

Jan Voigts/NY/FRS
04/09/2008 06:57 PM

To Timothy Geithner/NY/FRS@FRS
cc Arthur Angulo/NY/FRS@NY, Beverly Hirtle/NY/FRS@NY,
Brian Peters/NY/FRS@FRS, Patricia Mosser/NY/FRS@FRS,
Terrence.Checki@ny.frb.org, William
bcc
Subject Re: Fw: Lehman's Freedom CLO

To help cross the "bridge", it might be helpful if I take one step back to provide some context of this particular securitization, but also pass along Lehman's views generally on how they intended to use the PDCF as both backstop, and business opportunity. (A schedule of the underlying assets of the Freedom securitization is attached for reference).

Lehman's General View of the PDCF

In a March 20 meeting with Lehman's senior management team, part of the conversation focused on the PDCF (see below for specific information on the "Freedom" securitization).

- Lehman found the PDCF very useful, starting use on 3/18, but noted that it had little comprehensive impact on their positions and inventory.
- Managers said the FRB could help stimulate liquidity and growth in the corporate bond and triple -A ABS sectors using the PDCF as a source of liquidity.
- They noted that the PDCF should more resemble the ECB facility, and that it should be permanent.
- More specifically, Lehman managers believed that the PDCF would be more useful as a conduit for Lehman to pass their customers' collateral in order to target pockets of market illiquidity. (*Off-line, we wondered if this meant that Lehman, for a fee, would sell their PDCF access as go-between to customers who had liquidity problems and transfer the risk to the FRB*)
- Lehman managers went on to say that the investment banks had become a source of leverage for customers through the FRB. Previously, that role had been the "SIVs" and money funds.
- In this context, Lehman managers noted that they would participate in the PDCF from a public policy perspective, as well as from a business incentive standpoint. They saw the three FRB collateral facilities as programs Lehman and other IBs could use to stimulate secondary market activity again.
- Two notes of caution were raised:
 - There might be a desire to use the facility to generate cash,
 - Anything done with the PDCF could wind up on the balance sheet (no explanation at the time).
- In closing, Lehman managers noted that they believed the PDCF and other FRB facilities made the U.S. market more competitive against the advantage the Europeans had in the ECB facility.

Freedom Securitization

During the same March 20 meeting, the "Freedom" CLO came up near the end of the conversation. We were surprised when they noted that their debt structure team had converted unencumbered corporate loans into an investment grade facility (pending rating review), with internal pricing assuming a range of 10-30% haircuts on the underlying assets. The corporate loans had been financed using cash capital at the holding company level.

The Lehman management team also noted that while there was confusion about the purpose and utility of the PDCF, they saw this as an opportunity to move illiquid assets into a securitization that would be PDCF eligible. They also noted that they intended to create 2 or 3 additional PDCF eligible securitizations. We avoided comment on the securitization but noted the firm's intention to use the PDCF as an opportunity to finance assets they could not finance elsewhere.

Post Script.....

I understand that Brian and Steve recently had a conversation with a senior Lehman risk manager who echoed the same general sentiment, that the PDCF should be permanent, and would be part of their business strategy. (Brian and Steve could provide better information here.)

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Timothy Geithner /NY/FRS

04/09/2008 04:26 PM

To Jan Voigts/NY/FRS@FRS
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William Rutledge/NY/FRS@NY
Subject Re: Fw: Lehman's CLO

As a bridge to what?

Jan Voigts/NY/FRS

Jan Voigts /NY/FRS

04/09/2008 02:01 PM

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Subject Re: Fw: Lehman's CLO

It was created with the PDCF in mind.

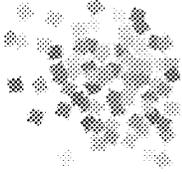
They were also planning two or three other similar securitizations that would be facility eligible .

The **potential** third-party sale of the Freedom Senior notes is attractive to them to possible get the \$2.26 off their balance sheet for a proce of the \$565 residual.

