

LEHMAN BROTHERS

MEMORANDUM

TO: Ken Cohen
FROM: Sunny Galynsky
DATE: December 19, 2007
SUBJECT: Corporate Audit Report
Real Estate: Principal Transactions – Americas

This report summarizes the results of our 2006 review of the Real Estate: Principal Transactions – Americas business.

SCOPE OF REVIEW

The objective of this audit was to evaluate the design and operating effectiveness of the system of internal controls over the Real Estate: Principal Transactions business.

Specifically, we reviewed the controls over origination and underwriting, asset management, transaction approval and processing, price verification, p&l generation, reconciliation to the Firm's books and records, footnote/valuation adjustments, and compliance with applicable regulations.

To evaluate these controls, we interviewed the appropriate personnel, documented and analyzed procedural workflows, and tested the Firm's records, where necessary.

CONCLUSION

Our review identified 13 control concerns, as well as 4 control enhancements. The control concerns are summarized below by theme, and are more fully discussed in the Detailed Findings section of this report which includes management's corrective actions plans.

Control Concern Themes

GREG Origination and Underwriting

- Obtain appropriate committee approvals for all deals. (Complete)
- Comply with the Firm's Customer Identification Program.
- Include aggregate sponsor level exposure in the New Deal Funding Review forms submitted to Senior Management and the relevant Committees as part of the deal approval process. (Complete – Pending Auditor Review)
- Develop a formal vendor approval and monitoring program.

GREG Asset Management

- Strengthen the current system infrastructure to provide robust deal management and reporting capabilities.
- Implement a documentation reconciliation with the custodian.
- Strengthen oversight over property and liability insurance programs.

Supervisory oversight

- Define and formalize supervisory review procedures for GREG.
- Formalize the review and approval process over restructure and foreclosure decisions.

GREG Policy and Procedures

- Develop and update policies for key aspects of GREG processes.

Product Control

- Strengthen oversight of Deal Expense reserves. (Complete)
- Strengthen the ongoing monitoring of FAS144 classifications.
- Obtain the price verification export directly from Trimont. (Complete – Pending Auditor Review)

BACKGROUND

The Principal Transaction Group provides equity and debt funds for real estate investment in non-stabilized assets which were scheduled to be repaid over a three to five year period. The group engages in originating and restructuring short term mezzanine loans (average duration of 2.5 years) which are secured by second mortgages or ownership interest in properties. These short term loans normally have a defined exit strategy. It also provides strategic equity for properties in markets that have a lack of competition due to its property type or have significant barriers to entry due to complexity of the situation or market issues.

The Principal Transaction Group – Americas, generated revenues of \$729 millions for the year ended November 30, 2006 and gross balance sheet stood at \$10.15 billion as of the same period.

FOLLOW-UP PROCEDURES

Individuals identified on the attached Detailed Findings section are responsible for developing and executing a plan of corrective action for the issues raised in this audit. The comments included in this report are deemed significant enough to warrant formal follow-up through a procedure that advises senior management of the status of open issues.

If corrective action cannot be completed as originally planned (that is, if the completion date must be extended or the nature of the corrective action must be modified significantly), the responsible party should discuss the proposed change with Corporate Audit to gain concurrence. Unless advised otherwise, corrective action will be considered to still be in progress, and will be reported as such to senior management. Open audit issues that are aged beyond their original corrective action date will be included in a semiannual report that is issued to the Audit Committee of Lehman's Board of Directors.

Distribution

Archer, M.
Barsanti, A.
Berkenfeld, S.
Bernard, C.
Breakstone, B.
Broderick, D.
Calo, J.
Chew, M.
Cohen, J.
DePalo, V.
Goodman, J.
Gopalkrishnan, H.
Gray, L.
Higham, P.
Holderman, J.

Hom, M.
Jain, S.
Johnston, L.
Kebede, A.
Kimmel, S.
Malin, M.
Nebel, R.
Nineham, S.
O'Connor, B.
Papantonio, E.
Phelps, D.
Picallo, A.
Polizzotto, J.
Puskuldjian, P.
Reilly, G.

Rosen, G.
Rowe, C.
Rudofker, B.
Shih, S.
Stigliano, S.
Tringali, J.
Vena, S.
Walsh, M.

Lehman Brothers
Detailed Findings and Management Action Plans

Real Estate: Principal Transaction Group - Americas

December 2007

Significance: Control Concerns

GREG Origination and Underwriting

1. Obtain appropriate committee approval for deals

We noted several deals that were not submitted to respective Committees for approval as required per the GREG Policy and Procedures. Specifically:

- Two deals were not submitted to the Firm's Commitment and Investment Committees.
- Two deals were not submitted to GREG's Credit Committee.

