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2007 Risk Appetite Limit

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LEHMAN BROTHERS

Executive Summary

- The purpose of this document is to review the proposal for the 2007 Risk Appetite limit
- In prior years, we have used ROTE of 10% to define the minimum revenue required in a downturn, and also used a compensation to revenue ratio as an alternative constraint
- Based on the analysis of the performance of our competitors in a downturn year (1998, 2001 and 2002 – see appendix for details), we propose setting the "hurdle" at a ROE of at least 10%, a ROTE of at least 13% and a compensation to revenue ratio of no more than 60%. The downturn scenario that meets these constraints generates a ROE of 10.5%, a ROTE of 13% and a compensation to revenue ratio of 59.2%. This represents a higher performance hurdle than in the past, reflecting a stronger, more diversified franchise overall
- Based on our assumptions for Risk Appetite, this downturn scenario requires revenues of $13.6 billion. Our assumptions for compensation and non-personnel expenses are :
  - Headcount reductions of 10% or approximately 2,500 [TBC with Jim Emmert]
  - Average NGNNH compensation reduction of 35% [TBC with Jim Emmert]
  - NPE reduction of 14%
- We also modified the methodology used to estimate the revenue before risk losses to exclude the principal and proprietary revenues ($2.7 billion budgeted in 2007) from the calculation
- Based on the above scenario, we recommend a Risk Appetite limit for 2007 of $3.2 billion, up $0.9 billion from 2006 and $1.0 billion higher than the current usage of $2.2 billion
  - This implies that the Firm could "afford to lose" $0.5 billion on top of the losses of banking, client and origination revenues if principal and proprietary revenues did not make any money in 2007

Risk Appetite Results

- We recommend setting the Risk Appetite limit at $3.2 billion for 2007.

Downturn Scenario – Financial Performance

$ millions except per share data

	2007F
Total Revenues	**13,631**
Personnel Expense	8,074
Non Personnel Expense	2,954
Pretax Income	**2,603**
Income Tax	750
Net Income	**1,854**
Preferred Dividends	66
Net Income to Common	**1,788**

Performance Indicators	
Earnings per Share	$3.11
PE / Revenue	**59.2%**
NPE / Revenue	21.7%
Pretax Margin	19.1%
Effective Tax Rate	28.8%
Return on Equity	10.5%
Return on Tangible Equity	**13.0%**

Risk Appetite Results

	2007F
Total Revenues Before Risk Losses [1]	**17,430**
Minimum Revenue Level Required	13,631
Maximum Risk Appetite Limit	**3,799**
Less 15% Discount [2]	(570)
Proposed Risk Appetite Limit	**3,229**
Average Quarterly Revenue Before Risk Losses	4,358

Three Year Quarterly Revenue Trend

	2006	2005	2004
Q1	4,461	3,810	3,144
Q2	4,411	3,278	2,926
Q3	4,178	3,852	2,623
Q4	4,600	3,690	2,883

1. *The $17.4 billion represents an 11% decline versus 2007 Plan of $19.5 billion and a 1% decline from the 2006 forecast of $17.65 billion.*
2. *The 15% discount reflects historically low levels of market volatility.*

Revenue Before Risk Losses

- Revenue losses from banking, client and origination revenues in a downturn scenario amount to $2.1 billion, reducing the 2007 revenues from the budgeted $19.5 billion to $17.4 billion

Downturn Scenario versus 2006 Forecast

$ millions	2007 Revenue Downturn	2006 Forecast	% Variance
Fixed Income	8,736	9,050	-3%
Equities	4,149	4,025	3%
Investment Banking	3,205	3,325	-4%
Investment Management	1,641	1,625	1%
Global Trading Strategies	400	395	1%
Global Principal Strategies	400	155	158%
Other	(1,100)	(925)	19%
Total	**17,430**	**17,650**	**-1%**

