

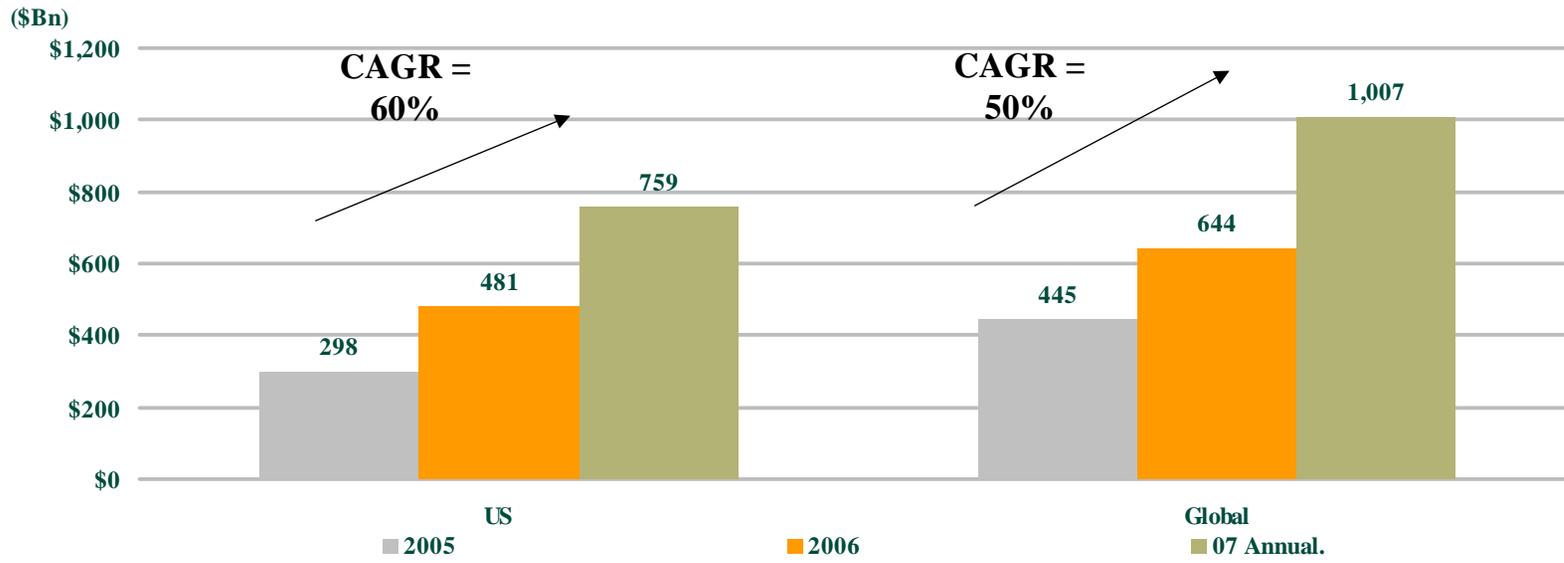
Leveraged Finance Risk

June 2007

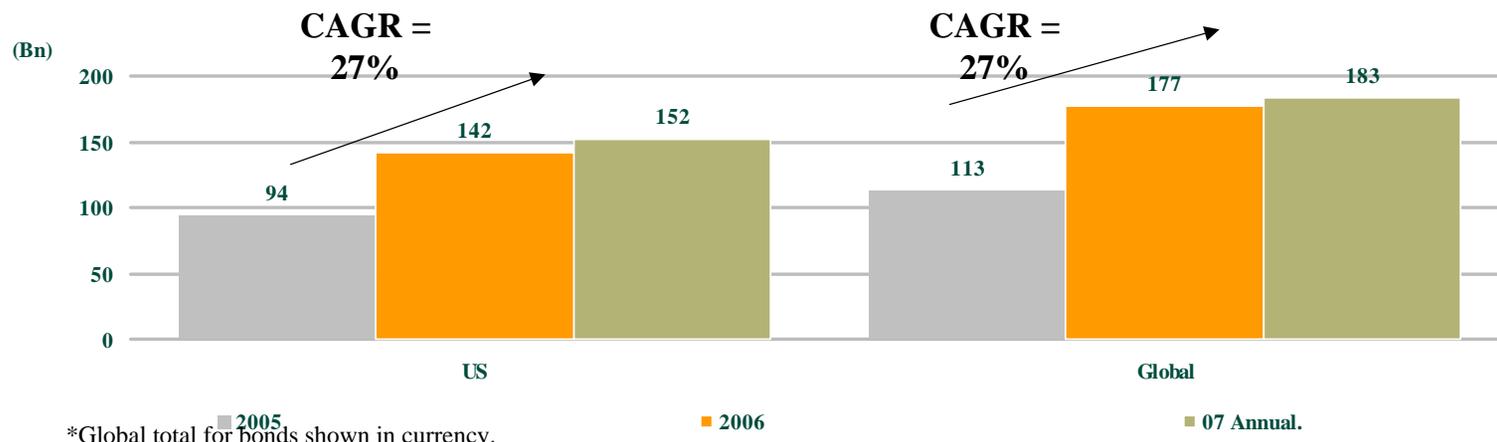
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The leverage finance market has been growing rapidly

Leverage Loans



Bonds



Our Market Share and rank have improved this year both in the U.S. and Globally for Leveraged Finance

Leverage Loans

	2007*			2006			Δ		
	Amount (\$mm)	Share	Rank	Amount (\$mm)	Share	Rank	Amount (\$mm)	Share	Rank
Global Leveraged Loans	\$52,771.6	3.8%	8	\$34,282.7	2.9%	12	\$18,488.90	↑0.9%	↑4
US Leveraged Loans	\$37,618.6	4.0%	8	\$23,424.3	3.0%	9	\$14,194.30	↑1.0%	↑1

Bonds

	2007*			2006			Δ		
	Amount (\$mm)	Share	Rank	Amount (\$mm)	Share	Rank	Amount (\$mm)	Share	Rank
Global HY	\$11,820.4	6.5%	7	\$9,654.5	5.5%	9	\$2,165.90	↑1.0%	↑2
HY US	\$11,482.4	7.6%	5	\$9,020.3	6.4%	7	\$2,462.10	↑1.2%	↑2

*Annualized 2007

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2

