TESTIMONY OF RONALD M. BARONE

MANAGING DIRECTOR, STANDARD & POOR'S RATINGS SERVICES

BEFORE THE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

COMMITTEE ON GOVERNMENT AFFAIRS

UNITED STATES SENATE

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Good morning, Mr. Chairman and members of the Subcommittee. I am Ronald M. Barone, a managing director in the Corporate and Government Ratings Group of Standard & Poor's Ratings Services. From 1994 until Enron Corporation's bankruptcy in December 2001, one of my roles at Standard & Poor's was to serve as a corporate analyst with respect to Enron. I was the primary Enron analyst from mid-1996 until early 2000 and then became and have remained the manager of Standard & Poor's ratings work for Enron.

I am joined today by Nik Khakee, a Director in Standard & Poor's Structured Finance Group. Mr. Khakee serves as Global Co-Head of Derivative Ratings. Mr. Khakee is Standard & Poor's senior analyst regarding credit derivatives-based Structured Finance transactions and was the senior analyst involved with our work on the Yosemite and Credit Linked Notes Trusts. The comments I will make a little later regarding those trusts were prepared by Mr. Khakee.

On behalf of Standard & Poor's, we welcome the opportunity to appear at this hearing. Standard & Poor's shares the Subcommittee's urgent sense of the need to investigate all the circumstances relating to Enron's collapse and its impact on the financial markets to prevent future harm to employees, shareholders, investors and the financial marketplace itself of the sort that has already occurred here. Before turning to the specific issues which the Chairman has asked us to address, I would like to take a moment and provide some background on Standard & Poor's and credit ratings in general.

Background on Standard & Poor's and the Nature of Credit Ratings

Standard & Poor's began its credit rating activities 85 years ago with the issuance of credit ratings on corporate and governmental debt issues and today is a global leader in the field of credit ratings and risk analysis. Standard & Poor's is — and has always been — independent of any investment banking firm, bank or similar organization. Since 1916, Standard & Poor's has rated hundreds of thousands of issues of corporate, government and structured financed securities through periods of economic growth and recession. Standard & Poor's also assesses the credit quality of, and assigns credit ratings to, managed funds and the ability of insurance companies to pay claims.

Ratings are a key component of the capital markets, which have functioned effectively for decades in the United States, and which are growing and flourishing in many countries abroad. Investors throughout the world look to Standard & Poor's ratings to help in their understanding of credit risks. While all parties may not agree with our ratings at all times — they are, after all, *opinions* about an issuer's creditworthiness at a particular moment in time — Standard & Poor's credit ratings have gained respect and authority throughout the investment community because they are widely understood to be based on independent, objective and credible analysis. Standard & Poor's rates more than 99.2% of the debt obligations and preferred stock issues publicly traded in the United States, and our ratings are generally regarded as a global benchmark for assessing these issues.

I want to say a few words about what a rating is and what it is not. When Standard & Poor's issues a rating, we are offering our own opinion about a company's medium- to long-term credit risk. Similarly, ratings on particular instruments, such as the notes related to the structured finance transactions that I will discuss in a few moments, reflect our opinion about the likelihood of default on those instruments. In determining all of our ratings, we try to take into account whatever relevant future events may be anticipated. Because events always occur which are unforeseeable or simply unknowable, we regularly review our analysis.

Standard & Poor's does not perform an audit of the issuer, does not guaranty an issuer's payment on its debt, or provide insurance in case the issuer does not pay the debt. A Standard & Poor's rating does not constitute a recommendation to purchase, sell, or hold a particular security. Nor does a Standard & Poor's rating speak to the suitability of an investment for particular investors. Rather, a rating reflects our opinion as of a specific date of the creditworthiness of a particular company or security based on our objective and independent analysis. Because ratings concerning creditworthiness are not investment advice or recommendations, they are fundamentally different from recommendations made by equity analysts as to whether investors should "Buy," "Sell," or "Hold" a security. Standard & Poor's also does not issue credit ratings on an issuer's common stock.

