SENATOR SUSAN M. COLLINS

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

Oversight of Investment Banks' Response to the Lessons of Enron

Today's hearing is the fourth the Permanent Subcommittee on Investigations has held this year examining the collapse of the Enron Corporation. It is the third hearing looking specifically at the role played by some of America's leading financial institutions in transactions that enabled Enron to paint a false picture of its financial health and that contributed to the ultimate bankruptcy of the company.

Our earlier hearings documented that certain financial institutions - - Merrill Lynch, JP Morgan Chase, and Citigroup - - 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. These complex transactions allowed Enron to deceive its investors, customers, and employees.

Today's hearing will provide additional evidence of the complicity of financial institutions in Enron's deceptions. We will examine four multi-million-dollar structured finance deals that enabled Enron to produce misleading financial statements and, in one case, claim a highly questionable $125 million tax break. Citigroup funded two of the four transactions, and JP Morgan Chase funded the other two.

The first three transactions, known as Fishtail, Bacchus and Sundance, involved Enron's so-called "sale" of certain assets at inflated values to special purpose entities (SPEs) that had been established by Enron, Citigroup or Chase. In each case, the allegedly independent SPEs purchasing the assets were funded with equity "commitments" by Citigroup or Chase that did not truly place funds at risk or were supported by secret oral guarantees by Enron that invalidated the SPEs' independent status.

Each of the transactions, fabricated to look like an arms length sale of a financial asset, was a artifice designed to enable Enron to obtain a Citicorp or Chase loan or to sell an asset to itself. The evidence strongly suggests that Citigroup and Chase were not innocent pawns in these transactions. Warning flags were abundant. An internal memorandum from a senior Citicorp official strongly objected to the transactions, warning that the "GAAP accounting is aggressive and a franchise risk to us if there is publicity . . . ." Citigroup's involvement in helping disguise what were essentially loans as phony asset sales enabled Enron to inflate its sales revenues and produce misleading financial statements.

The final transaction, known as Slapshot, involved a $1.4 billion loan and related transactions that were designed to take advantage of foreign tax rules and produce Canadian tax benefits for Enron. This complex web of transactions was designed by JP Morgan Chase and used Enron affiliates or SPEs in the United States, Canada and the Netherlands. In simplest terms, Slapshot involved a legitimate $375 million loan issued

by a consortium of banks and a phony $1 billion loan issued by a JP Morgan Chase controlled SPE. The $1 billion loan was issued and repaid on the same day through a complex series of structured finance transactions. The $375 million loan was to be repaid over five years.

Chase provided the $1 billion for the phony loan by approving a $1 billion daylight overdraft on an Enron account at Chase. The overdraft presented no risk, however, to Chase because the bank required Enron to deposit a separate $1 billion in an escrow account for the duration of the so-called "loan." Chase then circulated $1 billion through more than a dozen bank accounts held by Enron and Chase affiliates and SPEs, returning the $1 billion overdraft to the original Chase account by the end of the day.

The end result of all the transactions used to accomplish both loans was that Enron was able to treat its quarterly $22 million loan repayments - each of which was a payment of principle and interest on the $375 million loan - as purely interest payments on the $1 billion loan. By characterizing each $22 million loan payment as an interest payment on the larger loan, Enron claimed that it was entitled to deduct the entire $22 million from its Canadian taxes, for a total of $125 million in Canadian tax benefits. In return for designing this phony loan structure and arranging the series of funding transfers, thereby enabling Enron to claim its loan repayments as fully deductible, Chase received a fee of $5.25 million from Enron. Outside experts consulted by Chase cautioned "that in our opinion, it is very likely that Revenue Canada will become aware of the proposed transactions ... [and] will challenge them under the [general anti-avoidance rule]."

The transactions that we are examining today once again demonstrate the extraordinary actions that investment banks undertook to keep Enron, an important client, happy. The checks and balances that were supposed to ensure the integrity of financial transactions apparently were compromised by conflicts of interest and the lure of big fees.

It undermines the integrity of our capital markets when some of the most prestigious financial institutions in our country are involved in designing, marketing, executing, and profiting from financial transactions intended to enable public companies to engage in deceptive accounting and tax strategies.

In earlier testimony, the financial institutions have denied any responsibility, claiming it is not their fault if their clients choose to account for these transactions improperly. But the troubling fact remains that Enron could not have gotten away with what it did for so long without the active participation of its financial institutions.

Numerous documents examined by the Subcommittee clearly demonstrate that the financial institutions that partnered with Enron knew of the company's intentions. In fact, in some cases, the financial institutions helped design the transactions specifically so that Enron could cook its books. For example, Chase's own documents highlight a particular advantage of the deal as "[not providing] a 'road map' for Revenue Canada," which was explained to Subcommittee staff as a selling point so that the deal would not easily be identified by the Canadian tax authorities and audited.

We will also hear today from the watchdogs - - representatives of the Securities and Exchange Commission (SEC), the Federal Reserve, and the Office of the Comptroller of the Currency (OCC). There are a number of questions about the role of the regulators.

To what extent do these regulatory agencies examine the type of transactions engaged in by JP Morgan Chase and Citigroup that enabled Enron to misrepresent its financial condition?

What is their view of the legitimacy of the transactions we are examining today? Do the regulators have the authority and expertise to oversee these complicated transactions?

Has the current regulatory structure kept pace with changes in the financial markets and the innovations in structured finance? The answers to these questions are critical to strengthening our free enterprise system and restoring public confidence in our capital markets. 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 and U.S. financial institutions.

When the individual investor doesn't have access to critical information, information that is known only to corporate management and their financial partners, the playing field is far from level. We must ensure that our financial institutions act with integrity. And, we must ensure that investors, large and small, have access to complete and accurate information to guide their investment decisions.

In closing, I want to take a moment to express my appreciation to Chairman Levin and our staffs for their handling of this investigation. For the past year, our staffs have worked together on this matter with what I believe may be an unprecedented level of cooperation and partnership. I want to thank the entire Subcommittee staff for their hard work and dedication and Chairman Levin for his leadership and commitment to this effort.

And special recognition goes to Linda Gustitus who has led Senator Levin's committee staff since 1979. Linda will be retiring soon, and her skillful leadership will be missed.