

The Brick Stood Up Before. But Now?

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Once upon a time, three little pigs invested in Enron ([news/quote](#)). The first built his portfolio from the flourishing golden straw of Enron stock, and beamed as it doubled and tripled in value. The second chose the unseasoned lumber of Enron bonds, pleased with the generous interest they paid. The third, preferring safety to high returns, took shelter behind double-walled brick: short-term Enron notes backed by collateral and guaranteed by both a bank credit line and an insurance policy.

When the wolf arrived at Enron's door last fall, forcing that once-swaggering company into bankruptcy, Enron's stock incinerated like dry grass, and its bonds smoldered down to pennies on the dollar. Not even Enron's mighty bankers expect to retrieve all of the billions in unsecured loans they made to the shattered giant.

But according to credit analysts at Moody's Investors Service, the holders of those short-term Enron notes — called asset-backed commercial paper — have collected every penny of the \$58 million they were owed.

The tools that built that storm-proof shelter are known collectively on Wall Street as "structured finance." Over the last 30 years, Wall Street has used these techniques to create more than \$5.2 trillion in asset-backed securities in the United States alone, with an additional \$305 billion expected to be issued this year. International issues patterned on the American model are proliferating, especially in Europe.

Home mortgages, car loans, credit card debt, student loans, equipment leases — all these assets, and more exotic ones like future receipts from British pubs and the box-office take for Steven Spielberg's future movies, have been remodeled into asset-backed securities. Those securities can now be found generating handsome returns for pension funds, mutual funds, banks, brokerage houses, insurance carriers, hedge funds and even some individual investors. A result, bond market experts say, has been the expansion of credit to consumers, greater liquidity and flexibility for lenders and the modulation of risk for corporations.

There's just one problem: The same financial tools used to create asset-backed securities were also used to construct the elaborately camouflaged and booby-trapped partnerships that have been blamed for Enron's collapse. As a result, those tools are suddenly attracting the suspicious scrutiny of regulators, lawmakers, bankruptcy judges and investors. And that is making everyone in the profitable and well-paid world of structured finance very nervous.

"Enron gives a very useful tool a bad name for no reason," said Ronald Gilson, a law professor at both Stanford and Columbia. "Structured finance is used for a zillion different and worthwhile purposes. The problem is Enron used it to create a structure that was genuinely not transparent, to hide things."

His concern was echoed by David M. Eisenberg, a partner at the law firm Simpson Thacher & Bartlett and a pioneer in securitization, the process of creating asset-backed securities. "Any financing techniques can be abused," Mr. Eisenberg said. **"Securitization is not special in that. But true securitization is about transferring risk to others — and**

Enron only appeared to be doing that, when in reality they were retaining the risk themselves."

In an effort to distinguish asset-backed securities from the more Enron-like uses of structured finance, the Bond Market Association, an industry group representing securities firms and banks, has been lobbying Congress and issuing white papers that defend the asset-backed securities market as "flexible and efficient financing that benefits everyone."

Moody's Investors Service, a bond-rating agency, is preparing a primer to help investors understand the garden-variety securities that make up the public market. One recent Morgan Stanley report on asset-backed securities, perfectly capturing the new battle cry, was simply titled "This Is Not Even Close to Enron."

But in fact, many of Enron's off-balance-sheet partnerships, on paper, are simply wildly complicated permutations of the basic structures involved in the creation of asset-backed securities: special-purpose entities, credit enhancements and contractual arrangements — including interest-rate swaps and other derivatives — that move assets, and the risks and rewards of owning them, from one entity to another.

Consequently, whatever courts, regulators, lawmakers, accountants and investors decide about the permissible uses of special-purpose entities could have far-reaching and unintended consequences for Wall Street's highly profitable structured-finance business. And that, in turn, will affect the companies that rely on structured finance to solve legitimate credit and cash-flow problems.

THE market's current suspicion about any corporate use of structured finance could hit hardest at companies already struggling with the weak economy, warned William C. Repko, managing director of the restructuring group at J. P. Morgan Chase ([news/quote](#)), a leader in structured finance. "My nervousness is that we may have a perfectly fine company out there that can't satisfy the market's demand for disclosure and we'll have a liquidity crisis," he said.

Indeed, the earliest use of structured finance was to provide lifeboats for financially swamped Rust Belt companies like International Harvester and the financing arm of Chrysler. Mr. Repko, a bluff and genial raconteur, still has the yellowing paperwork for those 20-year-old deals. In each case, a special-purpose entity was created, legally distinct from the parent, to buy the troubled company's accounts receivable — money it expected to receive from its customers — and to borrow from banks, using those promised revenues as collateral.