When we provide a rating of "A," "BBB" or "C," we are encapsulating our opinion into a letter or series of letters, which may be accompanied by a plus or minus. Our credit ratings also generally include more information about the rationale for the rating and our outlook as to the long-term credit quality. Long-term credit ratings are divided into several categories ranging from "AAA," reflecting the strongest credit quality, to "D," reflecting default. Ratings from "AA" to "CCC" may be modified by the addition of a plus or minus sign to show relative standing within the major rating categories, although the categories themselves remain the prime component of the rating. Ratings in the "BBB" category or higher are considered by the market to be "investment grade," a term first used by regulators to denote obligations eligible for investment by institutions such as banks, insurance companies, and savings and loan associations. The term has gained widespread use over time in the investment community.

In addition to issuing letter ratings, Standard & Poor's also uses other well-known and understood indicators and signals to alert the marketplace to noteworthy aspects of our ratings. A rating, for example, can appear on "CreditWatch" signaling the strong possibility of a rating change. CreditWatch actions are normally taken in response to specific events or sudden changes in circumstances that have a high potential to affect creditworthiness. However, not all rating changes are necessarily preceded by a "CreditWatch" listing because circumstances may call for an immediate rating change. Additional informational tools useful to investors are Standard & Poor's "Outlooks" which offer long-term (one-to-three-year) perspective on credit quality. Outlooks are assigned to all long-term issues.

Standard & Poor's Commitment to Objectivity

Standard & Poor's objectivity is a key component to the credibility of our ratings in the marketplace. In order to ensure maximum objectivity, fairness and in-depth analysis, ratings are assigned by a committee, not by any individual. Moreover, no portion of an analyst's compensation is dependent on or connected with the performance of the companies that analyst rates or the amount of fees paid by that company to Standard & Poor's. The record bears out Standard & Poor's emphasis on objectivity and credibility. There is an exceptionally strong correlation, which has existed for decades, between the ratings initially assigned by Standard & Poor's and the eventual default record: the higher the initial rating, the lower the probability of default and vice versa. The information below shows cumulative default history over the past fifteen years of issuers rated by Standard & Poor's based upon the rating category they were initially assigned. This clearly demonstrates the very low probability of default of an issue initially rated in the "AAA" category (only 0.52% have defaulted in the past fifteen years) contrasted with the much greater possibility of default for an issuer initially receiving our lowest rating level of "CCC" (54.38% have defaulted in the past fifteen years):

Rating Category	Percentage of Defaults Initially Rated in the Category
AAA	0.52
AA	1.31
A	2.32
BBB	6.64
BB	19.52
B	35.76
CCC	54.38

Our ratings opinions are based on public information provided by the issuer, audited financial information, and qualitative analysis of a company and its industry sector. We also may have access to certain confidential information of the issuer but only to the extent that the company's management lives up to its obligation to provide complete, timely and reliable information. We use that information and rely upon it. We tell the issuers we rate that we rely upon them to provide complete, timely and reliable information —

information that includes, but is by no means limited to, the company's financial information. As we told Enron (and, indeed, every other company Standard & Poor's rates): "Standard & Poor's relies on the issuer and its counsel, accountants, and other experts for the accuracy and completeness of the information submitted in connection with the rating process."

As mentioned earlier, we are not auditors, we do not audit the auditors of the companies that we rate or repeat the auditors' accounting work, and we have no subpoena power to obtain information that a company is unwilling to provide. We expressly rely on the companies we rate not only for current and timely information at the time of the initial rating but on an ongoing basis for the proper conduct of surveillance of the company's creditworthiness. This ongoing obligation includes providing on a timely basis all material changes to information the company has previously provided to Standard & Poor's. Indeed, our entire business as well as the United States financial system is based on the principle of full and fair disclosure.

Standard & Poor's Rating of Enron Corporation

With regard to Enron Corporation, from December 1995 until November 1, 2001, Standard & Poor's rating of Enron was BBB+, which we define as adequate ability to repay debt, but subject to worsening economic conditions. This was by no means the greatest vote of confidence a Standard & Poor's rating can bestow. It placed Enron at the lower levels of investment grade ratings and was well below what Enron repeatedly — and unsuccessfully — sought from Standard & Poor's. It was also well below how Enron was often treated when it borrowed money from the market.[1]

Standard & Poor's rating of Enron in the BBB category was calculated and monitored on an ongoing basis through a thorough analysis of, among other materials, Enron's reported and audited financial statements including, in particular, its cash flow, debt burden, and other key financial metrics relevant to our opinion concerning Enron's creditworthiness. Standard & Poor's also employed a capital adequacy and liquidity review as Enron's businesses focused more on energy trading and marketing. Standard & Poor's also took into account Enron's emphatic and repeated representations, both publicly and to Standard & Poor's, about its strong corporate commitment to maintain its creditworthiness. Over the years, Enron made such representations during personal visits to our offices by the company's CFO's (including Mr. Andrew Fastow) and, in at least one instance, an October 2001 personal telephone call to me from its Chairman, Mr. Kenneth Lay, who explicitly stated that maintaining Enron's creditworthiness was a top corporate priority.

