

The State of New York vs. Ernst & Young:

Putting Lehman’s Accounting for

“Repo 105” Transactions on Trial

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Table of Contents

| | |
|--|----|
| 1. Introduction | 1 |
| 2. The Economics of Repurchase Agreements..... | 5 |
| 3. The Accounting Rules for Repos | 7 |
| 4. Lehman’s Use of Repos..... | 17 |
| Lehman’s Repurchase Agreements | 17 |
| 5. The Multiple Causes of Lehman’s Failure | 24 |
| 6. Summary and Conclusion..... | 26 |

1. Introduction

The recent financial crisis in the United States had a number of causes. One of these was the slowly building erosion during 2006

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in the subprime mortgage² market. The defaults eventually spread into the prime mortgage market. Mortgage default rates were increasing even as many homeowners saw the value of their properties falling after the long-running housing bubble broke. Long before this Wall Street had been creating and selling financial products known as “collateralized mortgage obligations” (“CMOs”) and “collateralized debt obligations” (“CDOs”). CMOs and CDOs are “pass through” securities, backed by a pool of mortgages or other debt obligations. As the mortgage default rates started increasing in 2006, the value of the CMOs and CDOs also began to decline. Because the pools were owned by both commercial and “retail” (individuals) investors, the problems spread as widely through the economy as the ownership of the funds. Trading in these securities also began to slow substantially and the market for them essentially disappeared in some cases. Because there was no market in some instruments (such as auction rate securities), financial institutions—required to report the “fair value”³ of assets on their balance sheets—could not find reliable pricing data (or “marks”) to use in pricing the CMOs and CDOs held on their balance sheets. In attempting to mark-to-market billions of dollars in these pools, banks, brokerages, and other financial institutions were forced to take large write downs on them. It quickly became a “vicious cycle” as one institution’s

² “Subprime” mortgages are those that don’t meet certain credit standards (income-to-debt service, loan-to-value, etc.). They typically had higher rates due to the higher risks. During a period of rising asset values, lenders and borrowers weren’t as concerned with traditional credit measures.

³ The rules requiring financial institutions to mark-to-market their holdings were still developing. Even in calm times the transition from historical cost accounting to fair value accounting would have been challenging. Making the transition during a time of highly volatile pricing and evolving rules was almost a “perfect storm” of financial reporting.

mark downs led to more mark downs by other banks.⁴ The decline in values was compounded by panic selling and falling values in other asset classes like residences and even the equity markets. As one asset class after another followed the others down, some financial institutions were forced to sell some assets for any price. The losses financial institutions suffered due to CMOs and CDOs caused them to tighten their lending standards which led to the freezing of credit markets. The freezing of the loan market led to a liquidity crisis in late September 2008, as many companies could not get short term credit to finance operations. This helped turn a liquidity crisis into a recession.

The world of financial reporting by securities firms is back in the spotlight thanks to a lawsuit filed by departing New York attorney general Andrew Cuomo just before he became governor. More than two years after Lehman's collapse during the 2008 financial meltdown, then-attorney general Cuomo concluded that Ernst helped the failed investment bank "engage in a massive accounting fraud."⁵ The suit, filed on behalf of the State of New York, alleges that Ernst & Young, auditors of failed Lehman, issued false statements regarding its audits and other work on Lehman's financial statements, or committed other fraudulent acts and violated the Martin Act.⁶ The suit also claims that New York State

⁴ Some persistent rumors suggest that various CMO and CDO holders intentionally wrote down the value of their holdings below realistic values, hoping to force their competitors to take deep write downs. The theory behind the rumor is that it would create problems for their competitors, causing depositors to flee, drive up borrowing costs for the competitors, or even force them out of business.

⁵ *The People of the State of New York by Andrew M. Cuomo against Ernst & Young, LLP – Complaint, page 1.*

⁶ *The People of the State of New York by Andrew M. Cuomo against Ernst & Young, LLP – Complaint, pages 30 and 31.*

deserves more the more than \$150 million in fees paid to Ernst by Lehman over the seven years of its work there. While some commentators have noted the potential political and economic benefits of a suit this size, ultimately the case turns on the accounting for a small and complicated segment of financial instruments. Specifically the suit focuses on accounting for repurchase agreements—known universally as repos. Accounting for these instruments is not simple.

Repos, in one form or another, had been used in the United States for over 90 years by the time the financial crisis hit in 2008. They were first used by Federal Reserve banks as early as 1917 to extend credit to member banks in lieu of rediscounting commercial paper. Their use later expanded to include nonbank dealers in securities. The use of repos grew significantly in the 1970's due to the rising levels and increasing volatility of interest rates. Banks and nonbank dealers were looking for cheaper sources of funds, while the rise in interest rates made lending under repo agreements attractive to nonfinancial institutional cash managers who saw them as a relatively safe way to earn interest on cash that would otherwise be sitting in low-yield checking accounts. As a result, the counterparties⁷ in repo transactions expanded to include industrial firms, school districts, and other small creditors. In the mid 1980's a new form of repo was developed, the tri-party repo, to reduce potential creditor (counterparty) losses. Tri-party repos involve the borrower, the lender, and a third party clearing bank. The tri-party structure differs from bilateral repurchase agreements

⁷ A “counterparty” is the institution that extends cash to the original owner of the securities in exchange for the securities under the repurchase agreement. The counterparty is, in substance, a lender who expects to sell or transfer the security back to the original owner at a higher price, earning interest as a result of the entire exchange.

due to the treatment of the transaction in bankruptcy and the custodian services of the clearing bank. The market reached peak levels in 2008 when over \$2.8 trillion in securities were being financed through the use of tri-party repos. The well-established U.S. repo market provides benefits for borrowers and lenders, including liquidity for the U.S. Treasury and financial markets and an efficient form of financing for firms to fund their operations, among others. The collapse of the repo market has been cited by some as one of the main causes of the 2008-2009 financial crisis.

