

January 28, 2008

To: Files

From: Wyatt de Silva

Cc: Jerry Gruner  
Joe Palumbo

Re: Commercial Real Estate  
FAS 157 Adoption

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### Overview

Lehman Brothers adopted SFAS No. 157, Fair Value Measurements (“SFAS 157”) in the first quarter of 2007. SFAS 157 defines fair value, establishes a framework for measuring fair value, establishes a fair value hierarchy based on the inputs used to measure fair value and enhances disclosure requirements for fair value measurements. Additionally and also in the first quarter of 2007, Lehman Brothers adopted SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (“SFAS 159”), and applied this option to certain hybrid financial instruments not previously accounted for at fair value under SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*, as well as certain deposit liabilities at Lehman Brothers U.S. banking subsidiaries. The SFAS 159 election also applied to certain Other Secured Borrowings, which represents, among other items, the credit side of the FAS 140 and FIN 46R-related gross-ups (see [BB18-5 Memo](#) for details on this gross-up).

SFAS 157 defines “fair value” as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, or an exit price. The degree of judgment utilized in measuring the fair value of financial instruments generally correlates to the level of pricing observability. Financial instruments with readily available active quoted prices or for which fair value can be measured from actively quoted prices in active markets generally have more pricing observability and less judgment utilized in measuring fair value. Conversely, financial instruments rarely traded or not quoted have less observability and are measured at fair value using valuation models that require more judgment. Pricing observability is impacted by a number of factors, including the type of financial instrument, whether the financial instrument is new to the market and not yet established; the characteristics specific to the transaction and overall market conditions generally.

The overall valuation process for financial instruments may include adjustments to valuations derived from pricing models. These adjustments may be made when, in management's judgment, either the size of the position in the financial instrument or other features of the financial instrument such as its complexity, or the market in which the financial instrument is traded (such as counterparty, credit, concentration or liquidity) require that an adjustment be made to the value derived from the pricing models. An adjustment may be made if a trade of a financial instrument is subject to sales restrictions that would result in a price less than the computed fair value measurement from a quoted market price. Additionally, an adjustment from the price derived from a model typically reflects management's judgment that other participants in the market for the financial instrument being measured at fair value would also consider such an adjustment in pricing that same financial instrument.

Lehman Brothers has categorized its financial instruments measured at fair value into a three-level classification in accordance with SFAS 157:

Level I – Inputs are unadjusted, quoted prices in active markets for identical assets or liabilities at the measurement date.

Level II – Inputs (other than quoted prices included in Level I) are either directly or indirectly observable for the asset or liability through correlation with market data at the measurement date and for the duration of the instrument's anticipated life.

Level III – Inputs reflect management's best estimate of what market participants would use in pricing the asset or liability at the measurement date. Consideration is given to the risk inherent in the valuation technique and the risk inherent in the inputs to the model.

EY auditors Jerry Gruner and Wyatt de Silva (Mortgage Capital Team) and Jennifer Jackson and Nathalie Nguyen (E&Y FID/FAS 157 Team) met with Jonathan Cohen, SVP – Product Control, and Abe Kebede, SVP – Product Control, to discuss Lehman Brothers' FAS 157 policy and classification levels for the commercial real estate products as of 11/30/07.

### **Commercial Real Estate (Americas)**

Lehman Brothers' portfolio of Commercial Real Estate reported under Mortgages and Asset-Backed Securities include:

- Debt/Equity investments in commercial real estate (“PTG Investments”)
- Fixed/Floating rate commercial whole loans
- B-Notes/Mezzanine loans
- Real Estate Investment Trust lines of credit (“REIT LOC”)
- Commercial mortgage backed securities (“CMBS”)

### ***Level 1 Classification***

There are no commercial real estate products classified as Level 1. Although quoted market prices exist for certain CMBS, given the market conditions present at year end, adjustments are generally required to derive fair value at the measurement date and the frequency of trading is generally not sufficient to support classification as Level 1.

### ***Level 2 Classification***

#### **Fixed/Floating rate commercial whole loans**

Such loans within the commercial real estate business unit include commercial mortgages that have been originated by Lehman Brothers. Lehman's exit strategy for fixed rate loans has been securitization and sales of the individual tranches from the securitization. The exit strategy for floating rate loans has been syndication, securitization or sales of individual positions.

These portfolios are fair valued using cashflow valuation models and trader models and price tested via mock securitization and comparison to security pricing. All fixed/floating rate loans are generally classified as Level 2 as the fair value is derived from market prices for similar assets or using a valuation technique which uses observable inputs. Key inputs include current spreads and interest rate curves, which are obtained from 3<sup>rd</sup> party sources such as Commercial Mortgage Alert and Real Estate Finance & Investment publications. These assets are more liquid than those in the PTG portfolio due to the lower LTV ratios (typically less than 75%) and the ability to securitize and syndicate the positions, albeit in lesser volumes, in the current market. This is illustrated by the successful LB-UBS 2007-C7 securitization that took place in the last week of November 2007, and syndication and sale of tranches of the Hilton loan prior to year-end. Price testing is also performed on these portfolio via "mock securitization." In other words, the fair value of the population is assessed for reasonableness by assuming it was going into securitization and then reducing the expected cash proceeds by an expected profit margin and related deal costs.

