Structured fall-out

As a result of shifting lender liability in the post-Enron era, CIBC has been banned temporarily from certain structured finance transactions.

By Vern Kakoschke

The landscape for lenders has shifted dramatically since the implosion of financial giants Enron and Worldcom. The new rules now governing investment bankers are not limited to the architects of structured-finance transactions, but extend even to lenders who merely participated in those transactions.

Canadian banks are no exception and were recently caught in the widening net of lender liability. In the fall of 2003, court-appointed examiners investigating Enron's failure singled out two Canadian banks for allegedly aiding and abetting Enron's manipulation of its reported financial results through a series of complex structured-finance transactions. This was followed by the announcement in late December of a settlement between the Canadian Imperial Bank of Commerce (CIBC) and the U.S. Securities and Exchange Commission (SEC) regarding Enron-related allegations.

CIBC entered into agreements with regulators on both sides of the border to settle allegations made by the SEC that it helped Enron mislead investors. The financings in question were structured as asset sales for accounting and financial reporting purposes, allowing Enron to hide from investors the true extent of its borrowings. Between June 1998 and October 2001, Enron used these disguised loans to increase reported earnings by more than $1 billion, to increase reported operating cash flows by almost $2 billion and to avoid disclosure of more than $2.6 billion in debt on its financial statements.

CIBC settled with its regulators for its role in the Enron transactions. Not only did CIBC provide the debt and organize the syndicated loans made to the special-purpose entities established by Enron to house the assets in question, but it also provided the required equity contribution (normally 3%) to achieve the desired off-balance-sheet treatment. Apparently, CIBC received the "strongest possible assurances" from senior Enron officials that the equity would be repaid. As a result of such undocumented understandings, the equity allegedly was not truly at risk. In settling these allegations, CIBC paid US$80 million in disgorgement, interest and penalties without admitting any liability and consented to a final judgment permanently enjoining it from future violations of the antifraud, books and records, and internal control provisions of U.S. securities laws.

One novel portion of the settlement entailed an agreement between CIBC, the Canadian Office of the Superintendent of Financial Institutions (OSFI), and the Federal Reserve Bank of New York. In an unusual regulatory move, the agreement was used to prohibit CIBC from engaging in certain transactions and misleading practices. The following are the key components of CIBC's Agreement:

Independent auditor to monitor compliance: By February 27, 2004, new policies and procedures will include independent auditing for the next three years with a plan for auditing, monitoring for compliance, and reporting to OSFI and the Federal Reserve Bank of New York.

Structured finance prohibition: For three years "certain structured finance transactions" on behalf of any third party (defined as a U.S. public company and its affiliates) are prohibited. These transactions are defined to include the structuring or arranging of, or investment in: the equity component necessary to achieve FAS 125 and/or 140 off-balance-sheet treatment; tax-structured lease financings for third parties; and the sponsoring and administration of U.S., U.K., and Australian receivables conduit vehicles.

Misleading third-party activities: Transactions are banned when there is knowledge or belief that an objective of the third party is to achieve misleading earnings, revenue or balance-sheet
effects. This includes undocumented agreements in which any terms of the transaction related to risk transfer are not reflected in the written contract; and transactions with agreed-upon early termination when an agreement exists to unwind prior to the transaction's stated maturity at an agreed-upon price.

**Individual accountability:** Employees proposing or approving the bank's participation in any transaction covered by the new policies shall satisfy themselves that they are fully knowledgeable about all terms and that the applicable policies and procedures have been complied with prior to execution.

**Special restrictions applicable to quarter-end and year-end transactions:** Quarter-end or year-end transactions in which there is knowledge or belief that the third party's primary motivation is to achieve accounting (including off-balance-sheet treatment) objectives are banned unless specifically approved by the new Financial Transaction Oversight Committee.

**Financial transaction oversight committee to review certain transactions:** Created from senior representatives of various disciplines the Committee will review the following:

- Quarter-end and year-end transactions;
- "complex structured finance transactions" effected by a third party in which:
  - a known or believed material objective is to achieve a particular accounting or tax treatment;
  - there is material uncertainty with regard to the legal or regulatory treatment, or
  - a third party is provided the economic equivalent of a financing which would require committee approval;
- all early unwinds or termination prior to originally contemplated maturities of complex structured finance, quarter-end or year-end transactions, and
- any transaction determined by a member of the Committee as appropriate for review.

The purposes of the committee include:

- effective transactional risk management, including assessing legal and reputational risk;
- referral of any suspicious transaction to the U.S. Department of Justice monitor;
- requiring transactions to be sponsored by a person providing complete and accurate information regarding the transaction and the third party's purpose(s) for the transaction, and
- communicating full transaction descriptions to the independent auditor of the applicable third party regardless of any request for the information.

**Employee training and reporting:** Existing training programs will be reviewed and modified to ensure compliance with the new policies and procedures. A new internal policy-and-approval-process website will allow employees to communicate with the financial transaction oversight committee and a new ethics hotline will allow reporting of inappropriate behavior and/or any failure to properly abide by the new policies.

The Agreement demonstrates that financial regulators are adopting a much tougher stance with respect to Enron-style transactions. In addition to extracting significant penalties and banning individual employees from holding senior positions at public companies, the regulators have restricted CIBC from participating in certain segments of the market. This market-exclusion remedy may involve an opportunity cost that is at least as significant as the financial penalty. The significant reputational damage to the banks participating in such transactions may not be as easily measured but is certainly real. Personal liability has also been extended. No longer limited to retail brokers, personal liability may now extend to investment bankers who pursue aggressive financial structures.

The time-limited ban imposed on CIBC suggests that the transactions in question are not offensive per se and may continue to be pursued by other banks. Indeed, some financial institutions (particularly the non-banks) may view the void left by CIBC as an opportunity.

**On-line/Internet bank users:**

- 10% of Toronto adults used on-line/Internet banking in 1998.
- The number tripled to 3.4% of Canadian adults by 2003.
- Of those only 30% say an Internet bank is their principal institution.
- Internet banks enjoyed greater penetration in Ontario (15%) and much lower in Quebec (4%) and Atlantic region (6%).
- President's Choice Financial (11.1 million clients) and ING Direct (930,000 clients) are the top two institutions.
- 50% of PC customers identify PC as their principal institution, while only 7% of ING clients identify ING as their principal institution.
- Internet bank customers tend to have upper income status: 30% have a yearly household income of $80,000 or more vs. the 22% Canadian average.
- Men and women are equally likely to be Internet bank customers.

**Source:** BMMRTS facade (February 2004)

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