Active participants in the repurchase market include hedge funds, pension funds, insurance companies, and primary dealers, among others. The U.S. Federal Reserve also uses the market to implement monetary policy,

2. The Economics of Repurchase Agreements

A repurchase agreement or “repo” is a transaction involving the sale of securities along with a simultaneous agreement to repurchase the securities at a specified price on at a later date (the forward agreement). Depending on whether the repurchase agreement meets certain criteria under the accounting rules,⁸ it can either take the form of:

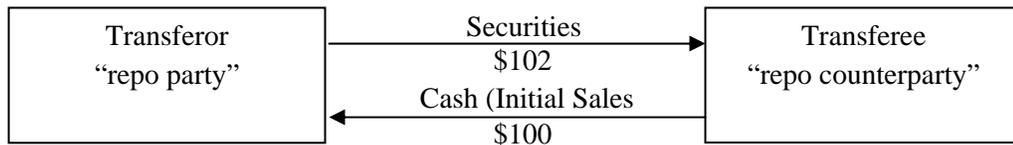
- A) A secured borrowing. That is, lending with collateral (i.e. a loan, if does *not* meet criteria) or
- B) The sale/purchase of financial assets and a forward repurchase/resale commitment (i.e. a sale, if it does meet the three criteria)

⁸ Previously SFAS 140; now ASC 860, “Transfers and Servicing.”

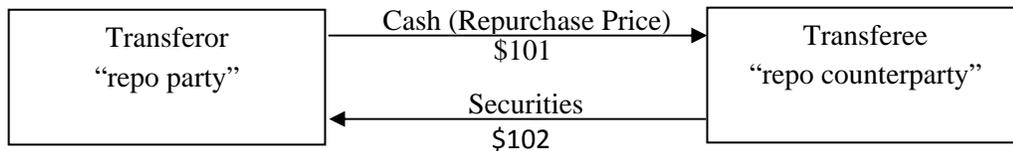
This distinction is key in the suit against Ernst. The State of New York is alleging that Lehman improperly booked a series of transactions as sales instead of as loans—and that Ernst approved of this practice through their audits.

The value of the securities sold in the initial sale is usually greater than the amount of cash received and the price specified to repurchase the securities is usually greater than the initial sale price. This is how the lender, the counterparty, earns its income, characterized as interest if the agreement is classified as a loan.

Initial Sale



Subsequent Repurchase



From an economic standpoint, a repo transaction is the equivalent of a secured loan. In the example above, the securities sold represent the collateral for the secured loan (\$102), the initial sale price (\$100) represents the principal amount and the excess of the repurchase price over the initial sale price represents the interest ($\$1 = \$101 - \$100$). However, in contrast to a secured loan, legal title to the securities used as collateral changes from the seller to the buyer at the time of the initial sale and then back to the seller upon repurchase of the securities.

3. The Accounting Rules for Repos

Like all other SEC registrants, Lehman was obligated to report its financial results in accordance with GAAP.⁹ GAAP is recognized to be a “six lane highway” where the same set of facts can result in different, acceptable conclusions. All the “lanes” under GAAP are “legal,” though some are more conservative than others. For example, in certain situations companies can select from different alternatives when booking sales (called “revenue recognition”) for long term contracts. Other examples include the use of LIFO versus FIFO inventory methods and accelerated depreciations methods for tangible property. A company’s financial statements reflect the elections and judgment of management on dozens of issues and, possibly, thousands of transactions. A key issue during the financial crisis was “reserve” accounting for bad loans (or portfolios of loans). Many financial services firms were simply unprepared for the tsunami of bad debt that hit their balance sheets. The evolving rules for fair value were probably a contributing factor as banks and others could not find any quotes for some of their financial assets.¹⁰

At the time Lehman entered into the repo transactions, accounting for them was governed by Statement of Financial Accounting

⁹ GAAP is an acronym for Generally Accepted Accounting Principles. GAAP is like “the law,” and is comprised of the standards, conventions, and rules accountants follow in recording and summarizing transactions. The top tier or “black letter” GAAP is the specific rules issued by the Financial Accounting Standards Board (the FASB).

¹⁰ Some commentators blame fair value directly for the entire financial crisis. Relief for firms came early in 2009 when Congress and the SEC directed the FASB to issue guidance that allowed firms to recognize the extreme circumstances of the then-current market.

Standards No. 140 (“SFAS 140”).¹¹ These rules, as revised, are now classified under Accounting Standards Codification 860 (“ASC 860”) called “Transfers and Servicing” under the classification system.

