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Market Risk Management: Limit Policy

Lehman Brothers Holdings Inc.

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LEHMAN BROTHERS

Market Risk Management

Limit Policy

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CONFIDENTIAL

Overview

Fundamental to risk management is the establishment and maintenance of a sound system of integrated market risk limits to control the range of market risks inherent in trading and investing activities. Limits define the level at which intervention is required from Senior Management with the appropriate authority (see "Management Action Triggers" discussed below). Market risk limits expressed in terms of potential loss associated with the Firm's activities have been defined with the following objectives:

- To be within the Firm's risk appetite;
- To protect the Firm's capital base;
- To reduce the volatility of the Firm's trading returns.

The overall risk limit framework is driven by the Firm Risk Appetite limit, which is approved by the Risk Committee on an annual basis and reviewed for possible updates periodically, as necessary. Risk Appetite limits are supplemented by VaR limits as well as by other guidelines using additional relevant metrics, as appropriate to the specific products and business. Limits are set at a Firm-wide level and cascaded down to the Divisions and Lines of Business within each Division on a global and regional basis. In addition, while the Firm does not manage risk on a legal entity basis, limits are nonetheless applied to the Firm's regulated legal entities as required.

The limits process is administered by Market Risk Management (MRM) in conjunction with the Global and Regional Business Division Heads. Limits are set annually as part of the Firm's budget process, and may be reviewed and amended during the course of the year, as may be appropriate in the context of changes in markets and the business.

The Cascading Limit Framework

The aggregate Firm-wide Risk Appetite limit is set by the Risk Committee, and any changes to, or breaches of, this limit require approval of the Risk Committee. In addition, the Risk Committee approves the allocation of the Firm-wide Risk Appetite limit to Business Divisions, based on the recommendations of Market Risk Management.

The Firm-wide Business Division Risk Appetite and VaR limits and the region-wide cross-Divisional limits for Europe and Asia form the set of Level 1 limits. Changes to, and breaches of, Level 1 limits require authorization from the Global Head of Risk Management and the Business Division/Region Head, as appropriate. Limits set within a Business Division, which may be either regional or for a global Line of Business, depending upon the business organization, are set by MRM in conjunction with the Business Division Heads and form the set of Level 2 limits. Changes to Level 2 limits require the approval of the Global Head of Risk Management and the Business Division Head.

Business Managers have the authority to set additional limits, including individual trader limits, if deemed appropriate, which form the set of Level 3 limits. Level 3 limits may be reallocated by Business Managers as they see fit so long as the Line of Business/Region stays within its limit overall.

Management Action Triggers

When a Level 1 limit is approached, or seems likely to be exceeded, the issue is escalated both within MRM and the Business Division/Regional Head, as appropriate. The Business Division/Regional Head and Global Head of Risk Management are then able to decide the action to be taken.

One of three courses may be taken:

- Allow the excess to remain for an agreed period of time in support of the specific trading strategy: this action may occur in cases where the excess was anticipated and discussed with MRM or where the excess is in support of a customer facilitation trade and there is unused risk capacity at the Firm-wide level;
- Agree, in some circumstances, to revise the limits if, for example, there has been a change in the business which warrants such a change; or
- The decision may be taken to reduce the risk profile back within the limit.

Likewise, when a Level 2 limit is approached or breached, the Division Head determines the appropriate course of action, taking into account the advice of MRM. Market Risk Managers are responsible to report all Level 2 limit excesses and any discussions with the trader or business unit manager regarding them to his/her manager in MRM, who in turn will alert the Global Head of Risk Management, and to the Division head. Provided that the limit for the Division has not been breached, the Division head may re-allocate intra-Divisional limits, subject to the advice of MRM. In addition, the Global Head of Risk Management is empowered to grant a temporary waiver of an intra-Divisional limit excess. If a temporary waiver is agreed, this becomes the limit used for the duration of the waiver. At the end of the waiver period the limit will revert to the previous level.

Documentation of Limit Excesses

Risk Management has the responsibility to maintain documentation of all current Level 1 and Level 2 limits and limit changes, and to maintain documentation of all Level 1 and Level 2 limit breaches and the course of action taken in respect of all breaches. The responsibility to administrate overages of Level 3 limits lies with the business.