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Why Was Lehman Brothers Rated 'A'?

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Table Of Contents

Why Was Lehman Brothers Rated 'A'?

Historically, ratings have provided value to the market by taking an intermediate- to long-term perspective primarily based on fundamental credit analysis. If ratings merely reflected prevailing market sentiment, they would not provide such independent analysis and value to the marketplace. In general, when appropriate, Standard & Poor's Ratings Services will take rating action when the credit implications of market sentiment (e.g., in terms of cost and access to funding) become reality.

Yet, there are cases where negative market sentiment-–whether or not grounded in fundamentals--can create significant difficulties for a company, and can even precipitate a failure. Companies that operate in particularly confidence-sensitive businesses and/or place heavy reliance on short-term borrowings are especially vulnerable to this phenomenon. This can give rise to a potential "credit cliff," where credit quality can deteriorate precipitously in a short period.

We view the recent collapse of Lehman Brothers Holdings Inc. as a case in point. In our view, Lehman had a strong franchise across its core investment banking, trading, and investment management business. It had adequate liquidity relative to reasonably severe and foreseeable temporary stresses. And looking beyond the current downturn, the firm had good earnings-generating ability. (Currently pending negotiations to sell parts of Lehman's global businesses attest to the strength of Lehman's franchise.)

Lehman certainly had its share of challenges, too. Since the turn in the credit cycle that started in mid-2007, weak business conditions and dislocation in the capital markets had affected Lehman adversely. In our view, Lehman was affected more than some of its peers among the broker-dealers because of its particular emphasis on leveraged finance underwriting, residential mortgage origination and securitization, and commercial real estate (CRE) finance–-business lines that have been hit especially hard by the current slump.

Moreover, during 2007, Lehman aggressively accumulated residential mortgages, residential mortgage-backed securities (RMBS), and CRE loans and equity investments on its balance sheet (see table 1). Although hedges during the second half of fiscal 2007 (ended Nov. 30, 2007) largely offset deterioration in the value of these assets, hedges were insufficient during the first half of the current fiscal year. Largely as a consequence of write-downs, Lehman had only breakeven pretax earnings in the first quarter (adjusted for special items; see tables 2 and 3), and incurred a $4.3 billion pretax loss in the second quarter (ended May 31, 2008). The write-downs included realized losses on asset sales, as Lehman reversed course and began shrinking its asset base.

Table 1

Exposures to Problematic Assets*

(Mil. $)	3Q08	2Q08	1Q08	4Q07
Residential Mortgages				
Securities	9,300	15,000	18,200	16,700
Whole loans	6,300	8,300	11,900	14,200
Servicing and other	1,600	1,600	1,700	1,200
Total residential	17,200	24,900	31,800	32,100
Commercial Mortgages				
Whole loans	15,500	19,900	24,900	26,200
Securities and other	8,500	9,500	11,200	12,700

Table 1

Exposures to Problematic Assets*(cont.)				
Total commercial	24,000	29,400	36,100	38,900
Real estate held for sale	8,600	10,400	12,900	12,800
Other ABS	4,600	6,500	6,500	6,200
Total mortgage and ABS	54,400	71,200	87,300	90,000
Leveraged finance	7,100	11,500	17,800	23,900
Total exposures	61,500	82,700	105,100	113,900

*Gross/notional exposures before hedges.

Table 2

Profitability Analysis

(Mil. $)	3Q08	2Q08	1Q08	4Q07	3Q07
Revenue as reported	(2,903)	(668)	3,507	4,390	4,308
Mark-to-market effects and special items					
GLG gain	N.A.	N.A.	N.A.	(400)	N.A.
Credit market-related	7,000	4,100	2,400	2,080	700
Gains on own structured notes	(1,400)	(400)	(600)	(320)	(1,000)
Total mark-to-market effects and special items	5,600	3,700	1,800	1,360	(300)
Revenues adjusted for mark-to-market effects and special items	2,697	3,032	5,307	5,750	4,008
Revenues adjusted for special items	(4,303)	(1,068)	2,907	3,670	3,308
Pretax income (as reported)	(5,824)	(4,087)	663	1,230	1,205
Adjustments to Pretax Income					
GLG gain	N.A.	N.A.	N.A.	(400)	N.A.
Credit market-related	7,000	4,100	2,400	2,080	700
Exit costs	30	160	34	18	44
Gains on own structured notes	(1,400)	(400)	(600)	(320)	(1,000)
Total mark-to-market effects and special items	5,630	3,860	1,834	1,378	(256)
Pretax income adjusted for mark-to-market effects and special items	(194)	(227)	2,497	2,608	949
Pretax income adjusted for special items	(7,194)	(4,327)	97	528	249
Pretax margin (%)	N.M.	N.M.	18.9	28.0	28.0
Pretax margin adjusted for mark-to-market effects and special items (%)	N.M.	N.M.	47.1	45.4	23.7
Pretax margin adjusted for special items (%)	N.M.	N.M.	3.3	14.4	7.5

N.A.-Not available. N.M.-Not meaningful.

Table 3

Write-Downs*

(Mil. $)	3Q08	2Q08	1Q08	4Q07	3Q07
Residential mortgages	4,900	2,000	800	1,300	N.A.
Commercial mortgages and other real-estate	1,600	1,300	1,000	900	N.A.
Other ABS	500	400	100	200	N.A.
Leveraged finance	N.A.	400	500	(320)	700
Total	7,000	4,100	2,400	2,080	700

*Net of hedges. N.A.-Not available.

