The Aftermath of Enron: Risk Management, Structured Finance, and Governance in the New World

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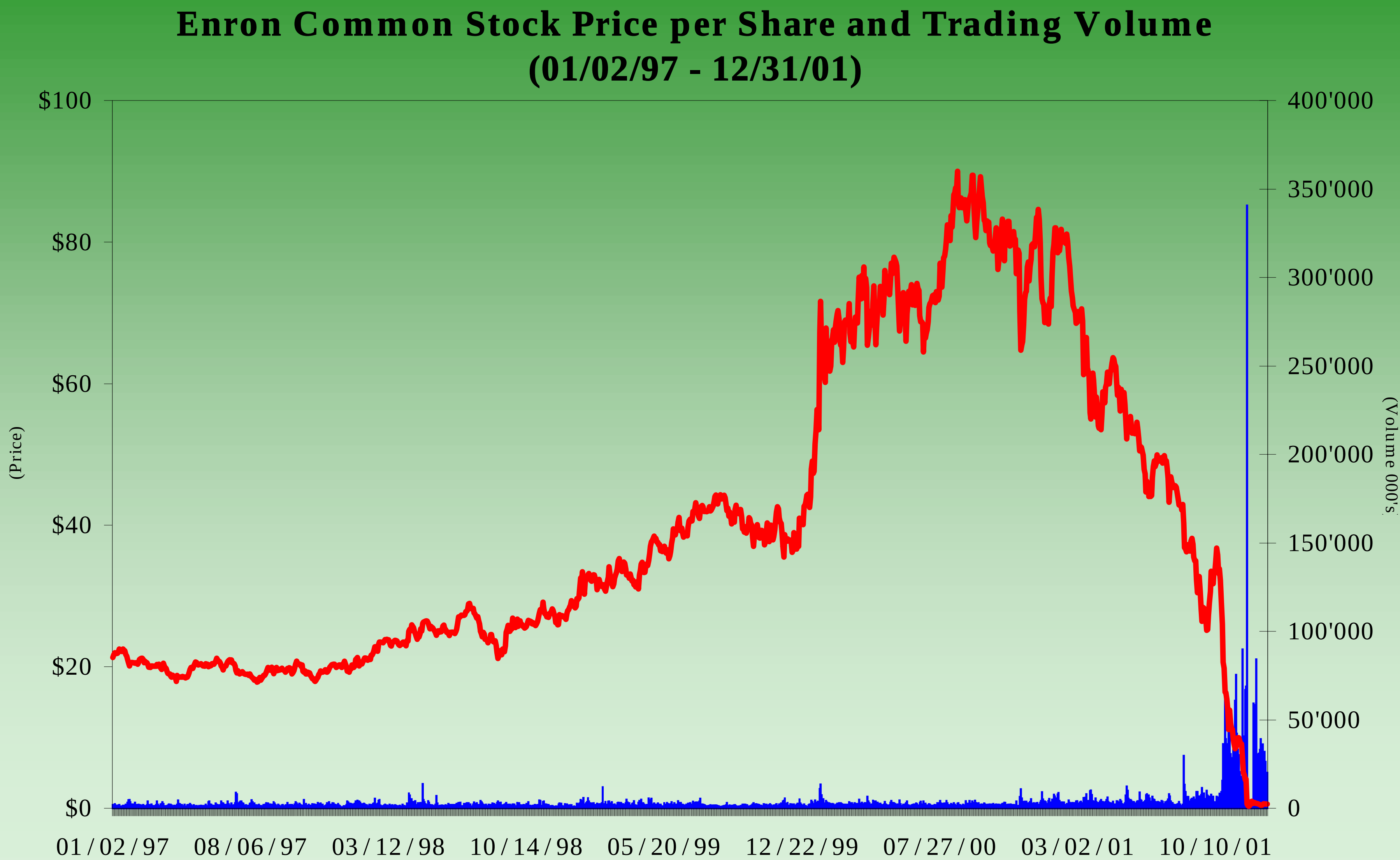
Agenda

- ***Introduction***
- Risk Management After Enron
- Structured Finance After Enron
- Corporate Governance After Enron
- Conclusion

The Good, the Bad, the Ugly…the End

Introduction



SOURCE: The Center for Research in Security Prices, Graduate School of Business, The University of Chicago.

