

**Testimony of John C. Diaz  
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Before the  
Permanent Subcommittee on Investigations  
Committee on Governmental Affairs  
United States Senate  
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Good morning Mr. Chairman, Senator Collins and members of the Subcommittee. My name is Pamela Stumpp, and I am a Managing Director at Moody's Investors Service and the Chief Credit Officer for the Corporate Finance Group. I am joined by my colleague John Diaz, a Managing Director in our Power & Energy Group. On behalf of Moody's, we are pleased to appear before you today at your request regarding your investigation into the role of financial institutions in the collapse of Enron.

For over one hundred years, Moody's has played an important part in providing informed and independent credit analysis to investors. We are proud of our history as the world's oldest credit rating agency and are cognizant of the responsibility that this legacy confers upon us. It was with this responsibility in mind that we accepted your invitation to share our views on the critical issues before you. At a time when America's faith in the integrity of its corporations and the stability of its financial markets is badly shaken, we applaud the efforts of this Subcommittee, the Congress and the Securities and Exchange Commission to investigate Enron's failure and identify the larger lessons that can be learned from the company's collapse.

We are especially interested in these issues because our rating decisions depend heavily on the integrity of the public financial statements provided by corporations. In our assessment of a company's creditworthiness, Moody's analysts begin with the premise that the issuer's SEC filings and audited financial statements are accurate. We then bring the benefit of our experience and expertise to our analysis. But as the Enron situation has demonstrated, where the principle of transparent public disclosure is abandoned, neither we nor the regulators can properly fulfill our obligations to the market and investors globally.

Before discussing Enron and related issues in more detail, it is important for me to note that Moody's did not have any knowledge, prior to Enron's bankruptcy, of the existence of Enron's prepaid forward and related swap transactions. Even today, our understanding of the specifics of these transactions is restricted to what we have gleaned from press accounts and the conversations we have had with the Subcommittee staff at their request. Based on our limited knowledge, these transactions appear to have been a form of borrowing. If such transactions had been accounted for as a loan, Enron's operating cash flow would have been reduced and its debt would have been greater. The disclosure of these transactions as loans would have exerted downward pressure on Enron's credit rating.

Of course, knowing all that we know today about the true nature of Enron's corporate enterprise, it is clear that Enron had not been an investment-grade company for several years. The compounded impact of these transactions alone on Enron's financial framework may have resulted in a lower rating and perhaps an earlier downgrade to below investment-grade status. More fundamentally, however, Moody's would have questioned management's motivations to implement such a structure.

As Moody's does with all corporate entities, we expressed to Enron our views regarding its creditworthiness. Specifically, Enron was rated in the Baa category, Moody's lowest investment grade level. Entities rated Baa contain speculative elements.<sup>[1]</sup> We had communicated to Enron that its Baa rating reflected its high level of debt relative to its

operating cash flow. Consistent with Moody's practice not to recommend that corporate issuers follow specific courses of action, Moody's did not instruct or suggest that Enron employ prepaid transactions or other artificial means to increase operating cash flow or to understate debt levels.

Moody's did provide ratings for the notes issued by the Citibank-sponsored Yosemite Trusts I and II, as well as the several Enron Credit Linked Notes Trusts. We viewed these transactions to be a means through which Citibank reduced its level of Enron risk. We have submitted, along with this opening statement, a diagram of the Yosemite structure as presented to us in the Offering Memorandum. Yosemite was a structure of the type that our Structured Finance Group examines and rates frequently. The purpose of these structures is essentially to transfer the credit risks associated with a particular company to third-party noteholders.

In this instance, a trust was created that issued notes to investors. Citibank was obligated to make payments to the trust, which were then passed to the investors. Citibank was not obligated to make these payments if Enron failed to pay on its senior obligations or filed bankruptcy. In exchange for principal and interest due under the notes, the investors assumed the risk that Enron might go into bankruptcy or fail to pay on its obligations. Therefore, the likelihood that the noteholders would receive the promised returns on these notes was linked directly to Enron's creditworthiness.

It should be stressed that structured financing is a common risk management tool available globally to corporations, financial institutions, and state and local governments. It is a recognized method, for example, of enhancing liquidity and of transferring credit risk when appropriately implemented. What may seem to be a complex structure can in fact genuinely accomplish one or both of these goals. The Yosemite transactions transferred Enron risk exactly as they were intended to do. The problem was that the actual Enron risk was different from that portrayed by Enron's incomplete and misleading financial disclosures.

The securities market can only function efficiently with transparent and credible financial information. It is critical to strengthen those elements of our financial infrastructure and bolster investor confidence. As a major consumer of publicly available information, we support rule changes by the SEC and Congress that enforce transparency and penalize corporate deception. Further, we endorse a principle-based approach to accounting, rather than a rules-based approach. Accounting that promotes adherence to the spirit and the letter of the rules would strengthen the foundations of our financial system.

At this critical juncture, we hope all market participants step forward to offer confidence-building measures. As far as Moody's is concerned, we are expanding our knowledge in key disciplines that have come to influence credit risk. We are recruiting specialist teams with particular expertise in credit-related areas such as accounting quality, corporate governance and off-balance sheet risks. These teams will supplement the work of our credit generalists in their analysis of a company's creditworthiness. We hope that our independent assessment of financial reporting and corporate governance will improve market transparency and contribute to the restoration of confidence in our capital markets.

Finally, as an institution that views its role in the capital markets with both pride and great seriousness, we welcome the opportunity to assist this Subcommittee in examining the shortcomings of the present system and in working toward effective solutions. Therefore, on behalf of our colleagues at Moody's, John Diaz and I would like to thank you for the opportunity to appear today, and look forward to answering your questions.

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Baa obligations are considered as medium-grade obligations (i.e., they are neither highly protected nor poorly secured). Interest payments and principal security for such obligations appear adequate for the present but certain protective elements may be lacking or may be characteristically unreliable over any great length of time. Such bonds lack outstanding investment characteristics and in fact have speculative characteristics as well.