STATEMENT OF SENATOR CARL LEVIN (D-MICH)
BEFORE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
ON
OVERSIGHT OF INVESTMENT BANKS' RESPONSE TO THE LESSONS OF ENRON

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One year ago, on December 2, 2001, Enron Corporation, then the seventh largest company in the United States, declared bankruptcy. The follow up to this financial disaster revealed a litany of Enron corporate abuses from accounting fraud, to price manipulation, insider dealing, and tax. Yet it is still the case today, as it was a year ago, that most top Enron officials have walked away from the scandal they created with tens of millions of dollars in their pockets, while Enron employees, creditors, and shareholders have suffered substantial losses.

As disturbing as Enron's own misconduct is the growing evidence that leading U.S. financial institutions not only took part in Enron's deceptive practices, but at times designed, advanced, and profited from them.

This is the third in a series of hearings held by this Subcommittee focusing on the role of financial institutions in Enron's collapse. Our first hearing looked at more than $8 billion in deceptive transactions referred to as "prepays." Citigroup and JPMorgan Chase repeatedly used these deceptive prepays to issue Enron huge loans that were disguised as energy trades, which enabled Enron to misstate the loan proceeds as cash flow from business operations. Investors and analysts were misled, along with the many employees who lost their life savings and jobs.

Our second hearing looked in detail at a sham asset sale from Enron to Merrill Lynch just before the end of the year 2000, so that Enron could book the fake sale revenue and boost both its year-end earnings and cash flow from operations. This transaction didn't qualify as a true sale under accounting rules, because Enron had eliminated risk from the deal by secretly promising Merrill Lynch to arrange a resale of the barges within 6 months, while guaranteeing a 15 percent profit.

In both hearings, substantial evidence showed that the financial institutions involved in the deals knew exactly what was going on – they structured the transactions, signed the paperwork, and supplied the funds knowing that Enron was using the deals to report that the company was in better financial condition than it really was. In the case of Citigroup and Chase, the banks not only assisted Enron, they developed the deceptive prepays as a financial product and sold it to other companies as so-called "balance sheet friendly" financing, earning millions in fees.

Today's hearing will look at another set of deceptive transactions that took place over a six month period from December 2000 to June 2001, involving Enron ventures in the pulp and paper business. These transactions were known as Fishtail, Bacchus, Sundance, and Slapshot. The evidence shows that Citigroup and Chase actively aided Enron in these transactions, despite knowing they employed deceptive accounting or tax strategies and were being used by Enron to manipulate its financial statements or deceptively reduce its tax obligations. Citigroup and Chase received substantial fees for their actions or favorable consideration in other business dealings.

These four transactions required months of work by the Subcommittee staff to untangle. The complexity of the deals made the deceptions almost impossible for anyone to understand without a detailed roadmap. They also show how far our financial institutions have sunk in misusing structured finance. Instead of using structured deals to lower financing costs or spread risk – which are legitimate uses – they used structured finance to mislead investors, analysts and regulators about a company's true activities and financial condition.

I will place in the record at this time our Subcommittee staff report that describes the four transactions in detail as well as charts and exhibits showing what happened. Here are some of the highlights from that report and our investigation.

FISHTAIL, BACCHUS, AND SUNDANCE

Enron constructed the first three transactions, Fishtail, Bacchus, and Sundance, as a sham asset sale of its new pulp and paper business venture in order to inflate its cash flow and earnings by hundreds of millions of dollars and to keep the substantial debts associated with this business venture off its balance sheet and out of the view of

investors and analysts. The first two transactions took place in December 2000. Enron first pretended to move its pulp and paper trading business off its balance sheet to a new joint venture it had set up called Fishtail. About one week later, in the Bacchus deal, Enron purportedly sold its Fishtail interest to another entity for $200 million. Enron then booked the $200 million as "sale" revenue and declared a profit and earnings of $112 million on its year-end financial statements, enabling the company to meet Wall Street expectations for its 2000 earnings.

In the Bacchus transaction, Enron allegedly "sold" its Fishtail ownership interest to a shell company it had established earlier called the Caymus Trust. EXHIBIT 301a shows how the transaction appeared on the surface.

The Caymus Trust came up with the $200 million purchase price by obtaining a $194 million loan from Citigroup and an apparent $6 million cash investment from FleetBoston Financial that was also guaranteed by Citigroup.

However, as EXHIBIT 301b demonstrates, the transaction was, in reality a loan. The evidence shows that in addition to openly guaranteeing repayment of the $194 million Citigroup loan, which is permissible under accounting rules, Enron's chief financial officer Andrew Fastow also made an undisclosed oral agreement with Citigroup to ensure Citigroup would not incur any loss connected with the so-called $6 million "investment." These two guarantees meant that Enron had, in effect, ensured repayment of the entire $200 million purchase price. Those two guarantees also meant that, under accounting rules, Citigroup was, in reality, providing Enron a loan and using the Caymus Trust as a pass-through rather than financing a real sale to a real company.

