Untangling Enron: The Reforms We Need

Interview with Randall Dodd

This derivatives expert warned about Enron's problems long ago. He believes that there will be other Enrons unless new disclosure and capital requirements are imposed on the over-the-counter derivatives markets. In this interview, he tells us what happened at Enron and how most effectively to prevent its recurrence.

Q Tell us what kind of company Enron was? How did it grow so rapidly? How did it book such profits?

A. Enron was, in essence, two companies. One was an energy supply company that purchased real physical assets such as pipelines and electrical power plants in order to provide energy. The other was a financial institution that functioned as a major dealer in wholesale and derivatives transactions in energy products, other commodities, and some financial derivatives.

Q What is a derivative? Why can it be risky?

A. There are four basic types of derivatives transactions:

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forwards, futures, swaps, and options. These instruments are sometimes combined to form more complicated transactions, but in the vast majority of cases, they are straightforward versions of these four types.

A derivative is a transaction that creates price exposure, that is, exposes the contracting parties to the risk of a change in price based on some underlying commodity, security, interest rate, or event. Derivatives, in contrast to a security or loan, generally do not involve ownership or title. If you buy $100,000 in Treasury notes at par and the price rises 10 percent, then your investment of $100,000 appreciates $10,000, or 10 percent. If you enter into a derivative to buy $100,000 of Treasury notes at par and the price rises 10 percent, then you can sell for a $10,000 gain. The difference is that you never owned the Treasury notes, and your investment was not $100,000 but perhaps as little as $3,000 deposited as margin or collateral. Using a derivative to obtain $100,000 in price exposure with $3,000 in margin means that it is a very leveraged position.

Derivatives can be risky for several reasons. The major reason is that investors can use derivatives to take larger risks than they could otherwise obtain by the use of the capital to directly purchase securities or other assets. Another reason is that derivatives, even when used to reduce or hedge risk, create new risks in the form of credit risk. Credit risk is the exposure to a counterparty's inability to fulfill the derivative contract. Yet another risk is that derivatives markets can become illiquid and prevent the market participants from adjusting or unwinding their positions.

Q How did Enron grow so rapidly?

A. The energy supply business grew rapidly by using debt to purchase a large amount of plant, equipment, and inventory in

the United States and abroad. For instance, two of the biggest losses that triggered its failure were an electric power plant in India and a water treatment facility in the United Kingdom. This rapid accumulation of assets, which was financed by bank loans and debt issuance, produced a high debt-to-equity ratio that was partially hidden from investors through the partnerships known as "special purpose entities." The financial institution grew rapidly by profiting from the broader growth in derivatives trading in general, plus profiting from trading during the energy crisis in California in the summer of 2000. Enron's trading activities were reported to be very innovative and aggressive, and its foray (although ultimately unsuccessful) into trading broadband access and wood pulp certainly bore this out.

Enron made large profits from its trading activities because it was both a dealer and a key market participant in the underlying commodities. Dealers make money in two ways. First, they earn the bid-ask spread as market makers when other market participants come to them to buy or sell. As long as Enron buys at a lower bid price than it sells at its offer price (also called ask price), it earns the bid-ask spread on trading volume. However, if all other market participants cease trading with Enron, then this lucrative business evaporates. Second, it earns speculative profits by taking a position in the market. In this capacity, Enron's dual role as energy supplier and dealer enabled it to have an advantageous "view." It had more information on the market. That enhanced its ability to earn speculative profits trading against other sophisticated and unsophisticated counterparties in the markets.

Q. Give us an example of how that can be an advantage.

A. The energy supply side of the company had the practical knowledge of energy producers about production costs, distribution problems, and sales opportunities, and any changes in that environment could be shared with Enron's trading desk.

On the dealer side of the company, it had the most immediate information about the order flow as market participants came to them to either buy or sell. If there are many more orders to buy than to sell, then it is a clear signal of upward price pressure. Enron as a dealer could share that information directly with its energy-supply operations.

Q Is there evidence that Enron was particularly aggressive about this kind of investing? Was it similar to Long-Term Capital Management (LTCM)?