In those prototypes, the special-purpose entity borrowed only from banks or other financial institutions. The more exotic ones, like most of Enron's, still do. But as investors and rating agencies became more comfortable with the technique, special-purpose entities were able to borrow by selling notes to public investors, offering them the safety of collateral and the comfort of dealing with entities less likely to be dragged into bankruptcy if a sponsoring parent got into trouble.

Today, the supply of such notes rivals the conventional corporate bond market. But the first step in creating each note was the birth of a special-purpose entity, a sort of talented box that can hold all kinds of assets and can borrow money, from banks or through the sale of securities, using those assets as collateral.

In "plain vanilla" deals, that is about as far as it goes — a special- purpose entity, for example, buys a pool of car loans from the General Motors Acceptance Corporation ([news/quote](#)), using money it got by selling public securities that are collateralized by those loans. Interest and principal payments on the car loans are used to make interest and principal payments on the asset-backed notes.

The same techniques work for student loans, credit card debt and, of course, home mortgages, which are the granddaddy of all asset-backed securities although they are generally treated as a separate genre.

BUT it can become a lot more creative than that, said Jay H. Eisbruck, senior vice president for structured finance at Moody's ([news/quote](#)). By the end of the 1990's, Wall Street's financial carpenters had created special-purpose entities whose securities were backed by almost any stream of future cash flow you can imagine, from court judgments to Medicare payments to music royalties to, yes, the bar tabs at British pubs and the future ticket sales for a diverse portfolio of DreamWorks movies. (The collateral for one such deal included the ticket sales for "Saving Private Ryan.")

Deals like that almost always require some sort of credit enhancements to assure investors that if the expected revenues fail to materialize — because of a sudden outbreak of temperance in London, perhaps — someone will make sure they are paid. A financial guarantee from a bank or insurance company is always appreciated, but investors will often simply accept a stack of collateral that greatly exceeds the face value on their notes.

Special-purpose vehicles are also central to the creation of synthetic leases, another product from the structured-finance carpentry shop that has been used by a host of companies — including, unfortunately for its advocates, Enron. A special- purpose entity set up by Enron bought the company's headquarters building in Houston and leased it backed to the company.

Often, such special-purpose vehicles raise the money to buy the buildings by selling notes to outside investors, just as in traditional securitizations. Thanks to quirks in accounting rules and tax regulations, this arrangement allows the original corporate owner to remove mortgage debt from its balance sheet while still claiming a tax deduction for the interest on the debt.

When a special-purpose entity need not rely on public investors to raise money, however, the architecture can become baroque, with cantilevered extensions, balconies and breezeways that attach to other deals. And that is what happened at Enron.

Consider what is known in Enron circles as "the Sequoia deal," an arrangement that created a source of funds suspended somewhere between equity and debt.

It was based on a template devised a decade ago by Goldman Sachs ([news/quote](#)), which called the securities involved Monthly Income Preferred Stock, or M.I.P.S. These once-novel but now widely used securities give issuers the tax benefits of debt but look like equity on their balance sheets. (Rating agencies and analysts are not fooled, said Brian M. Clarkson, senior managing director for structured finance at Moody's, and unlike some Enron deals, such arrangements are usually fully disclosed.)

Merrill Lynch ([news/quote](#)) followed with its own twist on M.I.P.S., and other investment banks developed their own refinements, adding a bell here or a whistle there. J. P. Morgan

Chase customized it for Enron, expanding the floor plan to include no fewer than four interconnected special-purpose entities:

- At the hub was Sequoia, which bought accounts receivable from Enron and paid for them with money borrowed from the special entity next door, called Cherokee, through the private sale of some asset-backed notes.
- Cherokee, controlled by Enron through another entity called Cheyenne, got the money to lend to Sequoia by selling Cherokee common shares to Enron and selling those chameleon-like preferred shares to an adjacent independent entity called Choctaw.
- Choctaw was controlled by outside equity investors and financed by bank loans organized by Morgan.

Then, after the financial carpenters from Morgan had swept up the sawdust and left Houston, Enron expanded the deal on its own, adding another matching wing that stretches off the Sequoia hub, with the money raised through a fifth special-purpose entity called Zephyrus.

The resulting Sequoia structure resembles the original M.I.P.S. template about as much as the space shuttle resembles the Spirit of St. Louis. And it has had a few malfunctions under the stress of Enron's bankruptcy. J. P. Morgan Chase has had to sue Enron to get an accounting of the assets contained in Sequoia, which it argues are the property of the secured lenders.

(Unlike the owners of Enron's asset-backed debts, who will quickly get all their money back thanks to those bank lines of credit, secured lenders like banks and bond holders may wait years to find out how much, if anything, they will recover.)

