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***Confidential* Presentation to:**

SP&A

Equity Adequacy and Equity Allocation

September 12, 2007

LEHMAN BROTHERS

Overview (I)

- 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
  - Optimal level of equity in the Firm as a whole (capital adequacy)
  - Optimal use of equity by businesses (capital allocation)

- Historically, the Firm used Net Leverage as a primary yardstick for equity adequacy and allocation. This approach is no longer adequate
  - Increasingly diverse risk characteristics of the Firm's assets
  - Industry trend of moving from leverage to risk-based Basel II-compliant measures (e.g., CSE). There are indications that some of our peers, e.g., MS, GS, already have more sophisticated capital allocation methodologies. Rating agencies are known to be working on CSE-compliant capital adequacy models

- At present, the Firm has in place several risk-based models to evaluate capital adequacy. While useful, none of them appear to fully meet the needs of effective capital management, e.g., transparency, practicality, and timeliness. As a result, evaluation of the potential business and financial strategies on prospective basis, as well as tracking performance of the businesses and the Firm in general over time is difficult.

- The primary objective of this project is to develop and implement a transparent analytical model that can be used as an effective management tool to
  - Track the usage of the Firm's equity capital on aggregate basis over time and estimate its sufficiency
  - Compare the level of the Firm's capital adequacy with its peers
  - Estimate the capital usage by BPM
  - Evaluate impact of management decisions on capital usage by BPM and by the Firm in the aggregate, thus providing a basis for estimating risk-adjusted ROE

Overview (II)

- We have developed an internal Equity Adequacy Framework
  - Builds on both risk and liquidity concepts
  - 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

- We believe that the Equity Adequacy Framework is both fundamentally robust and practical
  - Appropriately conservative
  - Testing of the model indicated its close alignment with the CSE model
  - Relatively transparent and easy to implement on both Firm-wide and business levels
  - Can be used to compare the Firm's capital adequacy with its peers

- Application of EFA to Lehman indicates that over the recent quarters, surplus has decreased, driven primarily by capital requirements associated with the growth of Less-Liquid assets
  - Our peers follow the same trend

- We are in process of rolling out the model
  - Well-received by rating agencies and the Finance Committee of the Board
  - Being integrated into 2008 Budget process

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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 is the Firm's ultimate line of defense against extreme and prolonged crisis, preserving its ability to reorganize and restructure without resorting to bankruptcy.

Multi-tiered Defense Structure

Severity and duration of adverse event	Line of defense / Components	Function / Protected stakeholders
• Rare, but not unrealistic (95% confidence) • One-year time horizon	**Risk Appetite Framework** • Earning power • Diversification • Flexible cost structure	• Ensures minimal acceptable level of earnings • Maintains the Firm's ability to recover while continuing to meet its obligations, including paying common dividends • Protects franchise
• Severe, highly unlikely (99.5% confidence) • One-year time horizon	**Risk Equity Framework** • Common Equity	• Ensures the Firm's ability to meet all financial obligations in distressed environment without restructuring • "Protects" equityholders
• Liquidity stress • 3-12 months time horizon	**Funding Framework** • Liquidity pool • Reliable funding	• 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
• Extreme, highly unlikely (99.97% confidence) • Time horizon > 1 year	**Equity Adequacy Framework** • Common equity • Hybrid equity	• 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

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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 or financing 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

