

Price Verification

Confidential

Price Verification Presentation

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LEHMAN BROTHERS

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Organization

Organization Structure

Pricing

Capital Markets Finance is a group of finance professionals who are independent from the business and report to the CFO of the firm. The group is closely aligned with the business units in order to enhance the control process and maximize the flow of communication across the organization. Capital Markets Finance is primarily accountable to:

- *Protect the Firm*
- *Provide daily revenue analysis and reporting*
- *Provide an independent and documented validation of inventory valuations*
- *Ensure appropriateness of valuation adjustments that adhere to globally consistent and approved standards*
- *Ensure, in conjunction with Risk Management, that appropriate models are used to value derivative transactions*
- *Interface with internal and external auditors and regulators*
- *Maintain a strong control environment that aims to enhance profitability and optimizes capital & risk*
- *Provide value-added analyses that drive good business decision-making*

Organization Structure (continued)

Pricing

Primary Responsibilities by Functional Areas

P&L and Risk Analysis	Valuation and Model Control	Business Support and Analysis
<ul style="list-style-type: none"> • Production and analysis of the daily P&L • Ensure adherence to inventory valuation and adjustment policies • Month-end accounting close process • Ensure appropriate use of existing models and implementation of new models • Implement process and technology efficiencies • Partnership with risk management for accurate risk reporting 	<ul style="list-style-type: none"> • Develop price validation procedures • Complete formal monthly price testing review • Review model appropriateness with Risk Management and Quantitative Research • Ensure globally consistent valuation policies • Prepare valuation and accounting based financial disclosures • Interface with internal and external auditors regarding inventory valuation substantiation • Primary interface with the accounting policy group 	<ul style="list-style-type: none"> • Capital reporting & analysis to ensure optimal capital usage • Revenue forecasting and budgeting process • Develop performance metrics to analyze business profitability and growth • Support strategic business initiatives: <ul style="list-style-type: none"> - Project management - Process improvement - New business support & analysis

Staffing – Valuation Control

Pricing

◆ The Americas valuation control staffing is as follows:

- Global central team of 2 staff including Neeraj Chopra
- Equities – 3 staff led by Jerry Shi
- Interest rate products, FX and Energy – 5 staff led by Scott Goswami
- Credit products – 4 staff led by Brian Sciacca *Wendy:*
- Mortgages – 4 staff led by Joseph Sapia
- Real Estate – 3 staff led by Abebual Kebede *IN USA*
- In addition, the valuation and control work in the regions is performed from within the product control groups.

SCOTT	JANE CHY
Alice	S
KATIE CHOW	

Pricing and Control Philosophy

Pricing and Control Philosophy – Mark Review Process

Pricing

- ◆ Trading personnel are responsible for marking inventory positions daily
- ◆ PC performs formal price validation procedures, on a monthly basis, to ensure that the firm's inventory is marked at fair market value
- ◆ This is in addition to the daily P/L process which incorporates controls such as risk based P/L explanatories
- ◆ Price validation procedures compare the firm's marks to a combination of:
 - Independent market quotes from vendors
 - Benchmarking against similar assets (e.g. bonds vs. CDS spreads or other bonds)
 - Recent trading activity (e.g. TRACE)
 - Collateral marks
- ◆ Alternative analytical procedures are performed for illiquid positions. Alternative analytical procedures include, but not limited to, the following:
 - Review financial statements, research reports and servicer / trustee reports for securitized assets
 - Perform mock securitizations for whole loan pools
 - Perform statistical analysis (i.e., historical volatility benchmarking)
- ◆ For products requiring complex models (i.e., synthetic CDO, callable range accrual, callable capped floater, target auto-redemption note and snowball), PC will generally perform output testing by submitting model valuations to external pricing services to ensure internal marks are reasonable
- ◆ All Variances exceeding a specified threshold are documented and considered for adjustment
- ◆ Product Controllers summarize results and are responsible for resolving variances with individual traders
- ◆ Unresolved issues are escalated to Senior Product Controllers and the Business Head, for resolution

Pricing and Control Philosophy – Mark Review Process (continued)

Pricing

- ◆ Price testing is summarized* by bucketing the results in the same categories suggested by the Fair Value Measurement exposure draft (as augmented by staff opinions), as follows:
 - Level 1 - Quoted prices for identical assets or liabilities are available in active reference markets
 - Level 2 – Quoted prices for similar assets or liabilities are available in active markets, adjusted as appropriate for differences that are "Objectively determinable". [Not expecting to use this category at present]
 - Level 3 – Quoted prices for similar assets or liabilities are available in active reference markets OR based on the results of multiple valuation techniques
 - Level 4 - For items where there are no observable markets and / or observable market inputs. In such instances, hypothetical market prices are replicated using entity inputs as a practical expedient

* It is anticipated that the final fair value measurement standard will have just three levels. Once this is issued, the policy will be revised accordingly.

Products within Fair Value Categories

Pricing

Level 1	Level 3	Level 4
<p>Corporate Equities Money Market Investments Corporate bonds Commercial Paper Preferred Stock US Governments G7 Governments Pass Throughs Muni Bonds Equity Listed options</p>	<p>Convertibles OTC Equity Products Corporate bonds Corporate loans FX Forwards Non-G7 Governments Interest rate derivatives - OTC Agency and non-Agency CMOs - IG Commercial Whole Loans Residential Whole Loans CMBS - securities</p>	<p>Credit correlation products Corporate loans Corporate bonds Fund Derivatives Mortgage residuals Non Agency CMO - NIG Muni RIBS Equity investments in Private Companies Real Estate equity and mezzanine debt Private convertibles</p>

Price Verification – Key Minimum Thresholds

Pricing

	De Minimis Threshold	Basis of De Minimis Threshold	Variance Threshold Based on Fair Value Measurement			
			Level 1	Level 2	Level 3	Level 4
Interest Rate Futures and Swaps Risk	\$0	PV01	Aggregate Variance Threshold of \$1mm for Each Risk Bucket			
Basis Risk	\$0	PV01	Aggregate Variance Threshold of \$1mm for Each Risk Bucket			
Treasuries, Agencies, Other Government Instruments and CMOs	\$0	Market Value	\$300K	N/A	\$500K	\$500K
OTC Bond Options and Mortgage Options	\$0	Market Value	\$300K	N/A	\$500K	\$500K
Cap/Floor and Swaption Vols	\$0	Vega	Aggregate Variance Threshold of \$1mm for Each Risk Bucket			
FX Spots and Forwards	\$0	Market Value	Aggregate Variance Threshold of \$1mm for Each Risk Bucket			
FX ATM and Skew Vol	\$0	Vega	Aggregate Variance Threshold of \$1mm for Each Risk Bucket			
Muni - Cash	\$1,000,000	Market Value	\$300K	N/A	\$500K	\$500K
Muni - Derivatives	\$0	Various Risk Based	\$300K	N/A	\$500K	\$500K
Muni - Cash (Alternative Procedures)	\$5,000,000	Market Value	\$300K	N/A	\$500K	\$500K
Muni - Derivatives (Alternative Procedures)	\$10,000	PV01	\$300K	N/A	\$500K	\$500K
High Grade - Cash	\$1,000,000	Market Value	\$300K	N/A	\$500K	\$500K
High Grade - Derivatives	\$10,000	PV01	\$300K	N/A	\$500K	\$500K
High Grade - Cash (Alternative Procedures)	\$5,000,000	Market Value	\$300K	N/A	\$500K	\$500K
High Grade - Derivatives (Alternative Procedures)	\$10,000	PV01	\$300K	N/A	\$500K	\$500K
Brady Options	\$5,000	Vega	\$300K	N/A	\$500K	\$500K
High Yield - Cash	\$1,000,000	Market Value	\$300K	N/A	\$500K	\$500K
High Yield - Derivatives	\$10,000	PV01	\$300K	N/A	\$500K	\$500K
High Yield - Cash (Alternative Procedures)	\$5,000,000	Market Value	\$300K	N/A	\$500K	\$500K
High Yield - Derivatives (Alternative Procedures)	\$10,000	PV01	\$300K	N/A	\$500K	\$500K
Bank Loan - High Grade	\$5,000,000	Market Value	\$300K	N/A	\$500K	\$500K
Bank Loan - High Yield	\$5,000,000	Market Value	\$300K	N/A	\$500K	\$500K
Cash CDO	\$1,000,000	Market Value	\$300K	N/A	\$500K	\$500K
CMBS / Derivatives / Hedges	\$0	Market Value	\$300K	N/A	\$500K	\$500K
REIT LOC / Commercial N/R Mezzanine and B Notes	\$0	Market Value	\$300K	N/A	\$500K	\$500K
Floating Rate Loans	\$0	Market Value	\$300K	N/A	\$500K	\$500K
Conduit	\$0	Market Value	<1% or > 4%	N/A	<1% or > 4%	<1% or > 4%
Equity / REO / Higher Leveraged Mezzanine Loans	\$0	Market Value	N/A	N/A	< \$-1mm or > \$5mm	< \$-1mm or > \$5mm
Stock / Futures / Listed and OTC Options / Warrants / Equity Linked Notes	\$0	Market Value	\$300K	N/A	\$300K	\$300K

Complex Derivatives Transaction Review Committee - Rules

Pricing ■

- ◆ Committee composition and scope
- ◆ Absolute size of P/L – over \$5mm on individual trade or series of trades
- ◆ P/L over a certain percentage of notional – over 5% of notional for notionals over \$10mm
- ◆ Poses additional valuation issues e.g. long dated vols
- ◆ Potentially leads to EITF 02-03 issues or other accounting complexity
- ◆ Not covered by existing models
- ◆ Leads to legal entity / infrastructure issues
- ◆ The valuation controller for each area will be responsible for ensuring that the above rules are complied with. If the product area has no specific valuation controller, the product control manager for that area will be responsible for escalating trades to the committee.
- ◆ The trades will be formally presented to the committee by the line staff nominated by the product control manager.

Complex Derivatives Transaction Review Committee - Presentation

Pricing

- ◆ Deal details e.g. type, size, maturity and P/L
- ◆ Brief market narrative including types of clients and rationale for trade
- ◆ Flow diagram summarizing the deal
- ◆ Risk metrics e.g. delta, vega, correlation sensitivity
- ◆ Potential accounting issues
- ◆ Potential valuation issues
- ◆ Potential modeling issues
- ◆ Legal entity
- ◆ Banking or Trading book categorization
- ◆ Any other significant issues e.g. operational or booking issues

Complex Derivatives Transaction Review Committee – Summary of Trades Presented for the Month

Pricing

- ◆ **CPPI Fund Derivative** – The desk restructured an existing trade that predated EITF 02-03, and thus, there was no hold back of day 1 P&L. This trade has a current MTM loss of \$1.9 million. The new trade has a day 1 P&L of \$4.7 million that will be subject to EITF 02-03, since implied volatility is deemed to be unobservable. The desk wanted to know whether 1) the entire day 1 P&L of \$4.7 million needs to be held back or 2) the day 1 P&L of \$4.7 million can be netted against the \$1.9 million loss, and thus, only \$2.8 million of day 1 P&L needs to be held back. Accounting Policy determined that each trade needs to be treated separately. As such, Lehman needs to recognize a loss of \$1.9 million from the old trade, as well as hold back \$4.7 million of day 1 P&L from the new trade.
- ◆ **CPPI Fund Derivative** – For structuring a CPPI fund derivative trade, Lehman receives a fee of 50 bps per annum. At day 1, the present value of this fee was \$800K. Lehman will receive this fee regardless of whether the trade gets early terminated. As such, the committee concluded that the present value of this fee can be recognized at day 1.
- ◆ **Forward Equity Trade** – Lehman signs a commitment to enter into a forward equity trade, receiving \$500 million on trade date and delivering shares of Intel in the future. The number of shares of Intel that Lehman is required to deliver is based on the average VWAP (volume weighted average price) between trade date and maturity date. The committee concluded that the forward equity trade should be considered as a derivative transaction. Furthermore, the \$500 million of upfront payment should be considered as a short-term debt. As such, the trade should be treated as a structured note and be fair valued in its entirety in accordance with FAS 155.