Our Market Share and rank have improved this year both in the U.S. and Globally for Financial Sponsors

Leverage Loans

	2007*			2006			Δ		
	Amount (\$mm)	Share	Rank	Amount (\$mm)	Share	Rank	Amount (\$mm)	Share	Rank
Global Leveraged Loans	\$34,166.0	5.9%	6	\$22,511.0	4.5%	11	\$11,655.00	↑1.4%	↑5
US Leveraged Loans	\$16,564.6	6.4%	7	\$10,228.0	4.1%	10	\$6,336.60	↑2.3%	↑3

Bonds

	2007*			2006			Δ		
	Amount (\$mm)	Share	Rank	Amount (\$mm)	Share	Rank	Amount (\$mm)	Share	Rank
Global HY	\$6,157.0	11.0%	4	\$3,831.6	7.7%	7	\$2,325.40	↑3.3%	↑3
HY US	\$6,013.6	13.0%	1	\$4,465.7	6.8%	6	\$1,547.90	↑6.2%	↑5

*Annualized 2007

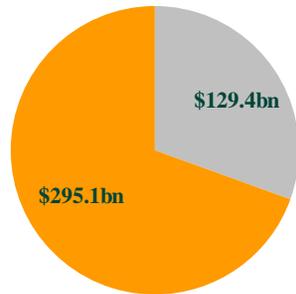
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3

We have been much stronger with Sponsors than Corporates

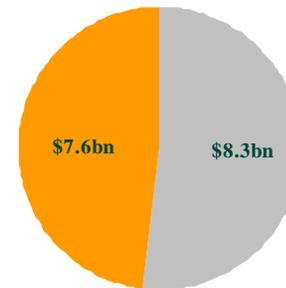
Financial sponsor transactions make up 30% of all U.S. Leveraged loans. It is 52% of Lehman Brothers' business.