SFAS 140 allowed repos to be accounted for either as secured loans or as sales (and subsequent repurchases) of assets based on certain qualifying criteria. Under the rules, a transfer of financial assets in which the transferor surrenders control over the assets is accounted for as *a sale* to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets *if and only if* all of the following conditions are met:

- a. The transferred assets have been isolated from the transferor; put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership;
- b. Each transferee has the right to pledge or exchange the assets it received;
- c. The transferor does not maintain effective control over the transferred assets.

Under the rules, accounting for the repo transaction as a secured loan treated both components of the transaction (initial sale and subsequent repurchase) as one transaction of two steps and involved retaining the transferred assets on the firm’s balance sheet. The cash received from the loan was offset by recognizing the secured loan liability. Since the assets received (cash) and resulting liability (secured loan) were both reported on the firm’s

¹¹ The pronouncement is titled “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities-a replacement of FASB Statement No. 125.” It was issued in September 2000 and amended in February and March of 2006.

balance sheet, this method resulted in on-balance sheet financing. By contrast, treating the repo transaction as a sale under the rules involved treating each piece of the transaction separately (two distinct transactions, not one) and removing the assets from the firm's balance sheet at the time of the initial sale. Under this approach, the cash received offsets the removal of the assets (securities) from the balance sheet as in a typical sale. Additionally, the firm also recognizes the repurchase portion of the contract as a forward purchase. A secured loan liability is *not* recognized when accounting for the repo as a sale, and this method is referred to as off-balance sheet financing.

The differences between the two alternatives are best illustrated through a simple example. Because both methods of accounting have the same effect on net income but differ significantly in the effect on the balance sheets, the example below is structured to demonstrate the differences in the balance sheet treatment of the repo and reduce the income statement effect to zero. In particular, the example assumes that the cash received in the initial sale is the same as the repurchase price (i.e. there is no interest) and that the transferor receives cash collateral equivalent to the full value of the transferred securities (accounting effect of forward purchase = \$0).

Consider a borrower, Bank A, which has total assets of \$1,000, total liabilities of \$600 and Equity of \$400 on Day 0. Assume that this bank also has \$100 of securities (included in its total assets of \$1,000) that it is considering using in a repo transaction. The balance sheet of this bank is presented below.

| <u>Balance Sheet of Bank A at Day 0</u> | | | |
|--|--------|--------------------------------------|---------------|
| <u>Assets</u> | | <u>Liabilities and Equity</u> | |
| Securities | \$ 100 | Total Liabilities | \$ 600 |

| | | | |
|---------------------|----------------|---------------------------------------|----------------|
| Other Assets | 900 | Equity | 400 |
| Total Assets | \$1,000 | Total Liabilities & Equity | \$1,000 |

On Day 1 the bank engages in a repo transaction. Under the terms of the transaction, the bank transfers the securities worth \$100 to a counterparty in exchange for cash of \$100, and a promise to repurchase the securities for \$100 on Day 4.¹² The balance sheet of Bank A, accounting for the repo as a secured loan, is presented below.

| <u>Balance Sheet of Bank A as of Day 1 (Secured Loan)</u> | | | |
|--|--------|--------------------------------------|--------|
| <u>Assets</u> | | <u>Liabilities and Equity</u> | |
| Cash from Secured Loan | \$ 100 | Secured Loan | \$ 100 |
| Securities (used for Repo) | 100 | Other Liabilities | 600 |

¹² As previously described, repos are usually structured such that the repurchase price of the transferred securities is higher than the initial price. For example, a bank transferring securities worth \$100 in a repo transaction, would receive less than \$100 in cash (say, \$98). The bank would also agree to repurchase the assets at \$99. The difference between the cash received (\$98) and the repurchase price (\$99) is the interest (\$1) charged to the bank on the repo transaction. The effect of the interest expense on the balance sheet of the bank under both methods of accounting is to reduce the balance sheet equity (through net income which is closed out to the balance sheet). In the highly sophisticated market for these securities, the pricing is very precise and the resulting yields are predictable, following reliable patterns (a yield curve) based on time, credit quality of the borrower, etc.

| | | | |
|---------------------|----------------|---------------------------------------|----------------|
| Other Assets | 900 | Total Liabilities | \$ 700 |
| | | Equity | 400 |
| Total Assets | \$1,100 | Total Liabilities & Equity | \$1,100 |

The balance sheet of Bank A, accounting for the repo as a sale, is presented below.

| <u>Balance Sheet of Bank A as of Day 1 (Sale)</u> | | | |
|--|----------------|---------------------------------------|----------------|
| <u>Assets</u> | | <u>Liabilities and Equity</u> | |
| Cash | \$ 100 | Other Liabilities | \$ 600 |
| Securities | 0 | Total Liabilities | \$ 600 |
| Other Assets | 900 | Equity | 400 |
| Total Assets | \$1,000 | Total Liabilities & Equity | \$1,000 |