The Good

Enron Pioneered „Asset Lite" Investment Strategy:

- Highly successful business model to exploit financial trading opportunities by acquiring information about and taking positions in physical markets with minimal capital expenditures
- Leverage intermediary assets, such as distribution systems
- „Create" new markets and liquify them by serving as a prime market maker, a „commodity bank," and an active trading operation

Enron had Some Important Successes:

- Enron's role as a gas bank fostered evolution of the gas market
- Enron helped bring badly needed liquidity to emerging markets
- Enron designed some genuinely useful and innovative financial products

Introduction

Introduction

The Bad

Enron Lost a Fortune on its „Asset Heavy“ Investments:

- While Enron was making money on asset lite in oil and gas, it was losing money on major capital intensive asset acquisitions
  - Indian power plant operation in Dhabhol
  - Water trading rights start-up firm Azurix
  - Acquisition of MG Ltd. (Metals)

Asset Lite also Did Not Work in Every Market:

- Failure of asset lite strategy in broadband market for bandwidth trading rights
- California power crisis created an „opportunity“ for Enron that some now argue it exploited using questionable methods, which, even if legal, created major PR problems for the firm

I ntroduction

The Ugly

In Need of Equity…:

- Enron's successful asset lite strategy made it *essential* for Enron to be a credit worthy financial counter party
- Enron's role as counter party to all trades in EnronOnline added to this pressure
- To compensate for its relative lack of hard assets, Enron needed to show a relatively large proportion of *equity capital*

…but in Search of Debt:

- The assets Enron did acquire were financed mostly with debt, acquired largely through special purpose entities (SPEs)
- Enron fought its way up to an investment-grade rating, but it *never* made it out of the bottom tier of investment-grade

The Best of Both Worlds:

- Enron appears to have used off-balance-sheet structured financing vehicles to conceal its true capital structure

I ntroduction

The End

- Enron's 3Q earnings release on October 16, 2001 included major losses and heavy write-downs on its ailing investments
- A $35 mn. charge-off to the LJM SPE in 3Q earnings began to raise questions about Enron's „true" capital structure
- Rumors began to spread that Enron CFO Fastow and his cronies has personally gained from LJM and other SPEs
- The stock price slid from $33 to $16 in two weeks, after which Enron CEO Kenneth Lay fired CFO Fastow
- As Enron searched for a white knight, the stock continued to slide and Enron began to experience a major liquidity crisis from counter party collateral calls and the like
- At $4 per share on November 28, 2001, the rating agencies cut Enron to below-investment-grade and thus accelerated a $690 million debt payment that Enron lacked the cash to make
- Enron filed for Chapter 11 bankruptcy protection on Dec. 2

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What Went Wrong in a Risk Management Context?

Governance:

- Lack of adequate separation between controls of Enron‘s financing SPEs and Enron itself
- Lack of oversight of senior management with respect to disclosure of off-balance-sheet financing and losses in those vehicles

Excessive Debt:

- Enron *clearly* shows the importance of equity capital
- A sound enterprise-wide risk management process should have flagged Enron‘s excessive reliance on debt finance

Independent Valuation of Financial Exposures?

- Some reports suggest that Enron may have used SPEs to create „artificial“ mark-to-market accounting compliance
- If true, Enron may have been reporting earnings based on deliberately mispriced financial market positions

What *Did Not* Go Wrong in a Risk Management Context?

Speculation:

- There is no evidence that Enron took excessive „market risk“ in its financial derivatives and trading areas
- On the contrary, Enron was well-regarded for market risk management and for its controls in this area
- Enron was not another Barings

Market Risk Measurement:

- Enron was also well-regarded for using state-of-the-art risk measurement systems
- There is no evidence that Enron‘s problems arose because senior management did not have adequate information about Enron‘s market risk on its trading books

Risk Management Lessons

- Risk management is not and should not be viewed as a substitute for sound corporate governance
- Enron's investment losses strongly underscore the need for *comprehensive, enterprise-wide* risk measurement techniques that consolidate physical asset and business exposures together with financial exposures
- Sound risk management must include evaluations of the adequacy of a firm's capital structure to support its business activities
- Firms should rely on independent valuation sources to revalue their positions
- Literal compliance with rules like FAS133 is not a substitute for risk management–*i.e.,* just because something is marked to market does not mean it has been correctly valued

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What is Structured Finance?