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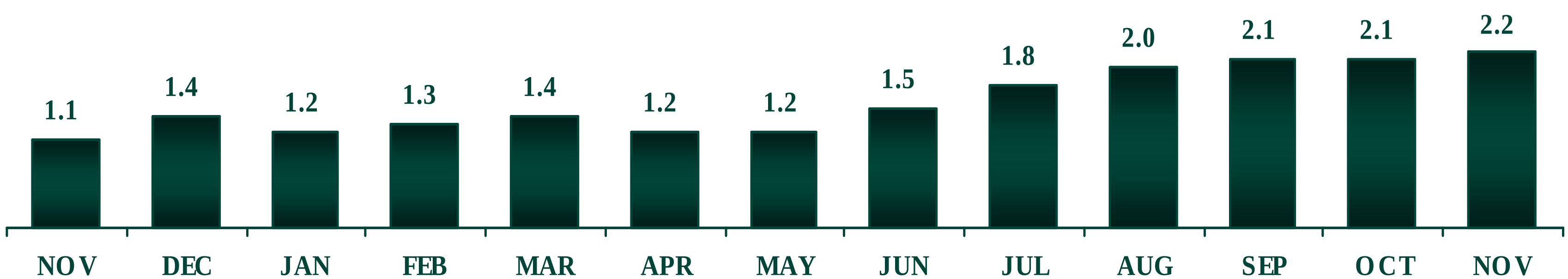
Risk Appetite Trend

- Risk appetite usage has been trending up in 2006, finishing the year at $2.2 billion

Risk Appetite Usage

$ millions	*Average Usage* [1]					*Limit*	
	1Q06	2Q06	3Q06	4Q06	Current[3]	2006	2007
Fixed Income	953	922	1,203	1,489	1,514	1,625	Paul Shotton to provide
Equities	398	436	357	392	427	550	
Investment Management	235	267	303	384	465	325	
Capital Markets Prime Services[2]	-	-	75	85	63	100	
Global Trading Strategies	189	249	296	349	370	450	
Global Principal Strategies[3]	-	-	149	171	175	300	
Diversification	(477)	(584)	(755)	(818)	(846)	(1,050)	
Total	**1,298**	**1,290**	**1,628**	**2,052**	**2,168**	**2,300**	**3,200**



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.*
3. *Current usage as of November 20, 2006.*

Appendix

Minimum "Performance Standard" Scenario

- In order to meet the "minimum performance" hurdle, the Firm needs to generate $13.6 billion of revenues in 2007 – 30% less than budgeted.

$ millions	2007 Forecast	**2007 Downturn Scenario**	% Change
Revenues	19,500	**13,631**	-30%
Fixed PE (Benefits, guarantees, etc.)	5,214	**5,214**	0%
Variable PE	4,400	**2,860**	-35%
Total Personnel Expense	9,614	**8,074**	-16%
Fixed NPE	2,700	**2,430**	-10%
Variable NPE	750	**524**	-30%
Total NPE	3,450	**2,954**	-14%
Pretax Income	6,437	**2,603**	-60%
Tax	2,124	**750**	-65%
Net Income	4,312	**1,854**	-57%
Preferred Dividends	66	**66**	0%
Net Income to Common	4,246	**1,788**	-58%
Average common tangible equity	16,210	**13,751**	-15%
Compensation / Revenue	49.3%	**59.2%**	9.9 pct.
NPE / Revenue	17.7%	**21.7%**	4.0 pct.
Pretax Margin	33.0%	**19.1%**	-13.9 pct.
Effective Tax Rate	33.0%	**28.8%**	-4.2 pct.
Net Margin	22.1%	**13.6%**	-8.5 pct.
ROTE	26.2%	**13.0%**	-13.2 pct.

Stress Scenario : Banking, Origination & Client Revenues

- In a stress scenario, the Firm would lose about $2.1 billion in banking, origination and client revenues

	$ millions	2007 Budget	Stress Sceanario	Non-risk revenue losses
IBD:	Advisory	1,250	-20%	(250)
	Underwriting	2,450	-10%	(245)
	Total	**3,700**		(495)
FID:	PTG	710		
	Prop Trading	280		
	In Business	150		
	Proprietary / Principal	1,140		
	Secondary Client	6,520	-10%	(652)
	Mortgage originations	1,375	-30%	(413)
	Total Secondary	9,035		(1,065)
	Banking revenues (incl. in IBD)	765		
	Total FID	**9,800**		
EQU:	Equity Strategies	275		
	In business	250		
	Proprietary / Principal	525		
	Secondary clients	3,515	-10%	(352)
	Total Secondary	4,040		
	Banking revenues (incl. in IBD)	460		
	Total Equities	**4,500**		
IMD:	Private Equity Gains	138		
	Asset Mgt Gains	32		
	Asset Mgt Minority Stakes	41		
	Proprietary / Principal	211		
	Fees & Other	1,589	-10%	(159)
	Total IMD	**1,800**		
GTS:	**GTS Total**	**400**		
GPS:	**GPS Total**	**400**		
OTH:	**Non-Core Total**	**125**	0%	-
FIRM:	**Total Firm**	**19,500**		(2,070)