A. This is precisely where it was most aggressive—and innovative. It created—or at least tried to create—centralized wholesale markets and derivatives markets where none existed before. These included bandwidth access, wood pulp, and nonprecious metals. It also ventured into weather derivatives and online credit derivatives.

LTCM, in contrast, did not create markets but merely sought to gain by trying to exploit pricing irregularities in markets that already existed. Enron both created markets and brought more sophisticated trading efforts to existing markets, while LTCM did only the latter.

Q. Was its success tied to rising energy prices?

A. I do not think its success was tied to rising prices. That would amount to assuming that it was always long, very long. The scuttlebutt I hear is that Enron was long to the same extent that other energy suppliers and wholesale traders were long. The decline in energy prices caused modest losses elsewhere, and by themselves would have resulted in similar modest losses at Enron.

Q Was there a straw that broke Enron's back?

A. There was no one straw or single reason it failed. Rather, it was a case that is best captured by Yogi Berra in explaining the Yankees' loss in the 1960 World Series, "We made too many wrong mistakes."

Here are the major "wrong mistakes" that Enron committed. Enron's energy supply business suffered heavy losses on such ventures as an electrical power plant in India and a water treatment plant in the United Kingdom. Enron also lost money trying to create markets in bandwidth access, steel, and other commodities. Adding to these losses, Enron failed because its management was allegedly caught defrauding the market with false reporting, tax evasion—or misreporting income—and manipulating accounting rules. Derivatives were used in the pursuit of each of these misdeeds. In response to these alleged misdeeds, and the downgrading of Enron's credit ratings, market participants lost trust in Enron and ceased to trade with it. Without the trading volume, Enron was without liquidity and without the volume that turned bid-ask spreads into large earnings. In the end, the greed that led to bad investment decisions, and the apparently criminal behavior that could have led to fraudulent hiding of debt and losses and the fabricating of income, proved to be a deadly combination.

Q. Is Enron, then, basically a financial institution? If so, what kinds of regulations do conventional financial institutions have that Enron does not?

A. Enron was a financial institution, and by all appearances a large one. However, it was subject to no federal regulation as a financial institution. The quarterly reports it filed under the securities laws pertained to Enron only as a corporation in general. All corporations that issue publicly traded securities must file such reports. However, financial institutions in the areas of

banking, insurance, mutual funds, pension funds, securities, and brokering of exchange-traded futures and options are subject to some basic safety, soundness, and transparency requirements that Enron and similar over-the-counter derivatives dealers are not. So Enron had no capital requirements, no margin or collateral requirements—the standards used by Enron turned out to be disastrous—no reporting requirements, no licensing or registration requirements, and there was no obligation as a dealer to make a market by maintaining bid and ask quotes as "specialists" on stock exchanges do. Traditional financial institutions must meet all these requirements.

Q. What did the Commodity Futures Modernization Act (CFMA) of 2000 do?

A. First, let me point out that the over-the-counter market in derivatives has never been adequately regulated. The market emerged only recently, and most of its growth has occurred in the past fifteen years. At first, this market was largely ignored by regulators, and after it grew to a size that demanded it be addressed, the regulators found it difficult to define the line of jurisdiction over the markets because of poorly written laws and richly endowed political opponents to such regulation.

Before to passage of the bill in December 2000, the government retained authority over fraud and manipulation in the over-the-counter derivatives markets. In addition, market participants were restricted under Rule 35 from conducting over-the-counter markets like an exchange.

The CFMA was a major bill that drastically reduced the level of prudential regulation of derivatives markets. It reduced transparency and the government's surveillance abilities over exchange-traded derivatives, and it completely eliminated or "excluded" federal derivatives regulation of the over-the-

counter market. Enron operated in that completely deregulated environment.

Q Are there other Enrons out there?

A. There certainly are other "Enron" trading firms and "Long-Term Capital Management" hedge funds out there. They may even be as large, but they are unlikely to be characterized by the level of criminal behavior or arrogance as their predecessors.

Q Was there a point at which the federal government could have or should have stepped in?