A key measure for financial services firms, like Lehman, is the concept of “leverage,” or how much of the firm is financed with borrowed funds instead of equity. Market participants (investors,

lenders, others) commonly use financial ratios to analyze the financial statements of a firm. One of the ratios used to evaluate financial firms is called a leverage ratio and measures how much debt—compared to equity—a firm is using to finance itself. The impact of on a firm’s balance sheet (and resulting ratios) for the different accounting methods of a repo demonstrates why management generally would prefer the sale method of accounting for repo transactions. The leverage ratio can be defined as assets divided by equity.¹³ The table below shows the leverage ratio for Bank A, calculated on Day 0 (prior to the repo) and then on Day 1 using both the two methods of accounting for the transaction.

| | Day 0 | Day 1 (Secured Loan) | Day 1 (Sale) |
|----------------|--------------|-----------------------------|---------------------|
| Leverage Ratio | 2.5 | 2.75 | 2.5 |

Bank A’s leverage ratio prior to the repo is 2.5 (measured as \$1,000/\$400). As expected, treating the repo transaction as a secured loan increases the leverage ratio of Bank A to 2.75 (measured as \$1,100/\$400). As expected, the leverage ratio is unchanged if the repo transaction is accounted for as a sale.

¹³ Basic financial ratios are often modified to make them more meaningful in specific industries. For example, Lehman used the net leverage ratio instead of a simple leverage ratio. Lehman defined “net assets”—the numerator for this ratio—as total assets less: (i) cash and securities segregated and on deposit for regulatory and other purposes; (ii) collateralized lending agreements; and (iii) identifiable intangible assets and goodwill. For the denominator, Lehman included stockholders’ equity and junior subordinated notes in “tangible equity capital,” and excluded identifiable intangible assets and goodwill.

Allegations regarding Lehman’s use of Repo 105 assert that the transaction was used to reduce reported leverage, or the leverage reported using the GAAP¹⁴ financial statements. So far, the example above demonstrates that leverage either increases or remains the same under either method of accounting.

Leverage can be lowered using a repo transaction accounted for as a loan by using the cash received under the repo to pay down other liabilities of the firm. For example, assume that Bank A uses the \$100 received from the repo to pay down other liabilities on Day 2. Bank A’s balance sheet on Day 2 accounting for the repo as a secured loan is provided below.

| <u>Balance Sheet of Bank A as of Day 2 (Secured Loan)</u> | | | |
|--|------|--------------------------------------|---------------|
| <u>Assets</u> | | <u>Liabilities and Equity</u> | |
| Cash from Secured Loan | \$ 0 | Secured Loan | \$ 100 |
| Securities (used for Repo) | 100 | Other Liabilities | 500 |
| Other Assets | 900 | Total Liabilities | \$ 600 |

¹⁴ GAAP is an acronym for Generally Accepted Accounting Principles. GAAP is like “the law,” and is composed of specific rules issued by the Financial Accounting Standards Board (the FASB) as well as industry practices and evolving conventions on developing issues.

| | | | |
|---------------------|----------------|---------------------------------------|----------------|
| | | Equity | 400 |
| Total Assets | \$1,000 | Total Liabilities & Equity | \$1,000 |

Bank A's balance sheet on Day 2 accounting for the repo as a sale is provided below.

| <u>Balance Sheet of Bank A as of Day 1 (Sale)</u> | | | |
|--|--------------|---------------------------------------|--------------|
| <u>Assets</u> | | <u>Liabilities and Equity</u> | |
| Cash | \$ 0 | Other Liabilities | \$ 500 |
| Securities | 0 | Total Liabilities | \$500 |
| Other Assets | 900 | Equity | 400 |
| Total Assets | \$900 | Total Liabilities & Equity | \$900 |

The table below shows the leverage ratio for Bank A, calculated on Day 0 (prior to the repo) and then on Day 2 using both methods of accounting.

| | Day 0 | Day 2 (Secured Loan) | Day 2 (Sale) |
|----------------|--------------|-----------------------------|---------------------|
| Leverage Ratio | 2.5 | 2.5 | 2.25 |

As can be seen from the table, Bank A's leverage (measured using

a standard leverage ratio)¹⁵ under the sale method accounting is now *lower* than it was prior to engaging in the repo transaction and using the repo proceeds to pay down an existing liabilities.

Leverage is one of the key factors used to evaluate financial firms. However, leverage is a double edged sword: On one hand, leverage is attractive to financial services firms because it expands the amount of capital the firm can deploy and hence increases income. On the other hand, leverage reduces a firm's ability to absorb losses and thus increases its risk.

For example, consider a firm that can borrow money at, say, an average of 3.0% and can lend at an average of 6.0%. The difference, or "spread," in the rates in this example is income to the firm. The greater the amount of money it can borrow and invest at these rates, the greater the amount of income it can generate. Given the choice, financial services firms will often borrow as much as possible when the spread is positive. Prior to the financial crisis, it was not uncommon for financial services firms to borrow *more than* ten times their equity base, i.e. an equity-to-assets ratio of 9.0%. In other words, some large banks and brokerages with a trillion dollars of assets had only \$90 billion of equity financing their operations. In fact, this financing position was actually conservative compared to some of their competitors. Some firms, including Lehman, had liabilities as much as *fifteen times* greater than their equity base (or equity of only about 7% of assets). Fortunately, a firm's ability to borrow money at a given rate is not unlimited. Investors recognize that the firm's riskiness increases along with its leverage and will demand a higher return on their investments in the firm, whether debt or equity, as the

¹⁵ There are additional measures of a company's leverage in addition to the leverage ratio, including the debt ratio (debt/total assets) and the debt to equity ratio (debt/equity).

riskiness increases.¹⁶ As a firm's costs of borrowing rises, profitability is reduced. Additionally, even if the firm is incurring losses on its investments, it must still pay interest on its borrowings.

