

Confidential Presentation to:

Standard & Poor's

Equity Adequacy Framework

August 17, 2007

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Overview

- ◆ Establishing the “optimal” amount of Equity Capital is essential for successful growth of the Firm
 - Meeting regulatory requirements; Establishing confidence with counterparties, creditors, and rating agencies; Supporting sustainable growth; Delivering adequate return to equity investors

 - ◆ It is commonly agreed that equity capital should be sized based on risk-driven, Basel II-compliant measures. Yet industry-wide accepted approach is yet to emerge
 - Regulators (SEC) provide guidance, but revisions are frequent and some components still controversial
 - Rating agencies working on CSE-compliant models, yet so far none has gained industry-wide acceptance

 - ◆ We have developed an internal Equity Adequacy Framework
 - Risk-based, accounts for different types of risk
 - 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.
 - Protects senior unsecured creditors, thus is consistent with key principles of credit rating

 - ◆ 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, as well as across firms

 - ◆ Application of the model to Lehman indicates adequate capitalization of the Firm
 - In recent quarters, the Firm’s risk-bearing capacity has been utilized more efficiently, however within established boundaries
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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
Severe but limited duration	Risk Appetite Framework <ul style="list-style-type: none"> Earning power Diversification Flexible cost structure 	<ul style="list-style-type: none"> Ensures minimal acceptable level of earnings Maintains the Firm's ability to recover while continuing to meet its obligations, including paying common dividends
Severe and extended duration	Risk Equity Framework <ul style="list-style-type: none"> Common Equity 	<ul style="list-style-type: none"> Ensures the Firm's ability to meet all financial obligations in distressed environment without restructuring
Severe but limited duration	Funding Framework <ul style="list-style-type: none"> Liquidity pool Reliable funding 	<ul style="list-style-type: none"> 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
Severe and long-term	Equity Adequacy Framework <ul style="list-style-type: none"> Common equity Hybrid equity 	<ul style="list-style-type: none"> 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

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 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.

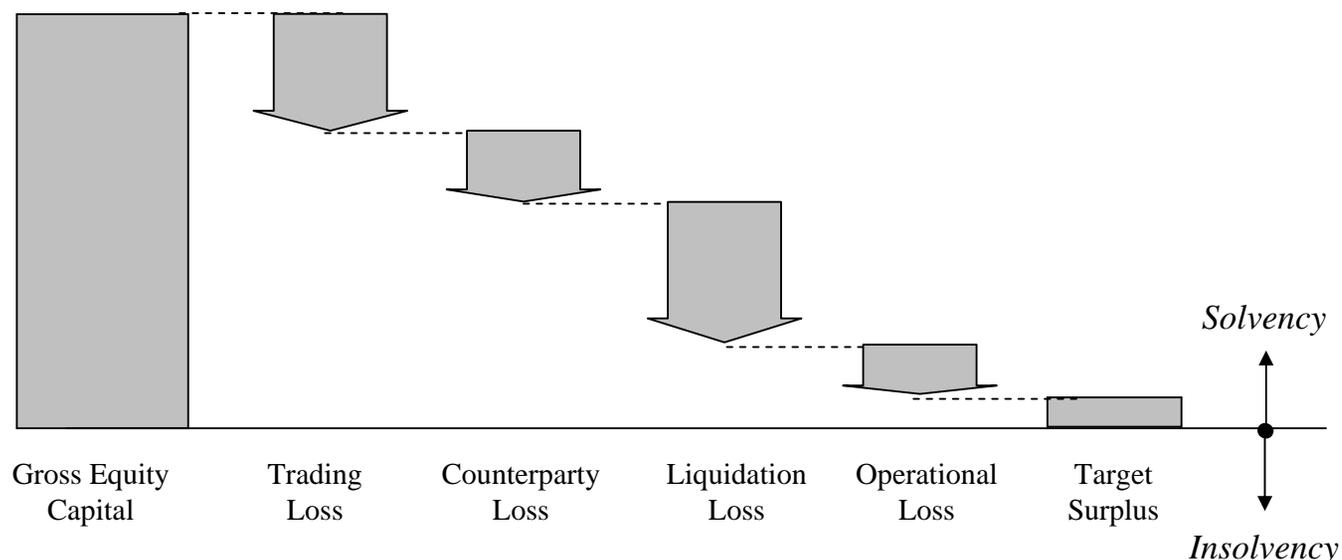
The value of intangible assets is materially impaired or lost

