

Lehman Monthly Risk Review
Package dated 11/8/07, meeting held 11/15/07

FINANCIAL RESULTS (ED GRIEB)

- Ed Grieb is leaving the job of financial controller to take an investor relations position. Martin Kelly is the new controller.
- Net Revenues for the month were at \$2.1bn, a very good month given the performance of the last few months, and Lehman's second highest October ever. Non-US revenues accounted for 44%, driven by Asia as Europe was down, notably credit and securitized products. Non-personnel expenses were \$350m, driven by some costs associated with MCD branch closures. They are estimating the full year's revenues to be \$20bn. This will include a significant gain on an investment in GLG (essentially a reverse IPO where GLG was acquired by an SPV) where their \$35m investment is being valued at about \$500m.
- Lehman took a \$190m gain on the mark-to-market of their own debt as spreads blew out during the last week of October.
- Fixed Income had revenues of \$626m, on par with average month 2007.
 - They took a \$400m gains on leveraged loans, as TXU sold close to par, earning \$200m. No marks were taken on Harman, as Lehman would not have funded it even if the sponsor had not backed out.
 - Securitized products were down \$300m, which includes gains on some hedges against the position. Aurora's production was \$550m last month, and production is shifting towards conforming product. A subprime deal was completed earlier in the week, where the AAA cleared. The collateral consisted of the last of BNC's production, with a projected cum loss of 5% or less. They have \$300m total exposure remaining from this securitization. There were 2 recent UK securitizations, but they did not have the details on these. There was also a Japanese securitization (LStars?) which sold at a premium at 107/108.
 - Commercial real estate was down \$100m due to writedowns on hedges. Lehman still asserts that the quality of the CRE loans is still good, but investors continue to push down the CMBX due to general fears about "mortgages." The Archstone term loan is being retooled to change some of the specifics, such as how amortization schedules are calculated, using lessons learned from levfin, in order to make the deal attractive to investors. A Windermere CMBS is in the process of being marketed. A single property was securitized in Japan (LJac?). In general, Jeff said that BB and below was selling on the securitizations, but the middle pieces have been harder to place. Lehman is over 50% of an upcoming \$3+billion securitization, LBOBs. The BB and below have sold, but the middle and AAA are still sticking. They have not taken losses on the conduit yet. Fixed rate deals have gotten done, but not floating rate. Cap. rates are rising.

- Equities had a record month at \$859m (compare to avg month 06 at \$325m and avg month 07 at \$542m). The main drivers were the volatility and cash businesses in Asia, volatility in Europe, GTS in India and the US), as well as some private equity.
- Investment Banking was \$316m for the month, slightly below average month 2007. Equity and debt origination was down, but M&A was strong with the TXU and ABN Amro deals.
- Investment Management was \$298 for the month, above average month 2007. AUM was up \$1bn. PIM revenue was flat. Lehman is liquidating one of its money market funds in which they had injected about \$6m of capital in order to prevent it from breaking the buck.
- Cash Capital Excess at LBI was down to \$3.1bn, but they project the number will be \$8bn by the end of the year. Net Leverage was 18.7x, with a target of 16.2x by the end of the year. LBI had net revenues of \$47m, again driven by the split hedges issue.
- The amount of Level 3 positions has been an internal focus this past quarter. The number grew from \$20bn last quarter to \$33bn this quarter. Lehman decided to move the entire book of subprime (\$6bn) and scratch and dent (\$1bn) from Level 2 to Level 3 during the quarter. The alternative would have been to move only certain pieces of the portfolio, but they ultimately decided to move the whole thing.

