Liquidity Risk Assessment: Lehman Brothers Holdings Inc.

Lehman Brothers Holdings Inc.

New York, New York, United States

Broad Industry:	Securities
Specific Industry:	Securities Holding Co.
Short Term Rating:	P-1

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Opinion

Moody's views the liquidity profile of Lehman Brothers Holdings Inc. as very strong. Current conditions in capital markets have challenged all financial institutions, highlighting the cyclical nature and confidence-sensitivity of the industry and reinforcing the absolute need for a solid liquidity profile. The viability of using high quality collateral to secure funding has also been challenged by recent events. Lehman has navigated quite well to date through persistently volatile and challenging financial markets, the sharp market-wide decline in valuations across numerous asset classes, tight global liquidity conditions, and the strong headwinds facing revenues drivers.

Subsequent to first quarter's end, announced on April 1st, Lehman issued $4 billion of convertible preferred stock. The success of the issue had the dual effect of reaffirming market confidence in Lehman during a time of market turmoil and of bolstering Lehman's cash capital and liquidity position. Under Moody's methodology for assessing equity characteristics of hybrid instruments, Moody's gives 75% equity credit to these preferreds.

The basis for Moody's assessment of Lehman's liquidity is the strength of their overall funding framework, which includes an ample liquidity cushion of high-quality unencumbered assets capable of being pledged or sold in order to repay all commercial paper, short- and long-term debt maturing within a year and to meet other contingent liquidity needs. Lehman's commercial paper and other unsecured short-term debt totaled $15.5 billion, or 9.6% of total unsecured debt, at February 29, 2008. This is one of the lowest percentages among peers. Lehman's total short-term unsecured debt obligations, including $19 billion of current maturities of long-term debt, were $34 billion, or 21% of total unsecured debt, at February 29, 2008.

LIQUIDITY MANAGEMENT

Lehman's Funding Framework, the firm's overall liquidity management tool, is structured so that even in a severe liquidity event, the core balance sheet supporting its businesses will not have to be reduced for pure liquidity reasons (although Lehman may choose to reduce the balance sheet for risk reasons). This approach incorporates the likelihood that secured lenders may react during a severe liquidity event by increasing haircuts (reducing acceptability of "less liquid" collateral) and that liquidity may become trapped in certain entities.

The Funding Framework has several components. First, Lehman maintains sufficient cash capital (long-term debt less current maturities, stockholders' equity, and portions of core deposit liabilities at bank subsidiaries) to fund fixed assets, illiquid securities, certain corporate loans, goodwill, secured funding haircuts, and liquidity trapped within regulated entities. The firm then evaluates the availability of Reliable Secured Funding (RSF) by asset class and requires amounts above the RSF to be term funded for at least ninety days. RSF is basically the total amount of unencumbered assets that Lehman believes can be funded on a collateralized basis in a time of extreme stress. The company also reported a $7 billion surplus as being available to the parent company and its unrestricted subsidiaries. Lehman has a minimum surplus target of $2 billion for the parent and its unrestricted subsidiaries. At February 29, Lehman reported regulated entities as having a cash capital surplus (cash capital sources over potential uses) of $8.8 billion.

Lehman's Maximum Cumulative Outflow model measures the cash required over any ensuing 1-year period to meet current obligations under a stress scenario. The model assumes that unsecured debt cannot be refinanced, a significant amount of loan commitments will be drawn, haircuts will widen and additional collateral must be posted. Since regulated entities tend to have trapped liquidity, most of this anticipated outflow would occur at the holding company. To address this issue, Lehman maintains a holding company liquidity pool consisting of substantial cash balances and unencumbered liquid assets. At February 29, 2008, the estimated pledge value of the liquidity pool at the parent company was approximately $34.3 billion, which is an amount greater than the aforementioned "anticipated outflow". The parent company also had access to other unencumbered assets with a market value of $64 billion. Under the assumption that liquidity will be trapped in a stressed environment within "restricted" or regulated subsidiaries, these subsidiaries held at February 29th an additional pool of unencumbered assets with a market value of $96.9 billion.

To prevent excessive maturity concentrations, Lehman's long-term debt maturities are laddered within three-, six- and twelve-month time horizons. In addition to long-term debt, Lehman sources term deposits via Lehman Brothers Bank, FSB (LBB), a Delaware-based thrift, Lehman Brothers Commercial Bank, a Utah-based industrial bank, and Lehman Brothers Bankhaus AG, a German bank subsidiary. These deposits, along with long-term debt and equity, are also included in cash capital. LBB deposits provide additional liquidity to fund mortgage loans. Total deposits at February 29th were $28.8 billion. Additional liquidity at LBB and LBCB is available primarily via Federal Home Loan Bank advances.

To further diversify its funding sources Lehman maintains several credit facilities. Lehman has a committed $2.0 billion three year unsecured revolving credit agreement for Lehman Brothers Holdings, which was successfully refinanced in March, maturing in February of 2011. Also maintained is a three and a half year $2.5 billion multi-currency unsecured revolving credit facility for Lehman Brothers Bankhaus AG and Lehman Brothers Treasury Co. B.V., expiring in April 2010. Each facility is subject to customary conditions and covenants. Both of these facilities are drawn on from time to time in the normal course of conducting its business; as of February 29, 2008 there were no borrowings outstanding from Holdings or the European facility. Lehman has also established a $2.4 billion one year, fully backed by a Aaa third party, revolving liquidity backstop that issues secured liquidity notes to pre-fund high grade loan commitments. Also established is a conduit that issues secured liquidity notes to pre-fund contingent acquisition commitments.