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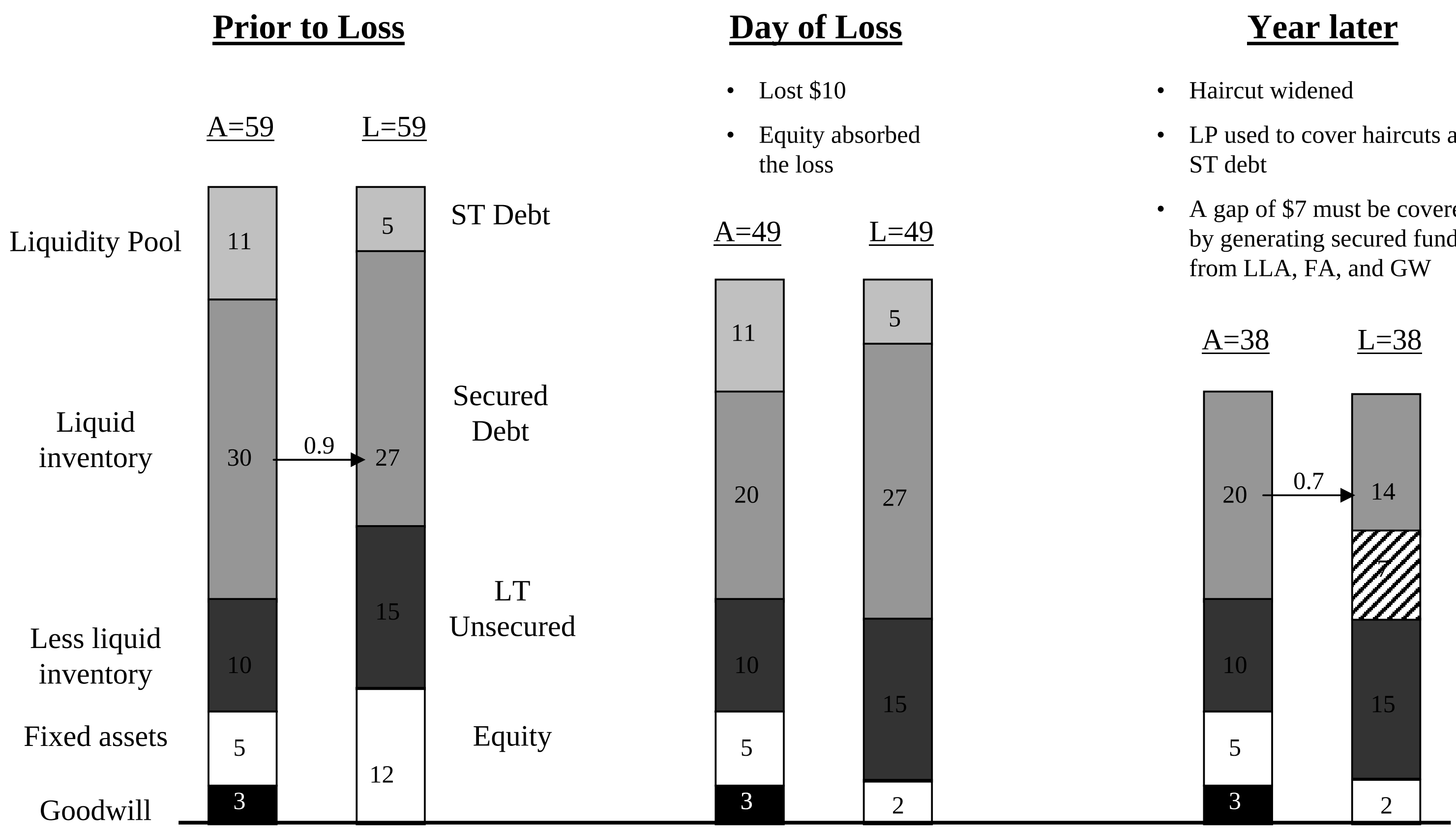
The Concept

To protect our senior unsecured creditors -- thus enabling restructuring outside of bankruptcy -- the Firm's Available Equity capital should be sufficient to absorb the losses caused by the crisis and to support refinancing or liquidation without support of unsecured creditors.

