

*Confidential*

# 2007 Risk Appetite Limit

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# Executive Summary

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- The purpose of this document is to review the proposal for the 2007 Risk Appetite limit
- Our proposal is based on the following assumptions:
  - The minimum performance hurdle is set at a 10.0% ROE. This translates into a compensation to revenue ratio of 58.7%, a pretax margin of 19.8%, and an ROTE of 12.4%.
  - The compensation expense is based on the 2002 downturn scenario: 10% headcount reduction (corresponding to approximately 2,600 people) and a 35% decline in NGNNH compensation (may be mitigated by a change in the equity grid, which has not been factored in)
  - NPE reduction of 20%
  - Non-risk losses associated with client driven revenues of \$3.35 billion, or a decrease of 17% relative to 2007 budgeted revenues of \$19.65 billion, resulting in revenues before risk losses of \$16.3 billion

	<i>% Change in Revenues</i>	
	<b>2006A</b>	<b>2007B</b>
Banking (Advisory, U/W)	(10)%	(19)%
Client Revenues	(8)%	(20)%
IMD Fees	(5)%	(15)%
Mortgage Origination	(5)%	(30)%

- The result of the above assumptions is a 2007 Risk Appetite limit of \$3.3 billion – up \$1.0 billion from the 2006 limit

# Risk Appetite Results

- We recommend setting a Risk Appetite limit of \$3.3 billion based on the following assumptions

## Downturn Scenario – Financial Performance

*\$ millions except per share data*

	<u>2007</u>
<b>Total Revenues</b>	<b>13,028</b>
Personnel Expense	7,650
Non Personnel Expense	2,792
<b>Pretax Income</b>	<b>2,585</b>
Income Tax	776
<b>Net Income</b>	<b>1,810</b>
Average Quarterly Revenue in Downturn Scenario	3,257

### Performance Indicators

Earnings per Share	\$3.03
PE / Revenue	58.7%
NPE / Revenue	21.4%
Pretax Margin	19.8%
Effective Tax Rate	30.0%
<b>Return on Equity</b>	<b>10.0%</b>
Return on Tangible Equity	12.4%

## Risk Appetite Results

	<u>2007</u>
<b>2007 Budgeted Revenues</b>	<b>19,650</b>
Client, Origination, Banking Revenue Loss	(3,349)
<b>Total Revenues Before Risk Losses<sup>1,2</sup></b>	<b>16,301</b>
Minimum Revenue Level Required	13,028
<b>Proposed Risk Appetite Limit</b>	<b>3,273</b>
Average Qtr Revenue Before Risk Losses	4,075

### Three Year Quarterly Revenue Trend

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Q1	4,461	3,810	3,144
Q2	4,411	3,278	2,926
Q3	4,178	3,852	2,623
Q4	4,533	3,690	2,883

1. Revenues before risk losses reflects 2006 actual revenues stressed for estimated revenue losses in a downturn – lower origination, banking, and client flows

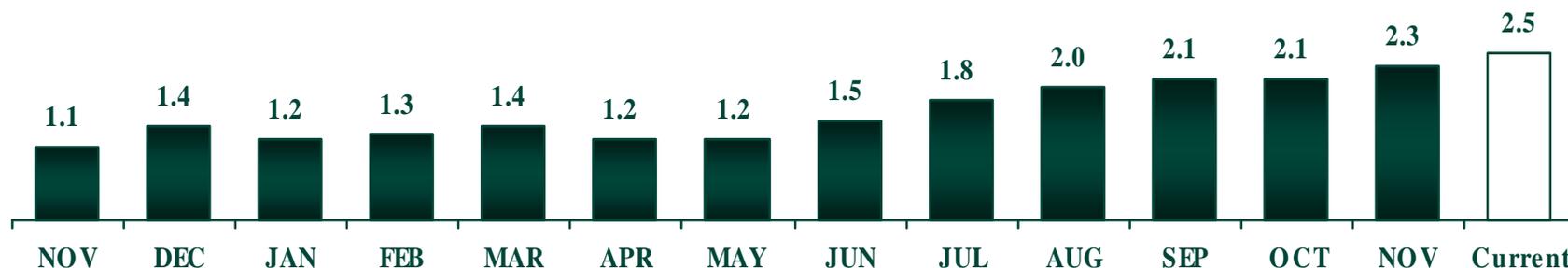
2. The \$16.3 billion represents an 17% decline versus 2007 Plan of \$19.7 billion and a 7% decline from the 2006 forecast of \$17.6 billion.

# Risk Appetite Trend

- Risk appetite usage has been trending up in 2006, finishing the year at \$2.3 billion

## Risk Appetite Usage

\$ millions	Average Usage <sup>1</sup>					12/29	Limit		'07 vs '06
	1Q06	2Q06	3Q06	4Q06	YE '06		2006	2007	
Fixed Income	953	922	1,203	1,489	1,611	1,649	1,625	2,200	35%
Equities	398	436	357	392	382	647	550	800	45%
Capital Markets Prime Services <sup>2</sup>	-	-	75	85	71	106	100	150	50%
Investment Management	235	267	303	384	451	454	325	450	38%
Global Trading Strategies	189	249	296	349	392	352	450	450	0%
Global Principal Strategies <sup>3</sup>	-	-	149	171	196	212	300	450	50%
Principal Investing / IBD	-	-	-	-	87	65	-	100	
Strategic Investing						20		150	
Diversification	(477)	(584)	(755)	(818)	(913)	(885)	(1,050)	(1,450)	38%
<b>Total</b>	<b>1,298</b>	<b>1,290</b>	<b>1,628</b>	<b>2,052</b>	<b>2,277</b>	<b>2,535</b>	<b>2,300</b>	<b>3,300</b>	<b>43%</b>



1. Average of daily Risk Appetite usage.

2. CM Prime Services and Global Principal Strategies were added to the Risk Appetite model in June. Prior to June, CMPS reported as part of FID and Equities, GPS reported in FID.

