A postmortem on Lehman Brothers

Oh, brother

Shining a harsh light on Lehman's bankruptcy

Mar 12th 2010 | From *The Economist* online

IT SOUNDS distinctly unpromising. A nine-volume, 2,200-page report by a court-appointed examiner into the causes of Lehman Brothers' bankruptcy, published on Thursday March 11th, has a table of contents that lasts for 38 pages. Its most exciting finding relates to an off-balance-sheet accounting gimmick. But the work of Anton Valukas, the chairman of Jenner & Block, a law firm, is crisp, clear and explosive.

Mr Valukas and his team took more than a year to research their report. They collected more than 5m documents and reviewed an estimated 34m pages of information. Looking at Lehman's IT systems was a particular challenge. The firm had a rat's nest of more than 2,600 systems and applications at the time it went bust; Mr Valukas boiled that down to the 96 most relevant ones, some of which are now operated by Barclays (the buyer of Lehman's American arm after the holding company failed). He also conducted more than 250 informal interviews, many of them with Lehman's directors and most senior executives.

The report's juiciest finding relates to Lehman's use of an accounting device called Repo 105, which allowed the bank to bring down its quarter-end leverage temporarily. Repurchase ("repo") agreements, whereby borrowers swap collateral for cash and agree to buy the collateral back later at a small premium, are a very common form of short-term financing. They normally have no effect on a firm's overall leverage: the borrowed cash and the obligation to repurchase the collateral balance each other out.

But Repo 105 took advantage of an accounting rule called SFAS 140, which enabled Lehman to reclassify such borrowing as a sale. Lehman would give collateral to its counterparty and receive cash in return. Because the deal was being recorded as a sale, the collateral disappeared from Lehman's balance-sheet and the bank used the cash it generated to pay down debt. To outsiders, it looked as though Lehman had reduced its leverage. In fact, the obligation to buy back the collateral remained. Once the quarter-end had come and gone, Lehman borrowed money to repay the cash and buy back the collateral, and its leverage spiked back up again.

Mr Valukas marshals plenty of evidence to back up his claim that "Lehman painted a misleading picture of its financial condition". The effect of Repo 105 was material: the firm temporarily removed around $50 billion-worth of assets at the end of the first and second quarters of 2008, a time when market jitters about its leverage were pervasive (see table below). Mr Valukas can see no legitimate business reason to undertake the transaction, which was more expensive than a normal repo financing and had to be done through its London-based arm because Lehman was unable to get an American lawyer to agree that Repo 105 involved a true sale of assets.

Repohensible

The effect of Repo 105 on Lehman Brothers' leverage

Date	Repo 105 usage, $bn	Reported net leverage, %	Leverage without Repo 105, %	Difference, percentage points
Q4 2007	38.60	16.1	17.8	1.7
Q1 2008	49.10	15.4	17.3	1.9
Q2 2008	50.38	12.1	13.9	1.8

Source: Examiner's Report

He also uncovers all sorts of unguarded e-mail traffic about the practice, which employees variously described as "window-dressing" and an "accounting gimmick". Bart McDade, who became president of Lehman in June 2008 and tried to stop the bank from being so aggressive in its use of Repo 105, described it in April of that year as "another drug we r [sic] on". Mr Valukas believes that "colourable claims"—meaning a plausible legal claim for damages—could be brought against Dick Fuld, the firm's boss, and three of Lehman's chief financial officers for filing "materially misleading" quarterly reports. He also thinks that Ernst & Young, Lehman's auditor, has a case to answer for allowing these reports to go unchallenged.

Whether the report will actually lead to lawsuits remains to be seen. Mr Fuld says he did not know about the Repo 105 transactions; Ernst & Young says that Lehman's reporting was in line with accounting principles. But even if executives were not breaching their fiduciary duties, the examiner's report gives Lehman's creditors and shareholders an awful lot of other reasons to feel aggrieved.

Lehman's liquidity pool was not that liquid, after all

As well as his findings on Repo 105, Mr Valukas describes how Lehman's liquidity pool, which was designed to allow the bank to survive in stressed financial conditions for 12 months, contained cash and securities that had been assigned as collateral to its clearing banks, which grew increasingly nervous about doing business with Lehman. On September 10th 2008, just five days before it filed for bankruptcy, Ian Lowitt, the bank's chief financial officer at the time, told investors that its liquidity pool remained strong at $42 billion. Yet an internal document from September 9th showed that it had a "low ability to monetise" almost 40% of the assets involved. The liquidity pool was not that liquid, after all.

Mr Valukas also draws back the curtain on the decisions that led Lehman into trouble in the first place. Lehman's chiefs signally failed to see the potential contagion from the subprime implosion. In its pursuit of growth, the firm's overall risk appetite was repeatedly increased and limits on the size of single leveraged-loan transactions were routinely ignored. Incredibly, stress tests failed to include many of Lehman's most illiquid assets. Even when executives began to understand the scale of the risks they were taking, they kept taking on business rather than walk away from deals. Board directors were unaware for several months in 2007 that Lehman had breached its risk-appetite limit. They also did not know that executives had used a new methodology, based on aggressive revenue projections, to increase that risk-appetite threshold again in January 2008. And so on, for page after damning page.

Mr Valukas's conclusion is that Lehman's aggressive growth strategy and its approach to risk reflected "serious but non-culpable errors of business judgment" rather than any breach of fiduciary duties. But the stain on the reputation of the bank's executives and directors has grown even larger.