Illustrative example



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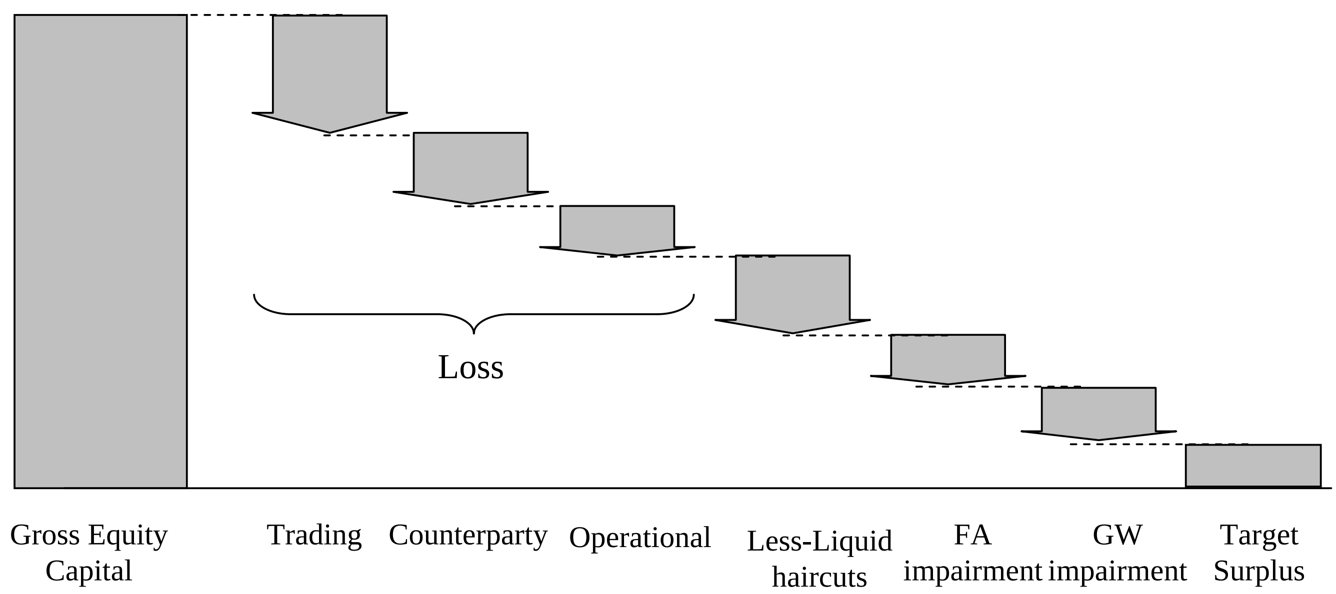
Analytical Model

To In order to support funding of the gap, the Firm's equity (prior to crisis) should be sufficient to cover the loss, the Goodwill and Fixed Assets funding impairment, and funding haircuts on illiquid inventory. For added conservatism, we assume that components of the loss are additive and include reserve requirement

Equity Compression in Crisis



<u>Available Equity</u> **<u>Required Equity</u>**

$$\left\{ \text{Common Equity} + \text{Hybrid Equity} \right\} - \left\{ \text{Trading} + \text{Counterparty} + \text{Operational} + \text{Less-Liquid} + \text{Impairment} + \text{Target Surplus} \right\} \geq \mathbf{0}$$

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Parameters of Model

Component	Includes	Approach
Trading	• Market Risk • Credit Risk	• VaR-driven • Reflects maximum loss over 1 year holding period with 99.97% confidence level
Counterparty	• Financing and derivative exposure	• Maximum Potential Exposure (Probability of default and expected recovery in default)
Operational	• Operational loss • Litigation loss	• Percent of revenues (5%)
Less Liquid	• Haircut on Funding of Illiquid assets	Triangulated based on • Estimated discount in fire sale • Haircut for non-recourse financing • Equity requirement in CDO structure
Impairment	• Haircut on Funding of Fixed assets • Devaluation or loss of intangible assets	Estimated by marking to market, then taking same haircuts as on illiquid assets Estimated by marking "Separable" assets to market, then taking same haircuts as on Corporate Investments
Target Surplus	• Protection against unexpected • Reserve for tactical opportunities	• $1.5 billion

Equity Requirements for Illiquid Assets

Estimating equity requirements (funding haircuts) for illiquid assets is difficult, particularly since the nature of the crisis is unknown. We use available market data on bank financing and observations of fire sales.

- The liquidation or financing value of assets (and, therefore, the equity charge) depends on several factors
  - Asset type and quality
  - Asset size relative to market liquidity
  - The nature of the crisis
- A representative sample of the baseline requirements is shown below

Capital charges (baseline sample)

Asset class	Charge	Asset class	Charge
Non-IG Contingent Commitments[1]	27%	Uncollateralized Spec-grade Derivatives	40%
HY Lending Commitments[2]	27%	Private Equity	
HY Loans/HY Bonds	27%	Venture Capital	40%
Real Estate PTG		Merchant Banking	40%
Senior Debt (assumed IG)	5%	Fund of Funds	25%
Mezzanine (assumed NIG)	27%	Asset Management Seed	25%
Equity	40%	Minority Stake	40%
Distressed Loans (assumed NIG)	27%	Corporate Investments	40%
Non-IG Retained Interest	40%		