TREASURY UPDATE (PAOLO TONUCCI)

- Paolo gave us an update on the current funding markets. He said the issue markets are just not there. Structured notes, which account for 30% of the total portfolio, are still being issued at a rate of \$500m per week. They are looking at the hybrid market (retail and institutional). They would have expected a coupon in the range of 7 to 7 1/8, but Wachovia just issued at 8 and Lehman would have to be higher. Mcaps are pricing at L+400 on the institutional side. In Europe, they could possibly issue a perpetual structure.
- Lehman is looking at a holding company capital ratio ending the year at 10.7 or 10.8. The ratio could be anywhere from 10.5 to 11. They are comfortable with that number given how difficult it is to issue right now. The decrease in commitments helps the ratio.
- The banks have grown \$7-8bn recently. Bankhaus has doubled to \$20bn, while LBB is shrinking, as it was set up to fund mortgages.
- They will be in touch with Matt regarding a capital computation question on index hedges. Basically, both longs and shorts are grossed up on various tranches of index hedges, and they have a netting question.

REGULATORY UPDATE (LAURA VECCHIO, TONY STUCCHIO)

- FINRA completed its audit of Neuberger (a quick audit since the b-d is basically nothing there). Lehman does plan on taking the capital out of Neuberger and

bringing it back to LBHI. Nothing has come up on the FinOp side, and the CSE exam is going relatively well. They have met with Audit.

- They gave us the usual complaints about OTS. The focus appears to be newspaper article based; that is, whatever is the hot topic of the day. They have finished examining the thrift and now have a holding company focus. The exam closes on December 12.
- The NYRO bd exam continues (“drags on”). They keep requesting documents and Lehman is not sure when it will finish.

CREDIT RISK (STEVE SIMONTE, VINCE DIMASSIMO)

Monoline Exposure (Steve Simonte, Julia Nand, Ana Arsov)

- As we requested, Lehman put together a comprehensive look at their exposures to monolines and DPCs. (All numbers below are as of 10/31/07.)
 - ACA
 - Lehman has 4 trades with ACA: CDS on SS tranche of ABS CDO (Corona Borealis) with a \$750m notional, and 3 trades where Lehman purchased protection on SS tranches of TABX (\$420m notional on 40-100%, \$300m notional on 25-100%, and \$225m on 62.5-100%). CE is \$49.8m (net of reserves of \$379m for TABX trades and \$142m for ABS CDO) and MPE is \$506.1m. ISDA includes collateral schedule which has unlimited threshold at current rating level and \$2m at BBB+. They have taken reserves of \$142m for the Corona position and \$379m for the 3 TABX trades.
 - If ACA is downgraded, all 30 of ACA’s counterparties will trigger a CSA. ACA is asking all the counterparties to waive the collateral call while they search for a strategic solution. Morgan Stanley has been enlisted to help run the process of coordinating the counterparties’ responses. So far, the response has been positive to the request. Lehman is in the top 7 of creditors with exposures. Should ACA go under, the process will be governed by insurance insolvency, which may hold up distributing any funds until the last policy has expired (30-40 years!).
 - During the 2nd quarter, ACA printed all of their positions. Lehman has one of the worst trades – the CDS with the 25% attachment point. They feel that this may be penetrated in mid 2008. Should Lehman actually need to make a claim against ACA, they would not hesitate to do so as this would put them in a better place in the pecking order above counterparties.
 - Lehman also has exposure from two interest rate swaps which ACA wrapped. The swaps were with nursing homes in California that currently have a standalone BBB rating. Lehman is in talks with the

company to convert their debt to fixed rate and terminate the swaps. They would need to raise \$21m in order to cover the mtm.