Model Approval Process and Control Committee

Pricing

- ◆ Model approval process
 - Models are built by the Quantitative Research group
 - Independent review and approval by the Model validation
 - Further review and approval by the Finance group including review of valuation adjustments

- ◆ Model Control Committee
 - Composed of senior representatives from the Quant Research, Analytics, Model Validation and Finance groups
 - Meets on a monthly basis to discuss all model control related issues
 - Reviews pipeline of new models, sets priorities for review, sets limits etc

Model Approval Process and Control Committee – Summary of Significant Issues and Work Being Performed for the Month

Pricing

- ◆ Temporary approval (by the Quant Research group) was granted for the Credit Hazard rate lattice model to value constant maturity default swaps
- ◆ The Risk Management Model validation group granted final approval on the Options for Lehman Aggregate Index model to value European options on the Index and the Energy Futures Curve model to value options on oil and natural gas futures.
- ◆ Several other models have been granted temporary approval in the past and these are being prioritized to ensure that the significant models are granted full approval by risk management as soon as possible.
- ◆ The model approval guidelines are being revised. In addition, model reserve methodology will initially be proposed by the Quantitative research group as part of the model documentation and be subject to the model approval process.

Summary of Price Verification Results

Price Verification Executive Summary – Fixed Income Division

Pricing

Aggregate Pricing Variance - Global FID			
in \$'000			
	<u>Re-marked</u>	<u>Resolved</u>	<u>Total</u>
Level 1	584	648	1,233
Level 3	1,806	15,657	17,462
Level 4	19,948	33,673	53,621
Total	22,338	49,978	72,316

***Definition of pricing levels:**

Level 1: Quoted prices for identical assets or liabilities are available in active reference markets.

Level 2: Quoted prices for similar assets or liabilities are available in active markets, adjusted as appropriate for differences that are "objectively determinable". [Do not use this category at present]

Level 3: Quoted prices for similar assets or liabilities are available in active reference markets OR based on the results of multiple valuation techniques.

Level 4: For items where there are no observable markets and / or observable market inputs. In such instances, hypothetical market prices are replicated using entity inputs as a practical expedient.

Price Verification Coverage – Fixed Income Division

Pricing

S'000	Risk Measure	Level 1				Level 3				Level 4			
		MV	Coverage	Risk Based	Coverage	MV	Coverage	Risk Based	Coverage	MV	Coverage	Risk Based	Coverage
Exposures:													
(i) Interest rate													
Govt bond & govt bond index cash & listed products	MV	14,194,362	99%										
Money market & MM index cash & listed products	MV	20,623,075	100%			1,533	100%						
Interest rates	PV01							4,976	100%			(2,432)	100%
IR ATM volatility	Vol + 1%							73,701	98%				
IR volatility skew: IR vol correlation	Vol + 1%											634	82%
IR volatility skew: vol of vol	Vol + 1%							(137)	52%			944	
IR FX correlation	Correl + 1%											(297)	98%
IR IR correlation	Correl + 1%											(159)	100%
Bond volatility	MV / Vol + 1%	43,990	100%					845	100%				
		34,861,427				1,533							
(ii) Credit													
Corporate bonds & options & listed warrants & third party CDOs	MV	5,959,911	92%			2,421,628	80%			176,595	58%		
Credit spreads	PV01							(2,582)	96%			48	66%
Default correlation	PV01 / Beta01							(877)	20%				
Recovery rates	Recovery + 1%											(164)	91%
Credit volatility	Vol + 1%							24					
		5,959,911				2,421,628				176,595			
(iii) Equity													
Stock & stock index cash & listed products	MV	(142,741)	91%			101,764	100%			102,169	98%		
Stock volatility	Vol + 1%							(336)	100%				
Dividend rates	D Rho												
Equity correlation	Correl + 10%												
		(142,741)				101,764				102,169			
(iv) Fund													
Fund units	MV	295,224	100%										
Fund volatility	Vol + 1%											(3,648)	100%
Fund vol of vol	Vol + 1%											(303)	100%
IR Fund NAV correlation	Correl + 20%											(2,532)	100%
Fund vol NAV correlation	Correl + 20%											96	100%
		295,224											
(v) Mortgage													
Agency CMO / bond	MV	6,836,789	100%			849,217	100%						
MBS bonds	MV	1,315,618	100%			2,085,851	100%			404,578	100%		
Pass-throughs	MV	1,427,130	100%			(7,221,214)	100%						
Residuals	MV									279,799	100%		
Servicing rights	MV					812,099	100%						
Whole loans residential	MV					31,276,912	100%			4,700,430	100%		
Mortgage volatility	MV					(4,746)	100%						
		9,579,536				27,798,118				5,384,807			
(vi) Real Estate													
Whole loans commercial	MV					1,388,637	100%			7,881,529	100%		
CMBS	MV	(855,055)	100%			15,925,621	100%			335,401	100%		
		(855,055)				17,314,258				8,216,930			
(v) Hybrid & Other													
Convertible bonds	MV					227,255	100%						
Ascots Derived Price	MV												
ABS bonds	MV	1,556,119	99%			1,822,801	95%			24,794	31%		
Loans	MV	902,545	95%			28,849,762	99%			3,156,203	99%		
Principal transactions	MV					908,616	100%			712,839	100%		
Inflation spread	PV01							(2,231)	100%				
FX volatility	Vol + 1%							(30,702)	89%				
FX delta	MV	429,803	100%										
Preferreds	MV	1,696,125	83%			440,407	72%			39,800			
Airtax swaps	PV01											(2,328)	100%
FX Options	MV / Correl + 20%					(35,148)	85%	(688)	100%				
Muni bonds	MV	1,187,641	99%			4,212,989	97%						
		5,772,234				36,426,681				3,933,636			
Overall Totals		55,470,536	99%			84,063,982	99%		95%	17,814,137	99%		92%

Price Verification Projects – Fixed Income Division

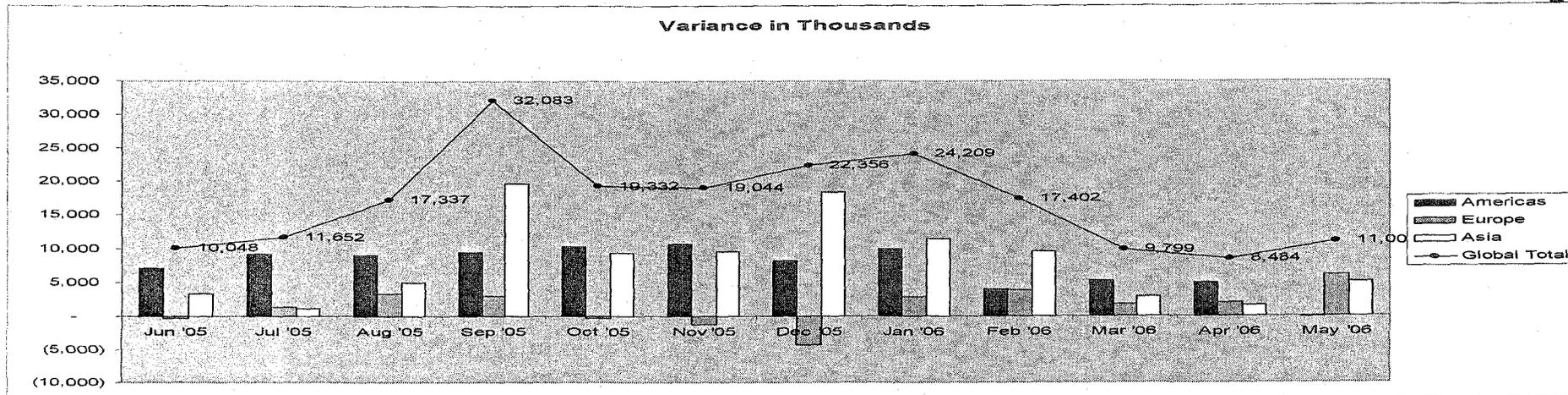
Pricing

In recent months, the Valuation and Control group:

- Performed price testing of CDO and CDO squared portfolios for Totem and the FSA, which help demonstrate observability for EITF 02-03 purposes.
- Completed re-calibration of cap / European swaption skew model. Now performing full re-pricing of the entire portfolio.
- Initiated price testing of oil options, gas options, oil curves, power curves and gas curves.
- Initiated output testing on IRP exotics (callable range accrual, callable capped floater, target auto redemption note and snowball products).
- Increased FX skew testing coverage from 60% to over 80% and submitted a total of 19 currency pairs to outside pricing service.
- Initiated the price testing of credit default swaps within the IRP business.
- Initiated the price testing of PSA swaps.
- Implemented thresholds for all IRP, Government, Liquid Market Product and FX positions.
- Developed matrix that provides better details on price testing coverage for FX and interest rate products.
- Expanded the tenor and sources in the price testing of all core interest rate products.
- Completed convexity testing of Eurodollar futures.
- Completed BMA / SAVR testing methodology.
- Initiated the price testing of interest rate swaps within the Mortgage and Real Estate businesses.
- Initiated price testing on skew for treasury options (working on submitting to outside service)

Price Verification Executive Summary – Equities Division

Pricing



◆ **May 2006 Business Level Comments: (> \$1mm Variance)**

◆ **Volatility Americas: +\$0.8mm**

- Overall Variance decreased \$(5.9)mm from \$6.8mm at April Monthend. The decrease was driven by the unwind of the Allstate trade which had previously had a \$2.3mm positive variance. DPL Warrants volatility variance decreased by \$(2.0)mm to \$(0.3)mm from \$1.6mm in April where the front office maintained a volatility of 16% and the 2 year historical finance benchmark fell from 17.06% to 15.79%. The volatilities of the BMO 2007 Outperformance option increased in the observable market, however, the front office had not adjusted it's mark volatilities. The position has now been remarked.
- The overall variance of \$0.8mm is comprised primarily of volatility variances, \$2.4mm, offset by negative overall correlation variance, \$(0.2)mm, negative dividend variance, \$(0.6)mm and negative delta variances, \$(0.3)mm.
- Volatility variances are driven by skew on Housing Basket Cliquet Notes, \$1.5mm, which is trended month over month and DGX Collars, \$1.3mm, which was due to large vega size and deemed within tolerance. Negative correlation variance, \$(0.2)mm, is driven by the BMO 2006 and 2007 outperformance options and is being trended month over month by finance. The dividend variance is driven by DPL warrants, \$(0.9)mm, and results from a very small difference in dividend yield as compared to historicals on a very large DRho Position, \$0.3mm.

