DISCUSSION CASE: Conflicts of Interests in Subprime Mortgages and at Goldman Sachs and Enron

Several important business professions, including attorneys, auditors, accountants, and financial analysts, function as economic "gatekeepers" "or "watchdogs." The gatekeeper function is to ensure that those who enter into the marketplace are playing by the rules and conforming to the conditions that ensure the market functions as it ought. It is universally acknowledged, for example, that markets should be free from fraud and deception. Ensuring that these conditions are met is an important internal function for market-based economic systems.

Some observers claim that the failure of gatekeepers to fulfill their responsibilities was a contributing factor in some of the most dramatic financial and ethical failures of recent years. Consider three cases: the subprime mortgage crisis, which played a major role in the 2008–2010 economic collapse, the Goldman Sachs work environment as described by Greg Smith, and the downfall of Enron and its accounting firm, Arthur Andersen.

A near complete meltdown of the global financial system, marked by the collapse of such major financial firms as Lehman Brothers, Countrywide Financial, Bear Stearns, and Merrill Lynch, brought about the global economic downturn of 2008–2010. Much of the fiscal troubles of these financial institutions can be traced to risky lending practices, particularly in the real estate mortgage sector. Financial analysts and credit rating firms played an important role in these events.

Reflect on how a traditional and conservative mortgage loan would work. A bank or other lending institution makes a loan to someone to purchase a home and holds the mortgage internally. While the loan is secured by the value of the home itself—if the person defaults the bank takes possession of the house—most banks required several additional steps to reduce the risk and ensure the security of the loan. It was not unusual for banks to require a 20 percent down payment, as well as requiring that the loan applicant have a steady job likely to provide a steady income, some savings, and a good credit rating.

These conservative lending practices have made mortgages very attractive investments. They were low risk and provided a steady income. It became common for larger financial institutions and investment banks to buy large numbers of mortgages and package them together as an investment security. These mortgage-backed securities proved to be highly attractive investments at exactly the time in the first decade of the twenty-first century when a significant amount of global capital chasing investment opportunities was available. In the middle of this process were credit rating firms such as Moody's, Fitch, and Standard and Poor's, which provided independent ratings for the risk and security of these investments. Mortgage-backed securities regularly had the highest, AAA, credit rating.

But as more money poured into the system, incentives were created to make more and more mortgage loans. This demand led to a cycle of increasingly risky lending practices. Lenders began to lower their standards, requiring little or no

down payment, lower credit ratings, little or no proof of income. These riskier, "subprime" loans also often were structured as adjustable rate mortgages (ARM), in which the borrower starts with a low interest rate that is repriced later on the basis of prevailing rates, or "balloon-payment" mortgages, in which the borrower starts with low payments but faces a large mortgage payoff at an early maturity date. As long as property values and incomes continued to rise and interest rates remained low, the cycle continued to expand. Unfortunately, this housing boom was not matched by a corresponding rise in household incomes. People simply were not earning enough to pay off their mortgages. As defaults increased, property values fell, which, in turn, led to more defaults as homes became worth less than the money owed on them. As defaults increased, the value of mortgage-backed securities collapsed, leading to further financial meltdown across the economy. The housing bubble had burst and took the entire economy with it.

In theory, as the lending practices changed and as mortgages therefore became riskier, the credit rating for mortgage-backed securities should have declined. Instead, most remained with AAA ratings. A decline in the credit rating, in turn, should have slowed the flow of capital into the housing market, which would have tightened credit and slowed the housing boom. In theory, the market should be self-regulating as long as gatekeepers such as financial analysts, credit rating institutions, auditors, and bank examiners fulfilled their roles. In practice, it was not a self-regulating system.

There were many contributing factors in the collapse of the subprime mortgage industry, but the failure of professionals in the financial industry to fulfill their gatekeeper responsibilities was one of them. In hindsight, this was perhaps not surprising, since credit rating firms were hired by the investment banks and financial institutions that were selling the mortgage-backed securities. Lower credit ratings would have made them more difficult to sell. In effect, if the rating agency is paid by the firm selling the security, the investor can no longer rely on the credit rating as impartial and accurate. Critics charge that this situation is a classic conflict of interest: the credit agency and their analysts have a responsibility to issue accurate ratings that are necessary for the market to function equitably, but their own financial interests incline them to produce ratings that favor the seller rather than the buyer. Evidence suggests that financial analysts and rating agencies systematically failed to exercise their professional responsibilities throughout this period.

Consider also the work environment at Goldman Sachs as described by Greg Smith (see the Discussion Case that opens chapter 4). Goldman is hired by clients, both individual and institutional, to manage their investment portfolios. As such, financial professionals at Goldman Sachs are agents hired to make decisions that are in the best interests of clients. Yet, these finance professionals are also employees of Goldman Sachs, a firm that has its own financial interests at stake. In theory, Goldman Sachs profits when their clients profit, and thus the interests of the firm and the clients align. Keeping these interests aligned, and serving the firm's interests by serving clients' interests, was the corporate culture so appreciated by Greg Smith.