- For the rest of the industry, Lehman expects them to be put on negative watch. At that point, they will need to raise capital. Lehman expects Assured, FSA, MBIA, and Ambac to have no trouble raising capital. They expected CIFG to get an infusion from its French parent, which occurred subsequent to our meeting. They think FIGC will need some type of M&A solution. XL is somewhere in the middle.
- MBIA
 - Direct notional exposure of \$753m with MPE \$22m. Indirect wrapped exposure on \$836m of muni bonds with a CE of \$28m. Also have exposure from GICs (Guaranteed Investment Contracts). In a GIC program, the cash from the sale of CDOs are put into these vehicles. The purchaser of the GIC receives interest and the return of the principal at some point. MBIA is providing the GIC, thus there is secondary exposure to them.
- Ambac
 - Direct notional exposure of \$675m with MPE \$47m. Indirect wrapped exposure on \$79m of interest rate swaps. GIC exposure of \$1.6bn with MPE \$378m.
- FSA
 - Direct notional exposure of \$2.7bn with MPE \$14m. Majority of exposure on SS corporate CDO. GIC exposure of \$843m with MPE \$396m.
- XL
 - Direct notional exposure of \$7.3bn with MPE \$192m. Indirect wrapped exposure on \$457m of interest rate swaps.
 - Lehman has taken reserves of \$13.2 on munis and fully reserved a HG ABS deal for \$42.5m.
- Assured
 - Direct notional exposure of \$3.0bn with MPE \$165m.
- FIGC
 - Direct notional exposure of \$846m with MPE \$32m. Indirect wrapped exposure on \$813m of interest rate swaps.
- PRIMUS
 - Direct notional exposure of \$903m with MPE \$12.5m.
- Theta
 - Direct notional exposure of \$675m with MPE \$13m.

Counterparty Credit Risk (Steve Simonte)

- We quickly talked about counterparty exposure as the monoline discussion ate most of our time. CE was up to \$47bn from \$42bn, while MPE was up to \$132bn from \$121bn. The top investment grade exposures were the usual suspects. On the non-investment grade side, ACA led the list with a gross current exposure of \$421m. Zama, a family holding company, was next with a CE of \$154m from equity derivatives collateral movements and has since been cleaned up. Baupost was next with \$80m of CE from settlement exposure.

Leveraged Finance (Vince Dimassimo)

- Commitments as of 11/14 were \$12.9 billion, down from \$13.9 billion a month ago. They put on two new commitments – Firth Rixson (\$674m) and Boise Paper (\$411m). Six deals were revised – Arysta LifeScience (↓\$599), Houghton Mifflin (↓\$261), McJunkin (↓\$228), Alliance Data (↓\$95), United Rentals (↑\$8), and A&P (↑\$11). Three deals closed – Metavante (\$400), ARINC (\$365), and Varel (\$160).
- Fundings decreased from \$11.8 bn last month to \$8.5 bn. Details are:
 - Closed deals: Metavante (\$90), ARINC (\$325), and Varel (\$160)
 - Increased fundings: ACTS (\$10), and First Data (\$14)
 - Syndications / Selldowns: TXU (\$2.6bn), LKQ (\$325), USIS (\$320), CDW (\$235), Syniverse (\$161), Varel (\$160), PHS (\$158), Verture (\$26), and Chevron Benelux (\$12).
 - FX Translation: +\$5
- Going forward:
 - Applebee's/IHOP (\$2.1bn) expected to close Nov 29. This is a whole business securitization. A portion of this debt was originally supposed to be wrapped by Assured, but they are rethinking this.
 - Houghton Mifflin (\$2.1bn) is scheduled to close Nov 21. The date was moved up. For the second lien piece they have found a price and are working on the first lien piece. They expect the pricing to eat into the fees but not fully.
 - United Rentals (\$975m) is scheduled to close Nov 20 but the sponsor may back out.
 - Sequa (\$820m) is scheduled to close Nov 30. Commitments are due Nov 21.
 - TRW/Mando (\$550m) is scheduled to close Nov. 30. This is an addition to an existing facility and Lehman is focusing on syndication with the existing lenders.

UPDATE ON EQUITIES TRADING (PAT WHALEN, SANDEEP GARP)