◆ **Volatility Asia: +\$5.1mm**

- Month over month variance increased \$3.5mm, from \$1.6mm in April. The price testing variance was driven mainly by the Japan OTC portfolio. The variance on Japan Index OTC portfolio moved from a negative variance of \$(1.0)mm to a positive variance of \$2.4mm. The variance was spread across various positions in the portfolio.
- Three significant outlier positions were found to be marked with a positive variance; Topix Variance Swap, \$1.6mm, which was deemed outside of tolerance and remarked after monthend, MCSI Singapore options, \$0.5mm, which is currently in discussion and China Construction Bank, \$0.5mm, which was deemed to be within tolerance.

◆ **Volatility Europe: +\$3.6mm**

- Overall variance increased by \$5.3mm from \$(1.7)mm in April. This variance change was driven by EUROSTOXX 50 which increased by \$2.3mm to \$1.8mm, SMI which debuted on the May focus list at \$1.0mm and US individual stock volatilities which increased by \$1.4mm to \$3.0mm. Variances were based on size and all deemed by Finance to be within tolerance.
- Stocks and Futures were marked to theoretical values which was the cause of a \$2.4mm variance in May.

◆ **Equity Strategies Europe: +\$1.4mm**

- Increase in variance, \$1.4mm, from a flat April monthend variance. The variance was caused by a single position, KBC GROEP, which the front office marked to include a merger arbitrage spread in its price. Post month end, the position was marked to market.

Price Verification Executive Summary – Equities Division (continued)

Pricing

- ◆ **Global Equities Price Testing Results:** *Positive variances increased from \$8.5mm to \$11.0mm*
 - **Americas:** Variance decreased by \$(5.0)mm to \$(0.1)mm (April, +\$4.9mm). The decrease was driven by Volatility Americas, where the Allstate Index Basket trade was unwound removing \$2.3mm of positive variance, the benchmark historical volatility for the DPL Warrants dropped significantly causing April's \$1.6mm variance to drop to \$(0.3)mm and a volatility price testing variance of \$(0.9)mm was found on the BMO Out performance option. The variance was corrected after month end and the volatilities were brought into line with the market.
 - **Europe:** Variance increased by \$3.2mm to \$5.2mm (April +\$2.0mm). This change was primarily driven by exposures held in Volatility Europe where the variance increased from \$(1.7)mm to \$3.6mm. All variances were within the bid offer spread. This change is the result of large OTC positions on EUROSTOXX, FTSE, SMI and US individual equities. This increase was offset by a decrease in Convertibles Europe variance from \$2.4mm to \$0.8mm due to timing differences of snapshots taken on positions traded in foreign markets.
 - **Asia:** Variance increased by \$3.5mm to \$5.1mm (April +\$1.6mm) The price testing variance was driven mainly by the Japan OTC portfolio. The variance on Japan Index OTC portfolio moved from a negative variance of \$(1.0)mm to a positive variance of \$2.4mm. The variance was spread across various positions in the portfolio.
 - **Overall:** Price testing for the division shows inventory to be appropriately marked at May month end.
- ◆ **Price Testing Coverage:**
 - Products in Global Equities are separated for calculation of coverage ratios into two separate categories. The coverage ratio for trades whose variances are based on market value is 99%. The coverage ratio for products whose variances are measured by risk sensitivity is 83%.

Price Verification Coverage – Equities Division

Pricing

S'000	Risk Measure	Level 1				Level 3				Level 4			
		MV	Coverage	Risk Based	Coverage	MV	Coverage	Risk Based	Coverage	MV	Coverage	Risk Based	Coverage
(i) Interest rate													
Govt bond & govt bond index cash & listed products	MV												
Money market & MM index cash & listed products	MV	(49,199)	100%										
Interest rates	PV01							(4,357)	100%				
IR ATM volatility	Vol + 1%												
IR volatility skew: IR vol correlation	Vol + 1%												
IR volatility skew: vol of vol	Vol + 1%												
IR FX correlation	Correl + 1%												
IR IR correlation	Correl + 1%												
Bond volatility	MV / Vol + 1%												
		(49,199)											
(ii) Credit													
Corporate bonds & options & listed warrants & third party CDOs	MV												
Credit spreads	PV01							(5,578)	100%				
Default correlation	PV01 / Beta01												
Recovery rates	Recovery + 1%												
Credit volatility	Vol + 1%												
(iii) Equity													
Stock & stock index cash & listed products	MV	(5,803,229)	99%										
Stock volatility	Vol + 1%							8,283	100%			39	100%
Dividend rates	D Rho							6,644	100%			(456)	100%
Equity correlation	Correl + 10%											(15)	100%
		(5,803,229)											
(iv) Fund													
Fund units	MV	1,065,185	100%										
Fund volatility	Vol + 1%												
Fund vol of vol	Vol + 1%												
IR Fund NAV correlation	Correl + 20%												
Fund vol NAV correlation	Correl + 20%												
		1,065,185											
(v) Mortgage													
Agency CMO / bond	MV												
MBS bonds	MV												
Pass-throughs	MV												
Residuals	MV												
Servicing rights	MV												
Whole loans residential	MV												
Mortgage volatility	MV												
(vi) Real Estate													
Whole loans commercial	MV												
CMBS	MV												
(v) Hybrid & Other													
Convertible bonds	MV	3,445,774	95%										
Ascots Derived Price	MV					18,226	91%						
ABS bonds	MV	321,414	100%										
Loans	MV												
Principal transactions	MV												
Inflation spread	PV01												
FX volatility	Vol + 1%												
FX delta	MV	(12,363)	100%										
Preferreds	MV	708,595	100%										
Altitax swaps	PV01												
FX Options	MV / Correl + 20%												
Muni bonds	MV												
		4,463,420				18,226							
Overall Totals		(323,822)	99%			18,226	91%		100%	0	N/A		100%

Price Verification Projects – Equities Division

Pricing

In recent months, the Valuation and Control group was able to:

- Improve Convertibles price verification by establishing a hierarchy of vendors and override policy.
- Improve accuracy of index and single name volatility testing by submitting more data to Mark-it consensus service.
- Implement method for estimating implied correlations through use of Mark-it data sampling and regression.
- Increase coverage of price-testing to include skew sensitive trades
- Streamline overall price-testing process to reduce time until variance reporting from T+10 to T+8
- Improve overall Mark-it rankings from typical lower quartile to top quartile ranking, through implementation of consensus data in front office.

Examples of Price Verification

Interest Rate Products

- ◆ Fixed Income Governments
 - PC performs price verification procedures on the entire portfolio
 - PC obtains independent prices from the following providers: EJV, IDC, Extel, GFI, and Bloomberg
 - PC applies variance thresholds of \$300k for level 1 products and \$500k for level 3 and 4 products to highlight positions for further review and potential adjustment

- ◆ Core Fixed Income Derivatives
 - PC performs price verification procedures on all risk exposures
 - PC obtains market data from independent vendors such as Bloomberg, Telerate, ICAP, Euro-brokers, and Prebon Yamane
 - PC applies variance threshold of \$1mm for each aggregate risk exposure, to highlight positions for further review and potential adjustment

Interest Rate Products (continued)

Pricing

◆ Mortgage & Treasury Options

- PC performs price verification procedures on the entire portfolio utilizing external market data sourced from GFI
- Mortgage options are independently valued using the Black Scholes model with external volatilities, repo rate, underlying security price, coupon, and time-to-expiry
- Treasury options are independently valued using the Trinomial model with external volatilities, repo rate, strike price, and time-to-expiry
- PC applies variance thresholds of \$300k for level 1 products and \$500k for level 3 and 4 products to highlight positions for further review and potential adjustment

