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REPURCHASE AGREEMENT AND THE CASE OF LEHMAN BROTHERS

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Introduction

On September 15, 2008 Lehman Brothers, the fourth largest investment bank in the world declared bankrupcy sparking chaos in financial markets and nearly bringing down the global economy. It was one of the largest bankrupcies in the history with Leman holding over $600 billion in assets.

The accounting trick that played an important role in the downfall of the Lehman is now famously known as a „Repo 105“.

In this paper I would try to provide a brief insight into activities that led Lehman into bankrupcy, explain the accounting mechanism that they used and explain how it affected the world economy.

Repurchase agreement (REPO)

To begin with, we must define REPO or Repurchase agreement. Repo in the most simplest words is just a secured loan, and as in any other loan there are two sides: borrower and lender.

REPO is an agreements between a borrower and a lender where the borrower, in effect, sells securities to the lender with the stipulation that the securities will be repurchased on a specified date and at a specified, higher price.

Borrower is selling a collateral to the lender in exchange for the cash and is obligating himself to buy it back. Meaning that if the borrowe defaults, the lender at least has a collateral. They can go out and sell their collateral and get their funds back. Usually the borrower gets the lesser amount of money than the collateral's value. This is in order to minimize the risk that lender must bear.

The main benefit of repos to borrowers is that the repo rate is less than borrowing from a bank. The main benefit to lenders over other money market instruments is that the maturity of the repo can be precisely tailored to the lender's needs.

REPOs are usually an overnight repos (1 day loans) or term repos (have terms greater than 1 day – usually weeks to months).

For the borrower these short-term funds are liabilities on the balance sheet.

This all sounds pretty simple and easy. Indeed, REPO are a standard practice on Wall Street, but from the simples can great trouble be.

Lehman Brothers and REPO 105

A firm that was once considered one of the major players in the global banking and financial services industries, but declared bankruptcy on September 15, 2008, after a catastrophic collapse caused by a mix of subprime mortgage exposure as well as negative rumors and alleged short selling in the market. The fall of Lehman Brothers marked the beginning of the public's awareness of the forthcoming credit crisis and recession of the late 2000s.

Using the method known as „Repo 105" the Lehman temporarily removed more than $50 billion of assets from the balance sheet, making it look better than it really was. So what was the trick?

So according to the examiner's report the following happened:

„In an ordinary repo, Lehman raised cash by selling assets with a simultaneous obligation to repurchase them the next day or several days later; such transactions were accounted for as financings, and the assets remained on Lehman's balance sheet. In a Repo 105 transaction, Lehman did exactly the same thing, but because the assets were 105% or more of the cash received, **accounting rules permitted the transactions to be treated as sales rather than financings, so that the assets could be removed from the balance sheet.**"

So, accounting rules have allowed Lehman to book the transactions as sales, rather than short-term loans as long as the assets were above 105% of the cash received. That was exactly what Lehman wanted – on balance sheet to appear as Lehman held less assets and hence appeared less leveraged.

Conclusion

According to all indicators, Lehman Brothers bankrupcy is referred as one of the greatest of the all times and it shook the financial world. What were the effects?

26 000 employees lost their jobs, millions of investors lost all or almost all of their money, producing chain reaction that started the world's worst financial crisis and economic downturn.

The question that started to emerge was if Lehman couldn't make good on its short-term debt, was it safe to lend money to anybody? Lehmans' fall contributed to a loss of confidence in other banks, a worldwide financial crisis and a deep recession in many countries.

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