As described by Smith, the Goldman culture had systematically and intentionally shifted away from this alignment. Instead of being served by the agents they hired, clients were disparaged as "muppets" to be manipulated for the financial gain of Goldman Sachs. Individual employees received promotions and huge bonuses based not on how well they served clients, but on how much money they made off of these clients.

But perhaps the classic case of such professional irresponsibility occurred at Enron and its accounting firm Arthur Andersen. The truth about these firms tells a shameful story of greed, dishonesty, and corruption that is perhaps unmatched in corporate history.

Enron was created in July 1985 through the merger of Houston Natural Gas and InterNorth, a natural gas pipeline company. Under the direction of CEO and Chairman Kenneth Lay, Enron evolved from a gas and energy supplier, to an energy trading company. By the end of the 1990s, over 80 percent of Enron's reported earnings were from energy trading rather than from its gas supply and pipeline divisions.

To minimize risks in the highly volatile energy industry, it was common for traders to "hedge" their positions, effectively entering into futures contracts that balance present risks. Senior management at Enron chose to balance their risks by entering into agreements with companies that its own executives created for that very purpose. Enron's relationships with these "special purpose entities" (SPEs) was at the heart of the company's corruption and collapse.

Using its stock as collateral, Enron would create a partnership with a small number of outside investors. Accounting regulations allow anyone with a minimum of 3 percent equity share to be identified as the SPE's owner. These regulations also hold that as long as Enron owned less than 50 percent of the SPE's voting stock, its debts did not have to be accounted for on Enron's books. As a result of these two accounting regulations, these SPEs were technically separate business entities. With capital raised by these partnerships, again using Enron stock as collateral, the partnership then enters into a joint venture with Enron. The SPE supplies capital, Enron supplies assets and, at least in theory, the joint venture proceeds. In the meantime, the money raised for the joint venture is used to pay off debt on Enron's assets. Thus, the entire process allowed Enron to record a lowering of its liabilities (as its debts were paid off) without also recording the corresponding increased liability (which had been shifted to the SPE). But because the SPE's debt was itself secured by Enron using Enron stock, the entire process is, while perhaps technically legal, nonetheless deceptive.

Three aspects of these relationships are particularly egregious. First, Enron's SPEs had little use other than to shift debt and risks off Enron's financial balance sheets. Other business and financial institutions use SPEs when they seek to minimize risks of legitimate joint ventures. Enron seemed to have no reason to form SPEs other than to create the deceptive impression it was financially in much better shape that it actually was. There were few legitimate "joint ventures" that were anything other than a façade for accounting deceits. Hedging its risks by entering into contracts with independent third parties, as is commonly done by many business institutions, does lower risk; hedging risks by entering

into agreements with oneself, does not. By financing these partnerships mostly with its own stock, Enron effectively was underwriting its own risks, which, of course, is not to underwrite them at all. Its relationships with these partnerships were being financed by Enron stock, and this provided a very strong incentive for Enron management to keep its stock value high. (The fact that senior management also were being granted significant stock options was another reason.) Further, the entire financial stability of the corporation was like a house of cards, supported only by its continuing ability to shift debt onto these SPEs.

Second, the person managing these partnerships (and reaping significant personal profits from them as one of the "outside" limited partners) was Enron's Chief Financial Officer Andrew Fastow. Thus, Fastow was negotiating with himself (or his subordinates) in forming the deals between Enron and these SPEs. One such SPE alone, called LJM Cayman L.P. (for "limited partnership"), reportedly earned its managing director—Andrew Fastow—millions of dollars. Later company investigations revealed that Fastow made $30 million from these partnerships. As an eventual result of its deals with just LJM, Enron had to take a billion-dollar write-down in its equity value.

Third, Enron was supported through all of this by its accounting firm, Arthur Andersen. Andersen was responsible for auditing Enron; that is, providing allegedly unbiased and accurate financial reports. Such audit reports provide the information that investors and creditors rely on when making decisions about investing in or extending credit to a corporation. But Arthur Andersen was also earning millions of dollars a year from Enron for consulting and advising work. Thus, the very professionals who had responsibility for providing unbiased and accurate audit information to Enron's board, its investors, its creditors, and its employees, were also involved in advising Enron's management on how to keep legitimate debts off its balance sheets.

The collapse of Enron began slowly at first. In early 2001 a few stock analysts began to raise questions about Enron's financial stability. A story in *Fortune* magazine also raised questions about Enron's valuation.[1]

Evidence suggests that these outsiders were not the only people to have doubts. Skilling and Lay sold over a million shares of Enron stock between November 2000 and September 2001. Numerous other high-level insiders, including board members and Enron's general counsel, also sold hundreds of thousands of shares during this period. Further, internal Arthur Andersen documents show that its executives also had real doubts about Enron's finances. An Andersen memo from February 2001 discussed the possibility of dropping Enron as a client. Andersen executives chose not to do this, acknowledging the multimillion dollar annual fees it received from Enron. For advice concerning just two of the hundreds of the SPEs it helped establish (LJM and Chewco), Andersen billed Enron $5.7 million beyond its annual auditing fees.

