

From: Elagoz, Melda <melda.elagoz@lehman.com>
Sent: Wednesday, July 18, 2007 12:34 PM (GMT)
To: Shotton, Paul <paul.shotton@lehman.com>; Bridgwater, Matthew <matthew.bridgwater@lehman.com>; Li, Joe <joli@lehman.com>; Lax, Stephen <slax@lehman.com>; Goodman, Jeffrey <jeffrey.goodman@lehman.com>
Subject: RE: Stress Testing
Attach: Stress Testing Policy & Procedures.doc

This is a copy I have. (Asked Lisa in case she has a more up to date one)

<<Stress Testing Policy & Procedures.doc>>

> _____
> From: Shotton, Paul
> Sent: Wednesday, July 18, 2007 8:24 AM
> To: Bridgwater, Matthew; Li, Joe; Elagoz, Melda; Lax, Stephen;
> Goodman, Jeffrey
> Subject: RE: Stress Testing
>
> see the Stress Testing policy doc
>
> _____
> From: Bridgwater, Matthew
> Sent: Tuesday, July 17, 2007 3:46 PM
> To: Shotton, Paul; Li, Joe; Elagoz, Melda; Lax, Stephen; Goodman,
> Jeffrey
> Subject: RE: Stress Testing
>
> Thanks
> Makes sense. Is this in a policy document somewhere and/or can we get
> it on the stress web page as a guideline?
>
> _____
> From: Shotton, Paul
> Sent: 16 July 2007 09:30
> To: Bridgwater, Matthew; Li, Joe; Goodman, Geoff; Elagoz, Melda;
> Lax, Stephen
> Subject: RE: Stress Testing
>
> Agree that current factors look light in some cases.
>
> As to the philosophy behind the stress scenarios; the intention was to
> create plausible "worst-case" moves which might occur simultaneously
> in a number of markets and expose us to the risk of significant loss,
> such as firms have experienced historically in, for example, the stock
> market crash in Oct 87, the Russian crisis in Aug 98, etc. The
> magnitudes of the shocks used should be the cumulative impacts over a

> period during which (on the basis of our empirical experience in such
> market-crisis times) our traders typically do not mitigate their
> exposures, either because liquidity disappears from the market and
> they cannot, or because they sit like rabbits caught in a car's
> headlights. In practice, we have translated this as equating shock
> factors to cumulative moves over a period of ~ 2 weeks for liquid
> markets (i.e. govies & IR derivatives) and up to 4 weeks for credit
> markets. Obviously, there is lots of room for poetic licence here -
> but I think you get the picture....

>

> Paul.

>

> From: Bridgwater, Matthew
> Sent: Friday, July 13, 2007 2:20 PM
> To: Shotton, Paul; Li, Joe; Goodman, Geoff; Elagoz, Melda; Lax,
> Stephen
> Subject: RE: Stress Testing

>

>

> Apols for delayed response, been clearing up some jobs pre my summer
> hols and apols if ive missed some points in todays email flows. No
> right answers on this of course but some thoughts below.

>

> Gut Feelings

>

> Looking at LehmanRisk definitions, In the absence of reliable
> historics assuming 'next time will be worse' ...

>

> * High grade spreads out 40%/50% .. feels like we are starting
> from a low base here. itraxxmain out whatwas it ~ low 20s to 32 last
> few weeks. thats nearly 40% and that was really a bump only. BBBs have
> been out to 300bps if i recall so dont we need some bigger shifts and
> differentiations?

> * HY market down 6.3% (Ba), 7% (B) etc. Sounds a bit low but not
> unreasonable. If these numbers are historic, have we factored them up
> eg ~ 50% or more to incorporate worse expectations for the future?

> * HY loans - down 1.3% Ba, 2.5% B ... sounds unbelievably low and
> not in LGD proportion to bonds (and theres an expectation that loan
> lgsds may be worse than expected v bonds due to differing balance of
> investors now / more blur between secured/unsec).

> * Im told (cant recall) CDO warehouse (heap of HY loans) isnt in
> the stress at all?

> * Primary. I think presynd are excluded, which they shouldnt be.
> All primary positions are so large and specific they ought to be done
> separately on a spreadsheet to factor in or out things in particular
> eg MACS but also flex, fees, leverage levels, deal size, liquidity (eg
> revolvers v poor), etc. know Joe's done some more advanced analysis
> on this recently.

>

> So quite a few material adjustments to make in terms of what is
> included and how it is done, but at least in terms of the moves i dont
> think people can complain if we use a bit of 'artistic licence' to
> quickly and judgmentally factor up stresses for prudence (eg by the
> extent to which leverage has increased in the last few years) and to
> make them consistent.

>

- >
- >
- >
- > Background Mumble
- > * What is 'stress'? scenarios to cover 'bumps' such as weve had
- > recently or to cover melt downs like weve had in ABX and will get in
- > credit sooner or later (later for now as credit fundamentals still
- > good / low default rate)? I presume the latter in which case i'd think
- > the stresses are too small. Whatever it is it better be comparable to
- > what actually happens when it inevitably does else we look caught
- > short.
- > * What time frame should be considred - I guess the time it takes
- > the firm to do something about it, i.e. asset liquidity based but
- > typically weeks - months if not the RA 1 year whilst incorporating
- > some position reduction.
- > * Whilst scenarios typically based on historic observations, we'd
- > expect the next stress to be much worse due to increased leverage and
- > likely contagion (eg HY loans, Primary, Trading and between prime
- > broker calls etc).
- > * Ideally there should be some consistency between businesses and
- > measures, eg RA and stress. EG if the risk appetite is saying on
- > average the HY trading risk is 10%, then the stress should possibly be
- > comparable so weve got a consistent story to tell, and within
- > measures here should be comparability.
- >
- >
- >
- >
- >