

The Lehman fraud

BY

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Lehman bros.

- 158 year old co.
- It is the largest bankruptcy of an investment bank in American history

The report on Lehman bros.

- Report submitted on: Mar 11, 10
- No. of pages: 2200
- Examiner: Anton R. Valukas
- May lead to: Possible further enquiry into Richard S Fuld. Jr, CEO , other key executives and E&Y
- Main finding:
 - “materially misleading accounting” and “actionable BS manipulation.”
 - Mr. Fuld is “at least grossly negligent in his role in overseeing Lehman”

What Lehman did?

- Lehman used financial engineering to temporarily shift \$50 B of assets off its books in the months before its collapse in Sep 2008 to conceal its leverage;
- In short: **they window-dressed!**
- They sold securities at the end of the quarter but planned to buy them back again days later!
- There was no substance to the colored transactions and there were no disclosures
- Mr. Fuld and other former Lehman officials are already defendants in no. of law suits

Repo 105

- Over 100 pages are devoted to the genesis of and process behind Repo 105.
- Lehman took a particularly aggressive accounting approach in repurchase agreements of short term loans commonly used by many firms for daily financing needs in which borrowers temporarily exchange asset in return for cash upfront.
- Lehman used repos to temporarily park assets off its books to make its end-of-quarter debt levels look better- while **calling them sales instead of loans!**
- Lehman started this accounting trick in 2001 and no American law firm would sign off on it.

Role of Federal bank of NY

- Lehman also raised quick cash to mask the extent of firm's troubles using troubled investments and they did it with the help of Federal Reserve bank of NY!
- Fed also lowered its standards for the kinds of collateral it would accept against such short term loans.
- Lehman packaged billions of dollars of troubled corporate loans into an investment called Freedom CLO. (66 corporate loans were packaged to create \$2.8 B of Freedom CLO)
- Then in a series of transactions it shifted Freedom back and forth to NY Fed in exchange for cash.

Freedom CLO

- When Lehman tried to pledge Freedom CLO as collateral for its trading positions with Citigroup, they rejected it as 'junk that was impossible to value'!
- A spokesman for FED said the loan facility was created to help the entire financial system and prevent problems at one bank from cascading.

The brain behind

- Herbert McDade known as 'Balance Sheet Czar' in Lehman was the main brain behind the manipulations
- He seemed aware of using Repo 105 to disguise true health of the investment bank
 - In an email in Apr 08 he said " I am very aware.. it is another drug we r on"

Ernst & Young

- E&Y signed off on Lehman BS **despite warnings from a whistle blower** (Mathew Lee, EVP) who said there were accounting improprieties.
- Lynn E Turner former chief accountant of SEC accused E&Y of abdicating responsibility to the audit committee.
 - He said "This is pretty aggressive and abusive. I don't know how under GAAP this follows the rules whatsoever.
 - This reeks of an auditor who, rather than being truly independent, is beholden to management“
- E&Y said they stood by their work for 2007, the last year they conducted audit of Lehman

Fuld's defense

- Fuld's lawyer said that Fuld did not know what these transactions were- he did not structure or negotiate them nor was he aware of their accounting treatment.
- This is the classic 'Deaf, dumb and blind' defense normally taken by CEO's
- But after SOX CEO certification such a defense is not possible!

Lessons

- New frauds happen whenever fancy new financial engineering products come up
- Taking debt out of BS is a classic fraud methodology –same thing happened in Enron
- This time it is Repo 105 –next time it will be something else
- Complex products which no one understands are fertile grounds for frauds
- Frauds do not happen overnight
- Greed is the cause of all frauds
- To say the truth is the most difficult thing
- No lessons will ever be learnt!

Source

- NY times and other articles.