**MF GLOBAL AND REPO ACCOUNTING**

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With the collapse of MF Global, focus naturally moves to the risky repo transactions in which the business enterprise engaged and the accounting for these transactions. After all, billions of dollars of liabilities were kept off the balance sheet. What rationale did MF Global have to remove the liabilities from its balance sheet?

The transactions ran like this (also see Felix Salmon’s “[What Happened at MF Global](http://blogs.reuters.com/felix-salmon/2011/11/01/what-happened-at-mf-global/)”). MF Global bought a large long position in European sovereign debt apparently thinking that the financial leaders of Europe were capable of and willing to address the mess in their economic house. The company then borrowed money in a repo, putting up these debt instruments as collateral. Given that the coupon on the bonds was greater than the repo interest rate, MF Global enjoyed the profits of the spread.

As [David Phillips explains](http://247wallst.com/2011/11/02/mf-global-and-corzines-folly/), if the leaders did in fact clean up their mess, the value of the debt instrument would rise and MF Global could sell the bonds for a huge profit, assuming the contract included a clause allowing early termination. Even if the contract did not include such a clause, MF Global could “synthetically” terminate it using derivative instruments.

Salmon went on to explain that this “repo to maturity” was not a risk-free arbitrage. MF Global accepted the default risk in the bonds; it also accepted the liquidity risk implicit in the margin calls.

As we all know, the Europeans did not fix their problems, MF Global’s collateral lost value, and the company started receiving margin calls. Unfortunately, it could meet only so many of these calls. Once the cash ran out, the game was over. (As to the missing $600 million customer deposits, we won’t be surprised if most of that money was employed to pay some of those margin calls.)

Throughout this process the borrowings were kept off balance sheet. To meet the “relinquish control” requirement to permit such treatment, MF Global structured the repo so that it matured when the bonds matured. The assertion is that the firm doesn’t control the debt instrument during the repo period, and when the repo matures, the firm will not regain control of the instrument because it matures on that date. Nice try.

Mf Global in fact did not relinquish control of the securities. If the firm had relinquished control in reality, then it would not have received those coupons.

What this unsavory incident reveals is that the FASB has not done its job. It should have fixed repo accounting ages ago. Even when Lehman brothers blew up in its face, the FASB merely tinkered with the issue instead of actually repairing the pathetic methods it allowed. (See critiques by [Adrienne Gonzalez](http://goingconcern.com/2010/04/the-fasb-punts-repo-accounting-to-the-sec/) at Going Concern, [Simon Kennedy](http://www.marketwatch.com/story/how-repo-105-was-lehmans-accounting-drug-2010-03-12) at MarketWatch, and [Francine McKenna](http://www.americanbanker.com/bankthink/PwC-MF-Global-commingling-client-funds-1043821-1.html) at re: The Auditors). The FASB has lost its bearing and continues to allow choices when it should just fix the problem.

What the Board should have done is focus on the economic substance of the transaction.  And the substance of a repurchase agreement is that it is a secured borrowing.  Thus, all repurchase agreements should be accounted for as secured borrowings.

Tom Selling at Accounting Onion (“[Repo Accounting Games](http://accountingonion.typepad.com/theaccountingonion/2010/04/fasb-could-easily-stop-repo-accounting-games-assuming-it-wants-to.html)”) provides an interesting alternative. For securities for which ownership has not transferred, he would account for them as secured borrowings. For securities in which ownership has transferred, he proposes the following:

1. At the inception of the agreement, a transferor would recognize an asset for the cash received and derecognize the securities transferred. Any difference between these two amounts would be reflected on the balance sheet as a change in shareholders' equity through net income.
2. To recognize the commitment to repurchase the transferred securities, a receivable for the future return of the transferred securities would be recognized at its fair value; and a payable would be recognized at its fair value for the price to be paid for the return of the transferred securities. ***In contrast to existing accounting rules, these two amounts must be presented "gross"— i.e., they may not be offset.***And again, any difference between these two amounts would be reflected on the balance sheet as a change in shareholders' equity through net income.

The key point is to keep the liabilities on the balance sheet; as long as that is done, we buy into Selling’s proposal.

The main culprits in this nasty affair are the FASB and the SEC. As we pointed out earlier this year (“[Reconsideration of Repurchase Agreements](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/87)”), the appointment of Leslie Seidman certainly demonstrates that the banking industry has captured the FASB.  Through this and other activities, she supplies the banking industry a license to continue its furtive reporting practices, including repo accounting. How else can you explain the neglect of the FASB to mend the rips and tears in present-day repo accounting?

Unfortunately, the SEC isn’t too far behind. Its original mission of protecting the investor has been lost on recent SEC chairs. If they cared for investors, they would have put pressure on the FASB to revamp repo accounting. By doing nothing, Mary Schapiro and her predecessors approve of crappy accounting principles and do not have the interests of investors at heart.

POSTSCRIPT

Some details about the repo transactions may be found in the [press release](http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9NDIxNDAzOXxDaGlsZElEPTQ0NDMzNHxUeXBlPTI=&t=1) for the second quarter of 2012. Greater details about the repo transactions may be found in [Second Fiscal Quarter 2012 Results](http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9NDIxNDAzOXxDaGlsZElEPTQ0NDI0MnxUeXBlPTI=&t=1), a document discussed during the firm’s conference call with investors on October 25, 2011. Page 6, for example, describes the “Short-term European Sovereign Portfolio,” giving crucial data about the countries, the amounts invested, and their maturities. Laughable, however, are the discussions about how corporate liquidity improved during the quarter and how bright the non-GAAP metrics depicted the performance of MF Global.

Note that many repos have short maturities, one day to a few days. Lehman Brothers, for example, tended to have rather short maturities. MF Global, with their “repo to maturity” had maturities often one to two years in length.

Finally, it is fascinating how some things stay the same. Many of these issues have been around for a while. For example, many of these aspects of repos were discussed in Elizabeth Osenton’s 1987 paper, “[The Need for a Uniform Classification of Repurchase Agreements: Reconciling Investor Protection with Economic Reality](http://www.wcl.american.edu/journal/lawrev/36/osenton.pdf?rd=1).”

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