January 22, 2002

The Honorable James A. Leach
Chairman Emeritus
Financial Services Committee
U.S. House of Representatives

Dear Jim:

I know that much titillating testimony will be taken about ENRON. There will be testimony about conflicts of interest, timing of disclosure, the role of external auditors, shredding of documents etc. The fact is these are matters which are already covered by existing rules, regulations and laws. I would suggest that the heart of the matter, far more difficult to describe in TV quick bites, newspaper reports, talk shows, or Congressional hearings is the nature of the transactions which caused ENRON to suffer such huge losses and precisely why and how the accounting rules permitted "wriggle room" not to disclose the transactions and their implications. I am convinced that ENRON is just the latest in a long series of scandals. As I have written over the last sixteen years, assuredly there will be other scandals of equal, if not greater magnitude, unless and until the regulatory authorities understand completely and fully the nature of off-balance sheet transactions and their implications. I ask your indulgence and hope that you forgive what may seem a lack of modesty, if I summarize below, yet again, my prior Congressional testimony and commentaries on this matter.

Sixteen years ago, in 1986, in a speech entitled, "Be on Guard in the Glittery World of Financial Innovations," I spoke of the implicit dangers of the derivatives markets and their accounting. The theme simply was that existing accounting conventions permit us to cover up the implications of off-balance sheet and leveraged transactions. In the 1990s in a piece entitled, "The Only Perfect Hedge is in a Japanese Garden," the article warned against "the use of accounting conventions" which are "irrelevant to financial risk management," and discussed the dangers of relying on "the seduction of accounting conventions." The article notes:

> "We, generally, do not mark to market. Many of the products are unmarkable. We do some transactions explicitly because our mistakes can be hidden, because accounting conventions do not record them, either because they are ad hoc or there is no market, or worse, they are off balance sheet. There is, typically, little reality testing. . . . And when losses can be ignored, greater risks are taken. I cannot take the time here to describe the latest FASB proposed draft on derivative accounting—they aren't bad; they are a beginning, but they are deficient—because they will

not, yet, put you under the pressure involuntarily of admitting to failure, risk and error."

Unhappily, in a somewhat prophetic vein, the article noted:

> "Sometimes, too, there are pressures for the financial operations to make up for, as a profit center, the shortfalls in the main-line business. The responsibility is sometimes initiated voluntarily in an effort to show that the corporate treasurer/CFO does not merely publish accounting statements and issue commercial paper, but is intimately involved in determining whether or not the company makes a profit and a yet higher return on its equity. For multi-national corporations, the correct timing of a move in the foreign exchange markets can do wonders to offset a fall-off in sales."

Eight years ago, after a series of public scandals involving the derivatives market, I again noted the inadequacy of accounting conventions to record off-balance sheet transactions, before the House of Representatives Committee on Banking, Finance and Urban Affairs on June 24, 1994. (That testimony followed my 1991 testimony in which I argued in favor of an independent study of derivative products and their financing.) I testified in 1994:

> "A lot has already been written and reported about derivatives: a minority staff report from this committee, Congressional hearings, a GAO study, a Group of Thirty report and commentaries by virtually every accounting, banking and securities association. There have been press reports of losses by dealers and corporations, lawsuits, investigations and attention by every relevant regulatory agency. For purposes here, let me try to focus on why the subject matter has and will likely cause a great deal of continuing stress. I believe it is a peculiar combination of five unique and potentially dangerous circumstances.
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> First derivatives can be used to leverage risk – interest rate, currency rate, share prices – without putting up a lot of money. That simply means that during a period of volatility, losses or gains are magnified manyfold. And often the leverage is asymmetrical; that is, the potential gains are limited, while the losses may be multiples of the maximum gain.
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> Second, current accounting conventions mask error, risk and mistake. They are not designed as risk management tools. They have tax consequences, which may be one of the reasons why it has been so difficult to develop a comprehensive set of conventions which also can be used for risk management purposes.
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> The truth is we do not, generally, mark derivatives to market...

> Third, senior managers are rarely as informed as traders, and legislation is not likely to make them so. Typically, senior management is usually unaware of the technical operations of financial engineering. Worse, they are often afraid to ask, out of concern of admitting to their lack of mastery over the subject matters, and I think we also must admit to the fact that there is a good deal of underlying hostility to financial superstars, mathematicians, physicists. . . . Management is not trained in the intricacies of convexity or volatility. As a result, reports are inadequate, supervision thin. Risk management leaves a lot to be desired. . . .
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> Fourth, many products, particularly over-the-counter derivatives and aspects of the mortgaged-backed market are idiosyncratic, ad hoc, unpublicized, illiquid. That means they are difficult, if not impossible, to price or value. It means that if held as collateral, there may be no buyers in the event of a forced sale, or the spreads between buyers and sellers may be so wide that even hedges are ineffective.
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> This brings me to my final point and, to my own mind, the most important. We have enough essays, surveys, studies, green books, Basle guidelines, international studies about credit risk, basis risk, legal risk, event risk, operational risk. They are all fine and so will be future ones -- whether mandated by legislation or done voluntarily. But they all read like a cross between graduate school theses, at best, and a public policy consultant's think-piece. We are writing essays without really knowing, in a systematic fashion, how the market works. We need far more precise day-to-day market information on who does what; how is it financed; how do bankers and dealers pass on their risks; how is leverage actually accomplished, etc."

Little, if anything, however was done. There were more scandals, more losses (Orange County, Barings, Merrill Lynch, Sumitomo Bank, Long-Term Securities, etc.). Again, I was asked to testify before the House of Representatives Committee on Banking, Finance and Urban Affairs, and I did so again on October 1, 1998.

And, again, I testified:

> "Little has changed from that testimony (House, 1994). I can only repeat, yet again, my primary recommendation: An independent study, authorized by and reporting to Congress should address the forgoing matters, conducted with subpoena power. It should not be an essay, survey or boiler-plate descriptions of the "market." The truth is there is very little expertise within the federal regulatory supervisory agencies as to precisely how the financing and leveraging is actually done in practice. That must be determined by a dedicated group with full access to the most sophisticated and active players in the market. Then, after the facts and operational practices and procedures are fully understood, the study can

then address some very difficult policy issues, e.g., 1) how to monitor or constrain activities in a global cross border market with different (or non-existent) regulatory structures; 2) how to share information about credit exposures without running afoul of anti-trust, privacy or competitive considerations; and 3) how to monitor and constrain "leverage."

Recently, at an SEC seminar in the Spring of 2001 and again in October 2001, at a symposium honoring the 40th Anniversary of the SEC Special Study, I argued that the single most dangerous, least understood, and poorest disclosed product in the securities markets were derivative transactions. I argued that the scandals and excesses were and are predictable. And they will occur again, particularly if we continue to avoid confronting the fundamental issues of leverage, off-balance sheet transactions and the deficiencies of the accounting for such transactions. While headlines surely will be made of document shredding, far more important from a public policy perspective is exactly what the off-balance sheet debt was used for, how much leverage was involved, who lent the money, what was the collateral for the debt, and, perhaps most important, what were the exact transactions resulting in such huge losses for ENRON.

Kindest regards,

Eugene H. Rotberg

cc: The Honorable Harvey Pitt
Chairman, Securities and Exchange Commission