“Separable” assets can be sold (at reduced valuations) allowing some recovery of Goodwill

The Model

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. To be conservative, we assume that the requirements are additive and include substantial reserve requirement.

Equity Compression in Crisis



$$\underbrace{\left\{ \begin{array}{l} \text{Common} \\ \text{Equity} \end{array} \right\} + \left\{ \begin{array}{l} \text{Hybrid} \\ \text{Equity} \end{array} \right\}}_{\text{Available Equity}} - \left\{ \begin{array}{l} \text{Trading} \\ \text{Loss} \end{array} \right\} + \left\{ \begin{array}{l} \text{Counterparty} \\ \text{Loss} \end{array} \right\} + \left\{ \begin{array}{l} \text{Less-Liquid} \\ \text{Funding} \\ \text{Haircut} \end{array} \right\} + \left\{ \begin{array}{l} \text{Operational} \\ \text{Loss} \end{array} \right\} + \left\{ \begin{array}{l} \text{Target} \\ \text{Surplus} \end{array} \right\} \geq 0$$

Parameters of Model

Component	Includes	Approach
Trading Loss	<ul style="list-style-type: none"> • Market Risk • Credit Risk 	<ul style="list-style-type: none"> • VaR-driven • Reflects maximum loss over 1 year holding period with 99.97% confidence level
Counterparty Loss	<ul style="list-style-type: none"> • Financing and derivative exposure 	<ul style="list-style-type: none"> • MPE (Probability of default and expected recovery in default)
Less Liquid Funding Haircut	<ul style="list-style-type: none"> • Haircut on Funding of Illiquid assets • Haircut on Funding of Fixed assets • Devaluation or loss of intangible assets 	<p>Triangulated based on</p> <ul style="list-style-type: none"> • Estimated discount in fire sale • Haircut for non-recourse financing • Equity requirement in CDO structure <p>Estimated by marking to market, then taking same haircuts as on illiquid assets</p> <p>Estimated by marking “Separable” assets to market, then taking same haircuts as on Corporate Investments</p>
Operational Loss	<ul style="list-style-type: none"> • Operational loss • Litigation loss 	<ul style="list-style-type: none"> • Percent of revenues
Target Surplus	<ul style="list-style-type: none"> • Protection against unexpected • Reserve for tactical opportunities 	<ul style="list-style-type: none"> • \$1.5 billion

Estimating Devaluation of Illiquid Assets

Estimating funding haircuts on illiquid assets is difficult, particularly since the nature of the crisis is unknown. We use available market data through bank financing, CDO structures 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

- ◆ An example of the baseline requirements is shown below

Capital charges (baseline sample)