Market



■ Sponsor ■ Corporate

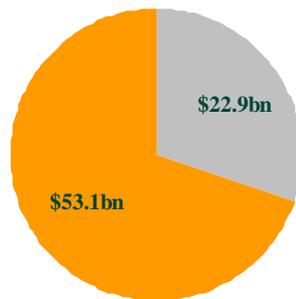
Lehman



■ Sponsor ■ Corporate

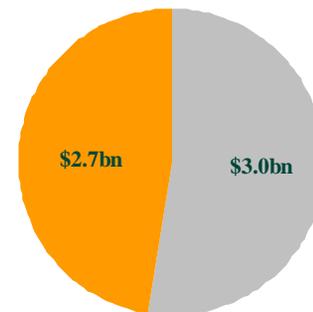
Financial sponsor transactions make up 30% of all U.S. HY Bonds. It is 53% of Lehman Brothers' business.

Market



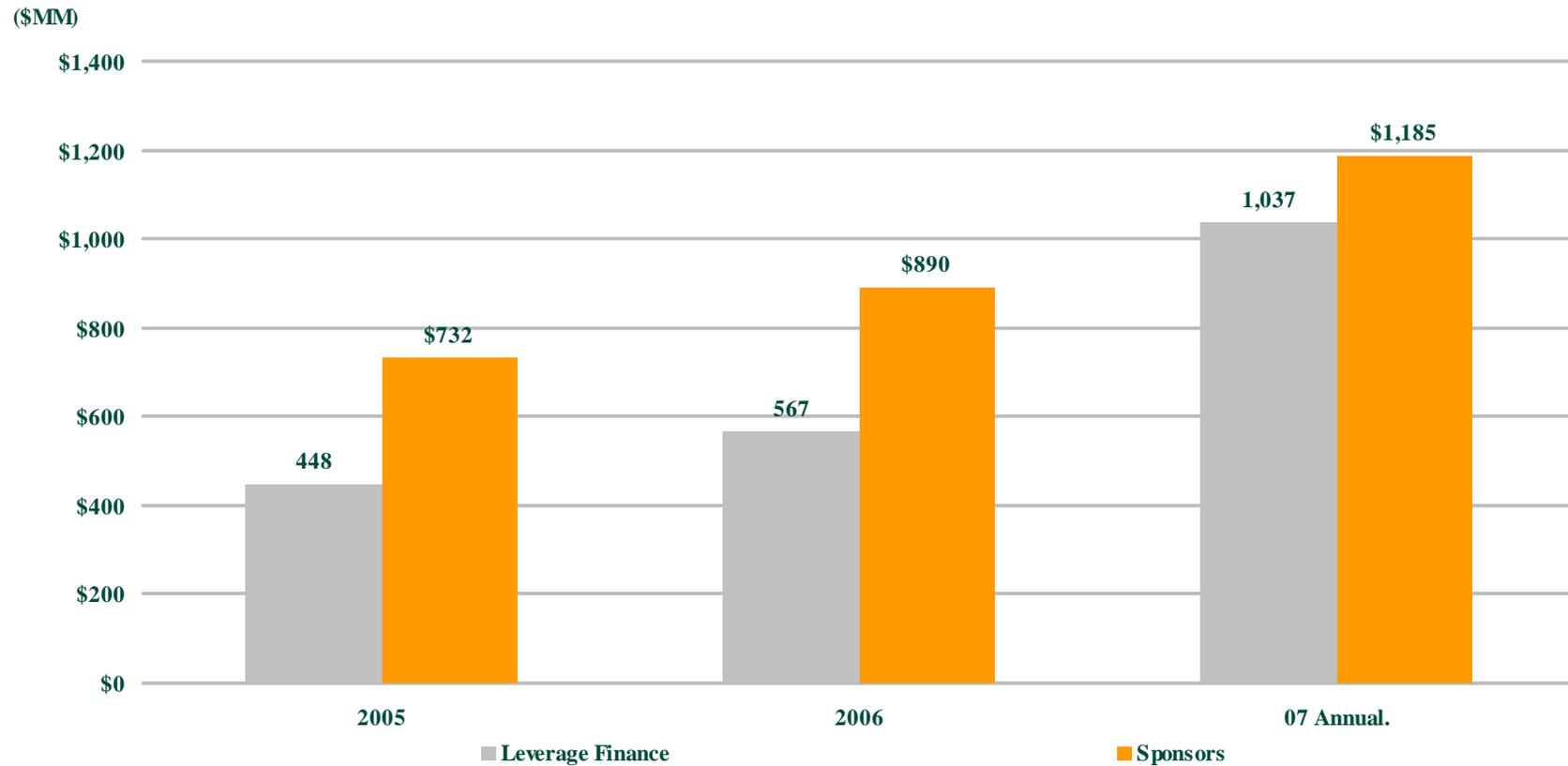
■ Sponsor ■ Corporate

Lehman



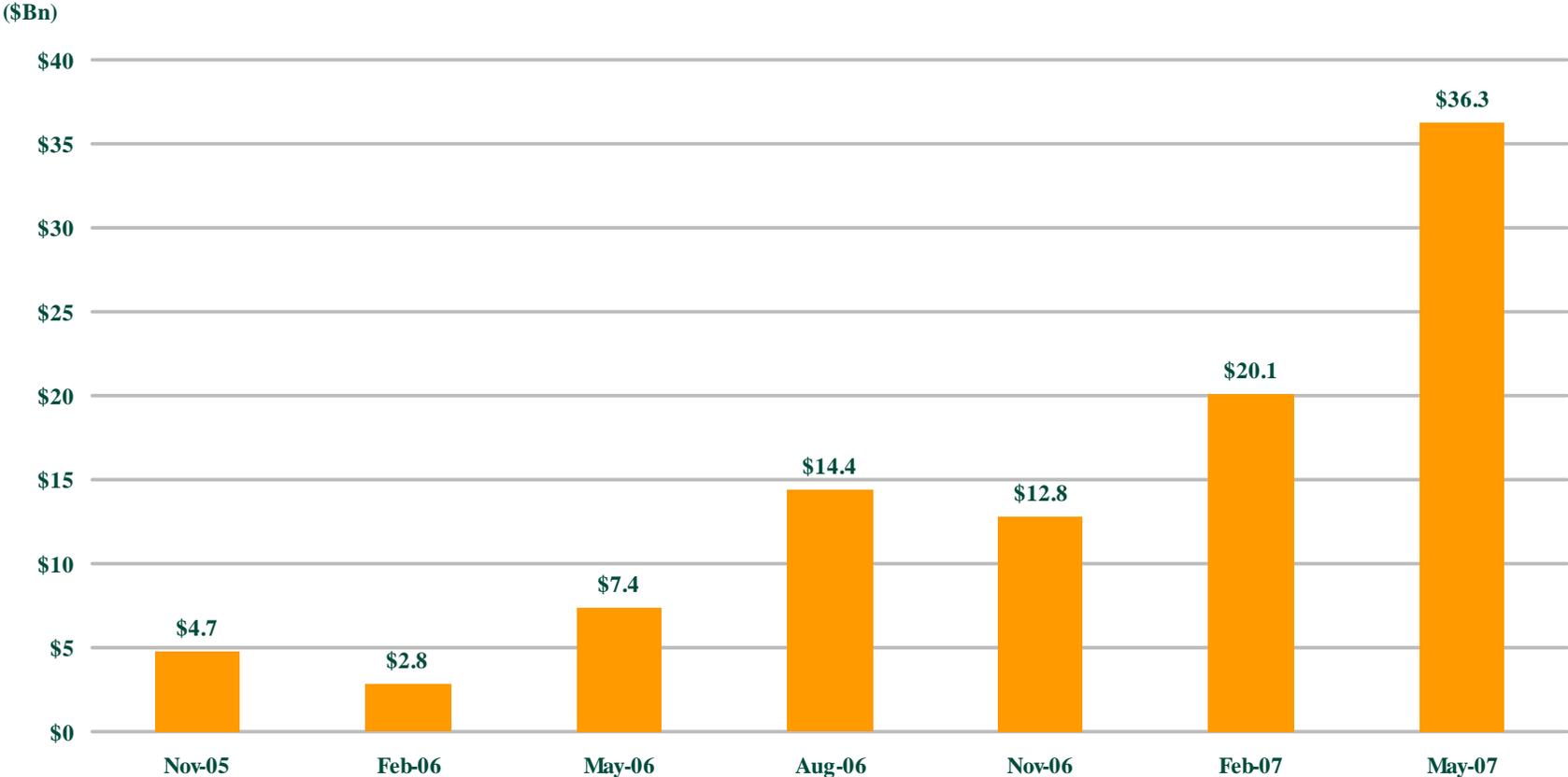
■ Sponsor ■ Corporate

Our Leverage Finance and Financial Sponsor revenues have been growing rapidly



As a consequence, our commitment risk has also grown rapidly

High Yield Contingent Commitments



Stressing the Portfolio

- ◆ We used our mandated commitments as of 5/31/07 plus Home Depot Supply (Staple)
- ◆ We have estimated the losses under three distinct scenarios.
- ◆ Our average cushion on our loan commitments before fees is 70 bps.
- ◆ Our average cushion on our bond commitments before fees is 60 bps.
- ◆ Our fee pool is \$ 579mm.