Increasing Troubles In Spring 2008

On March 21, 2008, we revised our outlook on Lehman Brothers to negative from stable, pointing out that the near collapse of The Bear Stearns Cos. Inc. several days before had highlighted the extent to which capital-market sentiments could hurt securities firms. On June 2, 2008, we lowered our rating on Lehman Brothers (holding company to 'A/Negative/A-1' from 'A+/Negative/A-1'), citing the much weaker-than-previously-anticipated earnings outlook for Lehman and its peers. We assigned a negative outlook to the lower rating, and we stated that we could lower the ratings further if Lehman were to incur substantial additional losses (beyond the second quarter) either as a result of depressed business conditions or sizable write-downs.

Our ongoing consideration of Lehman took into account the possibility that it could incur a substantial loss in the third quarter, given industrywide deterioration in the value of CRE and RMBS. However, weighing against a further rating action, in our view, were other factors: Lehman was making significant progress in reducing its exposure to problematic assets through sales, and, as was widely reported in the press, was developing plans to accelerate this process. Although these actions would necessitate capital raising (beyond the company's issuance of $4.0 billion of common stock and $2.0 billion of mandatory convertibles in June) to offset the reduction in equity levels, Lehman reportedly was considering a range of options for doing so.

In the meantime, though, negative market sentiment directed specifically toward Lehman was building. Among the five largest independent U.S. broker-dealers at the time, after Bear Stearns, Lehman Brothers was the next smallest and therefore the most vulnerable. Despite Lehman's being significantly larger than Bear Stearns had been, considerably more diversified, and, importantly, much more conservatively positioned in its funding and liquidity management, it still appeared on many "Who's next?" lists. Lehman seemed to serve as a lighting rod for market anxieties, as reflected in its share price decline and its widening debt spread.

Short selling may also have played a role: During the 30-day period when the SEC's ban on naked short selling was in effect, Lehman's share price was relatively stable. We saw that market anxieties intensified with the approach of Lehman's third-quarter earnings announcement, particularly given uncertainty about the extent of additional write-downs Lehman would need to record to reflect deteriorating asset values.

A Climactic September For Lehman

On Sept. 9, with Lehman's share price dropping significantly, we placed the ratings on CreditWatch given that, even though we perceived Lehman to have certain fundamental strengths, market sentiments–-which seemed to be escalating to the point of panic--would have the real-world effect of making it more difficult for Lehman to raise capital (by making it unlikely the company could successfully float new equity) and to maintain competitive funding costs. At that time, we believed a meaningful possibility remained that with the completion of contemplated actions, Lehman could both remain viable and achieve affirmation of the ratings.

On Sept. 10, in an accelerated preannouncement, Lehman reported a larger-than-anticipated third-quarter adjusted pretax loss of $7.2 billion, after mark-to-market adjustments (net of hedges) of $7.0 billion. A portion of the mark-to-market adjustments stemmed from realized losses, since the quarter included significant asset sales. Lehman also outlined the key elements of its plan to further "derisk" its balance sheet, including spinning off almost all of its remaining CRE assets to a newly formed company to be owned by Lehman's shareholders and additional bloc sales of portions of its residential mortgage portfolio. Obviating the need for new equity issuance, Lehman said it was pursuing the sale of a majority interest in certain units within its Investment Management division. This transaction would trigger an accounting benefit to reported tangible book value of about $3 billion through a reduction in goodwill, even before taking account of any potential gain realized.

With the completion of the investment-management transaction, Lehman's Tier 1 capital ratio (estimated to be a satisfactory 11% as of Aug. 31) would remain basically flat, taking account of the substantial anticipated reduction in risk-weighted assets. We commented on Sept. 10 that as part of our CreditWatch review we would assess the extent to which these measures would affect Lehman's credit profile, taking into account the economic risk the firm would continue to bear by extending debt financing to the asset buyers/spun-off entity. We stated that we did not view capital enhancement accomplished via the Investment Management stake sale in as favorable a light as new equity issuance, because Lehman would be giving up a portion of the revenues and earnings contributions of its substantial investment management business. Still, we continued to believe there was a possibility that the ratings could be affirmed if Lehman implemented these actions, although we highlighted in our published commentary the potential for a multinotch downgrade otherwise.

Whether it was because of the complexity of Lehman's plan, the extended time necessary to fully implement the plan, or the continuing asset valuation risks that Lehman would bear in the meantime, some other constituents were more negative in their reaction. Missteps in the communication of the company's prior efforts to raise capital, such as leaks about potential acquirers, did not help. Lehman's share price continued to plummet, ultimately ending down more than 80% for the week of Sept. 8-12. On Sept.10, another rating agency placed its ratings on Lehman on review, stating that the ratings could only be saved from a severe downgrade with a quick "strategic arrangement."

During the next few days, Lehman's efforts to find a buyer were unsuccessful, perhaps because the U.S. government and other Wall Street firms declined to support such a transaction by providing funding or assuming a portion of the asset value risk. In the wake of the government-backed fire sale of Bear Stearns, the bailout of Freddie Mac and Fannie Mae, and looming problems at other institutions, the U.S. government may have needed a "moral hazard example," to demonstrate that it would not be willing to rescue floundering major financial institutions in all circumstances.

Lehman had a large holding company-level excess liquidity pool of $42 billion as of Aug. 31, and it is our understanding that heading into the weekend of Sept. 13-14, Lehman still had substantial excess liquidity to cover near-term funding requirements. However, facing a likely complete collapse in confidence on the part of creditors, counterparties, and customers when it opened for business on Monday, Sept. 15, Lehman Brothers Holdings Inc. filed for Chapter 11 bankruptcy protection.

In conclusion, we believe the downfall of Lehman reflected escalating fears that led to a loss of confidence-–ultimately becoming a real threat to Lehman's viability in a way that fundamental credit analysis could not have anticipated.