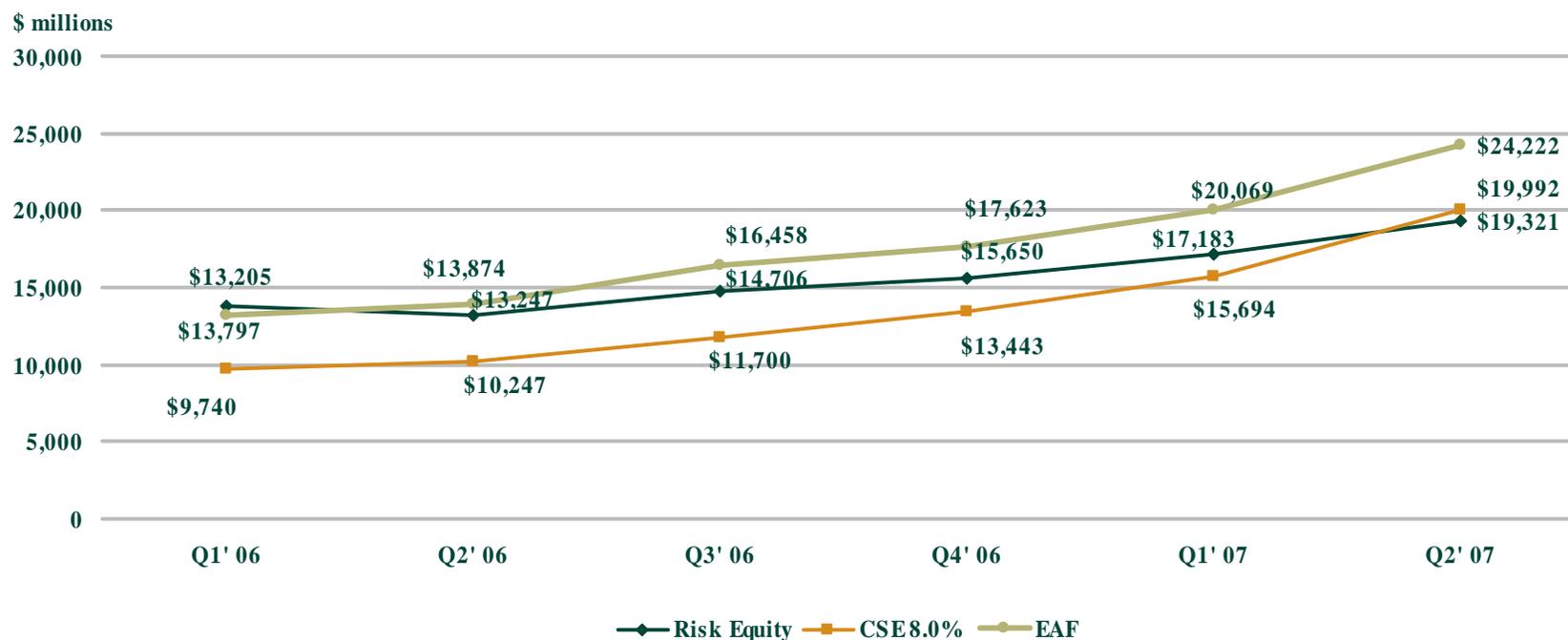
<u>Asset class</u>	<u>Charge</u>	<u>Asset class</u>	<u>Charge</u>
Non-IG Contingent Commitments (1)	5%	Uncollateralized Spec-grade Derivatives	40%
HY Loans/HY Bonds	27%	Private Equity	
Real Estate PTG		Venture Capital	40%
Senior Debt (assumed IG)	5%	Merchant Banking	40%
Mezzanine (assumed NIG)	27%	Fund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

(1) Charge reflects probability of actual funding

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.

Equity Capital Requirements by Model



Standards of Capital Adequacy

We remain adequately capitalized by all three key standards we apply: CSE, Risk Equity, and Economic Capital.

Capital Adequacy Metrics

<u>Equity Adequacy Framework</u>	<u>Q1' 06</u>	<u>Q2' 06</u>	<u>Q3' 06</u>	<u>Q4' 06</u>	<u>Q1' 07¹</u>	<u>Q2' 07²</u>
Requirements	13,205	13,874	16,458	17,623	20,069	24,222
Target Surplus	(1,500)	(1,500)	(1,500)	(1,500)	(1,500)	(1,500)
Gross Equity	20,116	20,699	21,089	21,929	24,518	26,001
Surplus/(Deficit) Before Target Surplus	8,412	8,325	6,131	5,806	5,949	3,279
Target Surplus	(1,500)	(1,500)	(1,500)	(1,500)	(1,500)	(1,500)
Surplus/(Deficit) in Excess of Target Surplus	6,912	6,825	4,631	4,306	4,449	1,779
<u>Risk Equity</u>	<u>Q1' 06</u>	<u>Q2' 06</u>	<u>Q3' 06</u>	<u>Q4' 06</u>	<u>Q1' 07</u>	<u>Q2' 07</u>
Requirements	13,797	13,247	14,706	15,650	17,183	19,321
Common Equity	16,398	16,887	17,301	18,096	18,910	20,034
Surplus/(Deficit)	2,601	3,640	2,595	2,446	1,727	713
<u>CSE</u>	<u>Q1' 06</u>	<u>Q2' 06</u>	<u>Q3' 06</u>	<u>Q4' 06</u>	<u>Q1' 07¹</u>	<u>Q2' 07²</u>
Requirements	9,740	10,247	11,700	13,443	15,694	19,992
Tier 1 Capital	14,775	15,535	15,861	16,015	18,488	20,377
Surplus/(Deficit)	5,035	5,288	4,161	2,572	2,794	385