		$ Millions	% Total
FYI:	Proprietary / Principal	2,676	14%
	Advisory	1,250	6%
	Underwriting	2,450	13%
	Mortgage Origination	1,375	7%
	Client Revenues	10,035	51%
	AM Fees & Other	1,589	8%
	Non-Core	125	1%
	Total	**19,500**	100%

Peer Benchmarking

- In the last three major downturn years (1998, 2001 and 2002), our competitors were able to keep compensation to revenue ratio relatively unchanged at 47-49% but experienced a dip in their ROE into the low teens

	1998	2001	2002
Return on Equity			
LEH	15.2%	15.9%	11.2%
MS	24.5%	18.5%	14.1%
MER	13.4%	2.7%	11.7%
BSC	21.7%	13.7%	18.1%
GS		13.0%	11.3%
Peer Average	19.9%	12.0%	13.8%
Comp & Benefits Ratio			
LEH	50.7%	51.0%	51.0%
MS	41.0%	42.4%	41.5%
MER	52.3%	51.5%	50.7%
BSC	48.2%	51.5%	48.9%
GS		48.7%	48.2%
Peer Average	47.2%	48.5%	47.3%

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Competitor History

Competitor Data - As Reported

($ in bn, except per share data)

	Revenue	% Change vs. PY	Net Income	Market Cap (6)	FTM P/E (7)
LEH (3)					
FY '05	$14.6	*26%*	$3.3	$33.7	11.4x
FY '04	11.6	*34%*	2.4	23.1	11.0x
FY '03	8.6	*40%*	1.7	20.0	11.6x
FY '02	6.2	*-9%*	1.0	14.9	16.5x
FY '01	6.7	*-13%*	1.3	16.0	13.8x
FY '00	7.7	*44%*	1.8	12.7	7.9x
FY '99	5.3	*30%*	1.1	9.2	10.2x
FY '98	4.1	*6%*	0.7	6.0	9.5x
FY '97	3.9	*12%*	0.6	6.0	11.7x
FY '96	3.4	*12%*	0.4	2.9	9.7x
FY '95	3.1	*3%*	0.2	2.4	12.6x
FY '94	3.0		0.1	1.6	17.3x
CAGR '99-'05	*18.3%*		*19.3%*	*24.1%*	
CAGR '95-'05	*16.9%*		*29.7%*	*30.4%*	
GS					
FY '05	24.8	*21%*	5.6	58.1	11.2x
FY '04	20.6	*28%*	4.6	50.5	12.0x
FY '03	16.0	*14%*	3.0	46.4	17.8x
FY '02	14.0	*-12%*	2.1	37.2	19.3x
FY '01	15.8	*-5%*	2.3	42.3	21.1x
FY '00	16.6	*24%*	3.1	39.6	13.0x
FY '99 (2)	13.3		2.7	33.1	15.9x
CAGR '99-'05	*10.9%*		*12.9%*	*9.8%*	
MER (4)					
FY '05	25.6	*16%*	5.0	60.9	11.8x
FY '04	22.0	*11%*	4.4	53.1	10.7x
FY '03	19.9	*8%*	3.8	52.4	12.8x
FY '02	18.3	*-15%*	1.7	37.1	14.1x
FY '01	21.5	*-18%*	0.6	41.6	12.3x
FY '00	26.4	*21%*	3.8	22.1	9.3x
FY '99	21.9	*25%*	2.7	15.5	10.5x
FY '98	17.5	*8%*	1.3	13.5	10.0x
FY '97	16.3	*19%*	1.9	12.0	11.3x
FY '96	13.6	*28%*	1.6	3.4	10.0x
FY '95	10.6		1.1	2.5	12.8x
CAGR '99-'05	*2.7%*		*10.7%*	*25.6%*	
CAGR '95-'05	*9.2%*		*16.0%*	*37.9%*	
MWD (5)					
FY '05	26.8	*13%*	4.3	60.4	11.1x
FY '04	23.7	*14%*	4.5	55.2	12.6x
FY '03	20.9	*9%*	3.8	60.0	16.4x
FY '02	19.1	*-13%*	3.0	49.3	16.0x
FY '01	22.1	*-16%*	3.5	61.2	18.1x
FY '00	26.2	*21%*	5.5	70.8	12.6x
FY '99	21.7	*32%*	4.8	68.7	17.0x
FY '98	16.4	*11%*	3.3	39.8	15.5x
FY '97 (1)	14.8		2.6	32.9	14.5x
CAGR '99-'05	*3.6%*		*-1.9%*	*-2.1%*	
CAGR '97-'05	*7.7%*		*6.4%*	*7.9%*	
BSC					
FY '05	7.4	*9%*	1.5	12.6	10.4x
FY '04	6.8	*14%*	1.3	11.0	10.5x
FY '03	6.0	*17%*	1.2	7.5	8.9x
FY '02	5.1	*5%*	0.9	6.3	12.1x
FY '01	4.9	*-10%*	0.6	5.7	14.0x
FY '00	5.5	*22%*	0.8	4.9	7.9x
FY '99	4.5	*4%*	0.7	4.8	9.3x
FY '98	4.3	*23%*	0.7	4.3	13.4x
FY '97	3.5	*18%*	0.6	4.3	10.4x
FY '96	3.0	*44%*	0.5	2.8	9.1x
FY '95	2.1		0.2	2.1	8.7x
CAGR '99-'05	*8.6%*		*14.3%*	*17.4%*	
CAGR '95-'05	*13.6%*		*20.1%*	*19.5%*	