As we all learned in 2008, many financial institutions were overleveraged and unable to absorb the losses resulting from a severe economic downturn. Evaluating the leverage of a financial services firm took on renewed importance as asset values continued falling. Under the evolving rules for "fair value" under GAAP, some assets, like portfolios of mortgages fell in value—or at least in reported GAAP values—substantially and quickly. For example, if a bank with \$1 trillion in assets and \$90 billion in equity had to write down \$45 billion of a mortgage portfolio (or other asset), that's equal to half the book equity and would take a firm from a 9.0% equity-to-asset ratio to 4.5%—a dangerously low level of equity.

A firm's financial statements are key to evaluating its financial position and future performance. Most ratios and evaluations of a financial firm's health, like debt-to-equity, liabilities-to-equity, etc. are based on the GAAP numbers presented in the financial statements. This is why the accounting for a repo transaction becomes more critical. As shown above, treating a repo as a sale can result in lower reported leverage on a firm's balance sheet. A decrease in the leverage ratio can signal to the market that the company has improved its balance sheet and is less risky.

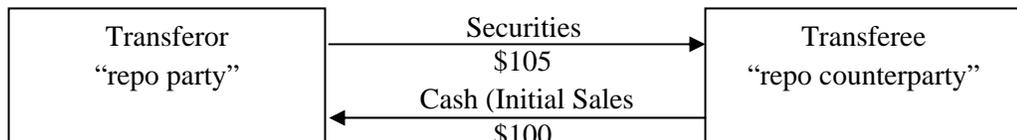
¹⁶ This is a direct corollary to mortgage lenders demanding higher returns on sub-prime mortgages due to the riskiness of those loans compared to conventional mortgages.

4. Lehman's Use of Repos

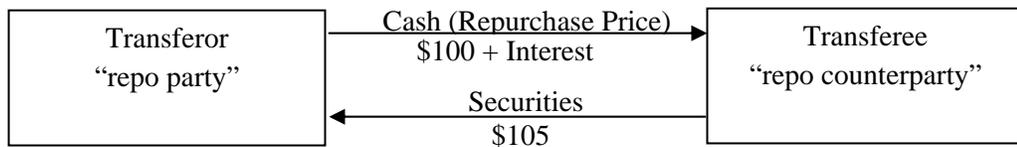
Lehman's Repurchase Agreements

Lehman's Repo 105 transactions were structured such that under the requirements they were treated as sales (and subsequent repurchases) of securities. Repo 105 was set up to allow Lehman to "repo" or reacquire fixed income securities. The name is derived from the fact that the value of the fixed income securities transferred by Lehman were 105% of the value of the cash it received. Similarly, Lehman also set up Repo 108 accounts for equity securities repurchase agreements. Under Repo 108, the value of securities transferred by Lehman was typically a 108% of the value of the cash it received. The only significant difference in the Repo 105 and Repo 108 is the difference in the value of collateral exchanged and the type of securities involved (equity instead of debt). Although the Repo 105 and Repo 108 were separate transactions, they are typically referred to collectively as Repo 105 transactions. The following diagram details Lehman's repo 105 transactions.

Initial Sale



Subsequent Repurchase



The 105% and 108% collateralization in the Repo 105 and Repo 108 transactions appear to be structured specifically in order to qualify for sales accounting by demonstrating the Lehman did not have effective control over the assets. Recall that one of the three requirements for a repo transaction to be recorded as a sale, is that the transferor must surrender effective control over the transferred assets. A specific, identified criteria in SFAS 140 used to evaluate whether a transferor has given up effective control over the assets is to determine whether the transferor's right to repurchase the assets is assured. If the transferor's right to repurchase the assets is assured, the transferor is deemed to have retained effective control and must account for the repo as a secured loan. If the transferor's right to repurchase the assets is *not* assured, the transferor is deemed not to have retained effective control and may qualify for sale accounting provided that all other criteria are met. SFAS 140 states that "transferor's right to repurchase is not assured unless it is protected by obtaining collateral sufficient to fund substantially all of the cost of purchasing identical replacement securities during the term of the contract so that it has received the means to replace the assets even if the transferee defaults." The rule goes on to specify that "[j]udgment is needed to interpret the term substantially all and other aspects of the criterion that the terms of a repurchase agreement do not maintain effective control over the transferred asset." Finally, SFAS 140 states that "arrangements to repurchase or lend readily obtainable securities, typically with as much as 98 percent collateralization (for entities agreeing to repurchase) or as little as 102 percent overcollateralization (for securities lenders), valued daily and adjusted up or down frequently for changes in the market price of the security transferred and with clear powers to use that collateral quickly in the event of default, typically fall clearly within that guideline."