Management Action Plan	Plan Owner	Plan Date
A formal review process to ensure that all relevant Committee approvals are obtained has been developed.	Barsanti, Anthony	Complete

2. Comply with the Firm's Customer Identification Program

Our review of deal due diligence procedures to ensure compliance with the Firm's Customer Identification Program, identified the following concerns:

- Instances where background checks for the principal, sponsor, and majority investors were not performed.
- Pre-established relationships entering into new deals were not subject to the background checks.

Further, GREG formal procedures and policies defining the background check requirements were not in place.

Management Action Plan	Plan Owner	Plan Date
GREG will develop a Policy and Procedure as part of the Underwriting Guideline to address the requirements of the background check process over the principal, sponsor, and interested majority parties as well as extending review over new deals from pre-established relationship.	Picallo, Albert	1/31/2008

3. Aggregate and monitor exposure at sponsor level

GREG manage counterparty and/or market risks by establishing deal level limits for approval by respective committees within the group and/or the Firm. However, there is no formal aggregation and monitoring of exposure at the sponsor level.

Management Action Plan	Plan Owner	Plan Date
WLT IT has enhanced the current Whole Loan Tracking system to aggregate exposure on deal and sponsor level across Real Estate products.	Picallo, Albert Hom, Michael	Complete
Going forward, aggregate sponsor level exposure will be included in all New Deal Funding Review forms submitted to Senior Management and the relevant Committees as part of the new deal approval process.		
Significant aggregate exposures will be included in the quarterly management reporting package provided to GREG Credit Committee and Risk Management. Pending Auditor Review.	Barsanti, Anthony	11/30/2007

Significance: Control Concerns

4. Develop formal vendor approval and monitoring program

GREG utilizes third party vendors for various aspects of its transactions (e.g., legal, environmental and property appraisals, etc.). Currently, there is no formalized review and approval process to ensure vendor suitability and competitiveness of the fee structure.

Management Action Plan	Plan Owner	Plan Date
GREG will develop a vendor approval program. This program will address initial due diligence review and approval process, on-going evaluation of vendors, and negotiation of contract and competitive fee structure.	Gray, Lynn	1/31/2008

Significance: Control Concerns

GREG Asset Management**1. Strengthen the current system infrastructure**

GREG does not have a robust system infrastructure to support the current business needs and management reporting capability (e.g. deal status updates, asset values, capital structure, market analysis, etc.). Management reporting is ad hoc and manually prepared based on the monthly excel based servicer export file.

Management Action Plan	Plan Owner	Plan Date
GREG will work with WLT Technology to develop the Business Required Document (BRD) to detail the required system enhancements. This will include enhancing the current WLT to provide robust reporting capability for status updates on deal performance, market value of the underlying assets, capital structures, etc. Upon completion of the BRD, a new plan will be created, with new completion dates, which will specify implementation timeline for the system deliverables.	Barsanti, Anthony Hom, Michael	5/30/2008
WLT Technology has enhanced the current WLT to automate the current MTM and P&L reporting process for debt and equity principal positions. WLT Technology will continue to enhance the current system to provide information on closings, draws, and pay-offs from WLT.	Barsanti, Anthony Hom, Michael	1/31/2008

2. Implement documentation reconciliation with the custodian

Controls were not in place to obtain acknowledgement of documentation receipts from the custodian and to track any missing documentation for commercial debt positions.

Management Action Plan	Plan Owner	Plan Date
GREG will develop a key documentation checklist and distribute to Custodian for signature as a form of acknowledging receipts.	Barsanti, Anthony	2/29/2008
GREG will work with our servicer to formalize a documentation control process to centrally review, track, and report any key documents (i.e., originals) that are not maintained by our Custodian. This should include reporting periodic matrix on missing key documentation and its age as well as action taken to resolve the issues.	Barsanti, Anthony	3/31/2008

3. Strengthen oversight over property and liability insurance programs

The servicer is responsible for reviewing and tracking insurance coverage and renewals for debt positions. They also provide quarterly data updates for REO, equity positions, and impaired asset liability to Lehman's risk insurance agent, who analyze and recommend adequate coverage under the blanket insurance program. However, Lehman oversight of the servicer functions does not exist.

Management Action Plan	Plan Owner	Plan Date
GREG Asset Management will require the servicer to provide periodic reporting that highlights insurance pending and past due renewals.	Barsanti, Anthony	1/31/2008
GREG Asset Management will require the servicer to provide periodic (i.e., quarterly) changes in insurance coverage due to new, withdrawal (i.e., sold, pay-off), and coverage increase/decreases to Lehman for review.	Barsanti, Anthony	2/29/2008

Significance: Control Concerns

GREG Policy and Procedures**1. Develop and update the current GREG operating Policy and Procedures**

GREG does not have documented Policies and Procedures for the following processes:

- Impaired Asset and Work Out Monitoring; and
- Oversight over Asset Management and Servicing.

Additionally, the Underwriting Policy and Procedures manual is not up to date.