Government Pricing Example – Level 1

Pricing

TIPS inflation book

Sec Id	IssuerName	Coupon	MatDate	Current Face	Trader's Price InvPx	Mkt Value	External Price			External Prices Diffs.			Results	
							EJVPx	IDCPx	Extel/Other	EJVPx	IDCPx	Extel/Other	Absolute Mkt Value	Variance
9128273T7	US TREAS INFLATION INDEX NOTE	3.83	01/15/08	(100,000,000)	102.44	(126,832,459)	102.52	102.55		(0.08)	(0.11)	126,832,459	(117,431)	
9128277J5	US TREAS INFLATION INDEX NOTE	3.38	01/15/12	(94,719,000)	105.47	(112,541,516)	105.56	105.59		(0.09)	(0.11)	112,541,516	(113,086)	
9128273T7	US TREAS INFLATION INDEX NOTE	3.63	01/15/08	(75,821,000)	102.44	(96,165,638)	102.52	102.55	102.58	(0.08)	(0.11)	96,165,638	(104,067)	
912828ET3	US TREAS INFLATION INDEX NOTE	2.00	01/15/16	(165,998,000)	96.11	(160,494,365)	96.12	96.18	96.21	(0.02)	(0.07)	160,494,365	(96,955)	
9128275V8	US TREAS INFLATION INDEX NOTE	4.25	01/15/10	(53,754,000)	107.03	(68,398,949)	107.11	107.13	107.16	(0.08)	(0.11)	68,398,949	(74,214)	
912810FR4	US TREAS INFLATION INDEX	2.38	01/15/25	86,133,000	98.32	89,864,726	98.28	98.27	98.30	0.04	0.05	89,864,726	(30,883)	
912828EA4	UNITED STATES TREASURY NOTE	1.88	07/15/15	(54,900,000)	95.47	(53,899,640)	95.50	95.52		(0.03)	(0.05)	53,899,640	(22,201)	
912810FD5	US TREAS INFLATION INDEX	3.63	04/15/28	12,552,000	119.91	18,614,152	119.78	119.83		0.13	0.08	18,614,152	(19,424)	
912828CP3	US TREAS INFLATION INDEX NOTE	2.00	07/15/14	(29,000,000)	96.91	(29,821,766)	96.94	96.95		(0.03)	(0.04)	29,821,786	(11,107)	
912828AP5	T 4 11/15/12	4.00	11/15/12	(34,910,000)	94.13	(32,859,981)	94.16	94.15		(0.03)	(0.02)	32,859,981	(8,026)	
912828BD1	US TREAS INFLATION INDEX NOTE	1.88	07/15/13	(9,168,000)	96.58	(9,642,898)	96.63	96.66	96.69	(0.05)	(0.08)	9,642,898	(7,988)	
9128274Y5	US TREAS INFLATION INDEX NOTE	3.88	01/15/09	(4,258,000)	104.36	(5,419,707)	104.42	104.46	104.49	(0.06)	(0.10)	5,419,707	(5,413)	
912828AP5	T 4 11/15/12	4.00	11/15/12	(23,000,000)	94.13	(21,649,372)	94.16	94.15		(0.03)	(0.02)	21,649,372	(5,288)	
912828FB1	US TREAS INFLATION INDEX NOTE	2.38	04/15/11	(3,558,000)	100.14	(3,590,508)	100.19	100.21		(0.05)	(0.07)	3,590,508	(2,250)	
9128273T7	US TREAS INFLATION INDEX NOTE	3.63	01/15/08	(517,000)	102.44	(655,724)	102.52	102.55	102.58	(0.08)	(0.11)	655,724	(710)	
9128274Y5	US TREAS INFLATION INDEX NOTE	3.88	01/15/09	(527,000)	104.36	(670,781)	104.42	104.46	104.49	(0.06)	(0.10)	670,781	(670)	
912828BD1	US TREAS INFLATION INDEX NOTE	1.88	07/15/13	(716,000)	96.58	(753,088)	96.63	96.66	96.69	(0.05)	(0.08)	753,088	(624)	
9128277B2	UNITED STATES TREAS NTS	5.00	08/15/11	(17,472,000)	99.93	(17,460,485)	99.92	99.93	99.96	0.01	0.00	17,460,485	(617)	
912828AF7	TII 3 07/15/12	3.00	07/15/12	(721,000)	103.65	(831,367)	103.69	103.75		(0.04)	(0.11)	831,367	(612)	
912828CZ1	US TREAS INFLATION INDEX NOTE	0.88	04/15/10	(904,000)	94.79	(904,780)	94.84	94.86		(0.05)	(0.07)	904,780	(544)	
9128272M3	TII 3 3/8 01/15/07	3.38	01/15/07	(479,000)	100.78	(609,449)	100.84	100.88		(0.07)	(0.10)	609,449	(494)	
9128275V8	US TREAS INFLATION INDEX NOTE	4.25	01/15/10	(357,000)	107.03	(454,262)	107.11	107.13	107.16	(0.08)	(0.11)	454,262	(493)	
9128276R8	US TREAS INFLATION INDEX NOTE	3.50	01/15/11	(364,000)	105.29	(440,459)	105.39	105.38	105.41	(0.10)	(0.09)	440,459	(453)	
912828CP3	US TREAS INFLATION INDEX NOTE	2.00	07/15/14	(696,000)	96.91	(715,723)	96.94	96.95		(0.03)	(0.04)	715,723	(267)	
9128277J5	US TREAS INFLATION INDEX NOTE	3.38	01/15/12	(162,000)	105.47	(192,482)	105.56	105.59	105.62	(0.09)	(0.11)	192,482	(221)	
9128277B2	UNITED STATES TREAS NTS	5.00	08/15/11	(6,152,000)	99.93	(6,147,945)	99.92	99.93	99.96	0.01	0.00	6,147,945	(217)	
912828EA4	UNITED STATES TREASURY NOTE	1.88	07/15/15	(511,000)	95.47	(501,689)	95.50	95.52		(0.03)	(0.05)	501,689	(207)	
912828AN0	T 3 11/15/07	3.00	11/15/07	1,397,000	97.13	1,356,915	97.11	97.13		0.02	(0.00)	1,356,915	(129)	
912828BV9	US TREAS INFLATION INDEX NOTE	2.00	01/15/14	(700,000)	97.07	(735,568)	97.06	97.11		0.01	(0.04)	735,568	(115)	
912810EZ7	T 6 5/8 02/15/27	6.63	02/15/27	630,000	115.92	730,309	115.92	115.89		0.00	0.03	730,309	(114)	
912810EZ7	T 6 5/8 02/15/27	6.63	02/15/27	459,000	115.92	532,082	115.92	115.89		0.00	0.03	532,082	(83)	
912828AN0	T 3 11/15/07	3.00	11/15/07	31,000	97.13	30,111	97.11	97.13		0.02	(0.00)	30,111	(3)	
912828DH0	US TREAS INFLATION INDEX NOTE	1.63	01/15/15	(647,000)	93.77	(635,529)	93.77	93.82		0.00	0.00	635,529	6	
912810EZ7	T 6 5/8 02/15/27	6.63	02/15/27	(145,000)	115.92	(168,087)	115.92	115.89		0.00	0.03	168,087	26	
912828AN0	T 3 11/15/07	3.00	11/15/07	(543,000)	97.13	(527,419)	97.11	97.13		0.02	(0.00)	527,419	50	
912828ET3	US TREAS INFLATION INDEX NOTE	2.00	01/15/16	200,000	96.11	193,719	96.12	96.18	96.21	(0.02)	(0.10)	193,719	74	
912828AN0	T 3 11/15/07	3.00	11/15/07	(1,266,000)	97.13	(1,229,674)	97.13	97.13		0.02	(0.00)	1,229,674	116	
912828FB1	US TREAS INFLATION INDEX NOTE	2.38	04/15/11	280,000	100.14	282,556	100.19	100.21		(0.05)	(0.07)	282,556	177	
912810FQ6	UNITED STATES TREASURY BOND	3.38	04/15/32	(171,000)	119.58	(230,439)	119.48	119.49	119.52	0.10	0.09	230,439	192	
912810FR4	US TREAS INFLATION INDEX	2.38	01/15/25	(878,000)	98.32	(916,039)	98.28	98.27	98.30	0.04	0.05	916,039	315	
9128277F3	UNITED STATES TREAS NTS	3.50	11/15/06	7,334,000	99.29	7,281,860	99.28	99.29	99.32	0.01	0.00	7,281,860	569	
9128277B2	UNITED STATES TREAS NTS	5.00	08/15/11	16,742,000	99.93	16,730,966	99.92	99.93	99.96	0.01	0.00	16,730,966	591	
912810FH6	US TREAS INFLATION INDEX	3.88	04/15/29	(582,000)	125.02	(885,351)	124.95	124.92	124.95	0.07	0.10	885,351	727	
912810FD5	US TREAS INFLATION INDEX	3.63	04/15/28	(513,000)	119.91	(760,760)	119.78	119.83		0.13	0.08	760,760	794	
912810EZ7	T 6 5/8 02/15/27	6.63	02/15/27	(5,831,000)	115.92	(6,759,414)	115.92	115.89		0.00	0.03	6,759,414	1,055	
912828AP5	T 4 11/15/12	4.00	11/15/12	4,791,000	94.13	4,509,658	94.16	94.15		(0.03)	(0.02)	4,509,658	1,101	
912828AP5	T 4 11/15/12	4.00	11/15/12	7,294,000	94.13	6,865,675	94.16	94.15		(0.03)	(0.02)	6,865,675	1,677	
912828BV9	US TREAS INFLATION INDEX NOTE	2.00	01/15/14	38,844,000	97.07	40,817,697	97.06	97.11		0.01	(0.04)	40,817,697	6,383	
912828CP3	US TREAS INFLATION INDEX NOTE	2.00	07/15/14	17,320,000	96.91	17,810,805	96.94	96.95		(0.03)	(0.04)	17,810,805	6,633	
912828EA4	UNITED STATES TREASURY NOTE	1.88	07/15/15	25,000,000	95.47	24,544,463	95.50	95.52		(0.03)	(0.05)	24,544,463	10,110	
912828BV9	US TREAS INFLATION INDEX NOTE	2.00	01/15/14	100,000,000	97.07	105,081,087	97.06	97.11		0.01	(0.04)	105,081,087	16,431	
912810FH6	US TREAS INFLATION INDEX	3.88	04/15/29	(17,733,000)	125.02	(26,975,820)	124.95	124.92	124.95	0.07	0.10	26,975,820	22,166	
912810FQ6	UNITED STATES TREASURY BOND	3.38	04/15/32	(25,366,000)	119.58	(34,183,069)	119.48	119.49	119.52	0.10	0.09	34,183,069	28,422	
912828DH0	US TREAS INFLATION INDEX NOTE	1.63	01/15/15	123,694,000	93.77	121,501,052	93.77	93.82		0.00	(0.06)	121,501,052	33,143	
912828CZ1	US TREAS INFLATION INDEX NOTE	0.88	04/15/10	66,615,000	94.79	66,672,472	94.84	94.86		(0.05)	(0.07)	66,672,472	40,096	
912810FS2	US TREAS INFLATION INDEX NOTE	2.00	01/15/26	(91,814,000)	92.56	(85,643,470)	92.48	92.51		0.07	0.05	85,643,470	51,612	
9128276R8	US TREAS INFLATION INDEX NOTE	3.50	01/15/11	42,703,000	105.29	51,672,813	105.39	105.38	105.41	(0.10)	(0.09)	51,672,813	53,163	
9128272M3	TII 3 3/8 01/15/07	3.38	01/15/07	100,000,000	100.78	127,233,532	100.84	100.88		(0.07)	(0.10)	127,233,532	103,235	
912828AF7	TII 3 07/15/12	3.00	07/15/12	131,750,000	103.65	151,917,599	103.69	103.75		(0.04)	(0.11)	151,917,599	111,782	
9128272M3	TII 3 3/8 01/15/07	3.38	01/15/07	117,455,000	100.78	149,442,144	100.84	100.88		(0.07)	(0.10)	149,442,144	121,254	
TOTALS:				76,671,000		92,380,703						1,914,992,087	(13,001)	
													0.00%	

Swap Pricing Example – Level 3

Pricing

USD LIBOR Swap Rates

Curve Point	LBSF Gov Yield	LBSF Spreads	LBSF Rate	Broker Rate	Variance Rate	Exposure	P/L Impact
2y	5.0372	45.00	5.4872	5.4846	(0.26)	(12)	3
3y	5.0295	46.75	5.4970	5.4945	(0.25)	(178)	45
4y	5.0300	48.75	5.5175	5.5179	0.04	871	36
5y	5.0305	51.75	5.5480	5.5480	0.00	(7)	(0)
7y	5.0649	54.00	5.6049	5.6037	(0.12)	137	(16)
10y	5.1166	55.75	5.6741	5.6718	(0.23)	420	(96)
12y	5.1166	59.75	5.7141	5.7110	(0.30)	715	(216)
15y	5.1390	61.75	5.7565	5.7548	(0.16)	1,339	(217)
20y	5.1614	63.25	5.7939	5.7912	(0.27)	351	(95)
25y	5.1838	61.50	5.7988	5.7996	0.08	911	73
30y	5.2062	59.00	5.7962	5.7982	0.20	(1,768)	(361)
40y	5.2062	58.00	5.7862	5.7880	0.18	(1,121)	(199)
						1,658	(1,043)

Complex Model Pricing Example – Callable Range Accruals

Pricing

◆ Details of callable range accrual structures that Lehman is comparing its marks with Totem's consensus survey:

