

# LEHMAN BROTHERS

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## ACCOUNTING POLICY MANUAL

<b>AREA:</b>	<b>5.0. TRANSFER OF FINANCIAL ASSETS</b>
<b>SECTION:</b>	5.2. Other Instruments
<b>SUBJECT:</b>	5.2.1. Repo 105
<b>OWNER:</b>	Brett Beldner
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<b>STATUS:</b>	Approved
<b>VERSION:</b>	1.1

### 1. Introduction

This policy provides a summary of the accounting rules which specify the conditions under which a repurchase agreement (repo) or reverse repurchase agreement (reverse repo), which are typically viewed as financing transactions and not removed from the balance sheet, should be recharacterized and classified as a purchase or sale of inventory.

### 2. Technical references

- FASB Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" (FAS 140).
- FASB Q&A 140, "A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" (FAS 140 Q&A).

### 3. Policy

#### 3.1 Overview

Included below is a summary of the Accounting Rules as to when a "repo" trade should be recharacterized as an inventory trade. All of the following criteria must be met including:

- 1) The Transaction is a True Sale at Law
- 2) The Transferor is deemed to give up Control over the Security Transferred
- 3) The Transferee has the ability to pledge or transfer the Transferred Assets, and such assets are Deemed Readily Obtainable

##### 3.1.1 True Sale Opinion

With respect to the first of these items, Linklaters has issued a True Sale opinion covering repo transactions documented under a GMRA agreement under English law. Therefore this policy is expected to cover Reverse Repo and Repo Trades executed in London under a GMRA agreement, provided also that the customer resides in a jurisdiction covered under English Law as noted on attached Rules of the Road Document. This transaction generally does not work in the United States because external counsel is not comfortable with writing a true sale at law opinion. (See Accounting Policy Memo No. 5.1.2, *Adequacy of Legal Opinion*, for more information on the requirements of a legal opinion.)

##### 3.1.2 Deemed to give up control of the security

With respect to the second of these conditions the Transferor would be deemed to retain control over the security transferred (i.e., recharacterization precluded) if the transferor were able to repurchase or redeem the transferred assets on substantially the agreed terms, even in the event of default by the transferee. Paragraph 218 of SFAS 140 provides that “the Board also decided that the 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. Judgment 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. However, 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. The Board believes that other collateral arrangements typically fall well outside that guideline.”

For purposes of this requirement the transferor is deemed to retain control if the contract is margined within a range of 95-105%. **See Attached Table 1 specifying minimum requirements necessary to conclude that transferor does not retain control.**

3.1.3 Ability to Transfer - Non specific Collateral

Lastly, the transferee has to have the ability to pledge or transfer the collateral. This must be a legal right and a substantive right. As such, the collateral cannot be specific such that it is required to be returned to the transferor at the end of the trade.

3.2 Sample Entries

The following Entries Would Be Required In the Event a Reverse Repo Met all of the Above Criteria for Recharacterization as an Inventory Purchase.

Assume: Reverse Repo \$100; Lehman Received 110 of government collateral with no ability to maintain margin.

1. Initial Entry Before Recharacterization

Dr. Reverse Repo	\$100	
Cr. Cash		\$100

2. Recharacterization Entry

Dr. Long Inventory - Governments	\$110	
Cr. Short Inventory - Derivative Liability		\$10
Cr. Reverse Repo		\$100

Lehman has a liability under derivative contract as we are required to sell under a forward contract \$110 worth of securities to reverse repo customer for payment of only \$100. Note: No P&L is created by the recharacterization.

Balance Sheet Netting - The recharacterized reverse repo trade now classified as a long government position can be netted via cusip netdown vs. Firm Shorts.

The following Entries Would Be Required In the Event a Repo Met all of the Above Criteria for Recharacterization as an Inventory Sale.

Assume: Repo \$100; Lehman Pledged 110 of government collateral.

1 Initial Entry Before Recharacterization

Dr. Cash	\$100	
Cr. Repo		\$100

2 Recharacterization Entry

Dr. Repo	\$100	
Dr. Long Inventory - derivative	\$10	
Cr. Short Inventory		\$110

Lehman has a receivable under derivative contract as we are required to purchase under a forward contract \$110 worth of securities for payment of only \$100. Note: No P&L is created by the recharacterization.

Balance Sheet Netting - The recharacterized repo trade now classified as a long government position can be netted via cusip netdown vs. Firm Longs.

**TABLE 1**

<b>Transaction Type</b>	<b>Collateral Type</b>	<b>Margining Provisions</b>	<b>Minimum Term**</b>
Reverse Repo	General collateral (i.e. normal haircut is less than 5%)	Lehman must be either: 1. Undercollateralized on reverse repo receiving securities whose value is less than 95% of the amount of cash loaned; or 2. Overcollateralized at the outset with no ability to subsequently maintain margin or terminate on short notice.	<ul style="list-style-type: none"> <li>• Trade term must be at least equal to normal settlement cycle plus one day</li> </ul>
Reverse Repo	Non-GC Collateral (i.e. normal haircut is 5% or more)	Lehman must be either: 1. Undercollateralized - same as above except 10% threshold; or 2. Overcollateralized - same as above	<ul style="list-style-type: none"> <li>• Trade term must be at least equal to normal settlement cycle plus one day</li> </ul>
Repo	General Collateral	Lehman must overcollateralize transaction by pledging securities whose value is in excess of 105% of the cash amount borrowed;	<ul style="list-style-type: none"> <li>• Trade term must be at least equal to normal settlement cycle plus one day</li> </ul>
Repo	Non -GC Collateral	Same as above except 10% threshold	<ul style="list-style-type: none"> <li>• Trade term must be at least equal to normal settlement cycle plus one day</li> </ul>

\*\* Note: The above table defines the terms and conditions necessary to recharacterize financing trades as inventory transactions for purposes of applying cusip netdowns for matched book positions.