Although judgment is required in assessing whether the cash received by the transferor is sufficient to fund substantially all of the cost of purchasing identical replacement securities, Lehman's 105% and 108% collateralization appears well above the guidance provided by the example in SFAS 140.

Another criteria that needs to be met in order to qualify for sale accounting, is that the transferred securities must be legally isolated from the transferor. Firms typically address this by obtaining a "true sale" opinion from a law firm. Lehman was unable to secure a "true sale" opinion from a US firm, though it did secure a "true sale" opinion from a British law firm, Linklaters. Lehman's internal Accounting Policy Statement required a legal opinion that the transfer complied with certain legal criteria relating to transfer of control of the securities to be booked.¹⁷

The Linklaters true sale opinion included a number of constraints. First, the opinion was addressed to Lehman's London based broker-dealer entity, Lehman Brothers International Europe ("LBIE") and was to be used only by LBIE. Second, the opinion only covered transactions governed by a 1995 or 2000 version of a Global Master Repurchase Agreement under English law, as applied by English courts. Accordingly, securities used for the Repo 105 and Repo 108 transactions were first transferred to LBIE. These securities included US Government bonds as well as other securities registered in the US.

Lehman's inability to obtain a "true sale" opinion under US law has been interpreted by the Attorney General's office as an indication that there was something improper about Repo 105 and Ernst should not have allowed Repo 105 to be accounted for as a

¹⁷ The People of the State of New York by Andrew M. Cuomo against Ernst & Young, LLP – Complaint – page 9, paragraph 19

sale. However, it appears that Lehman's inability to secure a true sale opinion in the U. S. has more to do with the legal environment in the United States, rather than the nature of Repo 105 transactions. In the U. S., prevailing case law was so varied that most law firms were unwilling to provide true sales opinions. By contrast, there was less uncertainty on this issue under English law, and a British firm was willing to issue a true sale opinion there.

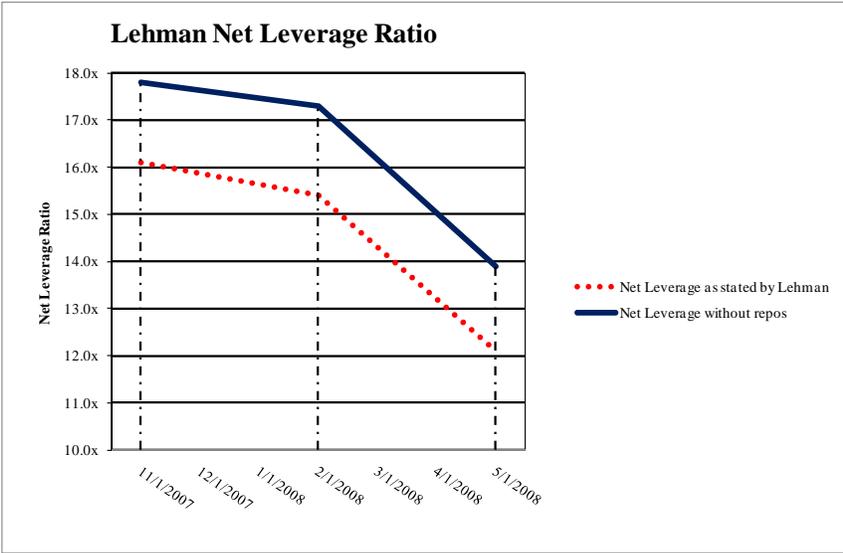
The effects of Lehman's use of repurchase agreements, as reported under GAAP, are illustrated below. Table 1 shows the amount of reported repurchase agreements that Lehman had outstanding at different points in time. For the period ended November 30, 2007, Lehman's reported net leverage ratio was 16.1, or \$16.1 of debt for every \$1.0 of equity.¹⁸ However the net leverage ratio would have been 17.8-to-1.0 had the repurchase agreements been accounted for as loans instead of "true sales." The effect was that Lehman reduced its net leverage ratio through the use of repurchase agreements accounted for as sales. For comparative purposes, Lehman's net leverage ratio for the period ended February 29, 2008 was reduced to 15.4-to-1.0 from 17.3-to-1.0 and for the period ended May 31, 2008 to 12.1-to-1.0 from 13.9-to-1.0.

Table 1

¹⁸ In other words, Lehman had \$6.21 of equity for every \$100 of assets.

| Repurchase Agreement Amounts (\$ millions) ¹ | |
|---|----------|
| Period Ended | Amount |
| 11/30/2007 | \$38,600 |
| 2/29/2008 | \$49,100 |
| 5/31/2008 | \$50,380 |

