The Smartest Guys in the Room - Postscript

In the last issue, I wrote a few remarks about Enron and mark-to-market accounting. A bit of further reading took to the UK connection here with the 'Natwest Three' whose involvement with Enron led three NatWest employees to jail sentences in the United States. Obviously I do not want to comment on this—but in an exculpatory book by one of the men (*A Price to Pay: The Inside Story of the NatWest Three* by David Bermingham) give an amazing insight into '*Investment Banking'* when applied to a UK Clearing bank.

As the story is told NatWest, which had bought an American boutique, (*Greenwich)* retired the then Chief Executive of NatWest Markets and persuaded the Greenwich Joint Chief Executive to come to London and run a reconstituted organisation. The man in question, Mr. Kruger, a brilliant but ruthless individual we are told changed the name to Greenwich Natwest. Moreover he found the Structured Trade Finance Department being run by some employee or other guilty of 'old bank' thinking and turfed him smartly out and replaced him by one Gary Mulgrew, later one of the co-indicted colleagues of Mr. Bermingham and one whose new-bank thinking eventually propelled him into an American prison.

What was Structured Trade Finance? Well it can mean many things to many people we are coyly told, but the resources of the department were mainly used for off-balance sheet financial transactions. What is off- balance sheet finance? Well the example we are given is that of a sale-and-leaseback which 'in one way' can be regarded as 'assets and liabilities that don't appear in the balance sheet'. Humph. This does not seem a very good example. If you sell an asset it's not yours, is it? True, you may have a contractual liability of a long lease, but costs, even fixed costs, are not the same as debt are they? Are there any better examples?

Well, some of the brief description of the job which follows is good orthodox stuff even if much of it could relate to ordinary lending ,or at most project-finance rather than what the writer calls off-balance sheet transactions. It is perhaps a weakness of the book that the sole such operation described in detail - the one which led to the prison sentences – quite apart from the defalcations alleged or acknowledged, was itself consciously designed to allow Enron to report 'earnings' which were not earnings at all, not then, not later, not ever, not by any definition known to mortal man, a judgement later confirmed *inter alia* by the wiping off the map of the company's once great international audit house, Arthur Andersen.

Mr. Bermingham points with pride to the transaction which preceded his downfall an (Enron-related) $2 billion loan which helped the Texan company acquire Wessex Water; the loan was underwritten and syndicated so that 'not a single dollar of it remained on the Greenwich NatWest (NatWest?) book'. Now if we are being churlish a loan, even a large loan, properly structured and secured on a United Kingdom utilities company does not, of itself, seem the sort of thing that you would stop people on the street to draw attention to. On the other hand, it was classic investment-banking work, *asset-lite* the loan created and passed on, generating a healthy fee in the process. But you have to ask.

Mr. Kruger hated equities. A sound view, honestly presented no doubt. He hated to hold assets too, all too conscious of their potential to turn sour in his hands. But here's the thing. I always understood merchant banking involved the bringing into being of equities or long-term quoted loan stock, assets to be channelled into broadly-based portfolios held by investors either as individuals or collectively, in pursuance of the objectives normally regarded as being held in common by long-term savers for both private and public beneficial ends; assets that is whose investment characteristics are at odds with the qualities normally regarded as desirable in bank balance sheets. But are ordinary loans not the very stuff of those sound bank balance sheets especially if their average duration can be extended by the judicial use of wholesale markets? But here we have a high-profile subsidiary of a major world bank anxious to offload these loans as dangerous things to hold – and be well rewarded for doing so. Rum.

So in pursuance of fees Mr. Kruger shrank the loan book he had inherited as key to the immediate generation of bank earnings – millions upon millions of dollars we're told. But NatWest was surely a sitting duck. Kruger set about the liquidation of his legacy loan book 'minimising the capital tied up, and maximising the fees earned'. Moreover, we are told that if the loan to be disposed of had a credit reserve against it (having been previously established by deducting pre-determined amounts from the income produced by it for example) this total was gleefully knocked off the face value of the loan, and then, even if the loan could only be sold for less than its face value, provided that the sum realised was greater than the face value *less* the credit reserve, there was a profit – and a bonus prospect. Rich.

The indications now is that the last (UK) man standing, Barclays, is now downsizing its investment banking operations. Bad luck on the investment bankers maybe, put perhaps not so bad for bank shareholders.

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