1. Includes MCAPS issuance for \$1.5 Billion accelerated from Q2
 2. Includes ECAPS issuance for \$350 million accelerated from Q3

Equity Adequacy Trend

The Model indicates adequate equity capitalization of the Firm. Over the recent quarters, surplus has decreased, driven by more efficient use of the Firm's risk-bearing capacity. Projections indicate increased equity surplus in Q3 and Q4.

Equity Surplus / (Deficit)

<i>Variables in \$mm</i>								
Performance data	Q1' 06	Q2' 06	Q3' 06	Q4' 06	Q1' 07¹	Q2' 07²	Q3' 07 - F	Q4' 07 - F
VaR 95% 1 day	42	33	48	53	73	87	95	101
Counterparty Risk Appetite	240	172	306	246	275	287	314	333
Less Liquid Assets	28,414	35,340	48,582	47,124	59,828	82,058	78,170	80,415
Revenue	15,281	16,414	16,740	17,583	18,168	19,270	19,398	21,600
PP&E	2,966	3,079	3,150	3,269	3,398	3,519	3,644	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
<i>Variables in \$mm</i>								
Equity Required	Q1' 06	Q2' 06	Q3' 06	Q4' 06	Q1' 07¹	Q2' 07²	Q3' 07 - F	Q4' 07 - F
Trading	1,371	1,096	1,593	1,740	2,401	2,861	3,134	3,318
Counterparty Loss	504	361	643	516	578	602	660	699
Less Liquid Funding Haircuts								
<i>Illiquid assets</i>	4,197	5,081	6,717	7,692	9,064	12,401	12,613	12,976
<i>Fixed assets</i>	2,390	2,507	2,577	2,697	2,811	2,923	2,937	3,042
<i>Goodwill</i>	382	397	464	462	631	752	1,161	1,149
<i>DTA</i>	2,096	2,112	2,128	2,136	2,178	2,219	2,261	2,303
Total	9,065	10,096	11,886	12,988	14,683	18,295	18,972	19,469
Operational	764	821	837	879	908	964	970	1,080
Total Gross Equity Required Before Target Surp	11,705	12,374	14,958	16,123	18,569	22,722	23,736	24,566
Target Surplus	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500
Total Gross Equity Required	13,205	13,874	16,458	17,623	20,069	24,222	25,236	26,066
Equity Available								
<i>Common Equity</i>	16,398	16,887	17,301	18,096	18,910	20,034	21,435	22,393
<i>Hybrids</i>	3,718	3,812	3,788	3,833	5,608	5,967	5,986	5,986
Total Gross Equity	20,116	20,699	21,089	21,929	24,518	26,001	27,421	28,379
Surplus/(Deficit) Before Target Surplus	8,412	8,325	6,131	5,806	5,949	3,279	3,685	3,813
Target Surplus	(1,500)	(1,500)	(1,500)	(1,500)	(1,500)	(1,500)	(1,500)	(1,500)
Surplus in Excess of Target Surplus	6,912	6,825	4,631	4,306	4,449	1,779	2,185	2,313

1. Includes MCAPS issuance for \$1.5 Billion accelerated from Q2
2. Includes ECAPS issuance for \$350 million accelerated from Q3