Callable Range Accruals

Structure	Maturity	Rate	Freq	DCC	Spread	Coupon	Coupon Step-Up	Freq	DCC	Obs Index	Range Ceiling	Range Ceiling Step-Up	Range Floor
1. Fixed cpn, fixed range	10yr	3mL	Q	A/360	--	9.25%	--	Q	30/360	3mL	7.00%	--	0.00%
2. Fixed cpn, fixed range	10yr	3mL	Q	A/360	--	8.00%	--	Q	30/360	3mL	8.00%	--	0.00%
3. Fixed cpn, step up range	5yr	3mL	Q	A/360	--	11.25%	--	Q	30/360	3mL	5.50%	0.5%/yr	0.00%
4. Floating cpn, fixed range	7yr	3mL	Q	A/360	--	3mL + 6%	--	Q	30/360	3mL	6.00%	--	0.00%
5. Fixed cpn, fixed range	7yr	3mL	Q	A/360	--	8.25%	--	Q	30/360	3mL	7.00%	--	0.00%
6. Fixed cpn, fixed range	15yr	3mL	Q	A/360	--	9.25%	--	Q	30/360	6mL	7.50%	--	0.00%
7. Mixed cpn, fixed range	7yr	3mL	Q	A/360	--	See note below	--	Q	30/360	3mL	7.00%	--	0.00%
8. Fixed cpn, fixed range	5yr	3mL	Q	A/360	--	8.25%	--	Q	30/360	6mL	6.50%	--	0.00%
9. Step-Up cpn, fixed range	10yr	3mL	Q	A/360	--	See note below	--	Q	30/360	3mL	7.50%	--	0.00%
10. Fixed cpn, fixed range	15yr	3mL	Q	A/360	--	10.00%	--	Q	30/360	3mL	7.00%	--	0.00%
11. Fixed cpn, fixed range	10yr	6mL	S	A/360	--	10.75%	--	S	30/360	6mL	6.50%	--	0.00%
12. Mixed cpn, fixed range	10yr	6mL	S	A/360	--	See note below	--	S	30/360	6mL	6.00%	--	0.00%
13. Fixed cpn, fixed range	10yr	3mL	Q	A/360	--	7.75%	--	Q	30/360	1y	6.00%	--	0.00%
14. Step-Up cpn, fixed range	10yr	3mL	Q	A/360	--	See note below	--	Q	30/360	3mL	See note below	0.5%/yr	0.00%
15. Step-Up cpn, Step-Up range	5yr	3mL	Q	A/360	--	See note below	--	Q	30/360	3mL	6.50%	0.5%/yr	0.00%
16. CMS Countdown	10yr	3mL	Q	A/360	--	7.00%	--	Q	30/360	See note below	See note below	--	0.00%
17. CMS Countdown	10yr	3mL	Q	A/360	--	Yr 1-5: 7.50%; Yr 6-	--	Q	30/360	See note below	See note below	--	0.00%
18. Floating cpn, fixed range	20yr	3mL	Q	A/360	--	3mUSD + 2.00%	--	Q	30/360	3mL	8.00%	--	0.00%
19. Mixed cpn, fixed range	7yr	3mL	Q	A/360	--	7.50%	--	Q	30/360	6mL	9.00%	--	0.00%
20. Fixed cpn, fixed range	5yr	3mL	Q	A/360	--	6.50%	--	Q	30/360	3mL	6.50%	--	0.00%

* Pay Coupon + Step-Up If: Range Floor <= Obs Index <= Range Ceiling
 Trade 7: 7.75% Fixed for yrs 1-3; 3mL + 575bps for yrs 4-7
 Trade 9: 3mL + 225bps for yrs 1-5; 3mL + 400bps for yrs 6-10
 Trade 12: 3mL + 850bps for yrs 1-5; 3mL + 950bps for yrs 6-10
 Trade 14: 9.25% + 0.5% every year after.
 Trade 15: 5.75% (yr1), 6.25% (yr2), 6.75% (yr3), 7.25% (yr4), 7.75% (yr5)

◆ Results of output price testing:

Includes our number in avg *highest lowest after knockout

CRA Results

Structure	Lehman Price	PriceOut	Consensus Price	Spread	StDev	Price Diff (Totem-LB)	Lehman St.Dev
1. Fixed cpn, fixed range	92.92		74.67	59.52	16.91	(18.25)	1.08
2. Fixed cpn, fixed range	31.33		30.56	40.04	12.07	(0.77)	0.06
3. Fixed cpn, step up range	258.43		318.27	167.42	57.03	59.84	1.05
4. Floating cpn, fixed range	179.15		174.88	106.68	29.99	(4.27)	0.14
5. Fixed cpn, fixed range	90.35		69.44	46.62	13.85	(20.91)	1.51
6. Fixed cpn, fixed range	106.24		95.00	73.77	21.69	(11.24)	0.52
7. Mixed cpn, fixed range	113.69	*	87.10	38.60	12.07	(26.59)	2.20
8. Fixed cpn, fixed range	94.93		104.97	46.25	13.53	10.04	0.74
9. Step-Up cpn, fixed range	74.95	*	42.23	69.63	21.95	(32.72)	1.49
10. Fixed cpn, fixed range	186.87		147.31	90.71	24.88	(39.56)	1.59
11. Fixed cpn, fixed range	123.33		107.64	101.44	27.66	(15.69)	0.57
12. Mixed cpn, fixed range	84.64		118.65	131.50	45.47	34.01	0.75
13. Fixed cpn, fixed range	1,287.51		1,334.23	233.77	69.35	46.72	0.67
14. Step-Up cpn, fixed range	58.35		74.39	48.34	15.42	16.04	1.04
15. Step-Up cpn, Step-Up range	148.87		155.85	39.38	11.48	6.98	0.61
18. Floating cpn, fixed range	382.03		317.3094	138.7585		(64.72)	NA
19. Mixed cpn, fixed range	-64.68		-59.5859	11.58		5.09	NA
20. Fixed cpn, fixed range	364.27		351.6233	47.118	16.3903	(12.65)	0.77

Positive Diff = Conservative
 Negative Diff = Aggressive

Equities

Pricing

- ◆ Stock, Futures & Listed Options
 - PC independently verifies the entire portfolios
 - PC verifies prices by reference to external sources e.g. Bloomberg
 - PC applies a variance threshold of \$300k to highlight positions for further review and potential adjustment

- ◆ OTC Options, Warrants & Equity Linked Notes
 - PC independently verifies the entire portfolio
 - PC utilizes the equity volatility matrix to establish independent volatilities
 - The equity volatility matrix obtains the implied volatilities for a series of indexes and single names by first capturing volatilities for listed options from Bloomberg with various strike prices and expiration dates
 - After the matrix pulls all of the listed volatilities from Bloomberg, it creates a chart of volatilities for each name.
 - PC compares the estimated volatility levels with the trader's volatility levels
 - PC applies variance threshold of \$300k to highlight positions for further review and potential adjustment

Equities Basket Pricing Example – Level 4

Pricing

- ◆ An Equity Linked Note, on which, the holder receives the worst performing stock of 3 stocks if it falls under a threshold, otherwise, coupons.
- ◆ The key inputs to be price tested are: Correlations and Volatilities
- ◆ Correlations:
 - Calculated 2-year historical pairwise correlations ($\rho_{HIST\ ij}$) for APPC, GT, and PFE based on 2 year daily data from Bloomberg
 - Determined each pairwise Implied correlation (Finance's $\rho_{IMP\ ij}$) using the formula: $\rho_{IMP\ ij} = \rho_{HIST\ ij} + \alpha * (1 - \rho_{HIST\ ij})$
 - where $\alpha = 0.1941$, is an adjustment factor estimated from about 100 pairwise correlations, representing market participants' consensus collected by MarkIt.
 - Revalued the trade with Finance's $\rho_{IMP\ ij}$ to derive the price variance: \$78K (the trade value changed from \$(4,631)K to \$(4,553)K)
- ◆ Volatilities
 - Obtained Finance's volatilities for APPC, GT, PFE from Bloomberg.
 - The difference between Finance's volatility and the front office volatility is multiplied by the Vega sensitivity to determine the variance for each stock.
 - The total price variance for volatility is the sum of variance for each stock

Equities Basket Pricing Example – Level 4 (continued)

Front office Correlations

	APPC	GT	PFE
APCC	1.00	0.45	0.43
GT	0.45	1.00	0.39
PFE	0.43	0.39	1.00



MV: -\$4,631,431

Finance Correlation

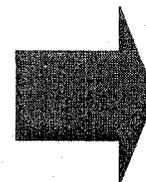
	APPC	GT	PFE
APCC	1.00	0.37	0.37
GT	0.37	1.00	0.32
PFE	0.37	0.32	1.00



MV: -\$4,552,959

Correlation Variance: \$78,472

Underlying	Front Office Vol	Fin Vol	Vega	Variance
APCC	30.78	30.69	10.96	-1
GT	39.34	40.11	15.18	12
PFE	21.95	23.51	7.32	11



Volatiltiy Variance: \$22,209

Illiquid Position Pricing Example – Convertible Bonds

Pricing

Sec Desc	Close Pos	Mark	Market Value	IDC	BGN	TRAC	Convertb ond	Average	Test Price	Test Mkt Val	Mkt Val Variance	Comments	Override
FLEETWOOD ENTERPRISES INC CONV	25,517,000	103.430000	26,392,233	102.50	-	-	103.38	102.66	102.50	26,154,925	(237,308)	within tolerance	
ALLOY INC CONV R/MD 5.375 08/0	8,535,000	105.500000	9,004,425	109.88	108.52	108.52	147.38	73.42	108.26	9,239,650	235,225	Priced to TRAC near close F4C	108.2560000
TRANSOCEAN SECDCO FOREX INC DE	10,000,000	70.860000	7,086,000	-	-	-	66.37	62.00	73.11	7,311,280	225,280	Priced to theoretical, val = 45%, trigger = 1	73.1128000
CONEXANT SYS INC SUB NT CONV 0	25,000,000	96.850000	24,212,500	96.13	96.11	-	97.00	83.67	96.13	24,031,250	(181,250)	within tolerance	
MERCURY INTERACTIVE CORP	18,654,000	104.500000	19,493,430	103.63	-	-	104.50	105.54	103.63	19,330,208	(163,223)	within tolerance, variance based on size	
AMERICAN EXPRESS CO CONV SR DE	17,500,000	103.694000	18,146,450	102.88	103.60	103.60	103.69	74.33	102.88	18,003,125	(143,325)	within tolerance, variance based on size	
LIBERTY MEDIA CORP SR EXCHANGE	20,347,000	106.667948	21,703,727	105.75	106.88	106.88	107.13	76.46	106.03	21,574,128	(129,600)	Priced to 5/30 close, where underlying (TWX)	106.0310000
UNIVERSAL HLTH SVCS INC DEB CO	24,653,000	57.061000	14,067,248	56.63	-	-	57.06	56.93	56.63	13,959,761	(107,487)	within tolerance, variance based on size	
WYETH CONV NOTE R/MD 4.23875 0	38,033,000	104.400000	39,706,452	104.13	104.13	104.13	104.00	73.39	104.13	39,603,763	(102,689)	within tolerance, variance based on size	
AMGN 0 03/32 REG (NEW)	92,738,000	73.860000	68,496,287	73.75	73.80	73.80	74.06	55.21	73.75	68,394,275	(102,012)	within tolerance, variance based on size	
CIENA CORP SR NT CONV R/MD .25	(10,000,000)	92.550000	(9,255,000)	91.38	89.48	89.48	87.38	68.76	93.38	(9,337,700)	(82,700)	Delta Neutral Calc, F15C	93.3770000
MERCURY INTERACTIVE CORP CONV	9,233,000	104.500000	9,648,485	-	-	-	-	99.25	103.63	9,567,696	(80,789)	Priced to IDC registered counterpart	103.6250000

Price Testing Process:

1. Prices from various sources are ranked according to hierarchy to determine Test Price
2. Test Market Value is compared to Lehman Market Value to determine variance
3. Variances are investigated individually and Test price is overridden with more reliable price. Override may be based on:
 - a.) Trade Data
 - b.) Theoretical Price
 - c.) Broker Quote
 - d.) Delta Neutral Calculation

CDO

Pricing

◆ Cash CDO

- PC independently verifies all cash CDO with market value in excess of \$1mm

- PC verifies prices by reference to:
 - Recent trading activity
 - Independent market quotes
 - Alternative analytical procedures e.g. spread / yield benchmarks provided by research reports and model valuation analysis

- PC applies variance thresholds of \$300k for level 1 products and \$500k for level 3 and 4 products to highlight positions for further review and potential adjustment

CDO (continued)

