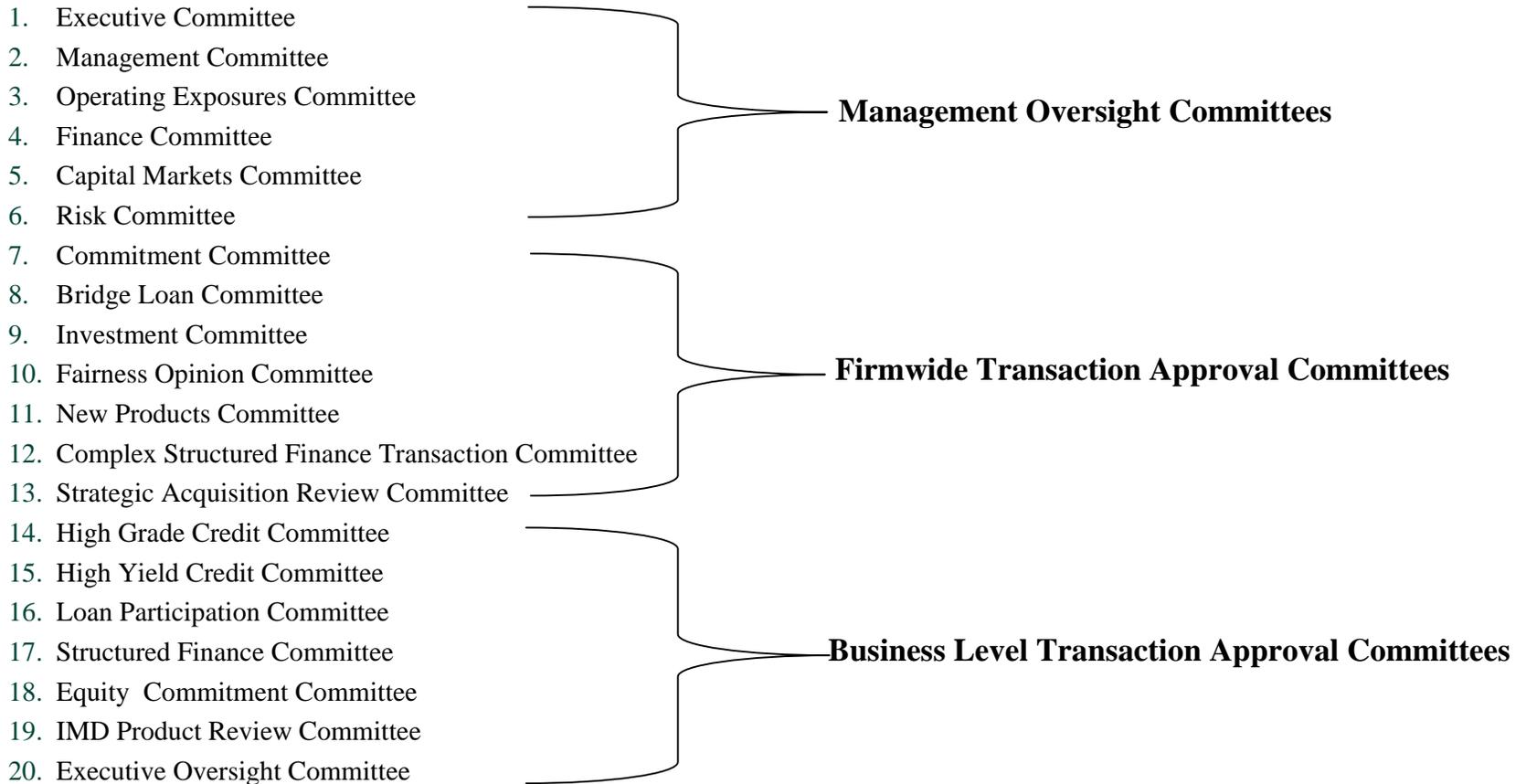
Risk Governance

Risk Philosophy

- ◆ Risk Management is one of our core competencies
- ◆ An essential part of Lehman Brothers' approach to Risk Management, is a strong internal control environment with multiple overlapping and reinforcing elements
 - Many parts of the Firm - Risk Management, Finance, Operations, Compliance, Audit, Trading Management, Capital Markets Senior Management – are involved in managing risk
- ◆ Risk Management is more than measuring and reporting risk
- ◆ Our approach applies analytical rigor overlaid with sound practical judgment
- ◆ One key feature which differentiates us from our peers is our integration of Market and Credit Risk Management
 - Allows us to leverage people, analytics, systems, data and information flows
- ◆ Risk Management works proactively with the risk-taking areas of the Firm before transactions occur
 - To ensure the least risky deal structure is executed
 - To ensure risk mitigants are in place, including getting appropriate levels of collateral
- ◆ The Risk Management Division
 - Develops risk policies and procedures
 - Develops risk measurement methodologies
 - Sets limits
 - Tracks actual usage against limits
 - Evaluates valuation models
- ◆ Our focus is balancing risk vs. return
 - We want to help ensure Lehman Brothers' risk appetite is deployed in the most efficient way
- ◆ At the end of the day nothing is fool-proof. While there is no guarantee against loss, we can minimize the probability of loss
 - We minimize market and credit risk through our client-driven franchise where we facilitate customers
 - We proactively manage risk both before and after trades are done by mitigating risk via management of the terms, outright sales or syndication, or hedging the remaining risk
 - We actively manage collateral assessment and collection where applicable
 - Risk is minimized through geographic, industry, asset class and customer diversification