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1 Enron often borrowed from banks, investors, pension funds, etc. at lower interest rates than those usually charged to companies rated BBB+.

As I have said, at the heart of the process which leads to a rating being issued by Standard & Poor's is an unambiguous understanding between the company seeking the rating and Standard & Poor's itself: The company is obliged to furnish complete, timely and reliable information to Standard & Poor's on an ongoing basis and we, in turn, use that and other information to assess the creditworthiness of the company and then offer our opinion as to that creditworthiness in the form of a rating. It now appears that with respect to several material items, Enron did not keep its part of this well understood bargain.

As has been well-publicized, Enron hid from public view the true nature of many of its dealings with its off-balance sheet partnerships and thus its true financial picture. This concealment extended to Standard & Poor's as well. More particularly, on February 1, 2002, The Special Investigative Committee of the Board of Directors of Enron Corp., chaired by William C. Powers, Jr., issued its report regarding Enron's deceptive practices and concealment related to certain off-balance sheet partnerships and special purpose entities ("SPEs"). The Powers Report focused on four entities: Chewco, LJM1, LJM2, and the Raptor entities. None of these was adequately described in any of the company's publicly reported financial statements, if at all.[2] Nor did Enron provide information — complete or

2 As the Powers Report observes, Enron's financial statements did mention the existence of some of these partnerships. "However, these disclosures were obtuse, did

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otherwise — about their nature to Standard & Poor's separately. In fact, in a series of presentations, Enron failed to mention these entities despite explicitly assuring us that it was providing a "kitchen sink" analysis of its affiliated off-balance sheet entities. We have previously provided the Subcommittee's staff with copies of two of these presentations.

In addition to the direct misrepresentations made to the marketplace and Standard & Poor's by Enron's management, other entities apparently played a role in misleading investors about Enron's true financial situation. Earlier this month, this Subcommittee published its report entitled, "The Role of the Board of Directors in Enron's Collapse," in which the Subcommittee concluded that there was a fiduciary failure by Enron's Board in allowing, among other things, the company to engage in "high risk accounting, inappropriate conflict of interest transactions, extensive undisclosed off the books activities, and excessive executive compensation." (July 8, 2002 Report at 3). Similarly, numerous press reports, as well as the Powers Report, have concluded that Enron's accountants, Arthur Andersen, bore significant culpability for Enron's troublesome practices and inadequate disclosures.

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> not communicate the essence of the transactions completely or clearly, and failed to convey the substance of what was going on between Enron and the partnerships."

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<u>Enron's Use of Prepaid Forward Transactions and Swap Transactions</u>

It now appears, based upon press reports and other sources of information, that Enron may have also incurred approximately $4 billion in debt-like obligations structured as prepaid forward transactions and swap transactions. Our contemporaneous understanding of these types of transactions was that, in the years leading up to its bankruptcy, Enron was engaged in prepaid forward transactions to actively manage its trading and marketing positions and cash flow. Based upon discussions with Enron, we understood these transactions to be part of Enron's Price Risk Management ("PRM") account. Moreover, according to these discussions, Enron's PRM accounts were by and large in balance, lending support to our assessment that these transactions were indeed being executed in accordance with Enron's stated purpose.

