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REPORT OF EXAMINATION

Lehman Brothers Holdings Inc.
New York, NY

Docket Number: S2511
Type of Examination: Holding Company - Limited
Examination Start Date: July 7, 2008
Examiner-in-Charge: Ronald S. Marcus

OBJECTIVE

The objective of this target review is the examination of commercial mortgage lending, real estate property investment and CMBS activities of Lehman Brothers Holdings Inc. (LHBI or the Firm). Discussions were held with management of the Global Real Estate Group (GREG) and those supporting or with oversight responsibilities for GREG, including Global Risk Management, Corporate Audit and Financial Control.

The field visit encompassed a review of the Firm's mortgage and real estate investment activities including property type and geographic location, largest loan exposures, writedowns, asset sales, valuation processes, hedging activities, risk management, internal audit and policies and procedures.

[redacted]

SUMMARY AND CONCLUSIONS

LBHI's commercial mortgage and real estate investment portfolio is very diverse with large holdings in the U.S., Europe and Asia. As its single largest asset class, totaling $50.4 billion at May 31, 2008, the portfolio represents very substantial credit and market risk and is a major source of continuing concern among regulators and investors. Total real estate related exposure would reach nearly $60 billion by including $9.5 billion of corporate debt and equity and other real estate related assets managed by GREG. Taking an outsized bet on real estate, the Firm's exposure to the commercial real estate market is larger than its competitors despite its smaller size and may likely precipitate major management and board decisions regarding additional capital raises, sales of strategic business or the ultimate sale of the Firm.

As part of its aggressive reduction of illiquid assets, whole loans and CMBS declined $9.5 billion during the first half of its fiscal year with $6.7 billion occurring in the second quarter. Also, real estate held for sale declined $2.5 billion over the past six months. As with residential whole loans and securities and leveraged loans, substantial net writedowns amounting to $3.2 billion have been taken thus far in fiscal 2008 in these asset classes.

Since these assets are either not actively traded and whose fair value are based largely on indirect inputs (Level 2) or are illiquid whose fair value is based on extrapolation or interpolations of observable market data or based on internal models (Level 3), fair value price discovery has been difficult. At May 31, 2008, Level 3 commercial mortgage loans and securities totaled $13 billion, or 63.1 percent, of $20.6 billion of total mortgage and asset-backed securities. At $22.7 billion, real estate held for sale, an illiquid asset class, but not one which is fair valued by SFAS 157, exceeds mortgage loans and securities by a wide margin.

Although, at 0.43 percent, delinquencies remain modest, the trend has been worsening over the past nine months. But, more foreboding, and most likely more accurately predicting the future path of the market, the Moody's/Real Estate Commercial Property Index has dropped nearly 12 percent since peaking in October 2007. Additionally, the CMBX indices have been sharply increasing with AAA CMBX spreads in mid-August trading 250 basis point over 10 year swap rates compared to 30 basis points over swaps 12 months ago. Clearly, with such large exposures to this deteriorating market sector, LBHI must take action soon to reduce its position and take the writedowns necessary.

Over the past month, there have been continuing reports, not denied by LBHI, and analysts' opinions that management is actively seeking to dispose of, through sale or spinoff, a large portion of its real estate related exposure to address investor concerns of its oversized real estate positions. With 153-182 percent of its equity, depending on whether corporate real estate is included, it is clear that LBHI is materially overexposed in this market sector. The ability to sell or otherwise dispose of a very substantial portion of its exposure, without having to accept fire sale prices, together with a possible capital raise, may be key to the survival of LBHI as an independent firm.

As with the residential mortgage business, there were major failings in the risk management process with senior management deciding to make major commitments to commercial real estate loans and investments and in 2007, significantly breaching established limits by making a very large commitment to the Archstone-Smith transaction. At the time, the Risk Appetite limit was $720 million, a $21.3 billion commitment was made to Archstone which resulted in over a $1 billion limit excess. A cover memo to the Executive Committee did not mention that the commitment would result in a material breach of risk limits, and implies that profit considerations trumped sound risk management practices.