1 In a stress environment 36% of Commitments expected to be funded

2 In a stress environment 30% of Commitments expected to be funded

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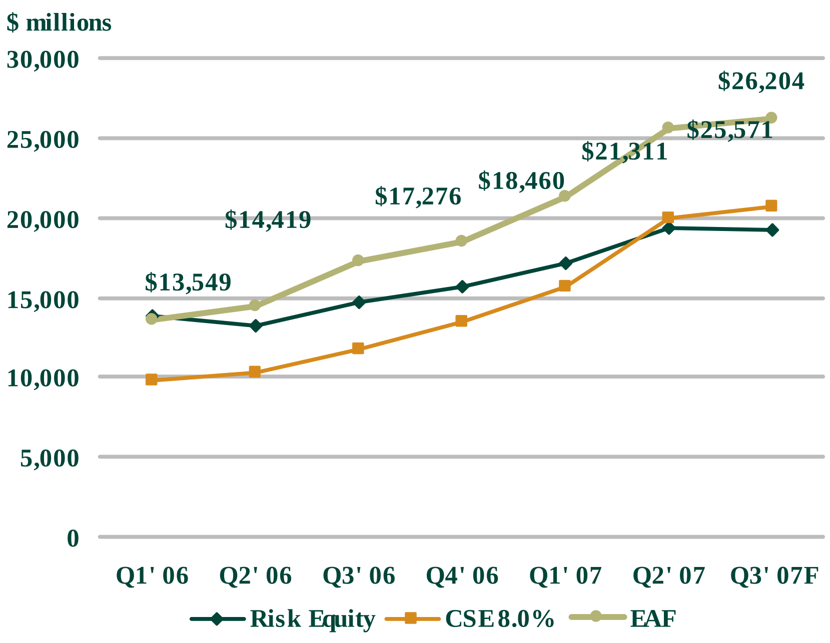
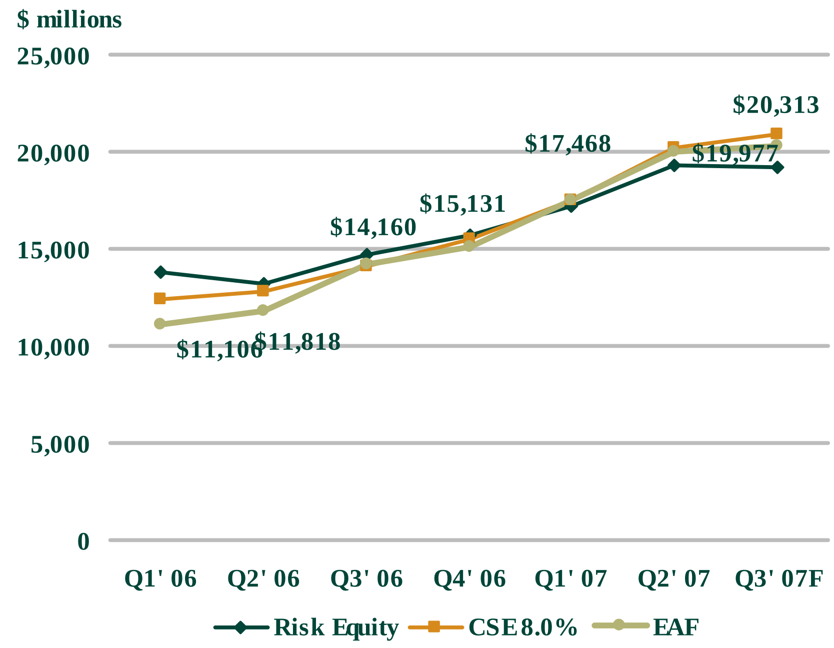
Comparing the Models

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. Adjusting for the difference, the two models indicate very similar requirements. As expected, Risk Equity model is less conservative, as it accounts for diversification across different risk factors, while both EAF and CSE models are additive.

