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THE ROLE OF THE FINANCIAL INSTITUTIONS IN ENRON'S COLLAPSE

July 23, 2002

Mr. Chairman, Ranking Member, Members of the Subcommittee, good morning.

Earlier this year Chairman Levin directed the Subcommittee staff to investigate the role of financial institutions in Enron's collapse. The Subcommittee staff – both Democratic and Republican – have worked for the past 7 months on a bipartisan basis to conduct this investigation. We have worked together to review over a million pages of documents and interview dozens of witnesses from Enron, Andersen, other accounting firms, credit rating agencies, and a host of financial institutions including Barclays, Citigroup, Credit Suisse First Boston, FleetBoston, JPMorgan Chase, and Merrill Lynch.

Numerous major financial institutions, both here and abroad, engaged in extensive and complex financial transactions with Enron. The evidence we reviewed showed that, in some cases, the financial institutions were aware that Enron was using questionable accounting. Some financial institutions not only knew, they actively aided Enron in return for fees and favorable consideration in other business dealings. The evidence indicates that Enron would not have been able to engage in the extent of the accounting deceptions it did, involving billions of dollars, were it not for the active participation of major financial institutions willing to go along with and even expand upon Enron's activities. The evidence also indicates that some of these financial institutions knowingly allowed investors to rely on Enron financial statements that they knew or should have known were misleading.

Our investigation, among other things, focused on one financing vehicle known as a "prepay." A prepay is commonly thought of as an arrangement in which one party pays in advance for a service or product to be delivered at a later date. Companies use prepays to receive money up front for services to be rendered in the future.

Enron constructed elaborate, multiparty commodity trades that they called prepays in order to book the proceeds from the prepays as cash flow from operations. But when all the bells and whistles are stripped away, the basic transaction fails as a prepay and what remains is a loan to Enron using a bank and an obligation on Enron's part to repay the principal plus interest. With that being true, the proceeds of the so-called prepay transaction should have been booked as debt and cash flow from financing, not as a trading liability and cash flow from operations.

In order for transactions like the ones used by Enron and the banks to be legitimately booked as a trading liability and not debt, four elements had to be present:

- The three parties had to be independent.
- The trades among the three parties could not be linked.
- The trades had to contain price risk.
- There had to be a legitimate business reason for the trades.

The Enron type prepays we examined failed on all accounts:

- Two of the three parties in the Enron trades were related, that is the banks and their offshore special purpose entities which the banks established and controlled.
- The trades among the parties were linked, that is contracts associated with the trades were designed so that a default in one trade affected the other trades.
- There was no price risk. Except for fees and interest payments, the final impact of the trades was a wash.
- Neither the banks nor the banks' special purpose entities had a legitimate business reason for purchasing the commodities used in the trades.

Let me describe the structure and operation of these sham prepays. [Appendix C and Appendix D that discuss the details of the prepays have been submitted for the record.]

Enron used these so-called "prepay" transactions to obtain more than $8 billion in financing over approximately 6 years, including $3.7 billion from 12 transactions with Chase and $4.8 billion from 14 transactions with Citgroup. This $8 billion figure is a conservative estimate for the 6 year period, based on the documents we were able to review; the full amount since Enron began using prepays in 1992 may be much larger. Barclays, Credit Suisse First Boston, FleetBoston, Royal Bank of Scotland, and Toronto Dominion participated in over $1 billion of the prepay transactions.

Accounting for "prepay" proceeds as cash flow from operations, rather than cash from financing gave the impression that the money from the prepays was part of Enron's ordinary business activities and not debt. Moreover, the Subcommittee has learned that Enron was simultaneously treating the prepay transactions as loans on its tax returns in order to claim the interest expense as a business deduction.

Enron's practice of using prepay transactions to understate debt and overstate cash flow from operations made its financial statement look much stronger. That, in turn, helped Enron maintain its investment grade credit rating and support, even boost, its share price.