COMMENTARY

Real Estate Assets

The Firm's mortgage and real estate related assets consist of whole loans, retained interests in securitizations, CMBS purchased in the secondary market, loans purchased as non-performing loans, equity interests in commercial real properties and derivatives referencing mortgages or MBS. Whole loans are either securitized or sold. When securitized, LHBI may retain certain securities known as retained interests, generally the unrated, equity tranches of securitizations.

Commercial mortgage-related positions are presented as a component of inventory within the Mortgage and Asset-Backed Securities category and real estate investments are presented as a component of the Real Estate Held for Sale category, both under the balance sheet line item of Financial Instruments and Other Inventory Positions Owned.

Commercial mortgage-related assets are reported at fair value and real estate held for sale positions are reported at the lower of carrying amount or fair value less cost to sell. Commercial mortgage assets are valued based on a number of inputs including observed trades in the marketplace, CMBX and ABX indices and other market information related to loss data on underlying obligations.

The table below shows commercial mortgage and real estate-related investments at May 31, 2008.

($ billions)

Asset Type		Number of Positions	WALTV [1]	WAM [2]	WALA [3]
Whole Loans					
Senior	$19.5	875	76%	34	18
Mezzanine	5.9	299			
Total	$25.4	1,174	78%	26	13
NPL	1.9	327			
Securities	5.3	371			
Equity	7.2	670			
Total	$39.8	2,542			

Booking Entities (Exhibit 1)

At May 31, 2008, $10.3 billion, 53 percent, of the $19.3 billion of commercial loans were held by the holding company, 16 percent by Lehman Commercial Paper Inc., eight percent by ALI, a domestic subsidiary and eight percent by the two U.S. banks. Two non-U.S. entities owned approximately 13 percent. About one-quarter of mortgage and real estate assets are held in Europe, which is related to the location booking entities.

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[1] Weighted average LTV
[2] Weighted average number of months remaining to initial maturity
[3] Weighted average loan age in months

Global Real Estate Group (GREG)

A business within the Fixed Income Division, GREG is responsible for structuring and distributing CMBS, originating and syndicating commercial real estate mortgage loans, bridge loans and bridge equity and investing in real estate for proprietary accounts and for private equity investors through the Investment Management Division.

Whole loans are originated by GREG through a network of correspondents and through whole loan purchases by the CMBS trading desk. Disposition has been mostly through securitization or, to a lesser extent, syndication of larger loans. However with the dormant market for CMBS, GREG has been syndicating many of its remaining whole loans in inventory and, in fact, the unit's major activity is now disposing of mortgage and real estate assets.

On a proprietary basis, the group makes equity investments, manages distressed debt and makes mezzanine investments in real estate. An integrated organization structure with trading, sales and research capabilities, GREG performs banking, sales and trading functions within its mandate. In addition to operations in the U.S., the group operates in Europe and Asia.

At this time, with demand for securitized products nearly non-existent, management has halted any new business activities and is actively working to reduce its positions through asset sales and work-out problem loans through restructuring or refinancing.

Credit Approval Process (Exhibit 2)

The credit approval process begins at GREG Regional Credit Committees which are responsible for the review and approval of all loans, equity investments, bridge equity and lines of credit with maximum approval levels depending on region and type of commitment. Those requests exceeding the maximum amounts specified for the Regional Credit Committees are tiered up to the GREG Global Credit Committee. For the largest commitments, the Firm Commitment Committee has approval authority. Other credit committees are responsible for Firm investments and divestitures, bridge equity and new products.

Composition of Portfolio (Exhibits 3 and 4)

A table showing the GREG portfolio by property classification and loan and investment type at May 31, 2008 is shown below.