Committee Structures

- ◆ Lehman has established numerous committees to oversee risk taking activities and to ensure that controls are appropriately administered and reviewed
- ◆ The key operating committees at the Firm include:



Risk Management

Risk Management Function

Risk Management is Independent from Trading

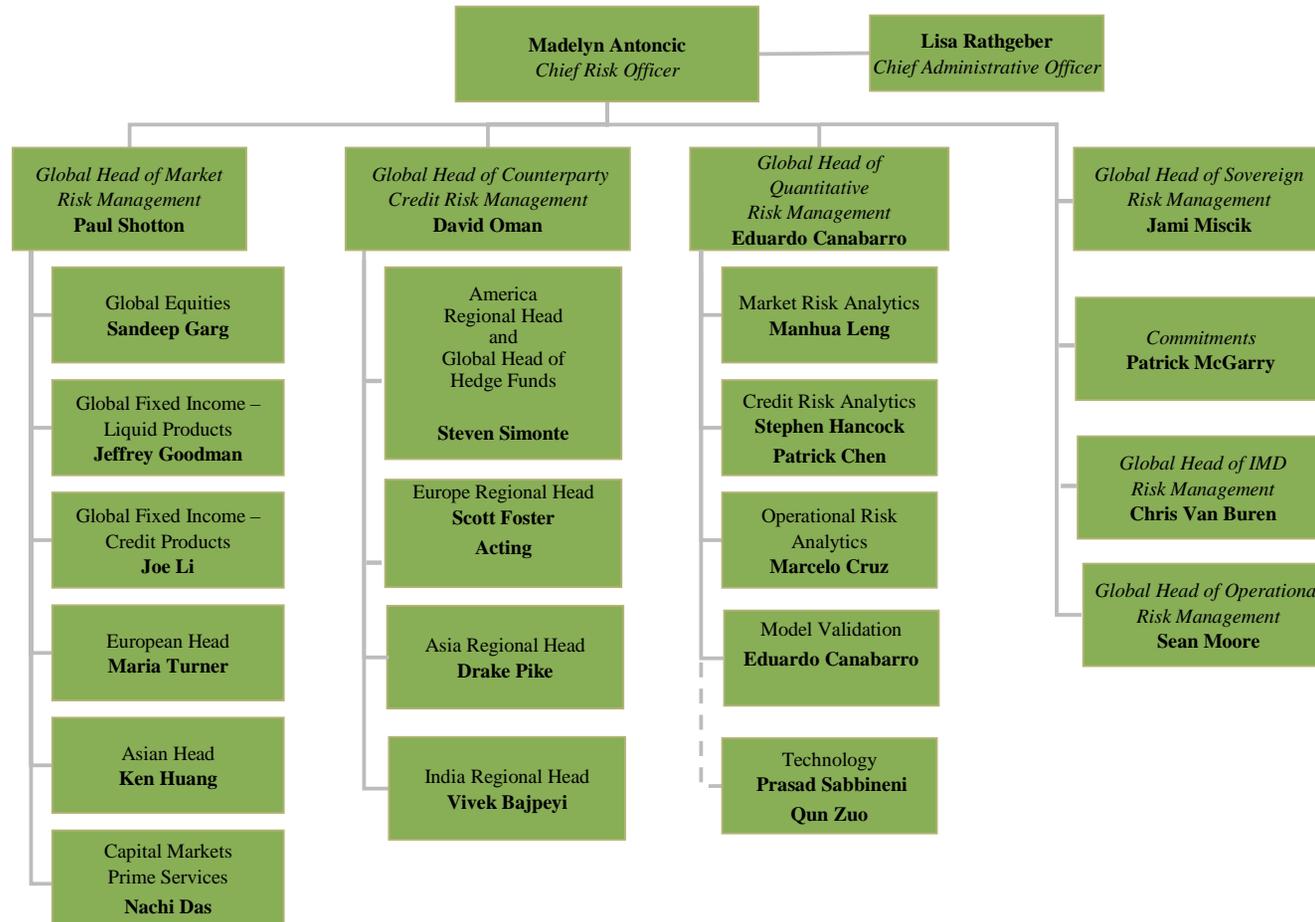
- ◆ The Global Risk Management Division is independent of the trading areas
- ◆ The Chief Risk Officer, Madelyn Antoncic, reports directly to Dave Goldfarb
- ◆ The Chief Risk Officer has put in place Global Heads for each department within the Global Risk Management Division
 - Global Head of Market Risk Management
 - Global Head of Counterparty Credit Risk Management
 - Global Head of Quantitative Risk Management
 - Global Head of Sovereign Risk Management
 - Global Head of IMD Risk Management
 - Global Head of Operational Risk Management
- ◆ Outside the U.S., Risk Management is “matrixed” reporting both to global risk management heads and to regional managers consistent with the trading businesses organization structure