(1) Morgan Stanley merged with Dean Witter & Company in June 1997 (pooling of interest)
(2) Goldman went public in May 1999
(3) Data are adjusted to reflect Lehman 2-for-1 stock split in Oct 2000
(4) Data are adjusted to reflect Merrill 2-for-1 stock split in Sept 2000 and June 1997. Merrill's FY05 results are as of 3Q05 or September 05 annul
(5) Data are adjusted to reflect Morgan Stanley 2-for-1 stock split in Jan 2000 and Jan 1997
(6) Stock price and common shares outstanding as of period end
(7) FTM (Forward Twelve Months) P/E is based on consensus analyst earnings estimates for these forward 12 months
Stock price as of end November for full years

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Historical Customer Flow and Other Revenues

Appendix

($ in millions)

	1999	%	2000	%	2001	%	2002	%	2003	%	2004	%	2005	%	2005
		'99 vs. '98		*'00 vs. '99*		*'01 vs. '00*		*'02 vs. '01*		*'04 vs. '03*		*'04 vs. '03*		*'05 vs. '04*	*CAGR '99 - '05*
Origination															
Leveraged Finance	308	*-8%*	130	*-58%*	101	*-22%*	213	*111%*	331	*-14%*	414	*25%*	411	*-1%*	*4%*
Other Fixed Income	488	*51%*	432	*-11%*	812	*88%*	693	*-15%*	704	*9%*	782	*11%*	1,158	*48%*	*13%*
Equity	434	*46%*	815	*88%*	440	*-46%*	423	*-4%*	429	*27%*	597	*39%*	922	*54%*	*11%*
Total Origination	1,230	*29%*	1,377	*12%*	1,353	*-2%*	1,329	*-2%*	1,464	*9%*	1,793	*22%*	2,491	*39%*	*11%*
M&A	512	*0%*	771	*51%*	587	*-24%*	415	*-29%*	366	*37%*	629	*72%*	780	*24%*	*6%*
Total Investment Banking	**$ 1,742**	*19%*	**$ 2,148**	*23%*	**$ 1,940**	*-10%*	**$ 1,744**	*-10%*	**$ 1,830**	*14%*	**$ 2,422**	*32%*	**$ 3,271**	*35%*	*9%*
Sales Credits															
Fixed Income															
Institutional	1,237	*-24%*	1,251	*1%*	1,692	*35%*	2,090	*24%*	2,653	*0%*	2,872	*8%*	4,007	*40%*	*18%*
PIM	197	*-7%*	205	*4%*	284	*39%*	379	*33%*	406	*5%*	404	*0%*	421	*4%*	*11%*
Total Fixed Income	1,434	*-22%*	1,456	*2%*	1,976	*36%*	2,469	*25%*	3,059	*1%*	3,276	*7%*	4,428	*35%*	*17%*
Equities															
Institutional	786	*14%*	1,253	*59%*	1,488	*19%*	1,336	*-10%*	1,562	*15%*	1,799	*15%*	2,350	*31%*	*17%*
PIM	329	*27%*	487	*48%*	383	*-21%*	335	*-13%*	229	*20%*	298	*30%*	526	*77%*	*7%*
Total Equities	1,115	*17%*	1,740	*56%*	1,871	*8%*	1,671	*-11%*	1,791	*16%*	2,097	*17%*	2,876	*37%*	*14%*
Total Sales Credits	**$ 2,549**	*-9%*	**$ 3,196**	*25%*	**$ 3,847**	*20%*	**$ 4,140**	*8%*	**$ 4,850**	*6%*	**$ 5,373**	*11%*	**$ 7,304**	*36%*	*16%*
Asset Management (excl PE)	**59**		**103**		**43**		**49**		**120**		**725**	*505%*	**889**	*23%*	*47%*
Mortgage Affiliates (Shadow)	**-**		**-**		**-**		**-**		**170**		**589**	*246%*	**1,486**	*152%*	*106%*
Total Customer Flow Revenues	**$ 4,350**	*1%*	**$ 5,447**	*25%*	**$ 5,830**	*7%*	**$ 5,933**	*2%*	**$ 6,800**	*29%*	**$ 8,520**	*25%*	**$ 11,464**	*35%*	*15%*
All Other Revenues	990		2,260		906		222		1,796	*-44%*	3,054	*70%*	3,166	*4%*	*18%*
Total Lehman	**$ 5,340**	*30%*	**$ 7,707**	*44%*	**$ 6,736**	*-13%*	**$ 6,155**	*-9%*	**$ 8,596**	*13%*	**$ 11,574**	*35%*	**$ 14,630**	*26%*	*15%*