- Lacking any real definition, „structured finance“ can be defined anecotally as *financing mechanisms or financial products that rely on the involvement of some agent to structure or restructure the cash flow and risk attributes of a portfolio of securities.*
- In Enron‘s case, structured financing techniques were used to help camouflage the firm‘s true capital structure by raising debt in off-balance-sheet SPEs rather than directly
- A major problem with Enron‘s SPE-based financing was governance-related
  - Enron employees often managed the SPEs
  - Incentive compensation distorted asset disposition and financing decisions
  - Personal gain by some of Enron‘s senior management overshadows the real purpose of the SPEs

Legitimate Examples of Structured Finance

- Most structured finance is *legitimate*
  - Securitization programs for assets like mortgages and credit card receivables are time-tested structured finance solutions that help liquify credit-constrained markets
  - Convertible bonds, some forms of mezzanine finance, and commodity-linked debt are structured financing forms that help firms manage their borrowing costs
  - Catastrophic bonds and insurance-linked notes are a competitive structured finance alternative to reinsurance
- An SPE does not necessarily mean a firm is hiding something
  - Captive insurers are frequently SPEs, but they are consolidated on the parent‘s balance sheet and disclosed
  - *Disclosure* of the SPE is arguably much more important than the *ownership* of the SPE

Structured Finance Lessons

- There is no substitute for transparency
    - A firm using structured financing solutions today would be well-advised to engage in significant voluntary disclosure about the nature of the SPE
    - When the consolidation of a SPE on a parent‘s balance sheet is an open question, err on the side of extra disclosure and conservatism
    - If a structured financing activity appears to lose much of its benefits if it must be disclosed, don‘t do it
- Independent structured finance reviews can be essential
    - Third-party examinations of structured financing solutions can provide investors with an extra degree of comfort about the purpose and legitimacy of the enterprise
    - Careful attention to modeling residual ownership interests in SPEs is sure to become a major focus of regulators, investors, and supervisory authorities

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Corporate Governance After Enron

Enron's Fatal Governance Flaws

- Conflicts of interest for managers of the SPEs *vis-a-vis* their loyalties–did the SPE or Enron's shareholders come first?
- Conflicts of interest for Enron's senior management–erring on the side of conservatism with respect to disclosure of the SPE-based financing would have jeopardized the firm's perceived credit rating and its entire asset lite business strategy
- Where were Internal Audit, the Board of Directors, and the Board Audit Committee throughout all this?
  - Did they have adequate information and fail to act?
  - Did they have inadequate information through a failure of the reporting process?
  - Were they simply deceived?
- There seems to have been a major lack of oversight of Enron's fundamental asset acquisition decisions

Corporate Governance After Enron

Solutions

- Principal-agent conflicts are inevitable in modern corporations
- A powerful policing mechanism to mitigate problems arising when agents (*e.g.*, managers) take actions contrary to the interests of principals (*e.g.*, shareholders) is the „market for corporate control“
  - Without adequate disclosure and transparency, the market for corporate control does not function particularly well
  - Take down regulatory and other barriers to takeovers and artificial mechanisms that support entrenched management
- Remove political barriers to „delegated monitoring“
  - External parties like rating agencies, insurers, and auditors should police a firm‘s disclosure and, at least indirectly, its governance
  - Remove barriers to delegated monitoring, such as unnecessary liability for the monitors

Non-Solutions

- Debates over how to improve corporate governance are as old as firms themselves, and are not easy to resolve
- In some ways, it is easier to identify *what not to do* and *what will not help* than the converse:
  - Additional personal liability for corporate officers is unlikely to help and will simply make it hard to find quality officers
  - Additional liability for Boards or Audit committees is also likely to make it hard to attract quality to these positions and thus is not likely to improve things, and skyrocketing D&O insurance will not help matters
  - Establishing a government oversight agency for accounting and disclosure will discourage voluntary disclosures of the sort that might have saved Enron
- Too much regulation constructed as a „stop-gap“ Enron response could just drive firms into friendlier regulatory and listing environments

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Conclusion

What Might Save Firms Like Enron in the Future?

- In the absence of governance problems and an essentially fraudulent capital structure, Enron still had major problems. What can firms *like* Enron learn from Enron's mistakes?
- Consolidated enterprise-wide risk management is essential
  - Integrated analysis of investment and trading activities
  - Comprehenive analysis of capital at risk
  - Investment quality evaluated through risk-adjusted return on capital (RAROC) lens
- If structured finance is desirable, engage in frequent disclosures and err on the side of too much transparency
- If more equity capital is required to support a fundamentally sound business, it is probably available in some form:
  - Contingent equity capital and other ART forms
  - External guarantees and synthetic equity to enhance entities like EnronOnline