Senate Probe Discovers How Banks Created 'Enronomics'

by Marcia Merry Baker

Newly released Senate Permanent Investigations Subcommittee (SPIS) evidence proves how major U.S., London, Canadian, and other banks, including J.P. Morgan Chase, Citigroup, Barclays, Crédit Suisse, Toronto Dominion, secreted billions of dollars in the energy-trade bubble run by Enron, Dynegy, Mirant, Williams, and many other big energy pirate companies, now bankrupt or nearly so. What *EIR*'s economic analyst John Hoefle wrote in 2001, in both Congressional testimony and articles on Enron's failure, is now being "discovered" on the Hill: The big banks were the sponsors, and even the creators, of Enron's and the others' off-balance-sheet looting schemes. Now, rumors are flying of a derivatives crisis hitting J.P. Morgan Chase and Citicorp, the top players in the "Enronomics" scandal.

Steps to save the real economy from the continuing explosion of this Wall Street debt bubble, was the focus of *EIR*'s testimony for hearings on "The Financial Institutions and Enron's Collapse," held July 23 and 30 by the SPIS of the Senate Government Affairs Committee and chaired by Carl Levin (D-Mich.). The testimony also supplied Congress with the Lyndon LaRouche's evaluation: "What we are facing today is the collapse of the financial system itself, not merely discrete sectors or the harm from isolated perpetrators of crimes."

'Pre-Pays' and Other Scams

July 23, Robert Roach, Counsel and Chief Investigator of the SPIS, released a bipartisan report on the role of the banks in the Enron collapse, with over 170 exhibits.

Roach said that not only did the banks know that Enron was cooking its books, but "some financial institutions . . . actively aided Enron in return for fees and favorable considerations in other business dealings. . . . The evidence indicates that Enron would not have been able to engage in the extent of the deceptions it did . . . were it not for the active participa-

FIGURE 1

Chase/Mahonia

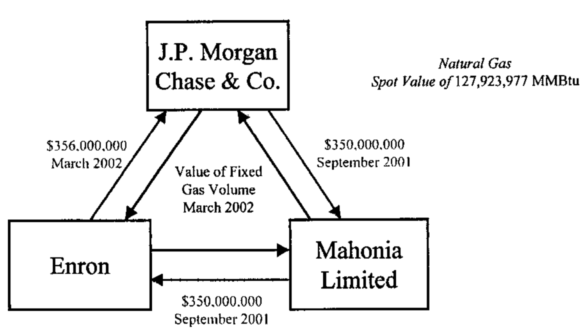
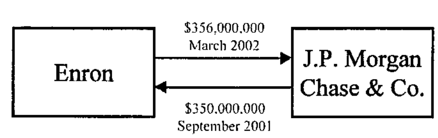


FIGURE 2

Chase/Mahonia Collapsed into Loan



These two figures (Exhibits 105 and 106) were prepared by SPIS for the hearings. The figures show how a debt magically becomes an asset with "creative bookkeeping."

tion of major financial institutions willing to go along with and even expand upon Enron's activities. The evidence also indicates that some of these financial institutions knowingly allowed investors to rely on Enron financial statements that they knew, or should have been known, were misleading."

Roach detailed Enron's use of "pre-pay" transactions with banks, wherein loans were disguised as paid-in-advance energy trades (bringing into Enron some $8 billion in pre-pays from banks over six years). This allowed Enron to understate its debt by 40% and overstate its funds flow from operations by 50%.

Morgan Chase and Citigroup pitched the pre-pay strategy. **Figure 1** was prepared by SPIS staff to show how a "special purpose vehicle" (an SPV; in this case, Mahonia) functioned as a deception mechanism for Morgan Chase to shunt money to Enron. In fact, the advance was a debt, as **Figure 2** shows.

Roach's exhibits included quotes from internal communications of the principals in the scams. Some examples:

- From a Morgan Chase internal e-mail: "Enron loves these deals, as they are able to hide funded debt from their equity analysts because they (at the very least) book it as deferred rev[enue] or (better yet) bury it in their trading liabilities."
- From a Citigroup internal e-mail: "E[nron] gets money that gives them c[ash] flow but does not show up on books as big D Debt."
- From an internal e-mail, by Arthur Andersen employee auditing Enron: "Enron is continuing to pursue its various structures to get cash in the door without accounting for it as debt."