Other insiders also called attention to Enron's shaky finances. Vice President Sherron Watkins, herself a former Andersen employee, warned Lay and other Enron executives about "serious accounting improprieties" beginning in the summer of 2001. In one letter to Lay, she claimed "I am incredibly nervous that we will implode in a wave of accounting scandals."

As the financial news grew worse, the ethical picture continued to deteriorate. Jeffrey Skilling resigned on August 14, 2001, citing personal reasons. When he testified under oath before Congress in early 2002, Skilling repeatedly claimed that he believed that Enron was in solid financial shape at the time of his resignation and that his resignation had nothing to do with increasing financial difficulties. Within days of Skilling's resignation and of receiving Watkins letter, Lay (who had returned as president and CEO after Skilling's resignation) exercised options on thousands of shares of Enron stock, making almost $2 million. By the end of August, Lay had sold over $16 million worth of Enron stock and Skilling had sold an additional $15 million. At this same time, Lay was assuring employees and the public that the company was in good financial shape. In late September, Lay urged employees to continue buying Enron stock, which was then selling at only $25 per share. Starting in late October, ostensibly as a result of a change in plan administrators, employee 401(k) retirement plans, over 60 percent of which was in Enron stock, were frozen, prohibiting employees from selling Enron stock. By the time the plan was reopened, the stock's value was only $9 a share.

By late September 2001, Andersen's auditors had decided that previous accounting decisions concerning the SPE partnerships were incorrect and that over $1 billion would have to be reduced from Enron's valuation. On October 12, an Andersen lawyer instructed employees to destroy all but the most essential documents concerning the Enron audit. This shredding of documents would continue for months, well after Enron was subject to numerous legal investigations.

On October 16, Enron issued its third-quarter financial report and acknowledged a quarterly loss of $618 million. The following day, it announced the results of Andersen's accounting decision and the resulting $1 billion reduction in asset value as a result of losses from LPEs. Because the financing for these LPEs was based on Enron stock, the more the stock price fell the faster the overall financial crisis accelerated. From October 16 until October 26, Enron stock fell from $33 a share to $15 a share.

On November 8, 2001, Enron acknowledged that widespread accounting errors in four previous years had overinflated Enron's worth by $600 million and admitted that additional information might still be forthcoming. The following day, Dynegy, Inc., a smaller competitor, announced that they had reached a tentative agreement to purchase Enron for $10 billion. Three weeks later, Dynegy backed out of the deal claiming that they, too, had been misled about Enron's financial status. In the following days, Enron's stock continued to fall and its credit rating was lowered to junk bond status, thereby causing more of the debt that financed LPEs to come due. On December 2, Enron filed for bankruptcy and laid off over 4,000 employees. For a corporation once ranked the seventh largest of the Fortune 500 and whose stock's value had hovered around $90 per share only a year earlier, bankruptcy represented an amazing downfall.

Throughout all of this, Enron's board of directors, and in particular the board's audit committee, should have been fulfilling their fiduciary roles as stewards of stockholder interest. While many on the board claim that they were uninformed about these dealings, the evidence suggests otherwise. It was the

board itself that had given Andrew Fastow permission to ignore the corporate prohibition against conflicts of interest when he negotiated contracts between Enron and the SPEs in which he held positions. Board members were also among the insiders selling large quantities of stock throughout 2001. But, like so many corporate boards, Enron's board were made up of many individuals appointed by the CEO as much for status and prestige as for business or financial acumen. Among the members of Enron's board audit committee was Wendy Gramm, former chair of the U.S. Commodity Futures Trading Commission. While working for the U.S. government during the first Bush administration, Gramm was a leading advocate for deregulation of the energy industry, a decision made late in the Bush administration that greatly benefited Enron. Gramm was appointed to Enron's board soon after leaving government service. She is the wife of Senator Phil Gramm from Texas, a member of the Senate Banking, Finance, and Budget Committees, who received $100,000 in campaign contributions from Enron for his last two campaigns.

DISCUSSION QUESTIONS

1. What were the responsibilities of the accountants at Arthur Andersen? To whom did they owe these responsibilities?
2. Who was harmed by the insider trading of Enron executives? What harm, if any, was done to employees who were prevented from selling Enron stock in their 401(k) accounts?
3. Who was harmed by misvaluing of subprime mortgages? Who benefited?
4. Who, if anyone, was harmed by Andrew Fastow's dual roles as Enron's CFO and as managing partner of Enron's SPEs?
5. What laws or policies would you recommend to prevent future Enrons?
6. What laws or policies would you recommend to reform lending practices in high-risk credit markets?

7.1 INTRODUCTION

Chapter 6 considered a range of potential rights that employees might claim within the workplace. Rights can be seen as claims that individuals have against others to be treated in certain ways or to receive specific goods. My rights determine what is owed to me by others. We now turn to the question of responsibilities, or what I owe to other people.

What do I owe to other people? A moment's reflection suggests that this question is too broad. The most reasonable answer would be that it depends; it depends on who the other person is. The responsibilities that I owe to my children are different from what I owe to strangers. My responsibilities to my mortgage company differ from my responsibilities to my employer. (This observation raises issues similar to those of the discussion of privacy in chapter 6.) In this way, we can think of responsibilities as involving three factors: (1) a person *A*,