STATEMENT

OPENING STATEMENT OF
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PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

The Role of the Financial Institutions in Enron's Collapse

Today is the second in a series of hearings held by the Permanent Subcommittee on Investigations into the events that contributed to the collapse of the Enron Corporation. More than six months ago, the Subcommittee embarked on a comprehensive investigation of Enron in an effort to gain insight and understanding of what appears to be a colossal failure of virtually every mechanism that is supposed to provide the checks and balances on which the integrity of our capital markets depend.

I would like to take a moment to praise Senator Levin and the dedicated Subcommittee staff on both sides of the aisle who have been tireless in their efforts to unravel complex transactions that were purposefully designed to confound and confuse. The undertaking has been enormous, and I appreciate all the work that has gone into this investigation.

The Subcommittee's first hearing examined the role of Enron's Board of Directors in the company's collapse and found that the board failed to play its required role as the guardian of the corporation's shareholders. The Board's failures, of course, are only part of the story.

We know now, nearly eight months after Enron filed for bankruptcy protection, that a web of conflicts of interest, accounting improprieties, high risk transactions, and appropriation of corporate assets by Enron executives contributed to the company's collapse. Today, we will examine the pivotal role of another set of players in the Enron story: the financial institutions.

The Subcommittee's investigation has revealed that certain financial institutions knowingly participated in, and indeed facilitated, transactions that Enron officials used to disguise debt and, thereby, make the company's financial position appear more robust than it actually was.

Through the use of structured finance vehicles that included a series of prepaid forward contracts and related swaps, Enron received billions of dollars in cash. A prepaid forward contract, or prepay, is essentially a forward sale agreement in which the buyer receives an up-front payment in exchange for a commitment to deliver goods or services in the future. Prepays are commonly used in the energy industry. When bona fide prepays are used for genuine business transactions, they are a perfectly legitimate means to provide needed cash to the seller and a desired commodity to the buyer.

However, as was the case with much of what went on at Enron, these transactions were neither simple nor as they seemed on the surface. Many of the so-called prepays, in fact, were not prepaid forward contracts at all. They did not transfer price risk. They did not utilize independent third parties. They were not entered into because the purchaser actually wanted oil or gas, nor were their terms driven by anything other than a desire to achieve an accounting end. Instead, they were elaborate circular transactions that were designed to disguise what were essentially loans totaling billions of dollars.

While these transaction were incredibly complicated, they essentially boil down to the following scenario. Enron entered into a contract with an offshore entity to deliver oil or gas at a date certain in the future in exchange for an up-front cash payment. The offshore entity, created by or at the behest of the bank, made the up-front payment to Enron with funds provided by the bank. In many cases, no oil or gas ever really changed hands. The banks understood up-front what their ultimate return would be because they hedged their risk, sometimes with Enron itself. The offshore entity supposedly participating as a trading counterparty, in reality, made nothing but preset fees, and Enron received an infusion of cash without having to disclose it as a loan on its balance sheet.

The facade of a prepay enabled Enron to misrepresent the cash it received as funds obtained from the company's operations rather than from financing. From an accounting standpoint, this is a critical distinction. Loans appear on a company's balance sheet as cash from financing or debt. A higher debt load raises questions about a company's borrowing power and ability to generate future profits and affects its credit rating. Cash flow from operations, however, enhances the appearance that the company is doing more business that it actually is and implies that such revenue, because it is from the company's core operations, is likely to continue in future periods.

Enron wanted these deals to be covered in a shroud of secrecy because they knew they could not stand up to scrutiny in the light of day. Furthermore, they wanted them to be limited to as few investors as possible in order to maintain the facade. In fact, an internal Enron document explains that the continued use of these transactions "is a sensitive topic for both the rating agencies and banks/institutional investors. The ability to continue minimizing disclosure will likely be compromised if transactions continue to be syndicated."

Maintaining an investment grade rating was vital to Enron. Had the rating agencies been privy to the circular nature of the transactions, they would have considered them to be financing or loans, and they would have factored that into their ratings. Full disclosure of Enron's source of capital might well have resulted in a downgrade of its rating.

Although many banks ultimately invested in these transactions, JPMorgan Chase and Citigroup were two of the principal banks involved. Their deals, known as Mahonia and Yosemite, respectively, enabled Enron to keep eight billion dollars off its balance sheet and, as a result, misrepresent its financial status to the rating agencies and the investing public.

JPMorgan Chase and Citigroup are two of the nation's most prestigious financial institutions. Yet, it appears as though they were willing to risk their reputations to keep Enron, an important client, happy. They participated in crafting the structure of these transactions. They used special purpose, off-shore vehicles of their own making as the "independent" third parties. They clearly understood Enron's motivation for wanting to use the prepay structures to hide the true source of the company's cash flow. This prepay charade led to Enron's never-ending need for more cash in order to pay off previous prepays, creating a merry-go-round of refinancings at the expense of investors.

While the majority of professionals in corporate America are ethical people, the public's faith in corporate integrity and professional judgment has been severely compromised by recent corporate scandals. The markets have been buffeted by both Enron and more recent revelations of corporate wrong-doing. The resulting crisis of confidence is not about the market system but rather the information that underpins its very validity, the information about the performance of companies whose shares are traded by investors around the world.

Some accountants, lawyers, investment bankers, analysts, and corporate executives, whose integrity and competence are critical to our system of free markets, have directly contributed to this crisis. Some have failed in their professional responsibilities and made it easier for the direct participants to get away with presenting a misleading picture to investors. The question now is how to restore trust and confidence in the markets and corporate America. Tougher laws, clearer standards, and swift and sure enforcement are part of the answer.

Fundamentally, however, restoring faith in America's capital markets requires that all the players do their jobs – not just government regulators and prosecutors but lawyers, accountants, investment bankers, market analysts, corporate management and boards – in accordance with the spirit, not merely the letter, of the law. We all share in the responsibility for making our markets operate as efficiently, transparently and fairly as possible. It is time to stop practices that are beneficial to a select few and harmful to thousands.

The testimony we will hear this morning about the role of financial institutions should provide some answers, and should yield valuable lessons for strengthening our free enterprise system, restoring public confidence in our capital markets, and ensuring that small investors, in particular, have access to complete and accurate information to guide their investment decisions.