MORGAN has also had to sue to force a group of insurance companies to honor the financial guarantees that the bank obtained to enhance the creditworthiness of another elaborate structured-financing deal it did for Enron, the oft-scrutinized Mahonia arrangements, whose fund-raising architecture included the use of various derivatives.

And, like all of Enron's lenders, Morgan now knows that its client had used some structured-financing techniques to conceal billions of dollars of debt from lenders, investors and credit analysts.

"It would appear that none of Enron's service providers or bankers saw the entirety of what Enron was doing," said Bill Winters, co-head of the fixed-income trading operation at J. P. Morgan Chase. "The entirety was known only to Enron."

The skepticism that was absent in Wall Street's earlier analysis of Enron's use of structured finance has returned with a vengeance and spread like a virus.

Accountants and those who write accounting standards have undertaken a wholesale review of how special-purpose entities should be disclosed to investors in audited financial statements. "This is something that is definitely going to be changed in the next year," said Paul K. Chaney, associate professor of management at Vanderbilt University.

A lot is riding on that change, said Martin Rosenblatt, a partner at Deloitte & Touche. The special entities used in most of the traditional forms of asset-backed securities — those backed by mortgages, car loans and credit card debt — will probably not be affected, he

said. "But everything else that uses a special-purpose entity is up for reconsideration," he said.

The trick, he said, is to give information about the entities "without making it appear that the company has debts that it does not really owe or assets that it does not really own."

Aside from actual rule changes, Professor Chaney said, the Enron mess is likely to make outside auditors much more curious about the special-purpose entities they find. "Today, no company is too big to say no to," he said.

How Congress and regulators will react is still uncertain. After the scandal broke, legislators who are considering a bankruptcy-reform bill withdrew a proposal to give extra protection to the most common special-purpose entities. "That's one of the casualties of Enron," said Mr. Eisenberg, the securitization lawyer.

And lawmakers at Enron hearings have already criticized the M.I.P.S.- style preferred stock issues the company used, "although they have been blessed by the I.R.S. for a decade," one investment banker fumed.

Enron's own trip through bankruptcy is another source of uncertainty for structured finance. Court decisions tailored to the facts of one case can have broader repercussions — as when, 18 months ago, a bankruptcy judge in the case of the LTV Corporation ([news/quote](#)) refused to recognize the claims of some special-purpose entities to which LTV had sold assets.

J. P. Morgan Chase is dug in on this front, trying to defend its rights under the numerous contracts drawn up to create the Mahonia and Sequoia transactions. "We thought we had hedged some of the risk, but as it turned out the insurance companies don't want to pay," said Mr. Winters at Morgan. "We've learned a valuable lesson from that."

Mr. Clarkson of Moody's agrees that credit analysts will be hyperalert to information about structured finance. But he cautioned that no amount of outside scrutiny could defend from deliberate obfuscation and fraud.

The most immediate threat to exotic forms of structured finance — and certainly to the heavily camouflaged structures preferred by Enron — may come from the marketplace. "The markets are a great carburetor," Mr. Winters said. "Companies that cannot tell a very convincing story about their exposure right now are being punished."

His colleague, Mr. Repko, expects a lot more disclosure about special-purpose entities in the financial statements that companies will file with the Securities and Exchange Commission over the next two months. "By virtue of the market's obvious distaste for these things, anyone who is halfway intelligent is going to be disclosing them," he said.

Indeed, the mere mention in the media that Krispy Kreme Doughnuts ([news/quote](#)) was planning to use a synthetic lease to finance a factory project caused such a backlash that the company swiftly abandoned the plan in favor of more traditional financing, Professor Chaney noted.

Most likely, after some initial nervousness, structured-financing deals that serve a clear economic purpose and that can be clearly explained will continue to be done. And deals that smack of earnings manipulation, debt concealment and self-dealing will get a lot more scrutiny.

"Most of the techniques that Enron used are legitimate tools that were totally abused," said Hans Stoll, who directs the Financial Markets Research Center at the Owen Graduate School of Management at Vanderbilt.

BUT the "key to the safe" is disclosure, said Professor Gilson, an opinion echoed by many.

Companies that want to use complicated structured-financing techniques should be prepared to explain them completely, he said. And in plain English, please — if only to demonstrate that the board of directors and chief executive understand the deals themselves. (Don't even try to persuade anyone that a structured-finance deal involving a closely related party — the company's chief financial officer, for example — is a good idea, he added.)

But it would be a shame, he said, if the tools of structured finance came to be seen as the equivalent of skeleton keys and safe-cracking implements. Like electric jigsaws and battery-powered screwdrivers, they can be used to create shelter from hardships, safe exits from risky places, room to grow and a stable foundation. But like all tools, he said, they are only safe if used at arm's length in the daylight.