Six months later, Enron and Citigroup set up another joint venture called Sundance to take possession of all of Enron's pulp and paper assets, including the asset presumably just "sold" to the Caymus Trust, and to keep the debt associated with these assets off Enron's balance sheet.

But this joint venture was also a sham. Enron's auditor, Andersen, had told Enron that it would approve off-balance sheet treatment of the Sundance joint venture only if at least 20% of Sundance's capital came from an independent investor and at least 3% of the total capital was placed at risk when the venture was formed and stayed at risk during the joint venture's operation.

EXHIBIT 302a shows that Sundance appeared to meet these accounting requirements. Enron contributed approximately $750 million in assets and cash. Citigroup appeared to have contributed $188.5 million, or 20% of the joint venture's capital. Citigroup's contribution included $28.5 million in stock and cash which supposedly met the requirement for 3% up-front capital-at-risk, and $160 million in "unfunded capital," that supposedly would be provided on demand.

But as EXHIBIT 302b shows, the reality was that Citigroup's alleged investment was a sham, because it was never intended to be at risk. As EXHIBIT 302c shows, the terms of the partnership included the following provisions: Citigroup could dissolve the partnership at anytime; Enron had to lose its entire $750 million before any of Citigroup's so-called "investment" could be touched, which meant Citigroup would have plenty of time to dissolve the partnership if necessary before it had to produce any funds; and Sundance had to keep $28.5 million liquid, segregated, and earmarked for Citigroup so that Citigroup could recapture that part of its is so-called "investment" at will. In summary and in reality, neither Citigroup's $28.5 million nor its "unfunded" $160 million were ever intended to be at risk.

The Sundance joint venture was a sham, and all of its assets should have been included in Enron's balance sheet. Indeed, just two days before the transaction closed, three senior Citigroup officials strongly urged the investment bank not to do the Sundance deal, with one warning that: "The GAAP accounting is aggressive and a franchise risk to us if there is publicity." But Citigroup did the deal, earning $ 1.8 million in fees and preferred dividends, and presumably got some good will from Enron. Citigroup also obtained full payment of the $200 million loan it had provided earlier in the Bacchus deal, since one of Enron's contributions to Sundance was the $200 million needed to "buy" the Fishtail assets from the Caymus Trust and pay off the Citigroup loan.

On paper, Fishtail, Bacchus, and Sundance seemed to bring new investment into Enron's pulp and paper business venture. In reality, these complex financial deals enabled Enron to use a $200 million Citigroup loan in a sham asset sale to boost its year-end cash flow and earnings, and then quietly return the funds via Sundance. Without Citigroup's participation and supplying the lion's share of the funds, Enron would not have been able to pull off these deceptive transactions.

SLAPSHOT

Slapshot is another highly disturbing example of a major U.S. financial institution's helping Enron engage in a deceptive transaction. It is particularly disturbing, because Chase itself designed the deceptive transaction. This was more than aiding and abetting. Chase designed the Slapshot deal and sold it to Enron for $5 million, enabling Enron to claim an estimated $60 million in Canadian tax savings and $65 million in financial statement benefits.

The Slapshot sleight of hand took place on June 22, 2001. It was designed as a tax avoidance scheme and, as we can see from the next EXHIBIT, it was a spaghetti bowl of structured finance arrangements using loans, funding transfers, and transactions involving Chase and Enron affiliates in two countries, many of which were established specifically to facilitate the deal. In essence, Slapshot took a valid $375 million loan issued by a consortium of banks to an Enron affiliate and combined it with a $1 billion sham loan issued by a Chase-controlled shell company called Flagstaff.

The sham $1 billion loan created the appearance but not the reality of a loan by using a shell game involving two different transfers of $1 billion through a maze of bank accounts belonging to Chase and Enron affiliates. Chase provided the alleged loan by issuing a $1 billion momentary overdraft to its shell company, Flagstaff. But Chase was unwilling to allow Flagstaff to release the funds to an Enron shell company called Hansen until Chase was sure that the $1 billion was fully protected and going to be returned the same day. So Chase required Enron to deposit a separate $1 billion in an escrow account controlled by Chase before Chase would release its $1 billion to Enron. Enron obtained its own $1 billion momentary overdraft on an account it held at Citibank and transferred those funds into an escrow account at Chase.

Then, through a series of near instantaneous transactions among Chase and Enron entities, the $1billion sham loan was briefly commingled with the real $375 million loan to create the appearance of a combined $1.4 billion loan to an Enron affiliate. The sham $1 billion was then separated back out through a series of additional transfers and moved within hours back to the Enron account at Citibank. In the meantime, the $1billion in Enron escrow funds was released to Chase.