(1)REPORT OF
ANTON R. VALUKAS, EXAMINER page 748



| Lehman Year Ended 11/30/2007 | | | |
|---|--------------------|--------------------|-----------------|
| <i>(in millions)</i> | As stated (| Repo Amount | w/o Repo |
| | w/Repo) | | |
| Total Assets | \$691,063 | 38,600 | \$729,663 |
| Cash and securities segregated and on deposit for regulatory and other purposes | (12,743) | | (12,743) |
| Collateralized lending agreements | (301,234) | | (301,234) |
| Identifiable intangible assets and goodwill | (4,127) | | (4,127) |
| Net Assets | 372,959 | | 411,559 |
| Total Liabilities | 668,573 | 38,600 | 707,173 |
| Total Equity | 22,490 | | 22,490 |
| Junior subordinated notes | 4,740 | | 4,740 |
| Identifiable intangible assets and goodwill | (4,127) | | (4,127) |
| Tangible Equity Capital | 23,103 | | 23,103 |
| Net Leverage Ratio ² | 16.1 | | 17.8 |
| <i>Repo Amount as a % of Total Net Assets</i> | <i>10.3%</i> | | |
| <i>Repo Amount as a % of Total Tangible Equity</i> | <i>167.1%</i> | | |

| Lehman Quarter Ended 2/29/2008 | | | |
|---|--------------------|--------------------|-----------------|
| <i>(in millions)</i> | As stated (| Repo Amount | w/o Repo |
| | w/Repo) | | |
| Total Assets | \$786,035 | 49,100 | \$835,135 |
| Cash and securities segregated and on deposit for regulatory and other purposes | (16,569) | | (16,569) |
| Collateralized lending agreements | (368,681) | | (368,681) |
| Identifiable intangible assets and goodwill | (4,112) | | (4,112) |
| Net Assets | 396,673 | | 445,773 |
| Total Liabilities | 761,203 | 49,100 | 810,303 |
| Total Equity | 24,832 | | 24,832 |
| Junior subordinated notes | 4,976 | | 4,976 |
| Identifiable intangible assets and goodwill | (4,112) | | (4,112) |
| Tangible Equity Capital | 25,696 | | 25,696 |
| Net Leverage Ratio ² | 15.4 | | 17.3 |
| <i>Repo Amount as a % of Total Net Assets</i> | <i>12.4%</i> | | |
| <i>Repo Amount as a % of Total Tangible Equity</i> | <i>191.1%</i> | | |

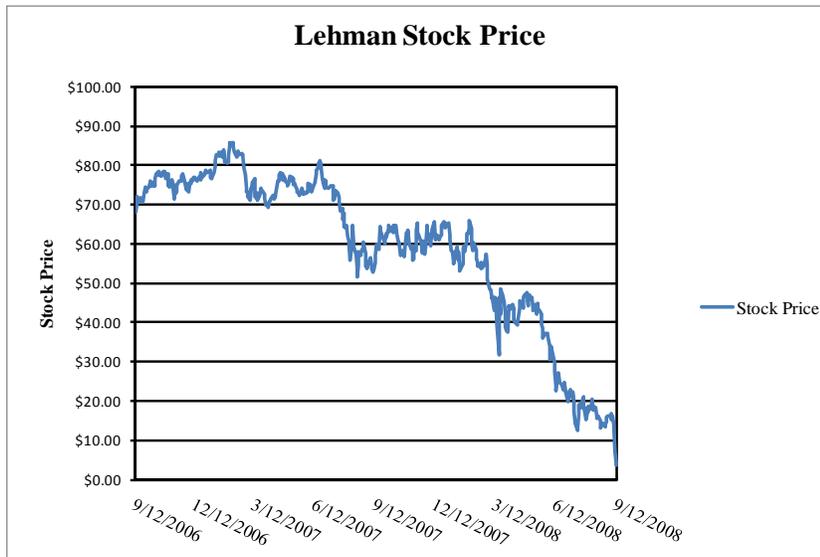
| Lehman Quarter Ended 5/31/2008 | | | |
|---|--------------------------------|--------|-----------------|
| <i>(in millions)</i> | As stated (Repo Amount | | w/o Repo |
| | w/Repo) | | |
| Total Assets | \$639,432 | 50,380 | \$689,812 |
| Cash and securities segregated and on deposit for regulatory and other purposes | (13,031) | | (13,031) |
| Collateralized lending agreements | (294,526) | | (294,526) |
| Identifiable intangible assets and goodwill | (4,101) | | (4,101) |
| Net Assets | 327,774 | | 378,154 |
| Total Liabilities | 613,156 | 50,380 | 663,536 |
| Total Equity | 26,276 | | 26,276 |
| Junior subordinated notes | 5,004 | | 5,004 |
| Identifiable intangible assets and goodwill | (4,101) | | (4,101) |
| Tangible Equity Capital | 27,179 | | 27,179 |
| Net Leverage Ratio ² | 12.1 | | 13.9 |
| <i>Repo Amount as a % of Total Net Assets</i> | <i>15.4%</i> | | |
| <i>Repo Amount as a % of Total Tangible Equity</i> | <i>185.4%</i> | | |

(2) *The People of the State of New York by Andrew M. Cuomo against Ernst & Young, LLP - Complaint; page 6 paragraph 13.*
Source: *Lehman 11/30/2007 financial statements filed with the SEC.*
Source: *Lehman 2/29/2008 financial statements filed with the SEC.*
Source: *Lehman 5/31/2008 financial statements filed with the SEC.*

Lehman defined “net assets”—the numerator for its net leverage ratio—as total assets less: (i) cash and securities segregated and on deposit for regulatory and other purposes; (ii) collateralized lending agreements; and (iii) identifiable intangible assets and goodwill. For the denominator, Lehman included stockholders’ equity and junior subordinated notes in “tangible equity capital,” but excluded identifiable intangible assets and goodwill. Because Lehman received a “sales” opinion from a U. K. law firm, this meant that transactions had to be based in the U. K. and involve securities from Lehman’s U. K. affiliate.

