EIR Economics

Derivatives 'end-users' get stuck holding empty bag

by Anthony K. Wikrent

Just two weeks after the Bank for International Settlements (BIS) issued new guidelines for derivatives dealers, nine U.S. derivatives dealers were slapped with a lawsuit by Charles County, Maryland, which has lost its entire operating budget for the next 45 days because of losses on derivatives contracts in which the county had invested.

Derivatives are contracts whose value is based on the value of other, underlying contracts; and derivatives dealers are the commercial and investment banks that create, price, sell, and trade financial derivatives. The derivatives markets have been unravelling at an accelerating pace since multibillion-dollar losses shattered Italian conglomerate Ferruzzi and German metals firm Metallgeselleschaft in the last quarter of 1993. That these derivatives disasters in Europe created shockwaves now being felt in the United States, merely illustrates the warnings of former BIS director Alexandre Lamfalussy and others, beginning in 1992, that derivatives had tied different financial markets in different countries together in a way that makes it impossible to foresee the results of an apparently isolated default on a derivatives contract.

The case of Charles County, however, may represent a new phase-shift in the process of the inevitable, onrushing collapse of the Bretton Woods monetary system, as forecast by economist Lyndon LaRouche (see "Early Disintegration of World Financial Markets," *EIR*, June 24, 1994). The Charles County Treasury had invested the county's *entire* portfolio of $27 million in various derivatives, about one-third of which are mortgage-backed securities, the market for which virtually disappeared in the first quarter, obliterating the $600 million hedge fund Askin Capital Management, and torpedoing General Electric's wholly owned subsidiary, Kidder Peabody. When an independent audit uncovered $2.8 million in losses on the county's portfolio at the beginning of July, the county's short-term budget was effectively wiped out.

According to county officials, the county now has no money to pay bills for the next 45 days, and is delaying payments to local agencies such as the county school board and the sheriff's office. The political ramifications of the complete insolvency of an entire county (especially so close to the nation's capital) are likely to be dramatic, as the U.S. Congress considers legislation to regulate financial derivatives.

The central legal issue in the Charles County case is a legal doctrine called *ultra vires*. This doctrine, established at the beginning of this century, and affirmed all the way up to the U.S. Supreme Court, holds that parties which conduct business with a government entity are obligated to know the legal authority of that government entity to engage in the business being conducted. In the case of Charles County, Maryland, state law prescribes that local governments shall invest *only* in short-term U.S. government securities that enjoy a very liquid market. This was why Charles County's short-term budget was wiped out: Since the county had no legal authority to buy derivatives in the first place, it now has no legal authority to sell them. In the meantime, however, somebody else now has the county's money, while the county is left holding somebody else's derivatives. Legal counsel for the county has filed for injunctive relief, essentially seeking an expedited legal process, to have the county's money returned to it.

The nine investment firms named in the county's lawsuit are: Lehman Government Securities; Prudential Securities; Donaldson, Lufkin & Jenrette; Smith Barney; Liberty Capital Markets; Ernst & Co.; Meridian Capital Markets; Mabon Securities Corp.; and Murchison Investment Bankers. Some of these are very big names indeed on Wall Street: Donaldson, Lufkin & Jenrette's William Donaldson, for exam-

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ple, is chairman and chief executive officer of the New York Stock Exchange. Charles County is being represented by the Baltimore law firm of Smith Somerville & Case.

The derivatives dealers who had hooked the county treasurer as a client (she was fired soon after the losses were uncovered in early July, along with her assistant), clearly either failed to look into the laws of Maryland, or deliberately ignored the law. But given that it was not one, but *nine* dealers involved, it strains credulity to believe that they were all so blissfully ignorant.

Other horror stories

There are more cases besides that of Charles County, Maryland. In Ohio, Sandusky, Putnam, and Portage counties filed suit last year against the Government Securities Corp. of Texas, seeking to recoup losses those counties had incurred on derivatives they had been sold by GSCT. In fact, the treasurers of these three counties had actually bought additional derivatives from GSCT—so-called inverse floaters, which GSCT said would offset losses on other derivatives GSCT had previously sold, which had declined in market value. When the inverse floaters also collapsed in value, the losses could no longer be hidden, and the matters fell into the lap of the respective county prosecutors. Sandusky and Putnam reached settlements out of court, with the Putnam County treasurer now enjoying three square meals a day in the county jail. The Portage County case continues in the courts.