A. Enron illustrates the problem with the laissez-faire approach to financial markets. Safeguards must be put in place first so that they precede market activity. Once a crisis emerges, there is little that can be done. The only action that might have proved effective was a quick and complete sale of Enron's trading operation that would have restored and ensured an investment-grade credit rating to that part of its business. The efforts to sell to Dynegy came too late and were too burdened by the effort to sell the heavily mortgaged physical assets and the highly leveraged "partnerships."

Q. Could the Enron management or the auditors have intervened soon enough to save the company and its shareholders?

A. In the first place, management should never have created these partnerships and capitalized them in the way it did, and the auditors should never have condoned that activity. Once those actions were committed, the damage only grew over time. Even if the partnerships had all been dissolved within three months, Enron would still have been liable to shareholders for fraud, and it still would have damaged the market's trust in the corporation.

I should point out again that this situation illustrates the importance of having the right rules in place from the beginning.

Q Many people say that the failure of Enron will not affect the financial markets. Is that true? Don't a lot of banks have exposure to the company?

A. The failure of Enron has already had an impact on U.S. and foreign financial markets. Although not cataclysmic, the collapse of Enron did cause substantial damage throughout the financial system. JPMorgan Chase, Citicorp, and the Bank of New York—to name just three—recently announced multi-hundred-million-dollar write-offs from their exposures to Enron. In response, Standard and Poor lowered its outlook for JPMorgan Chase from stable to negative. The second-largest mortgage bank in the United Kingdom lost $160 million, and a couple of Japanese banks lost so much on investments held in money market mutual funds that they had to cut the principal below par on those money market accounts.

As bad as the damages were, the fear was even greater. Back in December, there was a flood of corporate press releases announcing the amount that firms expected to lose due to Enron's bankruptcy. This voluntary publicizing of losses indicated that the fear was greater than the fact. It amounts to an ex-post-facto transparency born out of crisis.

Some say that the hands-off regulatory approach is justified because of the absence of a systemic collapse leading to economic conflagration. That is too high a hurdle and not the right standard for judging whether certain financial activities create a source of vulnerability or instability to the overall economy and thus the public interest. Enron is the largest bankruptcy in U.S. history, and it will inflict substantial damages on U.S. banks, broker-dealers (who are already being sued for under-

writing currently worthless Enron securities), insurance companies and pension funds that invested directly in Enron, energy companies, many small and large investors, and Enron's own employees.

Q What reforms, disclosure requirements, or regulations would you recommend?

A. I would recommend a set of prudential financial market regulations that are of three types. They are similar to regulations in other sectors of the financial system, and they should be applied to all financial institutions and derivatives transactions in order to improve safety and soundness and to maintain regulatory parity.

First, establish capital requirements and collateral-margin requirements. Capital requirements are critical to preventing the problems at one firm from becoming problems at another firm, and they prevent short-term problems at a dealer from causing the market to freeze up or melt down. Collateral-margin requirements do the same for each transaction. Collateral and margin requirements are not designed to protect fools from themselves but to protect the rest of us from the fools.

The current market practice for the use of collateral, insofar as there is one, is dangerous. It requires a firm to become "supermargined" if its credit rating drops. This means that a firm must post additional collateral for each position. Thus it requires additional funds just at the time the firm is in trouble for insufficient capital. This amounts to a crisis accelerator.

Second, establish registration and reporting requirements. All derivatives dealers and nonhedges should be licensed and registered for their participation in the markets. This is the same approach for securities markets, banking, insurance, and exchange-traded derivatives, and it should apply to over-the-

counter derivatives markets as well. Reporting requirements will make the markets transparent for the first time and allow the government's market surveillance efforts a chance to detect problems before they become a crisis.

Third, require derivatives dealers to act as market makers throughout the trading day by maintaining bid and ask quotes. They capture the advantages of their position in the market, and, like dealers in U.S. government securities (the most efficient and highly regarded over-the-counter market in the world), they should be obliged to act as market makers throughout the trading day. This will ensure market liquidity as they maintain bid-ask prices continuously through trading hours.

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