#### **B-Notes**

B-Notes are positions carved out from large loans as a means of credit enhancement. Financial institutions will take a loan and separate it into two pieces, the senior loan (A-Note) is typically securitized, while the junior piece (B-Note) is typically retained by Lehman. Lehman's exit strategy for these loans has been sales of the individual positions or hold to maturity.

These portfolios are fair valued using cashflow valuation models and trader models and price tested on an individual basis, using a Net Present Value analysis based on individual loan characteristics (such as expected cash flows) and values these loans like bonds for comparative purposes against their respective bases. B-Notes are generally classified as Level 2 as the fair value is derived from market prices for similar assets or using a valuation technique which uses observable inputs. Key inputs include current spreads and interest rate curves, which are obtained from 3<sup>rd</sup> party sources such as

Commercial Mortgage Alert and Real Estate Finance & Investment publications. These assets are also more liquid than those in the PTG portfolio.

### **REIT LOC**

Lehman provides lines of credit to REITs and operates on a basis similar to PTG (see discussion below). The key difference is that the REIT group lends to an existing trust that hold real estate assets, rather than lending to an entity (e.g. partnership) that is typically set up to finance a particular real estate asset. As such, the credit worthiness of the REIT must be evaluated in much of the same way as a corporate bank loan. Typically the exit strategy is to syndicate the loans with other investors and sales of the individual positions.

These portfolios are fair valued using cash flow valuation models and trader models and price tested on an individual basis, using a Net Present Value analysis based on individual loan characteristics. All REIT LOC are generally classified as Level 2 as the fair value is derived from market prices for similar assets or using a valuation technique which uses observable inputs. Key inputs include current spreads (REITS are usually public companies and rated by the rating agencies) and discount rates, which are obtained from 3<sup>rd</sup> party sources such as Commercial Mortgage Alert and Loan Connector publications. These assets are more liquid than those in the PTG portfolio, typically traded more like corporate bank loans. We note that some positions which are priced similar to PTG Investments are classified as Level 3 as these tranches have less observable inputs to the models in light of the market condition and inputs reflect management's best estimate of what market participants would use in pricing the asset at the measurement date (see discussions of PTG Investments below).

### **CMBS**

Commercial mortgage backed securities include investments in Lehman securitizations and other external residential CMBS transactions. The exit strategy for these products is trading/flow in the secondary market.

These positions are primarily valued using matrix pricing (matrix pricing uses available quoted market prices for the same or similar securities) and cashflow valuation models within RAMP. The cashflow valuation models use observable inputs (interest rates, credit spreads, weighted average life of underlying assets and prepayment assumptions) sourced from Bloomberg.

Investment-grade CMBS are classified as Level 2 as quoted market prices for the same or similar securities is still available, albeit at lesser trading volumes than in the past. Non-investment grade tranches, while a quite small population, are typically classified as Level 3 assets.

### ***Level 3 classification***

#### **PTG Investments**

PTG Investments include highly leveraged investments in commercial real estate, and can be in the form of debt or equity. Typically, these investments take the form of mezzanine financing or financing subordinated to debt provided by senior lenders such as banks. Mezzanine financing can be viewed as a hybrid of debt and equity financing as the lender is often able to convert debt capital to an ownership or equity interest. Lehman's exit strategy for PTG Investments is through sale of the underlying asset or refinance of the debt/equity positions. Foreclosures on the underlying property are rare and a last resort in terms of settlement of the financing.

These portfolios are fair valued using internal cash flow valuation models. These models measure fair value of the instruments by looking at available proceeds calculated on the basis of the waterfall payment structure of the instrument, outstanding principal balance, and present value of future cash flows, to arrive at a current exit price for the position. PTG Investments are price tested on an individual basis, using a Net Present Value analysis based on individual loan characteristics.

All PTG Investments are classified as Level 3 as they have less observable model inputs, particularly in light of the market conditions (i.e. minimal sales and origination volumes). In addition, the inputs reflect management's best estimate of what market participants would use in pricing the asset at the measurement date. Such inputs include current spreads, discount rates (which are obtained from 3<sup>rd</sup> party sources such as Commercial Mortgage Alert and Real Estate Finance & Investment publications) and underlying collateral values. The Level 3 classification is warranted, given the subjectivity involved in the valuation of the collateral (which involve estimates of absorption rates, capitalization rates, occupancy rates, etc.) and estimates of cash flows (e.g. debt repayments, equity returns), along with limited available information regarding recent transactions.

PTG positions are price tested using an independent cash flow model with inputs such as those noted above. However, discount rates and collateral valuation are also compared to independent third party resources.

Note: A portion of PTG Investments are classified as Real Estate Held for Sale. We note that these positions are carried at the lower of cost of market under the guidance of SFAS 144 (i.e. not carried at fair value under FAS 157).