Section I. Assets

1. Repo 105 and Repo 108

A repurchase agreement (a repo) is an agreement under which we sell securities to a counterparty for cash with a simultaneous agreement to repurchase the same or equivalent securities at a specific price at a later date. A reverse repurchase agreement (a reverse repo) is an agreement under which we purchase securities from a counterparty with cash and simultaneously enter into an agreement to resell the same or equivalent securities at a specific price at a later date. In general, repurchase and reverse repurchase agreements are used by counterparties to obtain or invest short-term funds and are considered secured financing transactions. That is, a repo is recorded as a borrowing (Dr. Cash, Cr. Repo Liability) and a reverse repo is recorded as a lending (Dr. Reverse Repo Asset, Cr. Cash).

However, there are circumstances under which a repo should be re-characterized from a secured financing transaction to a sale of inventory and a forward to repurchase securities, provided certain criteria in SFAS 140 are met. This policy addresses such situations. The concepts discussed in this policy also apply to reverse repurchase agreements re-characterized from investing transactions to inventory purchase transactions. However, because we generally do not engage in these transactions, the remainder of this policy addresses only the accounting for repo transactions re-characterized from secured financing transactions to sales of inventory and forward agreements to repurchase securities.

Overview

Repo 105 and Repo 108 transactions refer to repos with a counterparty in which we sell securities valued at a minimum of 105% (for fixed income securities) or 108% (for equity securities) of the cash received. That is, we sell fixed income securities with a fair value of at least $105 in exchange for $100 of cash for Repo 105, and equity securities with a fair value of at least $108 in exchange for $100 of cash for Repo 108. (Note that we allow Repo 108 to be done at $107 of fair value but we still refer to these transactions as Repo 108.)

Repo 105 and Repo 108 contracts typically are executed by Lehman Brothers International (Europe) (“LBIE”) because true sale opinions can be obtained under English law. We generally cannot obtain a true sale opinion under U.S. law.

For a repo to be re-characterized from a secured financing transaction to a sale of inventory, all the following SFAS 140 criteria must be met:

- The transaction is a true sale at law (SFAS 140.9a).
- The transferee has the ability to pledge or exchange the transferred assets (SFAS 140.9b). and
- The transferor is considered to relinquish control of the securities transferred (SFAS 140.9c).

True sale opinion

This policy addresses repo transactions executed in the UK under a Global Master Repurchase Agreement (“GMRA”) provided the counterparty resides in a jurisdiction covered under English law. Repos generally cannot be treated as sales in the United States because lawyers cannot provide a true sale opinion under U.S. law. See “Securitizations–adequacy of legal opinions“ in this Accounting Policy Manual for more information about the requirements for legal opinions.

The UK law firm of Linklaters has issued us true sale opinions covering Repo 105 and Repo 108 transactions documented under a GMRA under English law. (Linklaters also has issued true sale opinions for securities lending transactions documented under Overseas Securities Lending Agreements, Global Master Securities Lending Agreements, and Master Gilt Edged Stock Lending Agreements. However, all our current Repo 105 and Repo 108 transactions are documented under a GMRA.) For Repo 108, voting rights with respect to the transferred equity securities must be transferred to the repo counterparty for Linklaters to provide us with a true sale opinion.

Ability to pledge or exchange the transferred assets

The transferee must have the ability to pledge or exchange the transferred assets free of any contractual conditions imposed by us and/or operational constraints. This ability to pledge or exchange must be a legal right and an operational capability. For transactions involving third-party custodians such as in tri-party arrangements, the counterparty's re-use or re-hypothecation options in the Tri-party Services Agreement must be executed to ensure the transferee has the legal right to pledge or exchange the transferred assets. Practical operational constraints must be removed to enable the transferee to pledge or exchange the transferred assets. An example of a practical operational constraint is re-transferring assets that are not considered readily obtainable in the marketplace. If such assets are used in the repo and the transferee pledges to or exchanges the assets with a third party, the transferee may be unable to re-deliver the same (or substantially the same) assets to the transferor because of the difficulty of obtaining such assets. As a result, the transferee would be operationally constrained from pledging or exchanging the assets. Ordinarily, for an asset to be readily obtainable, a market must exist where the assets are either traded on a formal exchange or are considered liquid and trade in a market where price quotations either are published or are obtainable through another verifiable source.

Relinquish control of the transferred assets

Re-characterization of a repo from a secured financing transaction to a sale of inventory and a forward to repurchase assets is allowed only if we demonstrate we have relinquished control of the transferred assets. We retain control over a transferred asset if we are assured of the ability to repurchase or redeem the transferred asset, even in the event of default by the transferee. Our right to repurchase the transferred asset is assured only if it is protected by obtaining collateral (i.e., cash) sufficient to fund substantially all of the cost of purchasing the same or substantially the same replacement assets during the term of the contract. If we can fund substantially all of the cost of purchasing the same or substantially the same replacement assets, we are viewed as having the means to replace the assets, even if the transferee defaults, and we are considered not to have relinquished control of the assets. For purposes of this requirement, we have retained control of the transferred assets if a fixed income security is margined at less than 105% of the cash received or an equity security is margined at less than 107% of the cash received.

Transfers in which we transfer fixed income securities valued at a minimum of 105% of the cash received and equity securities valued at a minimum of 107% of the cash received are considered to be sales with a forward agreement to repurchase the securities rather than secured financing transactions. The assets transferred (i.e., sold) should be valued and margined frequently for changes in the market price of the assets to ensure the assets transferred equal or exceed 105% (or 107%) of the cash received. When both the foregoing criteria are met, the assets transferred are removed from our balance sheet and an asset under a derivative contract is recorded to reflect that we will repurchase, under a forward contract, the transferred assets.

Example entries

The following entries are recorded when a repo meets the criteria for re-characterization from a secured financing transaction to a sale of inventory and a forward agreement to repurchase assets. Assume a repo of $100 and we pledge $105 of fixed income collateral.

At the original sale date, our systems assume repos are secured financings so the entry before re-characterization is:

Dr. Cash	$100	
Cr. Repo		100

The re-characterization entry is:

Dr. Repo	$100	
Dr. Long inventory–derivative	5	
Cr. Inventory		105

We have an asset under a derivative contract because we are required to repurchase under a forward contract $105 worth of securities for payment of only $100.

At the repurchase date, the following entries are made (assuming frequent margining, where X is the value of the margin):

Dr. Inventory	$105+X	
Cr. Cash		100+X
Cr. Long inventory–derivative	5	

LEHMAN BROTHERS HOLDINGS INC.

Accounting Policy Manual

Section I. Assets

Technical references

FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*–*http://www.fasb.org/pdf/fas140.pdf*

FASB Statement No. 140 Q&A, *A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

E&Y Financial Reporting Developments booklet on SFAS 140–*PDF Files Linked in the Accounting Policy Manual\E&Y FRD ON SFAS 140.pdf*

D&T booklet on SFAS 140–*PDF Files Linked in the Accounting Policy Manual\D&T Booklet on SFAS 140.pdf*

Last updated

September 9, 2006

Owner

Margaret Sear