In determining how to treat forward prepaid transactions for purposes of ratings analysis, Standard & Poor's looks at a variety of factors and performs both quantitative and qualitative evaluations. For example, funds from a set of prepaid transactions may be treated as operational cash flow if it appears that the issuer, as part of a stated pre-defined

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(Powers Report at 17). <u>See</u> <u>also</u> Powers Report at 200-03.

strategy, is engaging in such transactions so as to smooth out cash flow or earnings and that the transactions can and likely will occur on a regular and consistent basis. Such treatment would also require a demonstration by the issuer of the resources necessary to deliver on the forward prepaid contracts in an on-going manner. On the other hand, if our analysis reveals that these transactions are more of a singular nature aimed at raising funds for the issuer in lieu of or in addition to other financing, then we will often factor the amounts in as alternative financing and adjust our analysis accordingly. While Enron did not provide specific details about particular transactions, it did provide us with a general understanding of its use of such prepaid transactions and other monetizations. This information, coupled with our analysis, led us to conclude that Enron was utilizing such transactions on a consistent basis for strategic reasons. Accordingly, we considered the funds from these transactions to be more akin to operational cash flow.

Enron did not, despite our repeated requests for complete, timely and reliable information, disclose any information revealing a link between the prepaid forward transactions and the swap transactions. Similarly, Enron provided no indication that these transactions were in any way related to any of the Yosemite or Credit Linked Notes transactions despite an explicit inquiry by Standard & Poor's regarding the effect, if any, of these structured finance transactions on Enron's financial situation. While our knowledge about the full nature of these transactions and/or any links between them is still limited, any lack of disclosure by Enron of their material aspects would have been yet another flagrant violation of Enron's duty and responsibility to provide Standard & Poor's with complete, timely and reliable financial information.

If such links did, in fact, exist and Enron's use of prepaid forward transactions and swap transactions were, in reality, an alternate form of financing giving rise to debt-like obligations, such information would have likely had a material impact on our ratings analysis of Enron. While in hindsight, and without full information, it is difficult to assess the degree of that impact, the effect on Enron's rating of approximately $4 billion in additional debt-like obligations would have, in all likelihood, significantly altered Standard & Poor's analysis of Enron's creditworthiness.

The revelation of the debt-like nature of these transactions would also have had a substantial effect on our qualitative analysis of Enron's creditworthiness. The very foundation of Standard & Poor's opinion on Enron's credit quality over the years leading up to its bankruptcy rested on the previously high regard that our analysts had for the company's risk management oversight and controls. The revelation that Enron may have been significantly more leveraged than previously represented to us and was possibly far more lax about its risk management controls than it led us to believe would have directly undermined this fundamental predicate of our ratings analysis.

Moreover, had they been revealed, any clandestine dealings and obfuscatory disclosure practices conducted by Enron's management would necessarily have cast long shadows on the validity of Enron's credibility in general and its financial reporting in particular. While it is difficult to say with certainty all the steps we would have taken had we known this potentially material information, Standard & Poor's does have a policy of not issuing ratings at all or withdrawing ratings when we conclude that we do not have enough information to form a clear and accurate opinion of the issuer's creditworthiness. The recent revelations about Enron certainly indicate that Enron materially failed to provide Standard & Poor's with the information necessary to form a true and accurate rating opinion.

It is worth noting as well that on no occasion did we advise, consult or suggest to Enron that it should employ these prepaid forward transactions and/or swap transactions, or any other means, to increase cash flow. As discussed above, the credibility of Standard & Poor's ratings in the marketplace is dependent on our ability to maintain objectivity. Therefore, Standard & Poor's does not advise or consult with any issuer as to how the issuer should conduct its business or present its financial information, and we certainly did not do so with Enron.

<u>The Yosemite and Credit Linked Notes Trusts</u>

The Subcommittee's Chairman, Senator Levin, has also requested information regarding our understanding of the structure and operations of the Yosemite and Credit Linked Notes trusts. Between November 1999 and May 2001, Standard & Poor's rated notes issued by the following Enron-related trusts: Yosemite Securities Trust I (November 1999), Yosemite Securities Co. Ltd. (February 2000), Enron Credit Linked Notes Trust (August 2000), Enron Credit Linked Notes Trust II (May 2001), Enron Euro Credit Linked Notes Trust (May 2001), and Enron Sterling Credit Linked Notes Trust (May 2001).

Each of these trusts possessed a standard credit linked notes structure in which the credit risk of a particular entity (the "Reference Entity"), which in these trusts was Enron, is transferred to the purchasers of notes issued by the trusts. In such transactions, a counterparty seeks to purchase protection against the default of a particular issuer. This protection can be most simply thought of as default insurance. This type of credit derivative is also most commonly thought of as a default or credit put option in which the holder of the put option holds the right to transfer obligations of the Reference Entity to the credit derivative protection seller in exchange for either money or other value. These transactions, like many other structured finance transactions, have been employed with frequency and with demonstrable utility over recent years. They provide sophisticated solutions to frequently complex financial challenges and they have often provided significant benefit to the marketplace.