Equity Capital Requirements by Model



Adjusted Common Equity Requirements by Model



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Equity Adequacy Trend

The Model indicates declining equity capitalization of the Firm. Over the recent quarters, surplus has decreased, driven primarily by capital requirements associated with the growth of Less-Liquid assets.

Equity Surplus / (Deficit)

Performance data	Q1' 06	Q2' 06	Q3' 06	Q4' 06	Q1' 07[1]	Q2' 07	Q3' 07 - F	Q4' 07 - F
VaR 95% 1 day	42	33	48	53	73	87	92	96
Counterparty Risk Appetite	240	172	306	246	275	287	310	317
Less Liquid Assets	23,654	30,280	43,001	44,561	56,887	76,556	71,660	74,849
Revenue	15,281	16,414	16,740	17,583	18,168	19,270	20,790	20,000
PP&E	2,966	3,079	3,150	3,269	3,398	3,519	3,584	3,774
GW&I	3,282	3,297	3,364	3,362	3,531	3,652	4,061	4,049
DTA	2,620	2,640	2,660	2,670	2,722	2,774	2,826	2,878

Variables in $mm

Equity Required	Q1' 06	Q2' 06	Q3' 06	Q4' 06	Q1' 07[1]	Q2' 07	Q3' 07 - F	Q4' 07 - F
Trading	1,371	1,096	1,593	1,740	2,401	2,861	3,035	3,168
Counterparty	504	361	643	516	578	602	639	667
Less Liquid Funding Haircuts				13,824	15,925	19,644	19,991	20,732
Less Liquid assets	*4,542*	*5,625*	*7,535*	*8,529*	*10,305*	*13,749*	*13,632*	*14,238*
Fixed assets	*2,390*	*2,507*	*2,577*	*2,697*	*2,811*	*2,923*	*2,937*	*3,042*
Goodwill	*382*	*397*	*464*	*462*	*631*	*752*	*1,161*	*1,149*
DTA	*2,096*	*2,112*	*2,128*	*2,136*	*2,178*	*2,219*	*2,261*	*2,303*
Total	9,410	10,641	12,703	13,824	15,925	19,644	19,991	20,732
Operational	764	821	837	879	908	964	1,040	1,000
Total Gross Equity Required Before Target Surp	**12,049**	**12,919**	**15,776**	**16,960**	**19,811**	**24,071**	**24,704**	**25,566**
Target Surplus	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500
Total Gross Equity Required	**13,549**	**14,419**	**17,276**	**18,460**	**21,311**	**25,571**	**26,204**	**27,066**
Gross Equity Available								
Common Equity	16,398	16,887	17,301	18,096	18,910	20,034	20,617	21,696
Hybrids/Preferred	3,718	3,812	3,788	3,833	5,608	5,967	6,014	6,014
Total Gross Equity	**20,116**	**20,699**	**21,089**	**21,929**	**24,518**	**26,001**	**26,631**	**27,710**
Surplus/(Deficit) Before Target Surplus	**8,067**	**7,780**	**5,313**	**4,969**	**4,707**	**1,930**	**1,927**	**2,143**
Target Surplus	(1,500)	(1,500)	(1,500)	(1,500)	(1,500)	(1,500)	(1,500)	(1,500)
Surplus in Excess of Target Surplus	**6,567**	**6,280**	**3,813**	**3,469**	**3,207**	**430**	**427**	**643**

1. *$1.5 Billion MCAPS have been added to Q1 gross Equity and $350mm ECAPS to Q2*

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Peer Benchmarking

Between 2005 and 2006, peers used up their capital surplus, and, in case of GS, went into deficit. The primary driver is substantial growth of Illiquid Assets and VaR.

Q2 2007	LEH	GS
VaR - 95% 1 day	87	135
Counterparty Risk Appetite	287	445
Less Liquid and Other Assets		
Illiquid Assets - LEH Definition	76,555	142,901
Plant, Property & Equipment	3,519	7,193
Goodwill & Intangibles	3,652	5,498
Deferred Tax Assets	2,774	3,988
Revenue	20,790	40,728

Q2 2007	LEH[1]	GS
Trading	2,861	4,439
Counterparty	602	935
Less Liquid Funding Haircut		
Illiquid Assets	13,749	29,174
Fixed Assets	2,923	5,797
IA/GW	752	1,539
DTA	2,219	2,193
Operation/Target Reserve	2,464	3,536
Total Capital Requirement	**25,571**	**47,615**
Gross Equity	26,001	43,459
Surplus / (deficit)	**430**	**(4,156)**