Property Type	Senior Debt	B Notes & Mezz	Bridge Equity	JV Equity	REO	NPL	TL/ RC	Repo	Total	Percent
Condo	$971.4	$558.0	$0	$119.2	$104.3	$0	$0	$0	$1,752.9	4
Hotel	2,563.9	1,079.0	--	406.7	97.7	33.4	--	102.7	4,283.4	9
Hotel (w/Condo)	602.0	64.8	--	18.8	--	--	--	--	685.6	1
Industrial	92.4	464.1	456.5	188.6	--	5.0	--	--	1,206.6	2
Land (Resi)	1,096.9	95.1	--	354.8	1,442.3	--	--	--	2,988.8	6
Land (Comm)	2,014.2	557.2	--	501.1	139.4	153.8	--	--	3,365.7	7
Land (Condo)	295.9	80.5	--	92.7	2.8	--	--	--	471.9	1
Mixed Use	2,869.1	805.8	--	100.4	47.6	684.9	--	75.5	4,583.3	9
Multifamily	2,320.1	3,380.1	1,605.9	480.2	854.4	35.6	7.7	--	8,684.0	18
Office	3,591.6	2,735.3	2,264.9	736.8	24.7	141.7	--	609.6	10,104.6	21
Retail	2,336.4	139.0	--	61.4	13.1	52.9	--	--	2,602.8	5
Various	280.3	222.2	--	598.5	17.2	706.6	241.9	54.5	2,121.2	4
CMBS	6,358.0	--	--	--	--	--	--		6,358.0	13
	$25,392.2	**$10,181.1**	**$4,327.3**	**$3,659.2**	**$2,743.8**	**$1,813.9**	**$249.6**	**$842.3**	**$49,208.8**	**100%**

Below is a breakdown by lien type of the portfolio. **(Exhibit 5)**

Investment Type	Amount	Percentage
Senior debt	$19.3	39.2%
Subordinated debt*	10.2	20.7
Equity**	10.7	21.7
NPL***	1.8	3.7
CMBS	6.4	12.9
Repo financing	0.8	1.6
	$49.2	100.0%

* Mezzanine and B-Notes (first lien on partnership interests)
** Bridge Equity, joint venture equity and REO
*** Purchased as non-performing loans

The amounts included in the above tables include $6.9 billion in corporate debt, $1.7 billion in corporate equity and $0.9 billion in other. The $39.8 billion in commercial mortgage and other real estate related interests reported in the public filings exclude these amounts from the totals since they are reported as Corporate Debt and Other in the 10Q and 10K reports.

In terms of location of distribution by geographic region, 57 percent is in the Americas, including 37 percent in the U.S.; 25 percent in Europe, across numerous countries; and 18 percent in Asia, mostly in Japan.

With $6.8 billion, or 14 percent of real estate-related holdings in land, there is a concentration in this riskier property type with a higher likelihood of material ongoing writedowns. Included in this category is the SunCal portfolio in California, a continuing topic of analyst comments, $1.6 billion; Heritage Fields, a joint venture with Lennar in California, $503 million; Exhibition City in Nevada, $326 million; Reva Land, a REO in Spain, $256 million; and Fontainbleau, a retail construction loan in Nevada, $172 million. Other investments in the top 10 are located in Montana, Japan, Mexico and the Bahamas.

Top 20 Exposures (Exhibit 6)

The table below displays the top 20 exposures which accounted for 37 percent of GREG's balance sheet at May 31, 2008.