More specifically, in the first Yosemite transaction, for example, the protection buyer was Citibank. The protection bought was insurance against the possibility of a default by Enron and certain losses that might arise from such a default to Citibank. By entering into a credit default swap and thus purchasing a default put option, Citibank was able to hedge itself because the protection seller (the trust) was obligated to pay monies or transfer value to Citibank upon Enron's default.

The protection seller, which in the first Yosemite transaction was named Yosemite Securities Trust I, collects a fixed periodic payment, akin to an insurance premium from Citibank, as compensation for the possibility that it will have to perform, i.e., send money to Citibank, if the named Reference Entity, in this instance Enron, defaults. The protection seller obtains the funds needed to perform on such an obligation by selling notes and certificates to qualified institutional buyers. Thus, for example, when Yosemite Securities Trust I issued $750 million of rated notes, it received, as cash, that same amount of money to invest in eligible investments and to satisfy its obligations to Citibank in the event of an Enron default. In order to meet Standard & Poor's criteria, the investments made by the trust must qualify as eligible investments, which in the case of Yosemite I meant they had various maturity and credit restrictions. The most material of these credit restrictions limited eligible investments to one of the following: securities rated AA- or higher or "Enron Investments." Enron Investments are obligations or participations supported, in whole or in part, directly or indirectly by Enron itself.

Our ratings analysis on the notes issued by these trusts requires us only to focus on the structure of the transactions and whether the default risk of the trusts' notes was a genuine pass through of the default risk of Enron. That analysis did not and does not include review of the day-to-day operations of the trusts after the closing of the transactions. As with all such transactions, it was and is the trustees' responsibility to ensure that the proceeds of the notes were invested in accordance with the terms of the indentures and that all of the trusts' operating requirements were met. Standard & Poor's is not a party to the transactions and, as such, does not interact with the trustees beyond being notified of credit events or material action being taken by the trustees that could affect our ratings. We also may interact with the trustees when we take ratings actions on the trusts.

I have included with this testimony a published research report from October 9, 2000 entitled, "New Issue: Enron Credit Linked Notes Trust." This report further explains our understanding and ratings analysis of these trusts.

Current Accounting Trends and Possible Changes Towards Greater Corporate Transparency

Clearly the collapse of Enron has been a terrible tragedy for its employees, shareholders, investors and business partners. Enron's demise, along with other recently revealed corporate accounting problems, has also damaged the public's confidence in the marketplace and economy as a whole. It has caused many to question the effectiveness of several long-standing and effective components of America's capital markets, most of which have functioned effectively for decades. At Standard & Poor's, we feel it is vital that these events be viewed as an opportunity to consider improvements that can be made to the system, weighing such improvements against the enormous benefits witnessed as the capital markets have grown in size and scope.

Because our ratings ultimately depend upon information provided by the issuer, Standard & Poor's has been a long-time champion of complete, timely and reliable disclosure of financial information and the best means of corporate governance. Standard & Poor's has supported, and will continue to support, any regulatory efforts aimed at enhancing these goals. The lessons from recent events, including the collapse of Enron, only underscore the need for such increased corporate transparency.

To that end, while we applaud the recent proposals and recommendations made by the Securities and Exchange Commission, Standard & Poor's has already stated publicly our belief that such proposals are only a partial solution as they still leave wide room for interpretation by companies and their accountants about whether certain items qualify for additional disclosure. Included with this statement are two articles published earlier this month on our website (www.standardandpoors.com) which address these topics. These articles, respectively, are entitled " Accounting Abuses and Proposed Countermeasures" (dated July 2, 2002) and "Enhancing Financial Transparency: The View from Standard & Poor's" (dated July 2, 2002). These articles focus on the various proposals and practices in light of Standard & Poor's ratings practices. We are also currently in the process of reviewing current accounting and regulatory requirements with an eye towards making specific recommendations for improvements aimed at fostering greater corporate transparency and restoring public confidence in the markets.

Thank you.