The July 30 hearings examined the relationship of investment bank Merrill Lynch to Enron. Two Merrill Lynch officers invoked the Fifth Amendment. A third explained why his company did business with Enron: "It was ranked as the most innovative company in the country for five straight years by the Fortune 500 company CEOs, board members, and senior management. It was ranked the top company for 'Quality of Management' " In one exhibit, the committee showed a videotape of Enron CFO Andy Fastow giving a presentation, and saying, "We've got to get the pension money coming in here," i.e., attract investments from pension funds.

EIR to Congress

John Hoefle introduced the *EIR* testimony, saying: "Our concern in providing this testimony, is to focus attention on the broad, urgent implications of the charge:

"1) We are right now at the end of a 30-year era characterized all along by policies tolerating or abetting such 'bubble-building' wrongful financial practices;

"2) We are in a process of economic breakdown;

"3) There must be measures on the scale of the 1930s 'FDR-period' policy responses, to replace the destructive policies of the past decades, with economy-building programs. Without that, no reforms, no tinkering, no indictments will do what's required."

Documentation

Enron Was How the U.S. Banking System Operates

This is part of the testimony submitted by EIR *to the July 30, 2002 Senate hearing on "The Role of the Financial Institutions in Enron's Collapse," held by the Committee on Governmental Affairs' Permanent Subcommittee on Investigations (SPIS).*

The committee's work opens the way for yet another layer to be peeled back from this rotten onion. We do not believe for a moment that Enron corrupted the financial institutions, but rather believe that Enron was the tool of certain financial interests and institutions who used the company as a battering ram for electricity deregulation and a vehicle for pumping up an energy-trading bubble. That energy bubble, along with the associated dot.com and telecom bubbles, were creatures of the "Wall of Money" used to jump-start the global financial system after its near-meltdown in 1998. Enron was an effect, not the cause, of a much larger financial scam. . . .

U.S. Debt Is Unpayable

One simple way to sum up the systemic financial crisis, is to look at the reality that the U.S. debt pyramid, built up over years of "Enronomics" of all kinds, *is unpayable.* Japan is in that state; other nations, such as Argentina are in chaos. But focus on the United States itself. In our issue of *EIR* for July 5, 2002, we published detailed graphs and statistics ("Rollover of U.S. Debt Will Yield Weimar Hyperinflation," by Richard Freeman and John Hoefle), from which we provide three summary graphs at the end of this testimony.

In short: By the end of 2001, total U.S. debt had reached $31.1 trillion. On average, over the last four years, U.S. debt has surged at the rate of $2.2 trillion per year, or almost $200 billion per month. The $31.1 trillion figure is composed of the basic categories of debt statistics kept by the Federal Reserve "Flow of Funds" reports for government debt (state and Federal), household debt, and corporate debt.

The U.S. debt pyramid has grown so large, that it is unsustainable, and all attempts to service it will not work. Moreover, every such attempt further destroys both the underlying U.S. physical economy, and its bankrupt financial system.

EIR's economics staff has determined, preliminarily, that by the end of 2001, on this outstanding debt, America's annual debt service bill—the interest payment, plus re-payment of a portion of the principal—had reached an unprecedented $7.4 trillion. This is equivalent to a staggering 72% of Gross Domestic Product.

It was as part of this rising debt balloon, that all kinds of "specialty bubbles" arose, including:

- $8 billion in financing advanced to Enron, from Chase and Citigroup, over the six-year period, 1995-2001.
- $1.1 trillions to the telecom sector was advanced between Jan. 1, 1996 until the end of the first quarter this year, by Wall Street and the City of London—nearly $200 billion annually—to build its speculative growth. Then, in recent months, came the spectacular bankruptcies—from Global Crossing, to WorldCom.
- $2.3 trillions from financial institutions were lent in new housing loans over the six-year period 1995-2001. Over three-quarters of these bank mortgages were acquired by Fannie Mae and Freddie Mac, and a few other agencies, now ticking timebombs. . . .

The Banking Sector Is Bankrupt

In contrast to these soaring financial obligations and debts, funding for actual capitalization of infrastructure, industry and agriculture has been at a next-to-nothing level in recent years. Now we're well into the collapse process because of this discrepancy.