Asset Name	Sponsor	Property Type	Region	Total	Type of Asset
Archstone	Tishman Speyer	Mulitfamily	U.S.	$4.6	Sr, Mezz, Br Eq, Term/Rev
Diversity Funding	Various	Various	U.K	2.5	Sr & CMBS
SunCal Portfolio	SunCal & Lehman	Land (Res.)	U.S.	1.6	Sr, REO & JV
Coeur Defense	LBREP/Atemi	Office	France	1.2	Bridge Equity & CMBS
Hilton Hotels	Blackstone	Hotel	U.S.	1.1	Sr &and Mezz
Prologis Portfolio	Prologis	Industrial	Germany	0.8	Sr, Mezz & Bridge Equity
Project Green/AMV	Various	Various	U.S.	0.6	CMBS
EOP Austin	Thomas Prop. Grp.	Office	U.S.	0.5	Sr, B-Notes, Br.Eq & T/Rev
Beacon III Porfolio	Broadway Ptnrs.	Office	U.S.	0.5	Mezz
Heritage Fields	Lennar/LNR	Land	U.S.	0.5	Sr & Mezz
Calvino (RE Fund)	Whitehall	Various	Italy	0.5	Mezz
Protego Retail Port.	Protego Fund	Retail	Sweden	0.5	Sr
237 Park Avenue	Broadway Ptnrs.	Office	U.S.	0.5	Mezz
GM Building	Macklowe Prop.	Office	U.S.	0.4	Sr & Mezz
Goodwater	LBREPII/Atos Cap.	Office	Germany	0.4	Sr
Canyon Ranch	WSG Group	Condo	U.S.	0.4	Sr & Mezz
Daito Apt Loan Port.	Various	Mult-Fam.	Japan	0.4	Sr & CMBS
Octopus (Germ.Off)	Sireo	Office	Germany	0.4	Sr & Mezz & JV Equity
Innkeepers USA	Apollo Invest.	Hotel	U.S.	0.4	Sr & Mezz
25 Broad Street	Swip Equities	Multi-Fam.	U.S.	0.3	Sr & Mezz
Total				$18.3	

Archstone and SunCal **(Exhibit 7)**

Archstone-Smith and SunCal are the two largest loan exposures in the real estate portfolio. Diversity Funding is composed mostly of a CMBS transaction.

Archstone, a large apartment REIT was acquired in a $21.3 billion transaction by an investment partnership with Tishman Speyer Properties in October 2007 in the largest public to private transaction in the multi-family REIT sector. Lehman's $4.6 billion position in Archstone is represented by $2.3 billion in senior debt, $521 in mezzanine debt, $1.6 billion in bridge equity and $185 billion in permanent equity.

Although management has stressed that Archstone has an extensive development program with over 5,000 units, a large land inventory with $2 billion of assets having been sold, the market has deteriorated and a $350 million markdown was taken in the second quarter of 2008. The equity exposure has been marked down 25 percent to a price of 75.

SunCal is a California-based privately-owned land developer with a strong historic relationship with the Firm. The developer owns large parcels of properties, particularly east of Los Angeles which it intended to sell to home builders. But, land values have plummeted as much as 60 percent in the area. The McAllister Ranch, a large master-planned residential community in Bakersfield, received a notice of default in May 2008, but LBHI's exposure has been reduced through sell-downs and writedowns. In the first half of fiscal 2008, $345 million of writedowns were recorded in its SunCal investments.

CMBS

Market Overview

The CMBS market began to decline slowly as the turmoil in the securitization markets began to seriously deteriorate beginning in the third quarter of 2007. Along with the dislocations in the residential mortgage markets, the pace of commercial mortgage securitization has slowed dramatically over the past six months. In the first half of 2007, $136.6 billion of CMBS were sold in 39 deals, but only 13 transactions totaling $12.1 billion were closed in the first six months of 2008, representing a 91.1 percent decline from the corresponding period in 2007. All issuance thus far in 2008 was underwritten in 2007 and held until sale to investors.

LHBI CMBS (Exhibits 8 and 9)

Since 1994, the Firm underwrote $140.1 billion of CMBS, placing it as the third largest underwriter with an 11.4 percent market share. In fiscal 2006 and 2007, during strong securitization markets, commercial mortgage securitizations were $19.0 billion and $19.9 billion, respectively. But, with the turmoil in the financial markets, only $4 billion of commercial mortgage loans were originated during the six months ended May 31, 2008 compared $32 billion for the six months in the corresponding period of fiscal 2007.