5. The Multiple Causes of Lehman's Failure

Lehman's fate was sealed on September 8, 2009 when federal officials decided to takeover Fannie Mae and Freddie Mac instead of Lehman. At that point, Lehman's only alternative was to find a potential suitor. But nobody was interested. On September 14, 2008 Lehman was forced to file for liquidation due to massive losses in the mortgage market and loss in investor confidence. So what led to Lehman's demise? Arguably, the downfall started in mid 2007. At that point, Lehman's stock traded in a range around \$75 per share, but the stock began to decline shortly thereafter (see the chart below). Lehman had historically been known as a major investor in the mortgage market, both subprime and prime. As these markets began to sour, Lehman was forced to write down many of its investments. Further, Lehman's counterparties (such as JPMorgan and Citigroup) began to ask Lehman to increase the dollar amount of collateral posted against its loans. On June 9, 2008, Lehman announced a 2nd quarter loss of \$2.8 billion. The combination of many factors, including, but not limited too, large investment write downs, loss of investor confidence, no potential buyer, and increased collateral by counterparties, ultimately lead to Lehman filing for liquidation.



Lehman's failure can be attributed to many causes. Since at least 2002, Lehman, like others, was dependent on short-term debt, including repos, to finance operations. This was standard industry practice and worked well in periods of readily available credit. Both market illiquidity and fear in the fall of 2008 were unprecedented. Lehman's bankruptcy was due in large part to its inability to roll-over its short term debt. Additionally, regulators such as the Federal Reserve and the Treasury were unwilling to commit public funds Lehman due to the political backlash following the earlier bailouts of Bear Sterns, Fannie Mae and Freddie Mac. Some critics have also argued that the problems may have been exacerbated by fair value reporting requirements. Markets for CDOs and CMOs that Lehman was heavily invested in dried up completely. Additionally asset values fell across the board and firms were required to report these cascading lower values on the financial statements. This resulted in the erosion of

already low levels of equity, further increasing the difficulties in accessing credit and concerns about bankruptcy.

While some observers may argue about the exact cause of Lehman's bankruptcy, what seems clear is that identifying one item—the accounting for Repo 105—as the sole cause of the Lehman bankruptcy deliberately ignores all the other factors that contributed. It was Lehman's inability to access short-term credit, rather than the mechanism (repos) used to access credit, that led to their demise. Arguably it was the primary cause. In other words, Lehman would have failed even if it had accounted for the repo transactions as a secured loan. Other firms that did not use repo transactions or that used repo transactions and accounted for them as short-term financing rather than sales (and subsequent repurchases of assets) also failed or had to be bailed out by public money.

6. Summary and Conclusion

Repo transactions have been a commonly used form of short-term securitized lending for decades. Participants and counterparties in repo transactions include banks and other financial institutions, the Federal Reserve, industrial firms and even small entities such as independent school districts. Lehman was only one of many firms using this tool. Both before and after Lehman's failure, U. S. GAAP required repos to be accounted for as sales (and subsequent repurchases) of securities if certain criteria were met. If the transaction failed any of the criteria, the firm had account for the transaction as a secured loan. The determining criteria require the

use of judgment. Specific guidance was provided by the rule makers.

Ernst and Young's role as Lehman's auditor was to provide an opinion, based on their audit, that Lehman's financial statements were prepared in accordance with GAAP. Ernst approved Lehman's sale accounting for Repo 105 as, in their judgment, the transaction met all the criteria specified by GAAP for sale accounting.

Proving that E&Y's judgment was fraudulent on these transactions will be difficult, especially considering that there were multiple causes for Lehman's failure, including a decision that Lehman should be allowed to fail.

Lehman was one of the largest sellers of collateralized debt obligations, which were at the center of the financial crisis and among the most heavily distressed asset classes. In fact, there is a convincing argument to be made that Lehman would have declared bankruptcy regardless of how they accounted for the Repo 105 transaction. The SEC had investigated the Repo 105 transactions, among other aspects of Lehman's failure. In March 2011 the Wall Street Journal reported¹⁹

SEC officials have grown more worried they could lose a court battle if they bring civil charges that allege Lehman investors were duped by company executives. The key stumbling block: The accounting move, while controversial, isn't necessarily illegal.

¹⁹ "Lehman Probe Stalls; Chance of No Charges," March 12, 2011

Further, the NY Attorney General's office may face difficulty in proving that investors (or others) were damaged by the accounting for the repos since Lehman was trading one type of highly liquid asset (typically Treasuries) for another liquid asset—cash. If the company had converted illiquid or impaired assets, such as illiquid real estate assets, into cash, the argument for damages would be stronger, presumably by counterparties but not the company's lender or investors.

Financial statements are only one part of a larger dataset available to investors and lenders. Investors would also be aware of well-publicized information made available by others opining that Lehman was overleveraged and under-reserved.

Proving fraud, including *scienter*, for a series of established transactions over many years involving sophisticated financial instruments and complex accounting that met its technical requirements will be difficult.

Sources

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