Risk Management Function

- ◆ Market Risk Management is responsible for ensuring all market risks are identified, understood, measured, monitored and captured by an appropriate metric. Risk managers work very closely with the trading desks in assessing risk and sit on trading floors with the desks they support
- ◆ Credit Risk Management is responsible for counterparty credit analysis and due diligence; assigning and maintaining internal risk ratings; credit limits for each counterparty; establishing country risk limits; preparing credit reviews; monitoring counterparty credit exposures on a current (CCE) and potential basis (MPE) including usage of credit limits
- ◆ Quantitative Risk Management is responsible for developing, implementing and maintaining the risk methodologies and systems used to measure market, credit and operational risks, as well as validating the pricing and valuation models used by the business units of the Firm
- ◆ Sovereign Risk Management is responsible for establishing a framework to assess political, economic, and social conditions and events in a foreign country that might adversely affect the Firm's interests or reputation
- ◆ Operational Risk Management is responsible for ensuring all operational risks are identified, understood, measured and monitored

Risk Management Organization

- ◆ Risk Management is a global, integrated function under the leadership of the Chief Risk Officer, Madelyn Antoncic. The Global Risk Management Department consists of 300 professionals, with 193 risk managers and 107 technologists



Risk Management Organization

Risk Management Qualifications

- ◆ The Global Risk Management Division (“GRMD”) consists of 300 professionals with staff in each of the Firm’s three trading centers, as well as credit risk personnel in key sales regional offices
 - Chief Risk Officer
 - Chief Administrative Officer
 - 52 Market Risk
 - 66 Credit Risk (Counterparty Credit and Commitments)
 - 32 Quantitative Analysis / Model Validation
 - 17 Quantitative Reporting
 - 5 Operational Risk
 - 5 Sovereign Risk
 - 4 IMD Risk
 - 10 Admin
 - 107 Technology
- ◆ Excluding technologists and administrative staff, we have 183 professionals in GRMD. These professionals are highly qualified, with advanced degrees and substantial experience. Many are either former traders, former desk quants or have relevant business experience

	Global (CRO/ CAO)	Market Risk	Credit Risk	Quantitative Analysis	Quantitative Reporting	Operational Risk	Sovereign Risk	IMD Risk	Total
PhD	50%	26%	0%	67%	0%	40%	33%	0%	20%
Masters	0%	60%	39%	29%	18%	20%	67%	100%	42%
Bachelors	50%	14%	59%	4%	76%	20%	0%	0%	36%
Other	0%	0%	2%	0%	6%	20%	0%	0%	2%
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%
Percentage of former traders, desk quants and business experience	50%	34%	21%	21%	n/a	40%	67%	33%	25%

External Constituents

Relationship with Regulators

- ◆ The Firm enjoys an excellent relationship with its regulators
- ◆ Many senior members of the Firm's Compliance group have either worked at, or with those who work at, the regulatory agencies. Members of the GRMD and the Compliance department also participate in numerous industry associations and sub-committees together with representatives from the regulatory agencies. This has allowed the Firm to develop a good working relationship with the various regulatory bodies
- ◆ Representatives of Finance and Risk meet monthly with the SEC (division of Market Regulation) to discuss the Firm's risk metrics and financial performance. This began as a voluntary meeting agreed to in order to help the SEC develop a better understanding of the Firm and is now part of the CSE process.
- ◆ The Firm was approved by the SEC as a Consolidated Supervised Entity (CSE) effective November 2005. This designation permits the Firm and its ultimate holding company to calculate net capital using certain risk based standards for market and credit risk.
- ◆ In addition, the NYSE, the CBOT, the OTS (for Lehman Brothers Bank) and the FSA in Europe and Asia and the BaFin in Germany conduct annual examinations and there have been no significant findings

External Constituents

Relationship with Rating Agencies

- ◆ Risk Management is one of the key groups facing off with the rating agencies and has built excellent relationships with them. The agencies consistently cite our strong risk management function and framework as one reason behind their favorable view of Lehman Brothers
 - Moody's
 - "We view risk management at Lehman as a significant credit strength for the issuer that supports its current A1, stable rating." (Risk Management Assessment, May 2006)
 - "Credit Strengths for Lehman Brothers Holdings Inc. are: disciplined growth and diversification efforts; rigorous risk management; exceptional cost discipline; strong institutional-customer flow business; profitable international expansion." (Credit Opinion, June 2006)
 - "According to Moody's, Lehman continues to be among the best financial services firms at managing liquidity and market risks, which has contributed to the firm's relatively low earnings and margin volatility. " (Press release announcing change in outlook from stable to positive, June 2006)
 - S&P
 - "Liquidity and risk management are strong so that a cyclical downturn in the securities industry should not pose major problems for Lehman." (Summary Credit Opinion, June 2006)
 - Fitch
 - "Market and credit risks are conservatively managed. (...) Risk governance is well-developed and follows industry best practices." (Credit Analysis, July 2006 (draft))

Risk Analysis and Quantification

Risk Management Integrated Framework

The Three Core Functions of Risk Management are

1. Understanding and identifying all risks
2. Ensuring that appropriate limits are in place for all transactions and products
3. Protecting the Firm against “catastrophic” loss



1. Have metrics to measure the risk for all products
2. Define a “Risk Appetite”
3. Have the ability to measure and monitor “tail risk”