By geographic region, with $5.3 billion in Europe, mostly the U.K., and $0.6 billion in Asia, $0.9 billion of CMBS held in the U.S. is a small part of the consolidated position.

Securitizations fell dramatically, from $7.9 in the first six months of 2007 to only $1.5 billion in 2008. The last issue sold was on April 17, 2008 when LBHI and UBS jointly offered $1 billion of CMBS. The AAA, 10 year tranche was priced to yield 190 basis points over swaps, about 15 basis points less than originally anticipated during a short period of investor interest. Based on the 10 year swap rate, the senior tranche yielded 6.34 percent.

Over the past two quarters, management has undertaken an aggressive asset reduction program to reduce more illiquid asset classes and to strengthen its capital ratios in an attempt to address high Level 3 asset positions and investor concerns regarding its financial position. Consistent with the execution of this initiative, at May 31, 2008, $5.3 billion of CMBS were held in inventory compared to $7.5 billion at February 29, 2008 and $12.2 billion at November 30, 2007, reductions of 29.3 percent and 56.6 percent, respectively since the end of fiscal 2007.

Unlike the RMBS market, the CMBS market has been experiencing low delinquencies. At January 1, 2008, the Firm's delinquencies over 60 days were 0.47 percent of $43.6 billion in outstanding fixed rate securitizations. Delinquencies have increased somewhat since the end of the first quarter of 2008.

CMBS Rating Trends and Rating Agency Opinions

According to Fitch, in May 2008, U.S. CMBS delinquencies rose only four basis points to 0.39 percent, with half of the increase due to one large health care non-performing loan. Multifamily, a property type with $8.7 billion, or 18 percent of LBHI's debt and equity portfolio, represented a significant percentage of delinquencies nationwide. Fitch recently reported that in the second quarter, U.S. CMBS is the one asset sector where upgrades continue to outpace downgrades. The rating agency expects that this trend will continue as negative rating actions, thus far, have been limited to borrower-specific credit events and isolated market issues. However, there has been an increase in watch list classes during the quarter.

Moody's rating actions have paralleled Fitch's with affirmations on 1,452 issuances, 234 upgrades and 123 downgraded tranches in the first six months of 2008. Moody's expects that there will be fewer upgrades going forward and with ratings are expected to be stable over the balance of the year. As expected, the investment grade tranches continued to perform better than non-investment grade with the overall ratio of upgrades to downgrades at 1.9 to 1. The investment grade classes ratio was 6:1, but the non-investment grade ratio was 0.3 to 1.

Regarding default rates, a study by Standard and Poor's has found that credit performance in 2007 was superior to 2006 (4.24 percent compared to 4.60 percent). But, in 2007 there was heavier issuance than in 2006 and the more comparable default rate was 5.01 percent, an increase from 2006. The ratings agency expects worsening performance on the 2005-2007 vintages and is increasing surveillance. Materially wider spreads over the past six months, 250 basis points over swaps compared to 85 over in 2007, and relatively small new issuance confirms emerging credit concerns in this sector.

On August 1, 2008, in a report of its rated CMBS, Fitch predicted the default level of CMBS issued in 2006 and 2007 would quadruple to 17.2 percent over 10 years assuming a recessionary environment comparative to 1992, compared to current default rates of four percent. A more modest economic retrenchment would produce a default rate of 13.7 percent. Its research stated that the historical default rate was 7.9 percent. Non-investment grade bonds would loss 96-100 percent of principal and BBB bonds would experience losses from 31-38 percent depending on the severity of a recession. The historical average is 33.5 percent. Although defaults are expected to rise substantially, actual losses, at 3.7 percent, would be much less severe. Fitch noted that in 1945, the worst year on record, losses only reached 8.8 percent.

