STATEMENT

OPENING STATEMENT OF
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PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

The Role of the Financial Institutions in Enron's Collapse

July 30, 2002

Today is the second hearing held by the Permanent Subcommittee on Investigations examining the role played by some of America 's leading financial institutions in the collapse of Enron. Our investigation has revealed that certain financial institutions knowingly participated in, and indeed facilitated, transactions that Enron officials used to make the company's financial position appear more robust than it actually was, thereby deceiving investors, customers, and employees.

Last week, the Subcommittee examined one such type of transaction; Enron and its bankers, JP Morgan Chase and Citigroup, call them "prepays." The evidence, however, revealed them to be nothing more than sham transactions designed to obtain, as one of the banks continued to tout on its website, "financial statement friendly financing." Like so many of the other deals at Enron, the apparent motive was to portray a false image of the company's financial health.

As NYU law professor and former judge William Allen noted in an April speech to the New York City Bar Association, banks such as JP Morgan Chase and Citigroup are supposed to play a valuable role in our system of corporate checks and balances because "they monitor debtors more closely than other providers of risk capital." Did the "lenders not understand that they were enabling deception?" Professor Allen asked. Much to my dismay, last week's Subcommittee hearing made clear that they did understand but chose to proceed anyway.

Our focus this morning is whether Merrill Lynch also participated in enabling Enron to deceive the public. There are four principal aspects of the Merrill Lynch-Enron relationship that we will examine. The first involves Merrill's purchase of Nigerian barges with electricity-generating equipment from an Enron-related entity in late 1999. This transaction allowed Enron's African division to meet its quarterly reporting target and announce to the financial world that Enron had sold a $12 million asset.

As with much at Enron though, the reality was a different story. Merrill's purchase of the barges was predicated on Enron's agreement that it would find another buyer for them within six months. Under a Securities and Exchange Commission accounting bulletin published that very month, such an arrangement clearly did not allow a seller to recognize revenue. Handwritten notes by a Merrill employee warned that there was "reputational risk i.e., aid/abet Enron income [statement] manipulation," but Merrill nevertheless went ahead with the deal.

Second, the Subcommittee will examine the actions taken by Merrill management in response to Enron complaints that Merrill's financial analyst had rated the company less favorably than Enron would have liked. Enron informed

Merrill that it would not be selected as a manager or co-manager of a large Enron stock offering solely because Enron objected to the rating of its equity research analyst. Merrill appears to have gone to extraordinary lengths to placate Enron and, subsequently, Merrill was added as a co-manager of the offering.

After the offer went public, Merrill executives kept Enron's Chief Financial Officer updated on the activities of the research analyst. On at least three occasions, Merrill actually sent the CFO copies of the analyst's internal lists of calls that he made to clients touting the offering. The analyst in question subsequently left Merrill, and his replacement immediately upgraded Enron.

This case raises troubling questions about conflicts of interest compromising the integrity of the ratings on which investors rely. Merrill came under fire earlier this year because of a New York State investigation that unearthed the fact that Merrill analysts were recommending securities that they privately believed to be undesirable. Merrill reached a $100 million settlement with the New York Attorney General and, as part of the settlement, implemented a set of new disclosures specified by the Attorney General's office.

Third, the Subcommittee will pursue Merrill's decision to participate in an Enron loan syndication. Enron sought Merrill's participation in a deal that had been arranged by JP Morgan Chase but had failed to raise the needed $482 million for an Enron-related company. Prior to the request, Enron had made it clear to Merrill that it was at a "distinct disadvantage" for obtaining future business from Enron because of its "reluctance to use its balance sheet to support Enron's business activities." Subsequently, Merrill agreed to participate in the loan syndication, despite indications that the investment would result in a financial loss. Ultimately, Merrill did indeed lose approximately $1.6 million in the deal.

Finally, the Subcommittee will look closely at Merrill's dealings with an off-the-books partnership headed by Enron's CFO. Enron CFO Andrew Fastow's investment company, LJM2, asked Merrill to provide a $10 million line of credit in connection with a $65 million revolving credit facility being syndicated to other banks by JP Morgan Chase. An internal Merrill document advocating the credit request states, "committing to this LJM2 facility will build ML's relationship with Andy Fastow, and assist ML in securing future investment banking opportunities with Enron."

Other Merrill E-mails warned against it, citing the lack of a rating and the nature of the credit risk. Nevertheless, two of the witnesses who were scheduled to testify before the Subcommittee today requested an exception to bank policy for the loan for the following reasons: "Enron is an excellent client. $40 MM in revenue in 1999[;]$20 MM in revenue for 2000 year to date[;] Andy Fastow is in an influential position to direct business to Merrill." In the end, the prospect of more lucrative business from Enron trumped those at Merrill who urged caution.

As we learn more about how prestigious financial institutions participated in transactions that allowed Enron to deceive investors, I am reminded of a congressional hearing almost a century ago with another banker. In 1912, J.P. Morgan appeared before a House subcommittee to be questioned about his firm's banking practices. He was asked whether it was true that his bank had no legal responsibility for the value of bonds it had sold clients. He responded that the banks assumed something even more important than legal responsibility - - moral responsibility. Yet, last week, when asked by Chairman Levin whether it was appropriate for a financial institution to act in a manner it knew was deceptive, one banker responded, "it depends on what the definition

of a deception is." It is this sad quote that sums up the attitude of some professionals on what their duty is in today's markets.

This attitude must change. The day of the deal that serves no other purpose than to exploit an accounting loophole, and the day when the law serves as the ceiling rather than the floor on the conduct of Wall Street professionals and corporate executives, must come to an end.

It is important to remember that the Enron debacle is more than just a tale of one company's greed. As a result of Enron's downward spiral and ultimate bankruptcy, shareholders – large and small, individual and institutional – lost an estimated sixty billion dollars. The collapse of Enron caused thousands of Americans to lose jobs, to lose savings, and to lose confidence in corporate America . It is time to halt practices that are beneficial to a select few and harmful to thousands.

I want once again to commend Chairman Levin for his leadership in this important investigation. The testimony presented to the Subcommittee last week, together with the testimony we will hear this morning, should yield valuable lessons for strengthening our free enterprise system, restoring public confidence in our capital market