Risk Management Integrated Framework

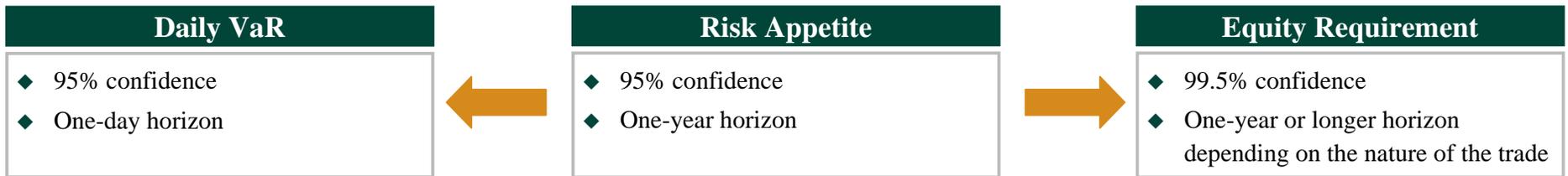
Risk Appetite

- ◆ We have developed a very robust and comprehensive framework for thinking about and managing risks and have established a framework for determining the most appropriate overall level of risk the Firm should be taking
- ◆ The framework begins with the amount of revenue the Firm would make in a downturn and is designed to balance risk and return
 - Our aim is to deploy enough risk in our businesses to generate strong cross-cycle returns
 - While at the same time limiting needless risk levels to ensure we meet our financial targets
- ◆ We have defined this level of risk as our Risk Appetite, which represents the quantity the Firm is “prepared to lose” in a year from market and counterparty credit risk, as well as from stress events
- ◆ We start with our financial targets
- ◆ We take into account a potential simultaneous slowdown in customer flow and banking activities (origination / advisory) which would negatively impact our financial targets since revenue shortfalls can also come from non-risk taking activities
- ◆ In calculating our overall Risk Appetite, our goal is to maintain a minimally acceptable ROTE and compensation adequacy including maintaining sufficient headcount to protect the franchise for the long-term
- ◆ We have been operating inside our risk appetite which is set at a level consistent with a 10% cross-cycle ROTE at a 95% confidence level
- ◆ Our overall risk management philosophy of conservatism and prudence has been a important factor in maintaining our credit spreads, and credit worthiness as well as our improving ratings

Risk Management Integrated Framework

Risk Appetite – The Center of Our Approach to Risk

- ◆ The Risk Appetite represents the quantity the Firm is “prepared to lose” in a year from market, event and counterparty credit risk. Risk Appetite usage is defined and measured at a 95% level of confidence

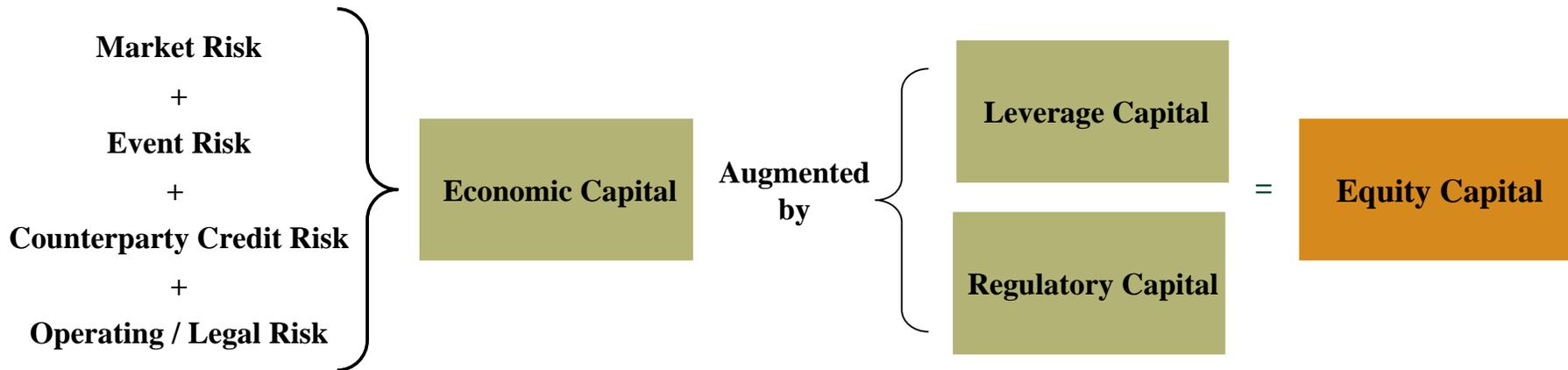


Risk Management Integrated Framework

Risk Equity

- ◆ The equity capital the Firm requires is the economic capital required to protect the Firm against market, event, counterparty credit and operational risks augmented by capital requirements due to external constraints
 - To the extent leverage or regulatory equity is an overriding constraint for the Firm, businesses are charged incremental equity on top of their economic (risk) equity