2006	LEH	GS
VaR - 95% 1 day	53	119
Counterparty Risk Appetite	246	553
Less Liquid and Other Assets		
Illiquid Assets - LEH Definition	44,561	114,008
Plant, Property & Equipment	3,269	6,990
Goodwill & Intangibles	3,362	5,686
Deferred Tax Assets	2,670	3,427
Revenue	17,583	37,665

2006	LEH	GS
Trading	1,740	3,913
Counterparty	516	1,162
Less Liquid Funding Haircut		
Illiquid Assets	8,529	23,193
Fixed Assets	2,697	5,634
IA/GW	462	1,592
DTA	2,136	2,742
Operation/Target Reserve	2,379	3,383
Total Capital Requirement	**18,460**	**41,619**
Gross Equity	21,929	38,536
Surplus / (deficit)	**3,469**	**(3,083)**

2005	LEH	GS
VaR - 95% 1 day	38	83
Counterparty Risk Appetite	240	519
Less Liquid and Other Assets		
Illiquid Assets - LEH Definition	22,203	53,627
Plant, Property & Equipment	2,885	5,097
Goodwill & Intangibles	3,256	5,203
Deferred Tax Assets	2,617	1,304
Revenue	14,630	25,238

2005	LEH	GS
Trading	1,263	2,729
Counterparty	504	1,089
Less Liquid Funding Haircut		
Illiquid Assets	4,138	12,841
Fixed Assets	2,325	4,108
IA/GW	356	1,457
DTA	2,094	1,043
Operation/Target Reserve	2,232	2,762
Total Capital Requirement	**12,911**	**26,030**
Gross Equity	18,820	30,752
Surplus / (deficit)	**5,909**	**4,722**

1. Includes 350mm in ECAP issuance accelerated to Q2 2007

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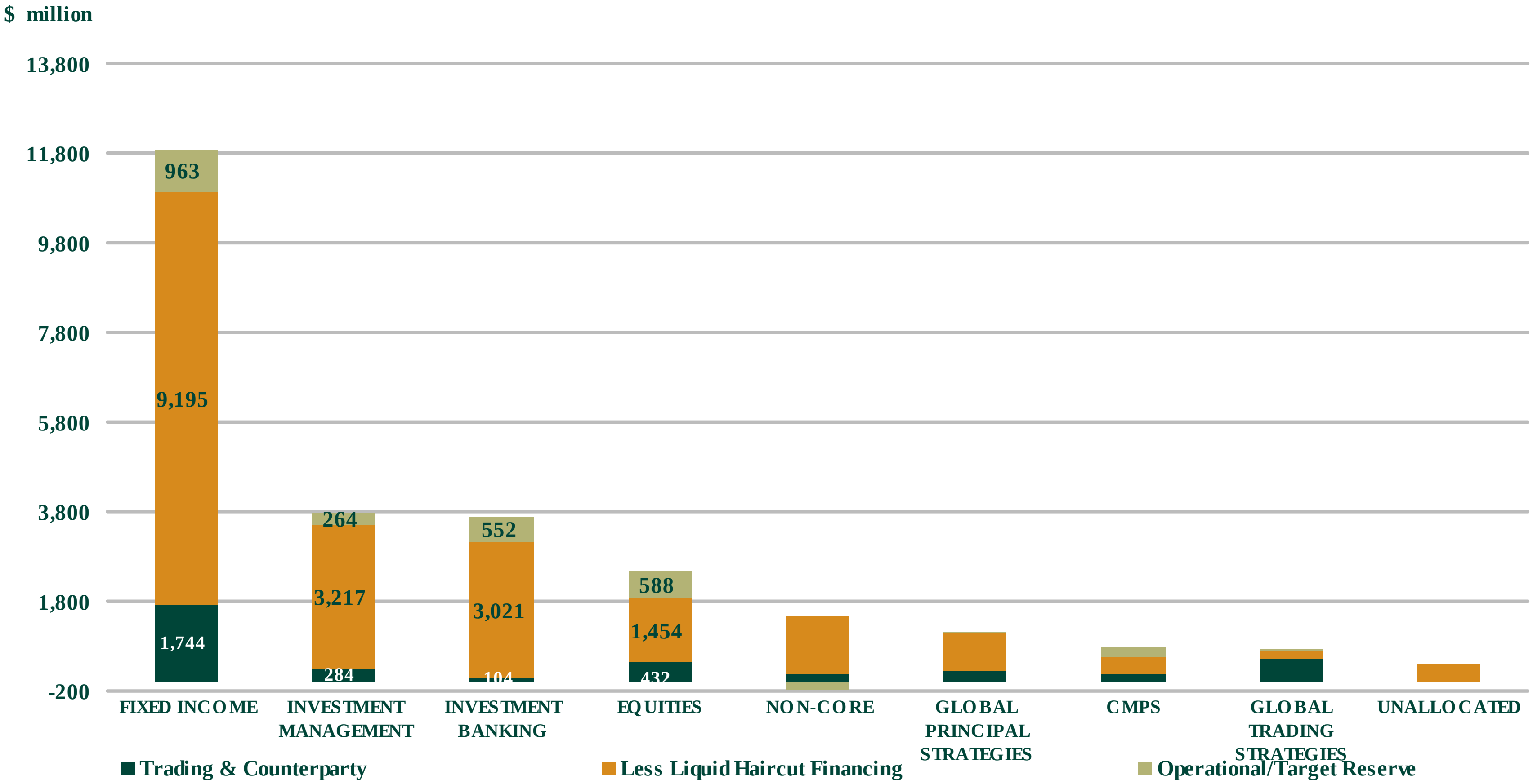
Capital Allocation By Division