Management Action Plan	Plan Owner	Plan Date
GREG is in the process of drafting and updating the current Policies and Procedures manuals to include all processes relating to the areas highlighted.	Gray, Lynn	1/31/2008

Significance: Control Concerns

Supervisory Oversight**1. Formalize the review and approval process over restructure and foreclosure decisions**

There is no documented review and approval process over impaired assets that are subject to restructure and/or foreclosure.

Management Action Plan	Plan Owner	Plan Date
GREG will implement a documented approval process over restructured and REO transactions. This should include a memo which provides key information for recommendations to be reviewed and approved by the Senior Management and GREG's General Counsel.	Barsanti, Anthony Broderick, David	1/31/2008

2. Develop Supervisory Control Policies and Procedures

There are no formalized policies and procedures covering supervisory responsibilities for the Real Estate group.

Management Action Plan	Plan Owner	Plan Date
Effort is underway to outline business's policy and procedures over banking products. Upon completion, Compliance will work with the business to define the supervisory responsibilities of the day to day activities for the Real Estate group.	Rosen, Gary Gray, Lynn	3/31/2008

Product Control**1. Strengthen monitoring over deal expense reserves**

Adequate justification and documentation did not always exist to support the ongoing need for all aged deal expense reserves. Specifically, the retention and/or release of expense reserve items were based on the Deal Manager's direction via email. Detailed explanations or documentation for the directives were not always provided.

Management Action Plan	Plan Owner	Plan Date
Product Control will implement a formalized review process of aged expense reserve items. Upon review, Product Control will document accordingly for any retention of the outstanding reserves longer than 270 days.	Cohen, Jonathan	Complete

2. Strengthen the ongoing monitoring of FAS144 classification

FAS144 stipulates all consolidated deals should be classified as Held for Sale or Held for Use. The properties that are held for sale require a definitive marketing plan, unless they are development deals. Currently, there is no formal mechanism to monitor the status of consolidated deals that may be subject to change in FAS144 classification. Specifically:

- Development deals with completed construction, and
- Held for Sale deals that are no longer being marketed for sale.

Management Action Plan	Plan Owner	Plan Date
Product Control will review the status of all consolidated deals that are in development stage on a quarterly basis. This should include discussion with Trimont Asset Managers to ensure that no significant development has taken place that might subject the property to FAS144 re-classification.	Cohen, Jonathan	Complete
Furthermore, all deals classified as Held for Sale per FAS144 will be reviewed after the one year anniversary in order to determine if re-classification of the asset is necessary.		
GREG will provide marketing plans to Product Control for any deals marked Held for Sale category per FAS144 after the one year anniversary.	Barsanti, Anthony	2/29/2008

3. Independently obtain Equity Export file directly from Trimont

There is a segregation of duties concern over the sourcing of the Equity Export file used by Product Control for its price verification process. At the time of our review, the file was sourced by the Front Office Asset Management team prior to forwarding to Product Control.

Management Action Plan	Plan Owner	Plan Date
Product Control and Asset Management team will ensure that property data from Trimont is received directly by Product Control. Pending Auditor Review.	Barsanti, Anthony Cohen, Jonathan	11/30/2007

Significance: Control Enhancements

GREG Asset Management**1. Reconcile and review active SPEs inventory to the WorldRecords system**

Currently, there is no reconciliation between the active SPE data maintained by GREG and the WorldRecords system, which retains all Firm SPE's across all business areas. Consequently, there are discrepancies between the FO records and the WorldRecord database maintained by Legal and Compliance.

Management Action Plan	Plan Owner	Plan Date
GREG will reconcile the records in WLT to the WorldRecord system.	Barsanti, Anthony	5/30/2008

2. Track past due reviews of the annual asset valuations

Lehman servicers submit annual Asset Summary Reports for each deal. GREG reviews these for agreement in the valuation approach. However, there is no formal mechanism to track past due reviews.

Management Action Plan	Plan Owner	Plan Date
GREG will develop a reporting tool which tracks the valuation of the positions that have not been reviewed.	Barsanti, Anthony	12/31/2007

Product Control**1. Enhance compilation of quarterly footnote disclosure**

Currently, the population of the origination and draws for the quarterly footnote disclosure is not sourced from the Firm's books and records. Instead, Product Control relies on the spreadsheets provided by the Front Office.

Management Action Plan	Plan Owner	Plan Date
WLT Technology is in the process of implementing system enhancements which allow users to aggregate and generate reports of sales, draws, and P&L information. Upon completion, PC will generate a report for quarterly disclosure from WLT.	Hom, Michael Cohen, Jonathan	2/29/2008

2. Enhance footnote review process

Our testing of the P&L Footnote Adjustment process, highlighted one instance where a \$1.9mm footnote adjustment was not fully supported.

Management Action Plan	Plan Owner	Plan Date
Going forward, Product Control will retain required documentation for footnote adjustments in accordance with the Global Adjustment Policy.	Cohen, Jonathan	Complete