- Pat Whalen gave us an update on Lehman's equities trading business – he is the head of global equities trading – Gerry Donini runs the US trading business. Pat gave us

the usual spiel on moving not storage, and much of the presentation was a bit of a sales pitch. Pat sees the market as moving towards determining the correlation between equity and other markets, and trading accordingly. He also noted that volatility and variance are becoming traded assets. He expects to see the convergence of long-only asset managers and hedge funds, and things that financing instruments will continue to be in demand. Over the last 3-4 years, the division has been pushed to take more risk, as they were only using 30% of VaR and b/s limits. The business is focusing on new markets as well, defined as Asia and some more EMG (where they are “putting a toe in the water”). He does not plan for prop trading to be more than 15-20% of the business, and sees Lehman as a market maker rather than a prop shop. Pat spoke about Asia, where he sees strong demand. The vol business there, which is an area of focus, tends to have local clients, including HNW customers. He encourages his traders to have (an express, one would assume) an opinion. Pat thinks that China is overheated like Japan in the late 80s, and when he hears people talk about a soft landing thinks “good luck.” He does worry about China and the US crashing together. According to Pat, Lehman is a major player in variance swaps, and is also very active in index options as well as block trades. Pat stated that while he used to spend most of his time on making sure that the traders had the right infrastructure to trade (sounded like a COO role), he now focuses much more time on market risk, and seems to work fairly closely with Sandeep. That said, increasing capacity has been a big area of focus. This conversation was a bit disjointed, but we did get a sense for where Lehman sees its equities trading businesses headed, for now at least.

MARKET RISK (JEFF GOODMAN, MARK WEBER)

- Risk Appetite fell this month to \$3.3 billion, down from \$4.3 billion the month prior. This reduction came primarily from the equities business (overall delta dropped from \$3.6 billion to \$1.4 billion). Around mid-October, equities RA dropped nearly \$400 million and stayed at the lower levels throughout the rest of the month.
 - Jeff said that there had not been a firmwide risk committee meeting in the past two weeks, and there might not be one the following week either. Do we want to say anything about this? They probably shouldn't advertise it as weekly if they're holding these only one out of four weeks.
- VaR ended the month down as well at \$109.2 million. The reduction driver is the same story – equities. Total firmwide VaR peaked around October 19 at \$160 million, when equity delta was at \$3.6 billion, and bottomed on November 8 at the \$110m level, when the equity delta was down to \$1.4 billion. Much of this reduction came from the US, and was concentrated in volatility flow (There is a nearly \$15 million drop in equities VaR over a few days in mid-October, nearly all of which came out of the US vol flow business). There was also a reduction in equity delta in Asia.
- SPG saw its VaR increase, but this was due to an increase in volatility rather than new positions. Mark pointed out some notable spread increases in indices such as the

CDX IG (47 to 75), CDX HY 362-481, ABX BBB (1623-1924) and ABX AAA (180 – 800).

- Lehman is putting on a USD notional \$935m deal contingent EUR/JPY FX forward. Lehman's risk is that the Yen will weaken and the deal will not complete. Deal completion is put at 90% likelihood, and MPE is \$112m if deal falls through.
- UK housing growth has slowed, and the European residential mortgage space continues to be challenging. As mentioned in previous months, there is no ability to hedge in this market, i.e. no CMBX equivalent. There have been some smaller deals in early October, but not all parts of deals were placed. The secondary market has stabilized somewhat. Lehman thinks this is a liquidity story as most people think European housing fundamentals are still sound, and UK non-conforming mortgages have not a subprime-style meltdown. Jeff noted that some forward sales of AAAs were exposed to big moves in spreads.
- Backtesting: Lehman had two exceptions at the 95% level, and one at the 99% on 10/29, with a loss of approximately \$300 million. This was the day of a Moody's downgrade, and substantial ABX losses (we might want to get more color on this). On 10/31, there was the other 95% loss (around \$100 million), driven by remarking of ABS residuals and a write-down on CRE whole loans (SPG had a \$101 million write-down in total). There were also losses on a long agency positions.

FOR THE MEMO

- Credit Risk Management has been heavily focused on exposures to financial guarantors, notably ACA. If ACA is downgraded, Credit Support Agreements ("CSAs") signed with all of their approximately 30 counterparties will be triggered and ACA will not be able to fund the resulting collateral calls. ACA has asked all their counterparties to waive the collateral call and Lehman is in negotiations with them on the terms. As of October month-end, Lehman had taken reserves in excess of \$500 million on the mark-to-market of their trades with ACA. Net of these reserves, Lehman has approximately \$50 million in current exposure.