Equity Capital – Economic Capital and Regulatory Capital



Risk Management Integrated Framework

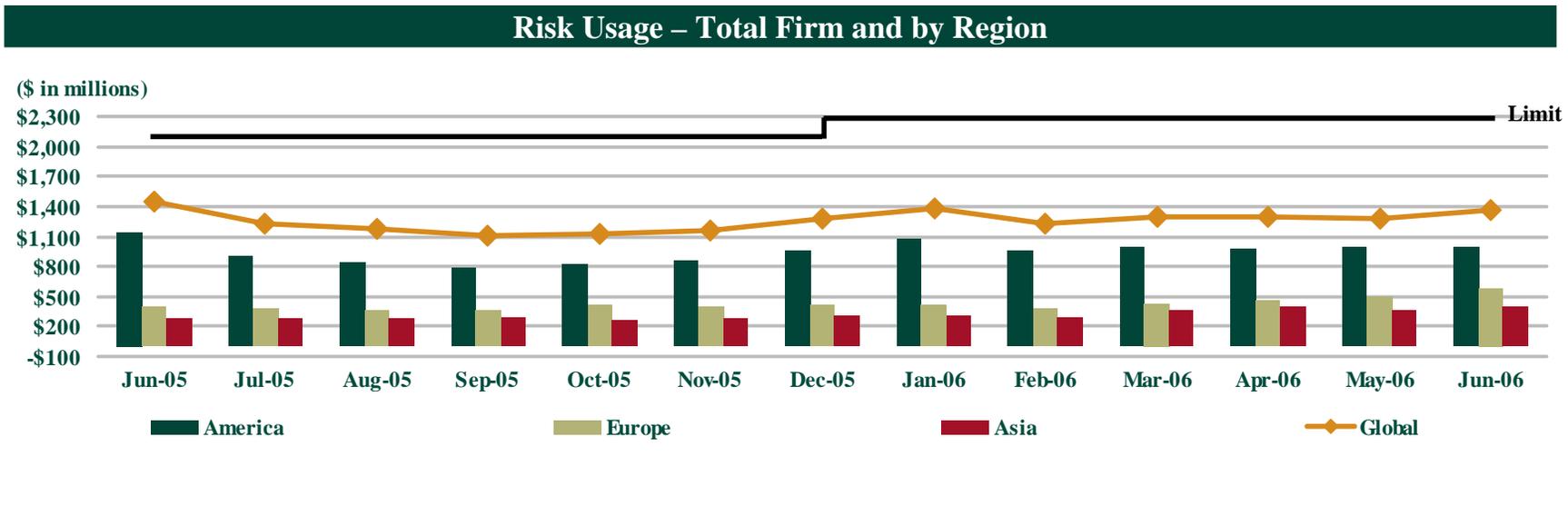
Risk Appetite Usage

- ◆ Risk appetite usage is measured on a globally consolidated basis and reported on a daily basis against our risk appetite limit
- ◆ Risk appetite usage is composed of
 - Market Risk
 - Measures the potential mark-to-market loss on all positions from adverse market moves
 - We use historical simulations which are “walk-backs” through time to determine what would have been the P&L impact on today’s portfolio if we relived each day over the past four years. We weight the data giving more weight to recent market moves while at the same time giving less weight to market moves further back in time.
 - This approach allows us to avoid making assumptions about distributions, about diversification, about relative risk factor weightings
 - In order to determine the reasonableness of the market risk measures, we do back-testing, comparing the market risk generated for the portfolio using the historical simulation approach to its actual trading P&L
 - Event Risk
 - Measures stress and “gap risks” which go beyond potential market risk losses. We measure these risks using statistically measurable stress analyses which capture losses associated with
 - Downgrades for high grade and defaults for High Yield loans, bonds and convertibles
 - Defaults for sub-prime mortgage loans
 - Property value losses on real estate
 - Dividend risk for equity derivatives
 - Deal break risk for merger arbitrage positions
 - Gap risk for fund derivatives
 - Counterparty Credit Risk
 - Measures the potential loss the Firm can suffer due to non-performance of our counterparties on forward settlements, financing and derivative transactions