Pricing

◆ Synthetic CDO

- PC independently verifies pricing on all synthetic CDO positions
- PC obtains yield curves from the Interest Rate Products desk. Yield curves are verified by the IRP controllers and not the CDO controllers
- PC obtains credit spreads from the Corporate Credit (e.g. Structured Credit Trading) desk. Credit spreads are verified by the Corporate Credit controllers and not the CDO controllers. This is achieved through the use of Mark-it partners
- Utilize the Mark-it partners consensus survey to understand the types of CDO portfolios that can be appropriately valued by the model by mapping the Mark-it portfolios to Lehman portfolios through the use of a scorecard.
- On a quarterly basis, PC verifies internal recovery rate assumptions against Mark-it Partners consensus survey

Synthetic CDO Pricing Example – Level 4

Pricing

- ◆ Mark-it partners supplies spread and recovery rate data for several baskets e.g. Global 1, consisting of 100 names, for points up to 10 years
- ◆ The data is supplied for 11 CDO portfolios

Global1

Rank	Company	Country	CDS										Upfront (appx.)	
			1y	2y	3y	4y	5y	6y	7y	8y	9y	10y	Recovery	RfA
1	Volvo AB	SE	4.0	4.5	6.4	12.9	18.9	24	28.0	31.3	33.8	35.7	37.2	40
2	Abbey National plc	SUB GB	4.0	4.5	5.0	9.6	14.4	19	21.8	24.4	26.4	28.0	29.2	15
3	Allianz AG	SUB DE	4.0	4.5	10.8	19.4	27.3	34	39.4	43.6	47.0	49.6	51.6	15
4	Allied Domecq plc	GB	4.0	4.5	12.4	21.6	30.1	37	43.1	47.7	51.3	54.1	56.2	40
5	American Express Co	US	4.0	4.5	6.5	13.1	19.1	24	28.3	31.5	34.0	36.0	37.5	40
6	Casio Computer Co Ltd	JP	4.0	4.5	5.0	6.8	10.5	14	16.1	18.0	19.6	20.8	21.7	40
7	AXA	SUB FR	4.0	4.5	11.0	19.7	27.7	34	39.9	44.2	47.5	50.2	52.2	15
8	BAA plc	GB	4.0	4.5	5.0	8.9	13.5	17	20.4	22.8	24.8	26.2	27.4	40
9	BAE Systems plc	GB	4.1	6.4	15.2	25.4	34.8	43	49.2	54.3	58.2	61.3	63.7	40
10	Banco Santander Central Hispano SA	SUB ES	4.0	4.5	5.0	9.8	14.6	19	22.0	24.6	26.7	28.3	29.5	15
11	Bank of America Corp	US	4.0	4.5	5.0	9.9	14.8	19	22.3	25.0	27.1	28.7	29.9	40
12	Bank One Corp	US	4.0	4.5	7.2	14.0	20.4	26	30.1	33.5	36.1	38.2	39.8	40
13	Mitsui Fudosan Co Ltd	JP	4.0	4.5	5.0	8.9	13.4	17	20.3	22.8	24.7	26.2	27.3	40
14	Bayerische Motoren Werke AG	DE	4.0	4.5	5.2	11.0	16.3	21	24.4	27.3	29.6	31.3	32.6	40
15	Boeing Co, The	US	4.0	4.5	5.7	11.8	17.4	22	25.9	28.9	31.3	33.1	34.5	40
16	British American Tobacco plc	GB	5.8	8.3	17.8	28.8	39.1	48	54.6	60.1	64.4	67.8	70.3	40
17	British Telecommunications plc	GB	4.0	5.8	14.4	24.4	33.5	41	47.5	52.5	56.4	59.4	61.7	40
18	Carrefour SA	FR	4.0	4.5	5.8	11.9	17.5	22	26.1	29.2	31.5	33.4	34.8	40
19	Cingular Wireless LLC	US	4.0	4.5	6.7	13.4	19.5	25	28.9	32.2	34.8	36.8	38.3	40
20	CIT Group Inc	US	4.0	4.6	12.6	21.9	30.5	38	43.6	48.2	51.9	54.7	56.8	40
21	Citigroup Inc	US	4.0	4.5	5.0	10.1	15.0	19	22.6	25.3	27.4	29.0	30.3	40
22	COMPAGNIE DE SAINT-GOBAIN	FR	4.0	4.5	6.8	13.4	19.5	25	28.9	32.2	34.8	36.8	38.4	40
23	Constellation Energy Group Inc	US	4.0	4.5	8.4	15.8	22.7	29	33.3	37.0	39.9	42.2	43.9	40
24	DaimlerChrysler AG	DE	14.2	17.3	29.3	43.3	56.2	67	75.9	82.9	88.3	92.5	95.8	40
25	Deutsche Bank AG	SUB DE	4.0	4.5	6.2	12.5	18.4	23	27.3	30.5	32.9	34.8	36.3	15

Synthetic CDO Pricing Example – Level 4 (continued)

Pricing

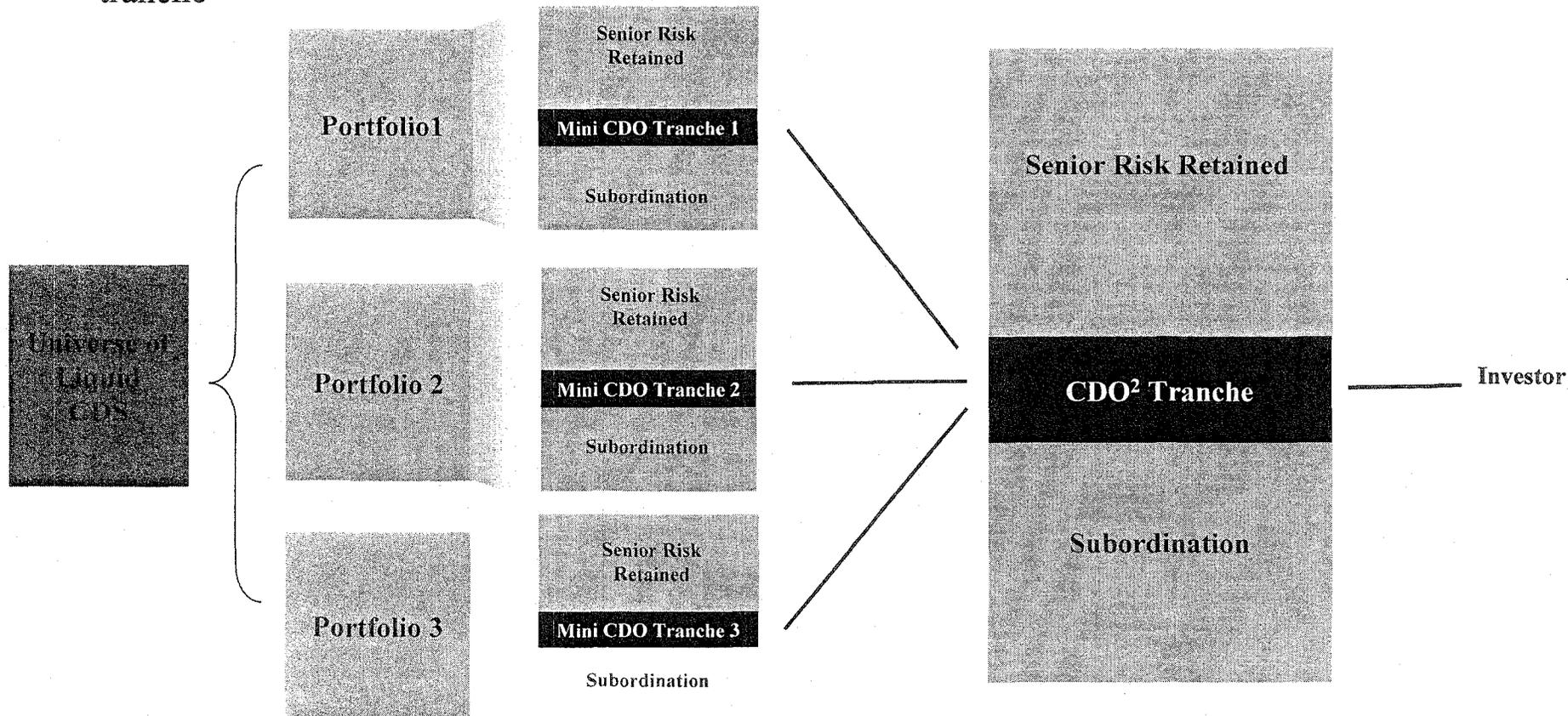
- ◆ PC then uses the data provided by Mark-it partners to generate Credit default swap spreads, PV01s and correlation for various attachment points and with maturities up to 10 year
- ◆ Mark-it partners then collate the data from 23 contributors including ABN Amro, Bank of America, Barclays, Bear Sterns, Citigroup, CSFB, Deutsche, HSBC, Goldman Sachs, JP Morgan Chase, Merrill Lynch, Morgan Stanley
- ◆ Mark-it then returns consensus data and this is compared to the Firm's marks

Markit Valuations Tranche Service Submission Template

	Tranche	Attachment	Size	CDS Spread				PV01			
				3	5	7	10	3	5	7	10
Global1	Super Senior	15.00%	85.00%	4.2	5.0	8.6	15.1	2.87	4.54	6.05	7.99
100 Names	10-15%	10.00%	5.00%	13.5	21.8	37.6	60.2	2.86	4.53	6.00	7.84
Swap Ref 42.2	7-10%	7.00%	3.00%	19.6	47.7	71.2	105.5	2.86	4.52	5.97	7.76
	5-7%	5.00%	2.00%	33.2	81.4	133.2	189.3	2.86	4.50	5.91	7.61
	3-5%	3.00%	2.00%	73.9	197.9	327.3	424.0	2.85	4.44	5.74	7.21
	2-3%	2.00%	1.00%	183.6	516.6	742.7	848.2	2.83	4.27	5.31	6.36
	Equity	0.00%	2.00%	1081.3	1578.2	1743.6	1690.1	2.51	3.40	3.91	4.41

Synthetic CDO² Pricing Example – Level 4

- ◆ CDO Squared: tranche on a portfolio contains synthetic CDO tranches
 - Exposed to large number of credits (200- 350)
 - There are overlaps among mini CDOs
- ◆ CDO Squared tranche is protected by subordination of mini CDO tranches as well as master CDO tranche



Synthetic CDO² Pricing Example – Level 4 (continued)

Pricing

- ◆ Reasons for using vanilla CDO as proxy
 - The behavior of CDO² is closely related to CDO
 - So we can leverage our experience of vanilla CDO
 - Provide similar PV / survival probabilities

- ◆ Constructing a Proxy CDO
 - Add up all mini tranches (netting overlapping credits)
 - Monte Carlo Simulation (10,000 iterations) is used to find corresponding attachment points
 - We want to figure out the subordination level of the proxy CDO tranche to make its survival probability on maturity date the same as that of CDO master tranche

Synthetic CDO² Pricing Example – Level 4 (continued)

Pricing

- ◆ Maturity: 7 years
- ◆ Portfolio: 260 credits
- ◆ 6 underlying mini CDOs
 - 100 equally weighted credits
 - Each credit appears in 2 or 3 mini CDOs
 - 100MM notional amount
- ◆ 6 mini Tranches
 - Width: 3%, or 3MM in notional amount
 - Subordination: around 6.5% - 7.5%, add up to 43.7MM in absolute amount
- ◆ Master CDO
 - Total notional: $3\text{MM} \times 6 = 18\text{MM}$

Synthetic CDO² Pricing Example – Level 4 (continued)