Another case is the Lousiana State Employees Retirement System (Lasers), which suffered $43 million in losses on derivatives investments early this year, after the state treasurer's office learned about Lasers' huge position in mortgage derivatives in late 1991, and expressed concern to Lasers' board. Lasers' board investigated the matter, and at the end of last year directed its chief investment officer, Vernon Strickland, who had bought the derivatives, to unload them. The resulting loss has sparked a host of lawsuits by retirees and others against Lasers, and the state treasurer, in turn, is considering taking legal action against the derivatives dealers who had done business with Strickland.

The approach of the Lousiana state treasurer to the Lasers imbroglio contrasts sharply with that of Florida, which has lost a reported $98 million on derivatives holdings of $3.1 billion. Bruce Gillander of the Florida State Treasurer's Office said that Florida will avoid the loss by holding its derivatives to maturity, at which time the dealers are supposed to pay off the derivatives (in this case, collateralized mortgage obligations—exactly the instruments that sank Askin) at par value. In the meantime, Florida will continue to collect its 7.5% interest for the next five years. What happens if the dealers go under, is left unsaid.

Speculators deliberately ignored the law

The arrogance of the commercial and investment banks and their lackeys in all these cases suggests that they are deliberately ignoring the law. Recall, for example, the spectacle of U.S. Federal Reserve Bank of New York President E. Gerald Corrigan, before the House Banking Committee last October, defending the practice of Fed officials accepting tickets for expensive sports and entertainment events from the very commercial and investment banks supposedly being regulated by the Federal Reserve System. Or, recall Federal Reserve Chairman Alan Greenspan's attempt during the same hearings to hide the fact that the Federal Open Market Committee has transcripts of all its meetings on file.

More recently, Mark Brickell, director of derivatives operations for J.P. Morgan bank, testifying in his capacity as vice chairman of the International Swaps and Derivatives Association before the House Banking Committee on July 12, exorciated the proposed "Derivatives Safety and Soundness Act of 1994" requirement that derivatives dealers be legally obligated to assess the suitability for their clients of the derivatives sold to them (see *EIR*, July 22, 1994). Such a suitabilty requirement, Brickell whined, "would introduce an unnecessary and undesirable element into the banker-client relationship"; "would subject banks and their affiliates to heightened compliance costs and likely lead to frivolous litigation"; and would force derivatives dealers to bear a burden none of the competitors had. Brickell quoted Greenspan, who had told Congress on May 25, "For the transfer of risk to be effective and the efficiency to be realized, end-users must retain ultimate responsibility for transactions they choose to make. In a wholesale market, sophisticated *and unsophisticated* end-users alike must ensure that they fully understand the risks attendant to any transaction they enter" (emphasis added).

But Howard Goldberg, of Smith Somerville & Case, said Brickell's was "a ridiculous position." Derivatives, Goldberg said, "are so sophisticated that many of the most astute securities people in the country can hardly figure them out. There are some derivatives that are so complex, we can't even get market prices from some very sophisticated securities firms."

Does Greenspan mean what he says? Is he—the chairman of the penultimate banking regulatory agency of the United States—so ignorant of the law as to assert *caveat emptor* for even "unsophisticated end-users" of derivatives? The Charles County case, if the doctrine of *ultra vires* is upheld, could help demolish not only the positions of Brickell and Greenspan, but also the institutions, and the very system they represent.

And that is exactly the problem. Looked at from the standpoint of what is real economic activity, derivatives are a ghastly abomination. Derivatives are nothing but the process of speculation and looting that the investment and commercial banks developed after the stock market meltdown of October 1987. Now the bills are coming due, and it's the "end-users" like the citizens of Charles County who are being stuck with the bill.