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04/09/2008 01:27 PM

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Subject Re: Fw: Lehman's CLO

Do we know if they intend to pledge to triparty for PDCF?

Brian Peters/NY/FRS



Brian Peters /NY/FRS

04/09/2008 01:23 PM

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cc Jan Voigts/NY/FRS@FRS
Subject Fw: Lehman's CLO

Yesterday's joy (?) over press reports that LEH had sold \$2.2 billion of bonds backed by their "Freedom" CLO was premature. The reports were incorrect. LEH still owns the notes for the moment.

----- Forwarded by Brian Peters/NY/FRS on 04/09/2008 01:17 PM -----

Jan Voigts /NY/FRS

04/09/2008 01:06 PM

To Brian Peters/NY/FRS@FRS
cc
Subject Re: Lehman's CLO

Brian,

Just got off the phone with Laura Vecchio at Lehman.

- Lehman has not sold the CLO, although there is investor interest.
- I will find out where the CLO is being held (legal vehicle).
- The \$2.26B Senior notes (A2,A) might be financed through something other than cash capital, but the \$565 subordinated is financed with cash capital at the holding co level.

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04/08/2008 07:09 PM

To Jan Voigts/NY/FRS@FRS
cc
Subject Re: Lehman's CLO

Just check with them again, and ask about the reports that they've sold 2.2 in bonds from this.

Jan Voigts

----- Original Message -----

From: Jan Voigts
Sent: 04/08/2008 05:56 PM EDT
To: Brian Peters
Subject: Re: Lehman's CLO

Nay nay,

Steve was at the same meeting. They intended to have this available for the facility, and intended to form 2 to 3 others.

The goal was to strip illiquid assets into securitizations that are facility eligible.

I have the full prospectus and will pass a copy to you tomorrow if you are interested.

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cc
Subject Lehman's CLO

I believe it was speculated that LEH was forming the CLO just to pledge it through PDCF. Evidently, we were incorrect. Uncertain, though, if they provided financing to the buyers.

Lehman's loan clearout

Bloomberg has [a lot more information](#) on the \$2.8bn "Freedom" CLO Lehman brothers closed last week. FT Alphaville reported news of the deal at the time. The [question we asked then](#), was,

would Lehman shift the equity tranche or would they (likely) end up keeping it.

The price of Freedom, for Lehman? \$565m.

Freedom CLO contains 66 loans, including debt the fourth- largest U.S. securities firm underwrote for buyouts, according to the indenture filed last week. New York-based Lehman will hold a piece of the \$565 million subordinated note, the riskiest portion, according to the term sheet. The bank sold \$2.2 billion of bonds with investment-grade ratings.

Still, that's a small price to pay for such an attractive clearout of Lehman's leveraged loan warehouses. (The bank had a total of \$10.9bn in "contingent" loan commitments at the end of the first quarter this year)

According to the prospectus, a slice of Freedom gets you exposure to:

First Data (KKR)

TXU Corp (KKR & TPG)

Sequa Corp (Carlyle)

and bank credit lines to... Imperial Tobacco and... Countrywide Financial.

All of these loans are trading low in the secondary market, which is perhaps reflected in the coupons Freedom is paying. The \$2.2bn senior notes will pay a 225bp spread, while Lehman's equity notes will collect the - potentially - fat remainder.

Standard & Poor's published an interesting research report on Tuesday, in which they noted a big discrepancy between pricing in Europe's primary loan market and the secondary market. On the one hand Europe's CLO investors, for example, see true credit risk and a high-spread environment. On the other hand, as S&P notes, "there has been only a limited change in primary pricing".

The key factor in getting the LBO pipeline moving again, said S&P, would be reconciling the two. Primary market loans terms need to meet secondary market spreads. And on existing debt, banks need to offer more.

It will be interesting to see whether the coupons offered by Freedom are judged to give value for money. With Countrywide, for example, at 79 cents on the dollar, and S&P warning of more corporate defaults ahead, CLO investors need nerve.