The $1 billion "loan" that was supposedly supplied by Chase was a sham. It was issued and paid back within minutes, without any of the credit risk that is the point of a loan, even during the few moments it moved from Chase's left pocket to its right pocket. It had no economic rationale or business purpose other than to circulate through multiple bank accounts to create the appearance of the larger $1.4 billion loan. Chase got more than $5 million for doing it. Enron got tax deductions and better financial statements.

Enron's tax counsel warned that this transaction "clearly involves a degree of risk," and cautioned that "in our opinion it is very likely that Revenue Canada will become aware of [the Slapshot transactions] and, upon becoming aware of them, will challenge them."

Chase also knew the Slapshot transaction was dubious. It worked with Enron to minimize the possibility Canadian tax authorities would discover it and even developed contingency plans in the event Canada disallowed the sham loan. When analyzing how to structure an interest rate swap that was a part of the transaction, for example, Enron and Chase jointly considered three alternatives, two of which were described as disadvantageous in part because they would produce a "potential road map" of the transaction for Revenue Canada. Enron and Chase jointly chose the third alternative which was explicitly described as providing "no road map."

In addition, Enron and Chase included in the transaction documents a "recharacterization rider" in which they agreed, if they were caught by Revenue Canada, to "re-classify" retroactively loan payments made by Enron to Chase to look like loans from Enron to Chase. How's that for a move: if Canada disallowed the Slapshot scheme and exposed Enron to additional taxes, Enron would try to make it look as though Enron was lending money to one of the world's largest banks!

Slapshot was designed and intended to be a deceptive transaction. Chase set it up to pretend that a $375 million loan was really a $1.4 billion loan by, for a moment, inserting an extra $1 billion in the transaction. The combined "loan" then provided the cover for Enron's Canadian affiliate to claim, for tax purposes, that it had an outstanding loan obligation of $1.4 billion and claim its entire $22 million quarterly loan repayments as tax deductible interest payments on the fake $1.4 billion loan, instead of deducting only that portion of the payments that was the true interest payment on the $375 million loan.

Enron could not have completed Slapshot without a major bank like Chase which had the resources to use $1 billion for a few brief moments and quickly move that $1 billion through multiple bank accounts across international lines. Chase charged Enron $5 million for its so-called "tax technology." Chase has also shopped the same "tax technology" to other companies.

The four transactions at issue today, together with the sham transactions examined at earlier hearings, all have deception at their core. All misuse structured finance, which has a legitimate purpose when used for a real economic objective such as lowering financing costs or spreading risk. But here, there was no such legitimate economic objective. The goal was deception, and none of the transactions could have been executed without the complicity and financial resources of a major financial institution.

The purpose of today's hearing is not just to expose another set of deceptive transactions, but also to take the next step and determine, one year after the Enron scandal broke, what is being done to prevent future deceptions.

Citigroup and Chase have each announced new programs designed to prevent their employees from participating in deals that produce deceptive accounting. We need to learn more about those programs, and whether they will prevent the type of deals we will be examining today.

But we will also find out what our financial regulators are doing – what concrete steps they have taken to prevent U.S. financial institutions from designing, executing, and profiting from illegitimate structured financial transactions intended to help U.S. companies engage in misleading accounting or tax strategies. We want to learn what concrete steps the bank regulators and SEC are taking not only to punish wrongdoing on a case-by-case basis – which is important – but also to create a deterrence program to be part of regular bank examinations to stop future wrongdoing.

There is a regulatory gap right now. The SEC does not generally regulate banks, and bank regulators don't regulate accounting practices or ensure accurate financial statements. Two steps need to be taken which, together, could close this gap. First, the SEC should issue a policy which states clearly that the SEC will take enforcement action against financial institutions which aid or abet a client's dishonest accounting, by selling deceptive structured finance or tax products or by knowingly or recklessly participating in deceptive structured transactions. Second, the bank regulators – including the Federal Reserve that oversees our financial holding companies – need to state that violation of that SEC policy would constitute an unsafe and unsound practice, thereby enabling bank examiners to take regulatory action during bank examinations.

We also need the SEC and bank regulators to conduct a comprehensive, joint review of the structured finance products being sold by or participated in by our financial institutions so we can root out the ones that corrupt financial statements. One year after Enron's collapse, we need the regulators to tell our banks and securities firms that the deceptions and the era of self-regulation are over.

Enron was an eye-opener about the extent and nature of corporate misconduct going on in the United States today and the role being played by our financial institutions. The question, now, is whether we have learned the Enron lessons and whether, in addition to punishing wrongdoers on a case-by-case basis, we have taken on the tougher task of building a new deterrence program to prevent future Enrons.