As contrasted to in the U.S., European CMBS performance worsened in the first half of 2008 as Standard & Poor's downgraded more securities than upgraded. Falling property prices in the U.K., and to a lesser extent Germany, have negatively impact performance in this asset class. As in the U.S., issuance has evaporated. Similar to the U.S., defaults have been very low at 0.10 percent. With $3.8 billion in CMBS exposure, mostly in the U.K., surveillance is primarily focused on the commercial property market in that country.

CMBX Spreads

Despite quite modest delinquency and default rates to date, AAA CMBX spreads in mid-August are trading 250 basis points over 10 year swap rates compared to 30 basis points over swaps a year ago. The rise in spreads has been dramatic over the past 10 weeks increasing from 129 basis points in late May 2008 to over 250 basis points in mid-August. Analysts believe that worries over the strength of retailers is driving higher spreads since delinquencies remain low compared to historic rates (0.44 percent in July 2008), only higher five basis points more than at the end of 2007. With a prolonged economic slowdown, some industry sources suggest that delinquency rates might approach 1.5 percent and losses might reach five to eight percent.

LBHI CMBS Prospects

[redacted]

Asset Reductions

Over the past two quarters, management has undertaken an aggressive asset reduction program to reduce more illiquid asset classes and to strengthen its capital ratios in an attempt to address high illiquid positions and investor concerns regarding its financial position. Evidencing this decline consolidated commercial mortgage and real estate-related positions declined to $50.4 billion at May 31, 2008 from $59.1 billion at February 29, 2008 and $51.7 billion at November 30, 2007.

The $50.4 billion aggregate amount is composed of $29.7 of commercial mortgages, securities and other and $20.7 billion in real estate held for sale.

Of these reductions, $7.3 billion was through loan and securities sales and $1.4 billion from repayments. These asset sales were across the capital structure with $2 billion each of senior and mezzanine loans, $2.3 billion in securities and $1 billion in equity. In the third quarter, through August 2008, management is estimating about $2 billion in further reductions in the absence of any large bulk asset sales.

***Writedowns* (Exhibit 10)**

Mark to market losses on these positions have been substantial. For the first half of fiscal 2008, there were $2.3 billion in gross writedowns, with no benefit from hedging, the same amount as net writedowns. In the second quarter, although gross writedowns were $0.9 billion, because of hedging losses, the net writedown grew to $1.3 billion. Over the past 18 months, gross valuation adjustments totaled $3.7 billion and net writedowns came to $3.2 billion due to positive hedging results over the period.

First half writedowns in approximately 200 positions were concentrated in the U.S. across all loan and equity positions. Writedowns amounted to $685 million in California, mostly with two developers-SunCal and Troxler; $279 million in other land and condos outside California; $343 million in whole loans; $150 million in CMBS; and $421 in bridge equity with Archstone contributing $289 million. In Europe, negative valuation adjustments in Europe accounted for only 17 percent of aggregate writedowns. And, in Asia, there was a $2 million net write-up across 14 positions because the market, in some Asian markets, such as in Singapore, have remained relatively strong.

***Level 3 Assets* (Exhibit 11)**

The illiquidity of commercial mortgage and real estate loans and equity interests in real estate may be estimated by the Level 3 assets in these asset classes. Of the total $37.9 billion in Level 3 assets, $10.9 billion were in the commercial mortgage and real estate bucket. The breakdown is as follows:

($ billions)

U.S.	$7.0
Asia	3.0
Europe	0.5
Japan NPL*	2.5
	$13.0

*Purchased as non-performing loans

Of the total of $29.7 billion of commercial mortgage loans and CMBS after SFAS 140 gross-up of $321 million (after consolidation of voting and variable interest entities), only $13.3 billion, or 44.8 percent, are categorized as Level 3. However, since real estate held for sale does not fall under SFAS 157, since it is valued at lower of cost or fair value, and is expressly excluded from inclusion under SFAS 157, it is not a Level 3 asset. Adding in $20.7 billion of real estate held for sale, mortgage and real estate illiquid assets would rise to $34 billion. LBHI considers that only $10.4 billion is its economic exposure since the amounts consolidated of VIEs under FIN No. 46-R does not reflect its underlying risk. Nevertheless, the exposure still remains uncomfortably high.