FID is by far the largest user of equity capital, accounting for almost 50% of total equity requirements

Risk Requirements Allocation, Q3 2007



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Capital Allocation By BPM

Q3 2007 Capital Allocation by BPM

3Q '07	Devaluation of Liquid Assets		Counterpary Risk		Devaluation of Illiquid Assets		Devaluation of Fixed Assets		Loss of Going Concern Assets			Target Reserve		
	VaR	Capital Requirement	Risk Appetite Usage	Capital Requirements	Less Liquid Assets	Capital Requirements	PP and E	Capital Requirement	DTA	Goodwill	Capital Requirement	Total Revenues	Capital Requirement	Total Capital Requirement
FIXED INCOME														
IR Products	4.8	158	55	116	49	13	243	196	95		76	1,384.8	169	728
Liquid Market Proprietary	2.2	73	0	0	-	-	49	39	12		9	277.2	34	155
High Grade	7.4	245	15	31	2,489	458	142	114	68		54	809.1	99	1,002
Emerging Markets		-		-	-	-	-	-	-		-	-	-	-
Securitized Products	5.7	187	10	22	1,541	610	245	197	256	27	232	1,396.8	171	1,419
Real Estate	1.6	53	0	0	14,914	2,815	362	292	80		64	2,065.0	252	3,477
High Yield	12.8	422	11	24	13,928	2,607	256	206	72		58	1,459.9	178	3,496
Insurance Products Group		-		-	-	-	-	-	-		-	-	-	-
Municipals	2.0	66	12	25	58	8	42	34	26		20	242.4	30	184
Foreign Exchange	1.8	60	25	52	10	3	47	37	40		32	265.3	32	217
CDO	1.3	44	18	37	4,665	890	115	93	34		27	656.1	80	1,171
Energy Trading	2.1	69	28	58	-	-	30	24	25	10	30	169.4	21	202
Fixed Income Corporate	0.0	1	0	0	3	1	(148)	(119)	92		74	(845.2)	(103)	(148)
Firm Relationship Loans - Fixed Income Share		-		-	-	-	-	-	-		-	-	-	-
Alternative Portfolio Solutions	-	-	-	-	-	-	-	-	-		-	-	-	-
Total FIXED INCOME	**41.9**	**1,376**	**175**	**367**	**37,657**	**7,405**	**1,381**	**1,113**	**800**	**37**	**677**	**7,881.0**	**963**	**11,902**
EQUITIES														
Cash	0.8	27	25	49	-	-	264	213	73		58	1,507.9	184	531
Portfolio	0.8	26		-	0	0	135	109	21		17	769.4	94	245
Volatility Flow	1.7	55		-	-	-	43	35	15		12	246.8	30	133
Systematic Trading	0.3	11		-	-	-	15	12	11		9	84.2	10	42
Event Driven	0.4	15		-	-	-	28	23	4		3	160.5	20	60
Convertibles	1.5	49		-	1,297	335	32	26	9		7	185.0	23	439
Volatility	1.7	55	42	78	2	1	318	256	71		57	1,811.4	221	668
Equities Strategies	1.6	51		-	217	59	60	48	20		16	341.7	42	216
Equity Corporate (Including High Yield Loan Share)	0.2	5		-	-	-	(51)	(41)	202	40	201	(293.2)	(36)	129
Firm Relationship Loans - Equities Share	0.3	11		-	-	-	-	-	-		-	-	-	11