The U.S. banking sector itself is bankrupt, not just those sectors in the headlines, such as steel, airlines, passenger rail, telecommunications, etc. Look at the two names cropping up with regularity: J.P. Morgan Chase & Co. and Citigroup. Both lent heavily to the energy-pirate and telecom sectors, and are undoubtedly facing losses in the billions of dollars as those sectors vaporize. But the most explosive banking liability of all is *derivatives.*

J.P. Morgan Chase is the result of the acquisition of J.P. Morgan & Co. by the bigger Chase Manhattan, a deal which has been an absolute disaster as measured in ordinary—and therefore misleading—market terms. The market capitalization of the combined Morgan Chase is now less than that of Chase alone on the day before the merger, with Morgan (or at least its equivalent value) having simply vaporized. This is not surprising, as it was likely a bankruptcy at Morgan, and perhaps Chase as well, which led to the takeover of the aristocratic Morgan by the commoners at Chase.

The merger only bought a few months. Indications are that Morgan Chase blew up in mid-2001 and was secretly taken over by the Fed, as Citigroup's predecessor, Citicorp, was taken over during 1989. During the fourth quarter of 2001, Morgan Chase combined its two lead banks, Chase Manhattan Bank and Morgan Guaranty Trust. As part of that process, $125 billion in assets and $7 trillion in derivatives simply disappeared from the combined banks' books, suggesting major financial problems. Still, with $24 trillion, Morgan Chase has more derivatives than any other bank in the world, and more than enough to make a spectacular explosion.

Citigroup may be under Fed control as well, as rumors of major derivatives losses circulate. Citigroup is the result of the 1998 takeover of Citicorp by Travelers Insurance, creating what is now the largest bank in the United States, with just over $1 trillion in assets and $9 trillion in derivatives. On July 18, Saudi Prince Alwaleed bin Talal, Citigroup's largest individual shareholder, said that he had invested another $500 million in the bank, raising his holding to $10 billion. Alwaleed, a nephew of Saudi King Fahd, obtained his initial stake in the bank shortly after the Fed took it over in 1989 and began arranging a bailout. The latest cash infusion raises suspicion that Alwaleed is performing a similar service for Citigroup.

Not to be left out is Bank of America, whose $620 billion in assets puts it third behind Citigroup's $1 trillion and Morgan Chase's $713 billion. Bank of America's $10 trillion in derivatives puts it solidly on the hot seat in any financial crisis, and it has also loaned heavily to bankrupt companies. Rumors are flying that Bank of America has applied to the Fed for a secret bailout.

If the Fed winds up running the three biggest banks in the country, who's going to bail out the Fed?

What Is Required—Policies and Principles

The kinds of emergency intervention policies now required, in the spirit of those in the 1930s, are summarized in a special report issued March this year, by the LaRouche-in-2004 Presidential campaign committee, titled, *Economics: At the End of a Delusion.* LaRouche lists a number of typical actions to be taken to halt the depression and launch a self-sustaining recovery:

"1. We must a.) put the international monetary-financial system into immediate, governments-dictated reorganization; b.) restore a fixed-exchange-rate system; c.) establish exchange, capital, financial controls, trade controls, and fair-trade forms of protectionist measures internally and externally; d.) increase drastically rates of taxation on financial capital gains, and substitute production- and technology-oriented medium- to long-term investment tax credits to entrepreneurs; e.) generate large masses of government-created credit at rates between 1-2% for, chiefly, a combination of entrepreneurial investment production and infrastructure investment; and f.) implement a general bank-reorganization program, which keeps needed banks performing essential functions for the community while under even drastic financial reorganization.

"2. We replace 'free trade' with the promotion of protected hard-commodity international trade, as part of the promotion of a global, long-term economic-recovery effort.

"3. We must introduce the economic equivalent of a high-technology-oriented 'arsenal of democracy' recovery program, both in the domestic economy and in world trade, to provide the qualitative dimension needed to reverse the monstrous loss of technologically progressive, physical-productive capacity and potential—a loss which has accumulated in the world as a whole during the recent thirty years, especially the recent quarter-century.

"We had better take such measures, to stop that process of collapse before it hits with irresistable, crushing force."