About $5.3 billion of CMBS are in Level 2 since there are more observable market prices for these securities, 77 percent of which are rated AA or better and 94 percent are rated as investment grade.

***Hedging Activities* (Exhibit 12)**

Hedging operations are conducted by traders in the GREG organization. While the floating rate book is mostly unhedged since there is no index which would adequately hedge floating rate mortgage and other loans, at May 31, 2008 the fixed rate portfolio was well hedged with $1.6 billion, or 86 percent, of the exposure hedged with CMBX ($0.4 billion) and TRS/DRS swaps, ($1.2 billion). Macro hedges using iTraxx/CDX are used to partially hedge the floating rate book on the assumption that with significant deterioration in the credit markets, spreads on the floating rate assets would widen.

For the three months ended May 31, 2008, total Firm hedging operations did not offset any losses incurred as a result of writedowns, and, in fact, ineffective hedge positions lost approximately $100 million, adding to gross writedowns during the period. With regard to commercial mortgages and real estate, unexpected divergences in the cash and derivative (hedging) markets, where the hedging indices rose substantially more than the underlying cash market, resulted in a net writedowns of $400 million more than gross writedowns. Thus, this asset class suffered more than residential, leveraged loans and other asset-backed positions in terms of hedge performance.

In the U.S., $26.6 billion of exposure to mortgage loans and securities were hedged by $3.5 billion in notional amounts of various types of indexes and swaps. Losses on hedging activities totaling $453 million in the U.S. and were attributed to fixed rate whole loans, $279 million, floating rate loans, $73 million, and CMBS, $101 million. The European and Asian book is not hedged since there are no appropriate hedging vehicles in those geographies. The net unhedged exposure was $21 billion, but the $101 million of writedowns was relatively modest.

Valuation Methodology **(Exhibit 13)**

The valuation methodologies used for mortgage-related assets incorporate a variety of inputs including prices observed from execution of trades in the marketplace, ABX, CMBX and similar indices that track the performance of a series of credit default swaps and other market information, such as data on remittances received and cumulative loss data on underlying obligations.

There are four Product Control specialists in Finance who are assigned to GREG who ultimately report to Gerry Reilly, Global Head of Product Control-Capital Markets. They are responsible for monthly updates of market values on all real estate positions. Assisting in the review are third-party providers of market prices of loans and real estate equities. Two servicers, Trimont Real Estate Advisors and Pacific Coast Capital Partners provide monthly data tapes that contain asset level information.

Product Control downloads all real estate inventory positions and aggregates position into asset classes for price testing. Pricing models for the following commercial mortgage and real estate asset classes are used to set monthly marks: debt, equity, conduits and large fixed rate loans, floating rate loans, B-Notes and Mezzanine loans, CMBS, REIT lines of credit and derivatives.

For example, for the debt model, collateral values are derived from independent market sources with haircuts of ten percent to account for selling costs and liquidity and discount rates to derived present values utilize spreads based on external sources for property type and LTV ratios. The model uses a "water fall" structure to determine available proceeds, present value of cash flows and compares market value versus the cost basis. Research is conducted for each position based on information on servicer websites and discussions are held with asset managers in GREG.

Annually, appraisals are ordered on properties with monthly updates of capitalization rates and recent sales. As is the case with all trading desks, GREG desks mark their own books with confirmation by Product Control and internal audits testing the process and the results.

Risk Management **(Exhibits 14, 15 and 16)**

With nearly $60 billion of consolidated real estate-related assets at May 31, 2008, the largest asset class, and one which is largely represented by illiquid positions, commercial mortgage and real estate exposure is substantial.