Review of Results

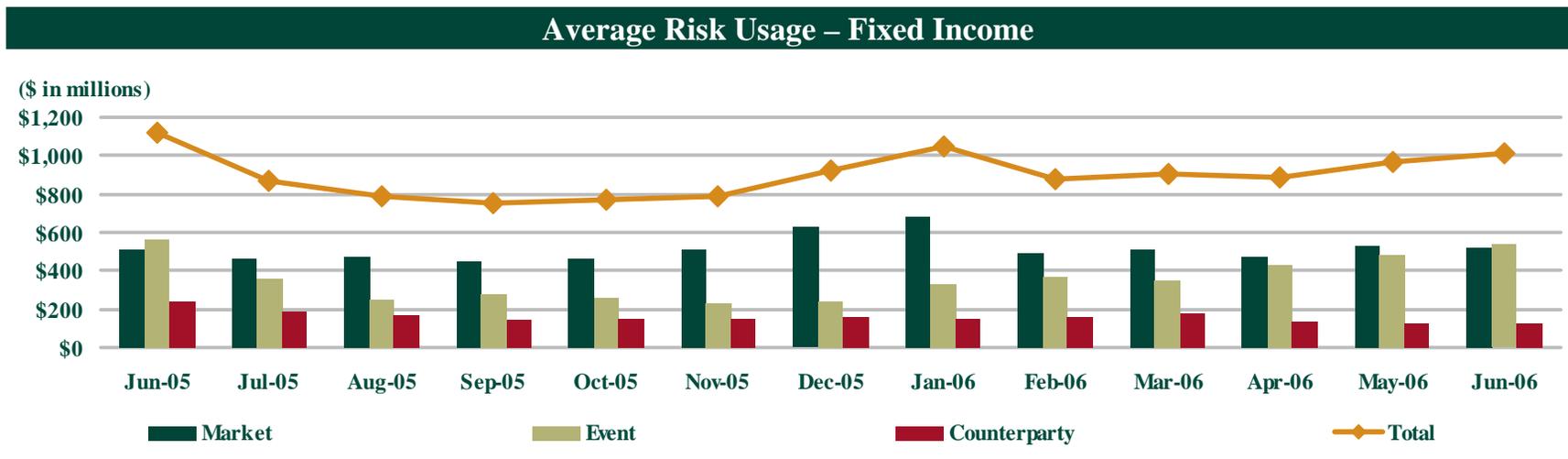
Risk Appetite Usage

- ◆ The Firm's overall risk usage remains well within its risk appetite limit of \$2.3 billion
- ◆ In absolute terms, total risk usage has been relatively stable over the past year
- ◆ We continue to grow our franchise which allows us to benefit from increased diversification due to an expanded product and business mix, as well as an expanded international presence
- ◆ From a regional perspective, Europe risk usage has grown from \$400mm a year ago to \$585mm while Asia risk usage has increased to \$390mm up from \$270mm
- ◆ In June 2006, Europe and Asia generated 44% of our total revenue, up from 23% a year ago.



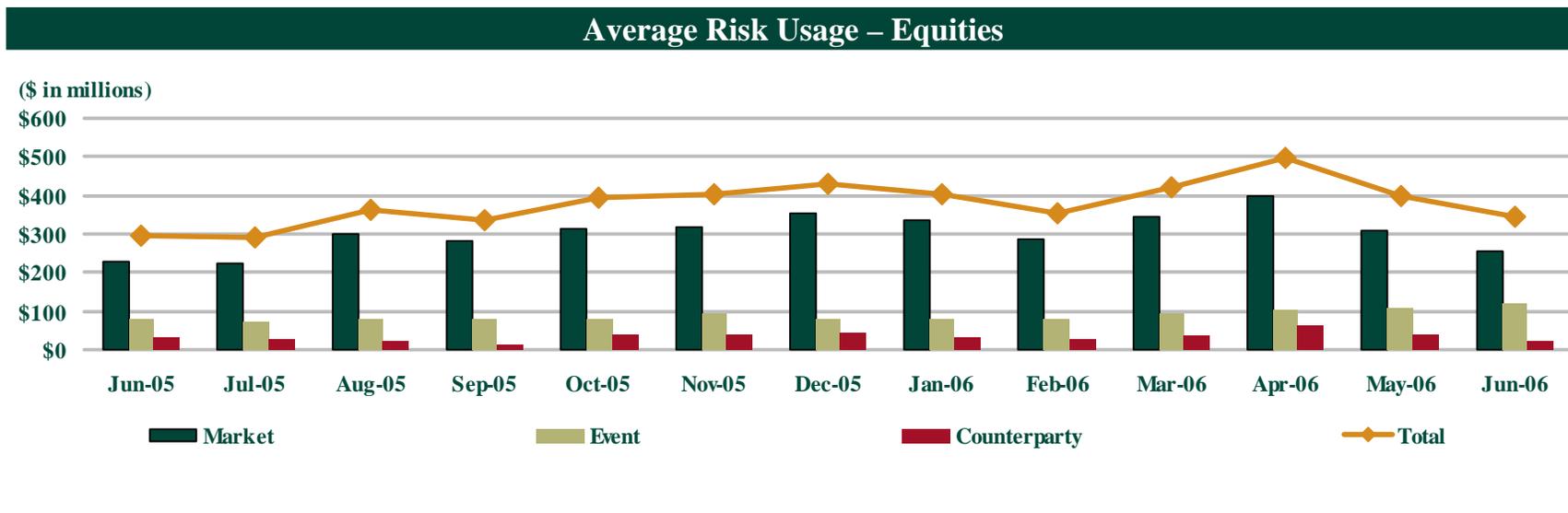
Risk Appetite Usage

- ◆ Fixed Income risk usage is down slightly from \$1.1 billion in June 2005, to \$1.0 billion currently
- ◆ Intra-year a decrease in event risk was offset by an increase in market risk
 - Real Estate risk usage declined to \$350mm, down from \$485mm in June 2005, having hit a low of \$150mm in December 2005. While our balance sheet at risk increased, overall risk is down due to the portfolio composition shifting toward more liquid, securitizable assets while exiting several large bridge equity positions
 - Consistent with the strong M&A/LBO markets, High Yield risk increased from \$310mm in June 2005 to \$360mm in June 2006
 - High Grade risk increased from \$220mm in June 2005 to \$330mm in June 2006, as strong credit markets through Spring 2006 allowed us to further grow our franchise.
 - Market risk peaked in January driving overall risk usage, as several desks in FID increased their net short interest rate exposures