Pricing

- ◆ Underlying CDO:
 - 260 credits
 - Notional of each credit: 1MM * Overlap
 - Total Notional=100MM * 6=600MM

- ◆ Loss on default for each credit: 2 or 3 units (same as overlap)

- ◆ We want to figure out the subordination level of the proxy CDO tranche to make its survival probability on maturity date the same as that of CDO master tranche

- ◆ Value as a typical synthetic CDO

Liquid Position Pricing Example – Leveraged Loans

Pricing

- ◆ The following illustrates the price verification of six liquid leveraged loan positions:

LEH ID	Name	Facility	Sprd	Maturity	Position	Internal Price	Internal MTM	External Price	External MTM	VAR	Extrnl Source / Comments
4591	GEORGIA-PACIFIC CORP	USD TLA	2.25%	12/20/10	45,357,559	100.000	45,357,559	99.953	45,336,286	(21,273)	LSTA; 8 BIDS
3971	DEX MEDIA, INC. (EAST)	NEW TRANCHE TLA	1.25%	11/08/08	12,037,016	99.000	11,916,645	99.321	11,955,332	38,687	LSTA; 7 BIDS
3974	DEX MEDIA, INC (WEST)	NEW TRANCHE TLA	1.25%	09/09/09	6,487,933	99.000	6,423,053	99.321	6,443,905	20,852	LSTA; 7 BIDS
3856	HAWAIIAN TELCOM COMM	DELAYED DRAW TLA	2.25%	04/30/12	12,000,000	100.000	12,000,000	99.656	11,958,756	(41,244)	LSTA; 4 BIDS
2802	WMG ACQUISITION CORP	REVOLVER	2.25%	02/28/10	1,772,667	96.500	1,710,623	96.825	1,716,385	5,761	LSTA; 5 BIDS
4953	GENERAL GROWTH PROP	USD TLA	0.00%	02/24/10	29,750,000	98.500	29,303,750	98.725	29,259,984	(43,766)	LSTA; 10 BIDS

Illiquid Position Pricing Example – Leveraged Loans

Pricing

- ◆ Position Overview - In June 2003 Lehman Brothers became a lender in a Ford Motor Credit Company (“FMCC”) secured back-stop Liquidity Facility for FMCC’s asset-backed commercial paper (“ABCP”) conduit FCAR Owner Trust (“FCAR”). The original unsecured commitment consisted of a \$85 million 364 day facility and a \$140 million 5 year commitment to FCAR.
- ◆ PC reviews the financial performance of FCAR based on monthly statements provided by FMCC:

	Structural Enhancement	Net Losses	+61 Days Delinquent
Historical (1997 - 2001)	3% to 5%	1.34%	0.35%
Jul-03	3.97%	1.87%	0.88%
Jul-04	4.10%	1.63%	0.26%
Jul-05	3.92%	0.89%	0.15%
Dec-05	3.79%	0.99%	0.15%
Mar-06	3.64%	0.98%	0.28%
Apr-06	3.87%	0.98%	0.28%
May-06	3.22%	0.98%	0.28%
Jun-06	3.41%	0.98%	0.28%

- ◆ PC benchmarks the position to similar securities based on underlying assets, duration / average life and credit rating. The following are the performances of the benchmark securities over the last three months:

Apr-06									
FORDO 06-A A2A		FORDO 06-A A3		FORDO 06-A A4		FORDO 04-A B		FORDO 04-A C	
Price	Yield	Price	Yield	Price	Yield	Price	Yield	Price	Yield
99.81	5.29	99.56	5.36	99.38	5.48	97.56	5.13	97.72	5.32
May-06									
FORDO 06-A A2A		FORDO 06-A A3		FORDO 06-A A4		FORDO 04-A B		FORDO 04-A C	
Price	Yield	Price	Yield	Price	Yield	Price	Yield	Price	Yield
99.78	5.33	99.38	5.47	99.06	5.69	97.52	5.21	97.47	5.48
Jun-06									
FORDO 06-A A2A		FORDO 06-A A3		FORDO 06-A A4		FORDO 04-A B		FORDO 04-A C	
Price	Yield	Price	Yield	Price	Yield	Price	Yield	Price	Yield
99.75	5.41	99.19	5.62	98.84	5.87	97.56	5.25	97.53	5.50

- ◆ Based on the financial performance of FCAR and the performances of benchmark securities over the last three months, PC was comfortable with the mark of 99.90 for the 364 day facility and 99.50 for the 5 year commitment.

Appendix

Explanation of Significant Variances – Fixed Income Division

Pricing

Business	Exposure Type	Level	Risk Measure	Exposure Size \$'000	Initial Variance \$'000	Remarkd \$'000	Resolved \$'000	Resolution
<i>Americas</i>								
Bank Loans	XEROX CORP 5YR (4/7/06)	1	MV	75,000	581	581		Desk changed mark post month-end; remaining variance is within threshold.
Bank Loans	GENERAL ELECTRIC CAPITAL CORP	1	MV	(54,866)	(347)	(347)		Desk changed mark post month-end; remaining variance is within threshold.
Bank Loans	MIRANT NORTH AMERICA (1/3/06)	1	MV	70,000	350	350		Desk changed mark post month-end; remaining variance is within threshold.
High Grade Credit: Americas	Southwestern 7.35 10/17	1	MV	9,752	648		648	Position was sold in June
IRP - Derivatives	USD Swap Curve	3	PV01	1,658	(1,043)		(1,043)	All marks are within 1/2 bp (B/O = 1bp). No adjustment necessary.
IRP - Derivatives	Libor-CP Basis	3	PV01	(201)	(1,027)		(1,027)	Variance is mainly attributable to inactivity in the market, as there is currently a lack of demand for these swaps. Variance represents 5bps based on net exposure and 4bps base on gross exposure.
IRP - Derivatives	CDS Hedge	3	PV01	(650)	2,270		2,270	Variance mostly came from LAZIO and Italy curves credit spread widening. Discussed with traders, they do not want to remark too aggressively as there is really no market for these illiquid CDS.
Mortgage Trading	SAIL NIM 2004-3 A	3	MV	5,170	584	584		Remarkd.
Mortgage Trading	IMSA 00-3 M3 CMO SERIES 00-3	3	MV	1,614	378	378		Remarkd.
Muni - Cash	HILLSBOROUGH CNTY FLA AVIATION	3	MV	2,277	(1,197)		(1,197)	Delta Airline bonds. Trader's mark is 55.0 and external price is 26.1 as of May monthend. External source was incorrect at month-end and was corrected to 64.86 (as of 6/8/06 when pricing is performed), while our desk has updated our internal price to 60. The current variance is below PC's pricing threshold and therefore does not require further action.
Muni - Cash	MINNEAPOLIS & ST PAUL MINN MET	3	MV	8,227	(308)		(308)	NW Airline bonds. Recent MSRB trades ranged between 70.0 and 77.0, the trader's current mark is 73.125, while IDC marks it at 70.386. Therefore, trader's mark appears reasonable.
Muni - Cash	ALLIANCE TEX ARPT AUTH SPL FAC	3	MV	24,197	359		359	American Airline bonds. Recent MSRB trades ranged from 93.72 to 100.00, trader's mark of 97.313 is within the bid and offer range.
Muni - Cash	NEW YORK N Y CITY INDL DEV AGY	3	MV	21,871	421		421	American Airline bonds. Prior trades on MSRB ranged between 108.600 to 111.155. The trader's mark of 108.810 is within the bid and offer range.
Muni - Cash	N Y CITY HSG DEV CORP MILITARY	3	MV	9,113	495		495	Lehman owns the whole issue as we were the sole underwriter of the military housing bonds. The piece we own currently is the sub debt of the senior and subordinate structure of the bonds. Variance mainly due to limited liquidity in this structure and lack of trading activities.

Explanation of Significant Variances – Fixed Income Division (continued)

Pricing

Business	Exposure Type	Level	Risk Measure	Exposure Size \$'000	Initial Variance \$'000	Remarkd \$'000	Resolved \$'000	Resolution
Muni - Cash	Becker MN Pollution Control (Northern PowerCP)	3	MV	61,209	506		506	Price variance due to the size of position held. Actual price variance is only 0.8%
Muni - Cash	Becker MN Pollution Control (Northern PowerCP)	3	MV	61,209	506		506	Price variance due to the size of position held. Actual price variance is only 0.8%
Muni - Cash	NEW YORK N Y CITY INDL DEV AGY	3	MV	30,110	755	755		American Airline bonds. Recent MSRB trades ranged between 109.7 to 110.897, while the trader's current mark is 108.70. Subsequently in June, PC verified that the internal mark was tightened to 109.66. The variance is also partially due to size of position held (over 30mm). PC will continue to monitor the position and price variance.
Muni - Cash	New York TFA Step Aa1/AAA	3	MV	133,946	853		853	Price variance due to the size of position held. Actual price variance is only 0.6%
Muni - Cash	NEW YORK N Y CITY INDL DEV AGY	3	MV	67,200	1,354		1,354	7 WTC Development bonds. Recent MSRB trades ranged between 99.594 to 105.403, while the trader's current mark of 103.265 is within the bid and offer range. This building has recently been completed and is currently 20% leased out, with Moody's potentially moving in to the building as well. PC and the desk will continue to monitor current events affecting this security.
Real Estate	LB Freeport LLC	4	MV	6,747	(6,747)		(6,747)	Property damaged by Hurricane in 2004. LB negotiating insurance claims. Based on latest estimated proceeds, \$5mm mark-down was taken in Jul-05 and another \$5mm in Sep-05. Loss offset by gain on debt position. Position marked to estimated recoverable value on a combined basis.
Real Estate	PCCP-Roseville(PAMI direct)	4	MV	5,000	25,548		25,548	1,678 acres of entitled land adjacent to the City of Roseville, CA. Plan is to complete improvements and sell lots to homebuilders. Current value is based on the present value of projected lot sell-out values. A slow down in home sales and rising construction costs are expected to result in reduced demand for lots by homebuilders. Home sales in Roseville were down 37% in Jun-06 versus the same period in 2005. The deal is not expected to be exited until 2012. Due to the large size of the project, the longer time period required to sell, and the slowdown in the west coast housing market, no mark-up is suggested at this time. Continue to monitor progress of lot sales.
Real Estate	LB Kamalani Inc.	4	MV	18,726	8,128		8,128	The property consists of a single parcel located off Waikoloa Beach Drive, on the island of Hawaii. Luxury housing development in its early stages. Continue to monitor progress of development and sales. No mark-up suggested at this time.
Real Estate	LB Rectort Inc.	4	MV	0	11,859		11,859	A 49% equity interest in a partnership that owns a class B, 26 story, 409k sf office building in downtown Manhattan. Property is 98% occupied. LB's ability to force a sale is limited. Lehman is currently discussing its intent to exit the deal with the sponsor. The senior debt in already in a securitization and any prepayments will have significant costs. A major tenant, NYC Department of Transportation, occupying about 18% of the rentable area has given notice that it will be leaving the building in August 2007. This will delay the discussion with sponsor regarding the sale of the asset, as the sponsor will first like to re-lease the space to be vacated. No mark-up suggested as our ability to realize the profits is uncertain at this time. Continue to monitor the progress of discussions with sponsor and leasing status.
Real Estate	Boulder Springs	3	MV	41,895	7,384		7,384	An unentitled 658-acre master-planned community located in Riverside County, CA. Development project in its early stages. Currently, in the process of obtaining regulatory approvals. No mark-up suggested. Will continue to monitor land development and obtaining of regulatory approvals.
Real Estate	LB Lai Honua LLC	4	MV	27,390	24,948	24,948		The Waiea Beach Villas at La'i Honua is a luxury condo development located within the Grand Waiea Resort & Spa in Maui, Hawaii. Construction is completed and Certificate of Occupancy obtained. Legal suit by general contractor. Partnership set aside \$19 million in an escrow with an insurance company in order to be able to close units. Marked up by \$7mm in May-06.
Real Estate	LB Fannington Hills V LLC	4	MV	5,000	(5,000)	(5,000)		Subject is a 26.05 acre parcel developed with 307,688 SF of speculative office space (two four-story buildings). The property is 40.75% leased to two tenants as of 4/06. Position written-off in May-06.
Real Estate	PCCP LB Culver Studios LLC	4	MV	18,616	(6,203)		(6,203)	Property is a full service movie studio on a 14 acre site in Culver City, CA. Property was unable to sustain debt service due to a stagnant lease season. The mezz loan was modified to accrue interest until such a time that cash flow is sufficient to cover debt. The Partnership has decided to construct an office adjacent to the studio. Construction will most likely start in 2Q 2006. Current value is based on the value of studio. Recent leasing activity as well as the construction of the office building is expected to increase the value of the property. Continue to monitor progress of construction and leasing activity.
				66,055	22,250	43,806		