- ◆ Our losses are calculated net of the fees being earned.
- ◆ These are not expected cases.
- ◆ This does not account for an idiosyncratic loss, just severe market move.
- ◆ These are mark to market estimates not expected realized losses.

Multiple Contraction

Multiples that can be financed by debt contract from 8-9 times to 7-7.5 x EBITDA

US Bridges \$838mm

Assumptions

US Bridges

Senior Debt	Put Bond Cap	+	175BPS
Sub Debt (Stub)	Put Bond Cap	+	275PBS
Sr. Equity 18%	(70-75 cents)		

Fall 2000

US Loans	(\$80) (Positive P&L)
US Bridges	\$441
Europe	\$22
Equity	<u>\$210</u>
Mandated Commitments Loss	\$593
HY Loan Holds	\$78
Total Loss	<u><u>\$671</u></u>

Market perceives heightened risk of recession/slow down due to threat of rising interest rates, commodity pricing pressures or growth slow down to point where investors fears EBITDA decline.

Assumptions

US Loans

RC	Current Clearing Spread for TLB + 100bps + 50 to 100 (depending on ABL, rating and other qualitative factors)
TLB	Current Clearing Spread for TLB + 50 (Average, including RC, 65bps)
2d Lien	Current Clearing Spread for 2d liens + 75 to 150 (depending on rating and other qualitative factors)

US Bridges

Senior Debt	Put Bond Cap +150bps (on average)
Sub Debt	Put Bond Cap +275bps (on average)

Europe Loans

Drawn 1L Debt	Current clearing spread +50bps
Undrawn 1L Debt	Current clearing spread +100bps
Second Lien Debt	Current clearing spread +100bps
Mezzanine Debt	11% (except for Lloyds, which is at 12%)

Equity

20% drop

HY Loan Holds

RC	Widening 50-100bps
TL	Widening 50bps

1998

US Loans	\$292
US Bridges	\$918
Europe	\$124
Equity	\$347
Mandated Commitments Loss	\$1,680
HY Loan Holds	\$124
Total Loss	\$1,804

1998 type market due to some sort of external shock or extreme fears causing leverage and liquidity unwind.