Risk Appetite Usage

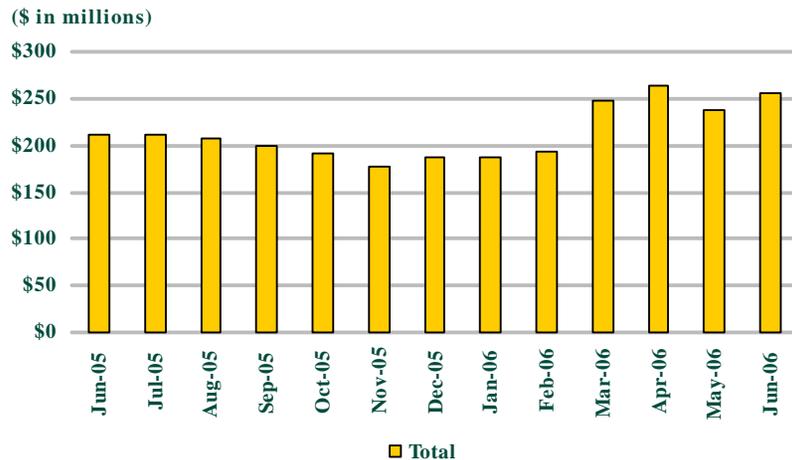
- ◆ Equities risk usage increased to \$340mm, up from \$300mm a year ago but down from the peak levels in April
 - Consistent with our strategy of building out our Equity Division, our net long delta exposure had increased over the past year from \$800mm to \$1.2bn. From February through April, we increased our exposures in all regions, particularly in America and Asia, reflecting our bullish view on these markets
 - We turned less bullish beginning in May and thus reduced exposure as the markets entered a major correction



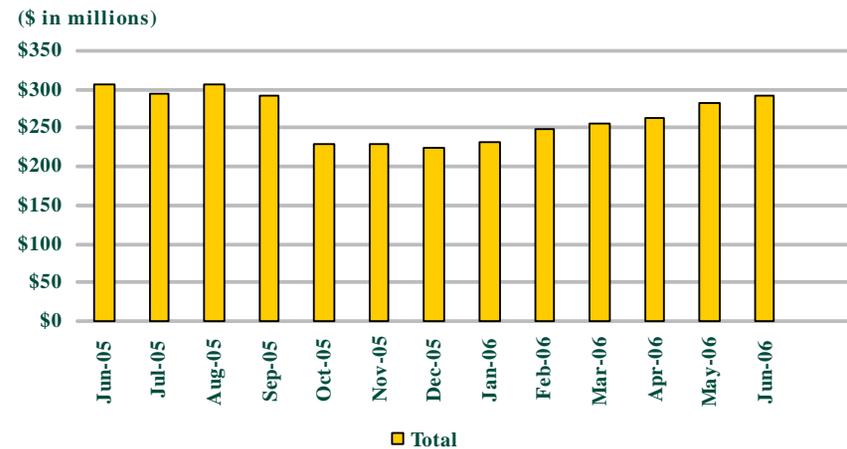
Risk Appetite Usage

- ◆ Global Trading Strategies risk usage increased from \$210mm in June 2005, to \$260mm
- ◆ While risk usage remained relatively stable for most of the past year, during the past quarter it has trended upwards, as result of position taking associated with M&A activities
- ◆ Investment Management risk usage, primarily driven by our balance sheet at risk in private equity funds and direct investments, is at similar levels of a year ago
- ◆ In the Fall, risk was reduced as we transferred assets we had been warehousing into new real estate funds
- ◆ Risk has trended up in the last few months as we position ourselves to launch new funds of private equity funds

Risk Usage – Global Trading Strategies



Risk Usage – Investment Management



Counterparty Credit Risk

- ◆ We continue to be prudent in our approach to counterparty credit risk
 - We have a very low tolerance for delays on receiving collateral, where applicable
 - We give very close scrutiny to the value of customer collateral posted against margin loans
- ◆ We have a very high quality credit portfolio
- ◆ 97.9% of our counterparty exposure is in investment grade names
- ◆ The bulk of our exposure is to banks and other financial institutions
- ◆ Hedge Fund exposure represents 1% of our total portfolio
- ◆ 91.3% of our exposure is in the U.S., Canada and Western Europe

Current Credit Exposure Trend by Rating

(US\$ million)

	Ratings						Percentages					
	2Q '05	3Q '05	4Q '05	1Q '06	2Q '06	Jun-06	2Q '05	3Q '05	4Q '05	1Q '06	2Q '06	Jun-06
AAA	3,759	3,745	3,569	4,347	5,506	4,823	21.1%	20.5%	19.3%	22.5%	20.5%	21.3%
AA	5,710	6,163	6,763	6,643	11,929	9,236	32.1%	33.7%	36.5%	34.3%	44.5%	40.8%
A	6,110	5,966	5,933	6,073	6,987	6,152	34.3%	32.6%	32.0%	31.5%	26.1%	27.2%
BBB	1,540	1,807	1,825	1,826	2,010	1,953	8.6%	9.9%	9.8%	9.5%	7.5%	8.6%
BB	564	467	314	336	308	359	3.2%	2.6%	1.7%	1.8%	1.1%	1.6%
B or Lower	130	155	135	83	82	135	0.7%	0.8%	0.7%	0.4%	0.3%	0.5%
Total	17,813	18,304	18,539	19,308	26,822	22,658	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%