Total EQUITIES	**9.3**	**305**	**67**	**127**	**1,516**	**394**	**844**	**680**	**426**	**40**	**380**	**4,813.8**	**588**	**2,474**
CAPITAL MARKET PRIME SERVICES														
Firm Financing	1.3	41	22	47	15	4	84	68	12		10	479.6	59	228
Futures		-		-	-	-	47	38	2		2	268.4	33	72
Equity Financing		-	22	45	32	9	136	110	14		11	775.9	95	269
Equity Synthetic		-	16	33	13	3	37	30	3		3	211.2	26	95
Clearing and Execution		-	2	3	-	-	48	39	18		15	274.6	34	90
Structured Transactions	-	-		-	-	-	30	24	4		3	171.5	21	48
Prime Services Corporate	-	-		-	-	-	(41)	(33)	41		33	(236.1)	(29)	(30)
Total CAPITAL MARKET PRIME SERVICES	**1.3**	**41**	**61**	**129**	**59**	**16**	**341**	**275**	**95**	**-**	**76**	**1,944.9**	**238**	**774**
INVESTMENT MANAGEMENT				-										
IMD - Private Equity	-	-		-	4,086	1,300	109	88	62	78	127	622.1	76	1,591
IMD - Asset Management	8.6	284		-	2,540	822	270	217	335	3,295	663	1,538.3	188	2,175
Total INVESTMENT MANAGEMENT	**8.6**	**284**			**6,626**	**2,122**	**379**	**305**	**397**	**3,373**	**790**	**2,160.4**	**264**	**3,766**
INVESTMENT BANKING	**3.1**	**104**			**20,507**	**1,995**	**791**	**638**	**486**		388	4,515.0	**552**	**3,676**
GLOBAL TRADING STRATEGIES	**15.6**	**514**			**283**	**75**	**70**	**57**	**59**		47	400.9	**49**	**742**
GLOBAL PRINCIPAL STRATEGIES	**8.1**	**266**			**2,863**	**754**	**58**	**46**	**33**		27	328.7	**40**	**1,134**
NON-CORE	**4.3**	**144**	**7**	16	**1,122**	**448**	**(220)**	**(177)**	**531**	**612**	1,036	(1,254.8)	**(153)**	**1,314**
TOTAL	**92.2**	**3,035**	**310**	**639**	**70,633**	**13,209**	**3,644**	**2,937**	**2,826**	**4,061**	**3,422**	**20,790**	**2,540**	**25,781**
UNALLOCATED	**-**	**-**			**1,027**	**423**	**-**				-		-	
TOTAL FIRM	**92.2**	**3,035**	**310**	**639**	**71,660**	**13,632**	**3,644**	**2,937**	**2,826**	**4,061**	**3,422**	**20,790**	**2,540**	**26,204**

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Implementation Progress and Next Steps

Ongoing
- Refining the methodology
  - Less Liquid charge
  - Target surplus
  - Operational charge

☑
- Obtaining “approval” from rating agencies
  - Positive reactions from Fitch and Moody’s
  - Discussions with S&P scheduled

☑
- Obtaining executive buy-in
  - IL/COM on board
  - Presented to BoD at September meeting

Started
- Obtaining buy-in from businesses
  - So far, initial discussions only

Started
- Rollout
  - Pilot in 2008 Budget
  - Portfolio optimization