Assumptions

US Loans

RC	Current Clearing Spread for TLB + 100 (+) 50 to 250 (depending on rating and other qualitative factors)
TLB	Current Clearing Spread for TLB + 75 to 200 (Average, including RC, 130bps)
2d Lien	Current Clearing Spread for 2d liens + 150-300

US Bridges

Senior Debt	Put Bond Cap +200bps (on average)
Sub Debt	Put Bond Cap +400bps (on average)

Europe Loans

Drawn 1L Debt	Current clearing spread +100bps
Undrawn 1L Debt	Current clearing spread +150bps
Second Lien Debt	6.50%
Mezzanine Debt	12% (except for Lloyds, which is at 13%)

Equity

33% drop

HY Loan Holds

RC	Widening 50-250bps
TL	Widening 75bps-200bps

2002

US Loans	\$551
US Bridges	\$1,650
Europe	\$269
Equity	\$525
Mandated Commitments Loss	\$2,995
HY Loan Holds	\$245
Total Loss	\$3,240

Full blown 2002 recession with EBITDA and multiple contraction. Significant pick-up in defaults.

Assumptions

US Loans

RC	Current Clearing Spread for TLB + 100bps + 150 to 275 (depending on rating and other quantitative factors)
TLB	Current Clearing Spread for TLB + 125-250 (Average, including RC, 170bps)
2d Lien	Current Clearing Spread for 2d liens + 275-450

US Bridges

Senior Debt	Bond price = 82% (on average)
Sub Debt	Bond price = 60% (on average)

Europe Loans

Drawn 1L Debt	Current clearing spread +200bps
Undrawn 1L Debt	Current clearing spread +250bps
Second Lien Debt	8.00%
Mezzanine Debt	13% (except for Lloyds, which is at 14.5%)

Equity

50% drop

HY Loan Holds

RC	Widening 150-275bps
TL	Widening 125-250bps

Risk Management Historical Analysis – 1998 and 2002

US Loans	356
US Bridges	578
Europe (Comm+Hold)	61
Europe Mezz/2nd lien	102
Equity/PIK	514
Total Loss	1,611

1998 type market due to some sort of external shock or extreme fears causing leverage and liquidity unwind.

Assumptions

Historical 1998 scenario – Spreads widen out to 1998 spread levels – On average, loans + 160 bp, bonds/Mezz/2nd lien + 380bp, sub +550bp, equity down 30%

US Loans	571
US Bridges	1,798
Europe (Comm+Hold)	94
Europe Mezz/2nd lien	253
Equity/PIK	770
Total Loss	3,487

Full blown 2002 recession with EBITDA and multiple contraction. Significant pick-up in defaults.

Assumptions

Historical 2002 scenario – Spreads widen out to 2002 spread levels – On average, loans + 200 bp, bonds/Mezz/2nd lien + 720 bp, sub +800 bp, equity down 45% on average

Possible Solutions

I. Institute hard limits for single transactions and total portfolio exposure.

- ◆ Our single transaction limit of _____ should be stratified by ratings. Currently it is not rating dependent.
- ◆ We should institute appropriate portfolio limits.
 - Loss limits should be \$750m for the portfolio.
- ◆ Notional Portfolio Limit \$20B
- ◆ Single New Notional Limit \$2B

II. Hedging

- ◆ Use 5 different hedging strategies
 - ◆ Solve for the cost of each strategy to payoff \$100m in severe market downturn
- 1) **Short LCDX**
 - Downside scenario: LCDX widens 125BPS from current levels. Equivalent to new issue spreads widening 150-200BPS (1998)
 - 125BPS widening equals a 5.25 point price drop, purchase \$1,900mm = \$100mm of protection
 - Cost of carry \$23mm per year
 - Rally Risk: \$30mm
 - Annual Cost Range: \$23mm – \$53mm
 - 2) **Short CDX**
 - Downside scenario: CDX widens 300BPS from current levels. Equivalent to new issue spread widening of 300-450 bps (1998)
 - 300bps widening equal to 10 point price drop, purchase \$1,000mm = \$100mm of protection
 - Cost of carry \$27.5mm per year
 - MTM Rally Risk: \$40mm
 - Annual Cost Range \$27.5mm – \$62.5mm annual

Possible Solutions (cont'd.)