The Subcommittee has done an analysis of what Enron's financial statements would have looked like had it accurately recorded the "prepay" transactions as debt. Please look at this chart, which is marked as Exhibit 104. The chart shows key figures from Enron's year 2000 financial statements, the last audited financial statements that the company filed with the Securities and Exchange Commission. The financial statements showed that Enron had total debt in 2000 of about $10 billion, and funds flow from operations in the range of $3.2 billion. We know from an Enron Board presentation that, at the end of 2000, Enron had about $4 billion in outstanding financing from its so-called "prepays." If Enron had properly accounted for these transactions, its total debt would have increased by about 40% to about $14 billion, and its funds flow from operations would have dropped by almost 50% to about $1.7 billion. Those are dramatic changes.

The impact on Enron's key credit ratios would also have been significant. These credit ratios are the ratios that financial analysts typically use to evaluate a company's financial health. With the inclusion of the prepays as debt, Enron's debt to equity ratio would have risen from about 69% to about 96%. Its debt to total capital ratio would have risen from 40% to 49%. And its funds flow interest coverage, a key measure of a company's ability to meet its financing obligations, would have dropped by almost half, from 4.07 to 2.37. The credit rating agencies testifying in the next panel will discuss the significant effect these numbers would have had on Enron's credit rating.

Any credit rating downgrade would have had serious consequences for Enron, including raising its borrowing costs, limiting the investors who could buy the company's bonds, weakening its trading status, and possibly triggering certain demand debt repayments at off balance sheet entities affiliated with the company. Enron was acutely aware of the importance of its credit rating and its financial ratios.

The Subcommittee staff has additional analysis regarding the financial impact that would have resulted if Enron had accurately reflected its "prepay" proceeds as debt, including drops in the company's enterprise value and a significant drop in its implied share price. In the interests of time, however, I will submit that analysis for the record and answer any questions you may have about it. I also ask that the other appendices to my statement be included in the Subcommittee's hearing record.

Enron was able to book "prepay" proceeds as cash flow from energy trades rather than cash flow from loans only with the assistance of the financial institutions. The banks provided the funding for the prepays, participated in the required complex commodity trades, and allowed Enron to use their offshore entities that they controlled as sham trading partners, for the explicit purpose of allowing Enron to disguise multi-million-dollar loans as trading activity.

Internal communications show that it was common knowledge among Enron, Chase and Citigroup employees that the "prepays" were designed to achieve accounting, not business, objectives and that Enron was booking the "prepay" proceeds as trading activity rather than debt. The evidence indicates that Chase and Citigroup not only understood Enron's accounting goal - increasing operating cash flow without reporting debt - but designed and implemented the financial structures to help Enron achieve its objective. Moreover, they accepted and followed Enron's desire to keep the nature of these transactions confidential.

By design and intent, the prepays as structured by Enron and the financial institutions made it impossible for investors, analysts and other financial institutions to uncover the true level of Enron's indebtedness.

Despite its desire to keep the information confidential, Enron dealt with so many financial institutions that word of its "prepay" structures began to circulate. Chase developed a "pitch book" to sell other companies on Enron-style prepays. The presentation describes the transactions as "Balance sheet 'friendly'. " It also sets out in general terms Chase's use of its special purpose entity, Mahonia, in structuring the trades and clearly explains that the trades are orchestrated to work together. This explanation of the deliberate packaging of the trades flatly contradicts claims that the trades are independent and unrelated. Chase apparently entered into Enron-style prepays with seven companies apart from Enron.

Citigroup also developed a presentation to sell companies on Enron-style prepays, promoting, in particular, the Yosemite structure it had developed to raise the money for the prepays from third party investors without explicitly informing them of the transactions. The presentation boasts that the structure "[e]xpands capability to raise non-debt financing and ... improve cash flows from operations" and "[e]liminates the need for Capital Market disclosure, keeping structure mechanics private." Citigroup shopped this Enron-style prepay to 14 companies, successfully selling it to at least three.

Enron is not the only company obtaining loans disguised as commodity trades, and recording cash flows from operations instead of from financing. Major financial institutions are knowingly assisting and even promoting such transactions, which would not be possible without their willingness to provide the funds, the paperwork, and a sham offshore trading partner.

Thank you. Mr. Brown and I would be happy to answer any questions.

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