Explanation of Significant Variances – Fixed Income Division (continued)

Pricing

Business	Exposure Type	Level	Risk Measure	Exposure Size \$'000	Initial Variance \$'000	Remarkd \$'000	Resolved \$'000	Resolution
<i>Europe</i>								
CDO	Index Tranche Default Swaps : CDXYH6 00-10% 5Y	3	PV01	78	1,800		1,800	Net index variance is deemed immaterial.
CDO	Index Default Swaps : ITRX S4 5Y Index	3	PV01	2,660	(2,000)		(2,000)	Net index variance is deemed immaterial.
					(200)	0	(200)	
<i>Asia</i>								
IRP - Derivatives	Swaptions/Caps/Floors/Exotics - ATM volatility	3	Vo1 + 1%	54,196 (Gross)	(1,340)		(1,340)	JPY Swaption price based testing was \$3.9mm aggressive against TOTEM. This was due to the trader being roughly 0.6% higher than the market on 5 yr maturities. Given the size of the traders exposure, approximately long \$5m, and the relatively small size of the volatility variation no further action is proposed. This result is offset by conservative marks on KRW swaptions which are marked lower 0.45% vols lower in the same bracket on long exposure of \$3.1mm.
IRP - Derivatives	Swaptions/Caps/Floors/Exotics - IR/FX correlation	4	Correl + 1%	385 (Gross)	1,088		1,088	We adopt an indicative approach by comparing the marks against historical correlations calculated directly from the respective market data variables, FX rate and Foreign and Domestic interest rate movements over a period of one year. The results indicate that the correlations are conservatively marked by \$1.1mm. The approximate nature of this calculation means we are satisfied with the variance.
IRP - Derivatives	Interest rate swaps / FRAs / FX fws - Interest rates	3	PV01	30,999 (Gross)	5,741		5,741	The result indicated net variance of \$5.7mm conservative on absolute risk of \$31mm. This was due to a small difference 0.5bps on large mid range JPY IR Libor exposure. This has been communicated to the desk. Given the size of the exposure we are satisfied with the variance.
FX & EMG JV LM	Swaptions/Caps/Floors/Exotics - FX volatility	3	Vo1 + 1%	7,313 (Gross)	385		385	This is due to slightly conservative cross correlation between zar/usd vs usd/jpy. Given the relatively small size of the variance (compared to the exposure) we are comfortable with the marking.
High Grade Credit: Short term Credit	HUWHY	3	MV	20,218	(294)		(294)	Variance is approximately 1% of the mtn. Given the nature of the credit, we are comfortable with the relatively small variance.
High Grade Credit: Short term Credit	PHILIP	3	PV01	(29)	364		364	PHILIPPINES (Sovereign) Net long CDS protection \$(28)k CS01. Closely marked to market (within 3 bps), variance due to large risk exposure, therefore we are happy with these marks are within Bid/Offer.
High Grade Credit: Short term Credit	GE	3	MV	10,773	(212)	(212)		Trader mark was 2pts above market price, and has remarked to within 1pt since month-end reducing the variance to less than 1% of mtn. We are comfortable with this small relative variance.
High Grade Credit: Short term Credit	SANYO	3	MV	49,489	300	300		Conservative price variance <1.5% split on different bonds from same issuer. Trader has since realised part of the positive variance, we are now comfortable as variance has been narrowed within Bid/Offer range.
High Grade Credit: Short term Credit	SAPURA	3	MV	7,000	428		428	This is an illiquid position which is hedged with a long CDS protection. Overall the risk is small and position is marked conservatively. The position is marked consistent with the CDS protection leg.
					6,460	88	6,372	
Total Significant Variances					<u>72,316</u>	<u>22,338</u>	<u>49,978</u>	

Explanation of Significant Variances – Equities Division

Pricing

Business	Exposure Type	Level	Risk Measure	Exposure Size \$'000	Initial Variance \$'000	Remarkd \$'000	Resolved \$'000	Resolution
<i>Americas</i>								
Volatility	BMOPEERS 2007 Volatility and Correlation	4	Revaluation	NA	(1,568)	(1,568)		Variance is trended month to month and there was an increase in negative variance of \$(0.6)mm on this position as a result of increased volatility in both BMO and the BMO Peers. The volatilities were remarked after monthend. Finance vols were 20% and 16% vs. Front office 16% and 15.5% for BMO and PEERS respectively, the Front office remarked to 18 and 17.5% which is within tolerance.
Volatility	HOUSING BASKET NOTE Skew and Volatility	4	Revaluation	NA	951		951	Variance mainly due to skew/smile which is trended from month to month. April variance: \$1.1mm. The variance is within tolerance given the size of the product and the consistent trend.
Volatility	DPL WARRANT Dividend	4	D Rho	(336)	(908)		(908)	Small dividend yield difference across large Drho position - no remarking proposed
Volatility	DGX March 2008 Collar Volatility	3	Vol + 1%	352	856		856	The Variance was due to volatility skews and is within tolerance because of the size of the Vegas for individual calls in the collar.
Volatility	DCELL CLIQUET NOTE Volatility	4	Vol + 1%	34	686		686	The listed market for this position is illiquid and the position is tested using the SPX skew. The historical ATM is based on a 100 day lookback since large event driven moves occurred before this period. The trader has remarked his volatility to 43 and we will review the variance in the following month.
Volatility	DGX December 2007 Collar Volatility	3	Vol + 1%	313	595		595	The Variance was due to volatility skews and is within tolerance because of the size of the Vegas for individual calls in the collar.
Volatility	HD COLLAR August 2006	3	Vol + 1%	174	559		559	Front office is marking this position at no skew due to size. The overall variance is within tolerance based on the size of the position.
Volatility	HOUSING/CD BASKET NOTE Skew and Volatility	4	Vol + 1%	111	494		494	Variance mainly due to skew/smile which is trended from month to month. April variance: \$0.6mm. The variance is within tolerance given the size of the product and the consistent trend.
Volatility	AA YEELDS Volatility	3	Vol + 1%	194	(458)		(458)	At monthend trade was outside of tolerance, however on 6/13 the volatility difference was within 1 point and within tolerance
Volatility	MEDIA BASKET NOTE Volatility	4	Vol + 1%	(280)	(425)		(425)	Variance is due to increases in volatility and correlation, finance believes that the front office volatility mark may be slightly low. The variance will be trended month to month. April variance was \$(0.3)mm and given the subjective nature of the mark, no remark is proposed.
Volatility	GOOG Collar Volatility	3	Vol + 1%	68	(413)		(413)	The desk has remarked post month-end
Volatility	BMOPEERS 2006 Volatility and Correlation	4	Vol + 1%	0	(369)		(369)	Variance is trended month to month and there was an decrease in positive variance of \$(0.4)mm on this position as a result of increased volatility in both BMO and the BMO Peers. The volatilities were remarked after monthend. Finance vols were 20% and 16% vs. Front office 16% and 15.5% for BMO and PEERS respectively, the Front office remarked to 18 and 17.5% which is within tolerance.
Volatility	SPX December 2009 OTC	3	Vol + 1%	1,131	356		356	Small volatility difference on a large position - no remark proposed.
Convertibles	NABORS INDS INC GTD SR EXCHANG	1	MV	260,355	565		565	The inventory has since been largely sold off and the variance no longer remains.
					923	(1,664)	2,587	

Explanation of Significant Variances – Equities Division (continued)

Pricing

Business	Exposure Type	Level	Risk Measure	Exposure Size \$'000	Initial Variance \$'000	Remarkd \$'000	Resolved \$'000	Resolution
<i>Europe</i>								
Volatility	Vega - Eurostoxx	3	Vol + 1%	(3,316)	1,824		1,824	The variance spreads evenly across the term and skew. With the ATM volatility differential less than 6bps, this is within the current bid/offer spread and deemed within tolerance.
Volatility	Vega - SMI - Swiss Market Index	3	Vol + 1%	(195)	985		985	The variance spreads evenly across the term and skew. With the ATM volatility differential less than 20bps, this is within the current bid/offer spread and deemed within tolerance.
Volatility	Vega - SAP	3	Vol + 1%	918	(854)		(854)	the variance occurs primarily at the 2 year ATM point where we have a Vega sensitivity of \$1.9MM and a volatility variance of 60bps, and for a single name this is considered within tolerance.
Volatility	Vega - Markit Stocks	3	Vol + 1%	1,451	(482)		(482)	The variance spreads over 8 underliers and the volatility differences are less than 1%. Within tolerance
Volatility	Vega - US Vols	3	Vol + 1%	281	314		314	The variance spreads over 3 underliers with subjective long dated volatilities. Within tolerance, given the size of the variance and subjective benchmarks
Volatility	Corporate Bonds	1	MV	92,073	521		521	There were 3 bonds as focus items namely Friends Provident, ABB and Cap Gemini yielding a variance of \$521K – the variance was 1.2%, 2.8% and 2.5% respectively when compared to Bloomberg and given the large market value this is considered within tolerance.
Volatility	Listed Futures	1	MV	1,411,113	876		876	Within tolerance, given large futures positions
Strategic Prop	KBC GROEP NV SHR 0.00EUR	1	MV	(19,139)	1,395	1,395		Post month end this product has been re-priced to reflect the correct spread with Almanora (which was held in a swap) and there are no further issues to note.
					4,579	1,395	3,184	
<i>Asia</i>								
Volatility	Topix Variance Swap	3	MV	(136)	1,621	1,621		Outside Tolerance - The variance was discussed and the position was remarked on Jun 9 and the P&L flashed.
Volatility	MSCI Singapore Options	3	MV	155	463	463		The desk has remarked the position post month-end
Volatility	China Construction Bank	3	Vol + 1%	364	519		519	Within Tolerance - The variance is spread across a large number of positions. The absolute vol variance is immaterial - no adjustment proposed.
					2,603	2,084	519	
Total Significant Variances					8,105	1,815	6,290	