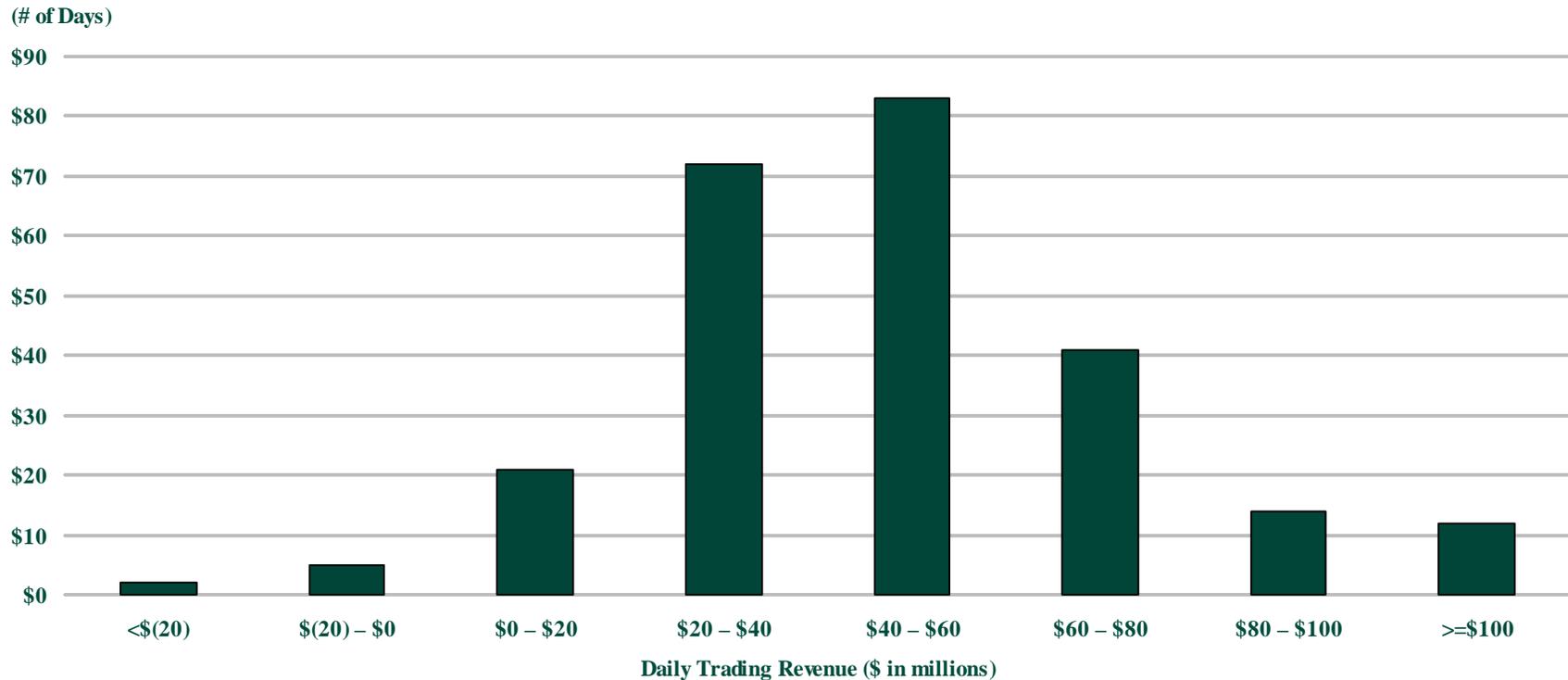
	2Q '05	3Q '05	4Q '05	1Q '06	1Q '06	Jun-06
Investment Grade	96.1%	96.6%	97.6%	97.8%	98.5%	97.9%
Below Investment Grade	3.9%	3.4%	2.4%	2.2%	1.5%	2.1%
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Note: Does not include money market deposits.

Trading Revenues

- ◆ Average daily trading revenue was \$49mm from June 2005 through May 2006
- ◆ Consistent with our conservative risk profile, we had only seven negative trading days

Daily Trading Revenue Distribution (June 2005 through May 2006)



Conclusion

Conclusion

- ◆ We have a strong culture of Risk Management throughout the Firm
- ◆ Our franchise is to facilitate clients
- ◆ We have developed a very robust and comprehensive framework for thinking about and managing all forms of risk
 - Our powerful risk and equity allocation tools help guide the Firm in its overall management and decision making
- ◆ We are prudent toward our approach to credit risk which has resulted in a very high quality and well diversified credit portfolio
 - We have very low tolerance for delays on receiving collateral, where applicable
 - We give close scrutiny to the value of customer collateral posted against margin loans
- ◆ Our approach is to mitigate risk through various hedging strategies, and follow a model of credit facilitation where we act as a conduit between our clients and the capital markets, rather than as the ultimate holder of the risk
- ◆ Our overall Risk Management philosophy of conservatism and prudence has been an important factor in our improving credit spreads, ratings and credit worthiness