Historical Comparisons

CUSTOMER FLOW REVENUE	1999 vs. 1998	2000 vs. 1999	2001 vs. 2000	2002 vs. 2001	2003 vs. 2002	2004 vs. 2003	2005 vs. 2004	Worst	Average	Model
Origination										
Leveraged Finance	-8%	-58%	-22%	111%	55%	25%	-1%	-58%	15%	-35%
Other Fixed Income	51%	-11%	88%	-15%	2%	11%	48%	-15%	25%	-10%
Equity	46%	88%	-46%	-4%	1%	39%	54%	-46%	26%	-35%
Total Origination	29%	12%	-2%	-2%	10%	22%	39%	-2%	16%	-10% Cap
M&A	0%	51%	-24%	-29%	-12%	72%	24%	-29%	12%	-20%
Total Investment Banking	19%	**23%**	**-10%**	**-10%**	**5%**	**32%**	**35%**	**-10%**	**14%**	
Sales Credits										
Fixed Income										
Institutional	-24%	1%	35%	24%	27%	8%	40%	-24%	16%	
PIM	-7%	4%	39%	33%	7%	0%	4%	-7%	11%	
Total Fixed Income	-22%	2%	36%	25%	24%	7%	35%	**-22%**	**15%**	-13%
Equities										
Institutional	14%	59%	19%	-10%	17%	15%	31%	-10%	21%	
PIM	27%	48%	-21%	-13%	-32%	30%	77%	-32%	17%	
Total Equities	17%	56%	8%	-11%	7%	17%	37%	-11%	19%	-13%
Total Sales Credits	**-9%**	**25%**	**20%**	**8%**	**17%**	**11%**	**36%**	**-9%**	**16%**	-10% Cap

OTHER REVENUE ($ in mm)	1999	2000	2001	2002	2003	2004	2005	Worst	Average
Corporate	(237)	420	85	(414)	(395)	(348)	161	(395)	(102)
Risk Arbitrage	245	246	37	(51)	632	251	55	(51)	204
Private Equity	131	300	119	(103)	68	319	328	(103)	195
Banking	(12)	-	(90)	(150)	(103)	(27)	(23)	(150)	(59)
Equities	268	641	292	(38)	-	(98)	(225)	(225)	115
Fixed Income	595	653	463	978	1,764	2,957	3,198	(382)	1,461
Total Other Revenue	**990**	**2,260**	**906**	**222**	**1,966**	**3,054**	**3,494**		**1,813**