3) Buy Options on Eurodollar Futures

- Downside scenario: Expect 50bps Fed Ease
- Purchase call spreads on March and June 2008
- Purchase \$12.5mm = \$100mm of potential profit
- Annual Cost Range: \$12.5mm - \$18.5mm

4) Buy Equity Index Options

- Downside scenario: a 10% decline in the S&P
- Buy at the money puts, roll twice per year cost \$75mm to provide \$100mm of protection or buy put spread, roll twice per year cost \$50mm
- Annual Cost Range: \$50-\$75mm

5) Buy Investment Bank CDS

- Downside scenario: Investment bank spreads widen by 30-60bps for ML, MS, GS, BS.
- Buy \$1.2bn of CDS = \$100mm of protection
- Cost of Carry \$19mm.
- Roll down + market risk = \$15-25mm
- Annual Cost Range: \$19-\$45mm

Total Hedging Profits = \$500mm
Total Expected Cost = \$200-\$250mm

IMPORTANT: This strategy is very costly. The market size will limit the ability to unwind these Hedges.

Recommendations

III. Tighten Underwriting Standards Through Establishment of Specific Guidelines

Specific Rules to be applied to all HY capital commitments

- ◆ Exceptions permitted but must be supported by written memorandum detailing the reasons for the exception
- ◆ The memorandum will be prepared by the deal team and must be approved by each member of the HYCC and the Firm Commitment Committee.

Proposed Guidelines

- ◆ Credit must be FCF positive by year 3 in the Downside Case
- ◆ Terms must provide flex to at least one covenant in the bank debt when the ratings group believes there is a 10% or greater chance of a B3 corporate rating
- ◆ Terms must provide for flex to at least one covenant in bank debt when the company has less than \$100mm EBITDA, irrespective of rating
- ◆ No toggling of first lien bank debt
- ◆ Base case model must indicate that the toggle feature on any debt tranche will not be exercised in year 1
- ◆ Terms must provide that toggle pricing is at least 50bps behind cash pricing and at least 75bps in the event that the toggle feature is exercised
- ◆ Terms must provide flex to limit any toggle of bonds or bank debt to no more than ½ of the tranche
- ◆ Bank cushion to current market clearing spreads (excluding fees) must be at least 25 bps for first lien credits expected to close within 4 mos. And 50 bps for first lien commitments with longer tenors. Second lien credits require 25bps additional cushion
- ◆ Bond cushion to current market clearing spreads (excluding fees) must be at least __bps for credits expected to close within 4 mos. And __ bps for credits with longer tenors. Subordinated bonds require __ bps additional cushion

Recommendations (cont'd)

IV. Exercise Greater Selectivity With Regard to Sponsors/Deals and Economics/Roles

Focus on Deals where Lehman has a leading M&A/Strategic Role

- ◆ Limited exceptions to proposed underwriting guidelines where Lehman is not receiving a meaningful M&A fee (at least \$10mm) and a lead role in the transaction
- ◆ Greater spread cushion/flex required for deals to sponsors other than [Carlyle, CDR, KKR, MDP, THL, SilverLake, TPG, Blackstone, Permira, CinVin]
- ◆ De-emphasize tag along financing roles in auctions
 - No FRL loans to credits where Committee was unwilling to underwrite to the proposed FRL terms

V. Make a Strategic Decision to limit Bridge Equity

Suggest limits

- ◆ Single Name: \$100mm
- ◆ Portfolio: \$1000mm

This will limit our loss to \$100mm – \$500mm in most scenarios.

Recommendations (cont'd)

VI. Sell Down Risk Through Non Traditional Methods

- ◆ Continue Silent Participation Sales with Summitomo and Commerzbank
- ◆ Seek to develop additional Silent Partners
- ◆ Develop Underwriting Program with Summitomo, RBC, and/or Others
 - ◆ Seeking to have another bank commit to 25% of our exposure shortly after the Lehman commitment.
 - The program will require significant fee pass-through
 - Objective is to establish a regular program of commitments to develop confidence that Lehman can regularly reduce its HY commitment exposure
 - This will have a natural negative selection bias on credit quality