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

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Agenda

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- Structured Finance After Enron
- Corporate Governance After Enron

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The Good, the Bad, the Ugly…the End

Enron Common Stock Price per Share and Trading Volume
(01/02/97 - 12/31/01)

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
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
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.
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 anecdotally 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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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–errring 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
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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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
  • Comprehensive 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