Risk Appetite is a measurement that represents the amount LBHI is prepared to lose in one year, currently $4 billion. The metric, calculated as an annual amount at a 95 percent confidence level, integrates market risk and event risk into one comprehensive indicator. Market risk is measured by the VaR measure which is based on simulated P&L's generated from four years of historical data and current exposures. For commercial mortgages, the principal market risk factors are interest rate risk and spread risk. The second type of risk, event risk, is related to potential property losses on real estate which would impact the value of mortgage loans. Potential losses are measured using a historical simulation approach to determine the earnings impact of real estate shocks. Each loan is individually evaluated and stressed by the market value of the property using a historical time series of property value changes less any senior debt and the Lehman loan on a mark-to-market basis. At May 31, 2008, market risk and event risk were about equally divided in total real estate exposure.

For real estate held for sale positions, those represented by debt and equity interest, stress testing is used to evaluate risks. At May 31, 2008, LHBI had $20.7 billion of real estate investments; however, the Company's net investment at risk was limited to $10.4 billion, as a portion of these assets have been financed on a non-recourse basis. Based on the results of stress testing a 10 percent decline in the underlying property values associated with this position, there would have been a net revenue loss of approximately $1.3 billion.

The Daily Risk Appetite Report, the primary risk management report issued by the Global Risk Management Department, has shown a substantial limit excess that has been outstanding since at least August 2007. As of August 13, 2007, real estate risk usage was $1.2 billion compared to the $720 million limit. Although the limit has been unchanged since at least that time, the actual risk appetite usage has increased primarily due acquisitions of real estate assets, particularly $21.3 billion commitment to Archstone-Smith in the third quarter of 2007.

Subsequent to the addition of Archstone exposure, Risk Appetite exposures continued to increase due to market volatilities (increasing market risk related to CMBS) and, secondarily, to markdowns in underlying property values (increasing event risk), thereby adding to already excessive risk positions. At July 9, 2008, the exposure to real estate was $1.5 billion, more than after that large transaction closed. This increase has occurred despite the steady reduction of commercial mortgage and real estate assets.

Since usage of Risk Appetite was far in excess of Risk Appetite limits, OTS asked for documentation relating to the reasons explaining the large increase. Global Risk Management provided email documents which revealed a request for Executive Committee approval for a $21.3 billion commitment for the acquisition of Archstone-Smith by LBHI and Tishman Speyer. That transaction was the primary driver behind the risk usage over limits. Documentation, including screen shots of the Lehman Risk System, evidenced notices of overage of limit excesses and approvals of the exceptions to Risk Appetite by the Risk Committee.

The commitment was comprised of $17.2 billion in debt facilities, $3.8 billion in bridge equity and $327 million in permanent equity. Due to the severe market dislocation before and after the deal closed in October 2007, the debt and equity syndications were not completed, and at May 30, 2008, $4.7 billion was remaining on the books including $2.1 billion of senior debt and $1.6 billion in bridge equity.

Internal Audit

The latest available internal audit dated June 21, 2007 reviews the results of the 2006 SOX review of securitization conduits, large commercial real estate loans.

The audit included a review of controls over commercial loan and trade entry/trade capture processing, price verification, P&L generation, reconciliation to the financial records and valuation adjustments for conduits, large loans and the CMBS business. Also included was a sample of loans booked at LBB and LBCB. Control concerns stated in the report were to obtain appropriate committee approval for large loan commitments, to price verify pending rate lock loans, to strengthen monitoring procedures over deal expense reserves, to segregate responsibility for servicer data uploads and to reconcile LB Bankhaus positions.

In addition, there were two recommended control enhancements relating to reconciliation of P&L estimates and actuals and to periodically review spreadsheet formulas. All control concerns have been addressed. The internal audit for 2008 should be available in August 2008.