# Minimum “Performance Standard” Scenario

- Minimum performance standard is set at a 10% ROE
- 26% reduction in revenues (downturn vs. 2006 actual) compared with 9% in 2002 vs. 2001 and 13% in 2001 vs. 2000
- Headcount reduction was assumed to be 10%, with a 35% decline in NGNNH compensation
  - May be mitigated by a change in the equity grid
- 2007 new initiative spending will be cut in half in a downturn
- Assumes a \$2 billion share buyback
- This results in a minimum revenue level of \$13.0 billion and a compensation and benefits ratio of 58.7%

	\$ millions	2007	2007	%	2006 Actual	%
		Forecast	Downturn Scenario	Change		Change
Revenues		19,650	<b>13,028</b>	-34%	17,583	-26%
Fixed PE		5,421	<b>5,103</b>	-6%	3,879	32%
Variable PE		4,266	<b>2,547</b>	-40%	4,790	-47%
Total Personnel Expense		9,687	<b>7,650</b>	-21%	8,669	-12%
Fixed NPE		2,750	<b>2,295</b>	-17%	2,380	-4%
Variable NPE		750	<b>497</b>	-34%	629	-21%
Total NPE		3,500	<b>2,792</b>	-20%	3,009	-7%
Pretax Income		6,463	<b>2,585</b>	-60%	5,905	-56%
Tax		2,152	<b>776</b>	-64%	1,944	-60%
Cumulative effect of accounting change		-	-		47	
Net Income		4,311	<b>1,810</b>	-58%	4,007	-55%
Preferred Dividends		66	<b>66</b>	0%	66	0%
Net Income to Common		4,245	<b>1,744</b>	-59%	3,941	-56%
Average common equity		19,695	<b>17,413</b>	-12%	16,876	3%
Average common tangible equity		16,363	<b>14,113</b>	-14%	13,564	4%
Additional share buyback			<b>2,000</b>			
Compensation / Revenue		49.3%	<b>58.7%</b>	9.4 pct.	49.3%	9.4 pct.
NPE / Revenue		17.8%	<b>21.4%</b>	3.6 pct.	17.1%	4.3 pct.
Pretax Margin		32.9%	<b>19.8%</b>	-13.0 pct.	33.6%	-13.7 pct.
Effective Tax Rate		33.3%	<b>30.0%</b>	-3.3 pct.	32.9%	-2.9 pct.
Net Margin		21.9%	<b>13.9%</b>	-8.0 pct.	22.8%	-8.9 pct.
ROE		21.6%	<b>10.0%</b>	-11.5 pct.	23.4%	-13.3 pct.
ROTE		25.9%	<b>12.4%</b>	-13.6 pct.	29.1%	-16.7 pct.

# Stress Scenario: Reduction In Banking, Origination & Client Revenues

- We calculated the non-risk losses by using 2006 actual performance and haircuts adjusted for the growth in capacity and for business cycle outlook. For principal investments we used the 2007 budget, which is 16% below the 2006 actual
- In a stress scenario, the Firm would lose about \$3.35 billion in banking, origination and client revenues compared to the 2007 Budget of \$19.65 billion

## Revenue Stress Scenario

\$ millions	2007 Budget	2006 Forecast	Versus 2006 Revenues		Adjusted revenue losses after non-risk losses	% Change vs. 2007	Notes
			Standard stress haircuts	Adjusted stress haircuts			
Advisory	1,250	940	-20%	-10%	846	-32%	Adjusted to reflect additional capacity and business cycle
Underwriting	2,450	2,398	-10%	-10%	2,158	-12%	
Client revenues	10,035	8,449	-10%	-5%	8,027	-20%	Adjusted to reflect additional capacity
IMD Fees	1,589	1,424	-10%	-5%	1,353	-15%	Adjusted to reflect additional capacity
Mortgage originations	1,375	1,017	-30%	-5%	966	-30%	Adjusted to reflect business cycle
Principal	2,676	3,171		-16%	2,676	0%	Capped at lower 2007 budgeted levels
Other	275	184		0%	275	0%	Based on 2007 budget (achievable in a downturn)
<b>Total</b>	<b>19,650</b>	<b>17,583</b>			<b>16,301</b>	<b>-17%</b>	

\$ millions	2007 Budget	2006 Actual	Adjusted revenue losses after non-risk losses	% Change vs. 2006	% Change vs. 2007
Equities	4,500	4,032	3,698	-8%	-18%
Fixed Income	9,800	9,029	8,189	-9%	-16%
IMD	1,800	1,653	1,564	-5%	-13%
GPS & GTS	800	577	577	0%	-28%
Other	275	184	275	49%	0%
Banking Offset	(1,225)	(1,230)	(1,007)	-18%	-18%
<b>Total</b>	<b>19,650</b>	<b>17,583</b>	<b>16,301</b>	<b>-7%</b>	<b>-17%</b>