THE LEHMAN BROTHERS CASE

A corporate governance failure, not a failure of financial markets

By Professor Arturo Bris - May 2010

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The examiner's report, published in March and prepared in relation to the Lehman Brothers bankruptcy case, describes the events that led to the largest bankruptcy in history. The case deals with the Chapter 11 reorganization of Lehman Brothers’ assets, but has evolved into a description of what may become the largest accounting scandal ever.

We had assumed that the collapse of Lehman in September 2008 was the consequence of a fatal combination of intricate accounting rules, complex derivatives, greed, excessive leverage and the complacency of rating agencies. It was also the trigger for a chain reaction across other financial institutions which suffered from the panic and liquidity freeze that followed.

The reading of the 22,000-page report shows instead the amazing similarities between the collapses of Enron in 2001 and Lehman Brothers in 2008. In Enron, the misbehavior of top executives (Ken Lay, Jeff Skilling and Andrew Fastow) was possible because of the inaction of both the board and the auditing firm. By means of the pre-pay transactions, these Enron executives managed to transform increases in leverage into positive cash flows, without any balance sheet impact and with a very simple off-balance sheet structure. The court examiner appointed in its Chapter 11 case showed that, in the absence of the pre-pay transactions, Enron’s debt-to-assets ratio would have been 45% instead of the reported 38% in 1999.

Does it sound familiar? Lehman’s equivalent of the pre-pay transactions is the Repo 105, a fascinating term that is going to become the new example of how to fool analysts and investors. I foresee dozens of books, business school cases and articles written on Repo 105. Through these transactions, Lehman Brothers managed to reduce leverage on the right-hand side of the balance sheet and, at the same time, reduce assets (some of them undesirable) on the left-hand side. Repo 105 transactions doubled between late 2006 and May 2008, were
known inside the company, exceeded the firm's self-imposed limits and typically happened at the end of each quarter, when financial information had to be released.

Simply put, the Repo 105 program transformed a financing transaction into an asset disposal. In a typical repo (short for “sale and repossession”), a financial institution borrows funds using securities (usually treasuries) as collateral. If a bank has securities for $105, it will borrow $100 from another institution presenting the securities as a guarantee for the short-term loan (typically from one night to three months). The $5 difference is called “haircut” and is the price for both the liquidity of the bond and its risk. Repo markets are not new – they were born at the beginning of the 20th century – and they have served a very legitimate purpose.

However, repo accounting is puzzling, to say the least. The collateral stays on the borrower’s books. The cash injection increases the bank’s balance sheet, as if assets were duplicated. Naturally, a liability arises for the borrowed amount, because at the maturity of the repo, the borrower returns the cash, plus interest, and gets the securities back. Originally, repos serve a very desirable objective of making money (that would be otherwise inactive) by circulating, lending and investing it.

A repo can also be structured as a simple asset disposal, in which a financial institution sells a security for a price. To perfectly replicate the repo, the institution will buy a similar security sometime later, and will have enjoyed the returns on the cash invested during that period. Such a transaction poses several problems. First, the security may be sold at a discounted price either because the market is not liquid enough, or because nobody wants those assets (think about mortgage securities in 2008). Second, there is no guarantee that the repurchase of the securities will be possible at favorable prices. However, it has the advantage that, if
successful, it allows the financial institution to raise capital which can be used to reduce its leverage, by getting rid of undesirable assets.

Magically, Lehman Brothers used repos reportedly for financing reasons, but accounted for them as asset disposals. In that way (with no transfer of the underlying security), Lehman circumvented the two problems mentioned in the previous paragraph and used the repo proceeds to reduce its leverage right before the disclosure period. These repo proceeds amounted to about $50 billion by September 2008 – which is more than the amount of General Motors’ outstanding bonds when it went bankrupt last year and is one-tenth of Switzerland’s GDP in 2008. Thanks to the Repo 105 program, Lehman’s reported leverage (assets to equity) dropped from 13.9 times to 12.1 times in the second quarter of 2008. Sounds like Enron.

Problem is it failed to disclose this. And because of the legal constraints in the US on the treatment of repo transactions as asset disposals, Lehman Brothers engineered them through its UK subsidiary. They were clearly used as leverage-reducing transactions because otherwise Lehman could have secured short-term financing at much lower rates — a Repo 105 implies a cost of financing of five percent, plus interest! Enron also used pre-pays to hide leverage.

Moreover, at this point the question is: who knew and what is their responsibility?

The court examiner states that Lehman’s CEO Dick Fuld denies "any recollection of Lehman’s use of Repo 105 transactions" (page 917). At the same time, he recognizes that "Fuld’s denial of recollection must be weighed by a trier of fact against other evidence" (page 918). In
particular, the confirmation by Bart McDade — Lehman’s latest president — that he had specific discussions with Fuld about Lehman’s Repo 105 usage in June 2008.

Despite their denial, the report also presents evidence against three former Lehman CFOs – Chris O’Meara, Erin Callan and Ian Lowitt. However, with respect to the board of directors it is also clear that "without exception, former Lehman directors were unaware of Lehman’s Repo 105 program and transactions" (page 945). Exactly like Enron.

Finally, there is controversy on the role of Ernst & Young and its knowledge of the Repo 105 program. The lead partner in the auditing firm states that “Ernst & Young did not approve the Accounting Policy”, it rather "became comfortable with the Policy for purposes of auditing financial statements" (page 949). Interestingly, when the examiner asked the auditor whether Ernst & Young should have considered the possibility that strict adherence to accounting rules could nonetheless lead to a material misstatement in Lehman’s publicly reported financial statements, he "refrained from comment" (page 954). It brings back to memory the images of Andersen’s auditors shredding incriminating evidence in the Enron scandal.

The examiner’s conclusion is devastating: “There is sufficient evidence to support a finding that claims of breach of fiduciary duty exist against Fuld, O’Meara, Callan and Lowitt and colorable claim of professional malpractice exists against Ernst & Young” (page 991). He also adds some evidence of questionable practices by JP Morgan with respect to its requests for collateral.

There are several lessons that the Lehman case teaches us. First is that perhaps most of the articles and books that have been published analyzing the 2008 financial crisis and the
Lehman collapse in particular have been misguided. Only now are we starting to see that at the bottom of all the bank failures there is — simply — fraud.

Which takes me to the second lesson: we do not learn from history. The basic structure and the players in the Lehman collapse resemble too closely some examples from the past (Enron, Worldcom, Parmalat). Finally, Lehman Brothers was not taken down by ill-intentioned short sellers and market manipulators. It was bankrupt well before September 2008 and thanks to financial markets it was revealed as the company it truly was. Now it is the time for courts and regulators to react.

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