

Derivatives Trader Refco Files for Bankruptcy

by Lothar Komp

Another earthquake is hitting the worldwide casino of financial derivatives. This time it is not just a single hedge fund, which has lost the money of its customers in high-risk financial speculation. Rather, a financial institution has collapsed that represented the intersection point for access to the futures exchanges in New York, Chicago, London, and Singapore for thousands of clients, among them innumerable hedge funds. Refco, Inc., the largest independent futures brokerage firm in the United States, had to declare bankruptcy on Oct. 17, after it was revealed that the company had doctored its balance sheets for several years, to hide the fact that its speculative losses were uncovered. The losses derived from 1998, the year when the global financial system was right on the edge of collapse, after the Asian crisis, the collapse of the Russian GKO pyramid, and the collapse of the hedge fund LTCM.

The Refco case makes clear that the hedge funds serve the financial establishment as more than a tool for risky financial transactions that they don't want to be known by the regulatory authorities. A further important function of these unregulated funds, which German Federal Financial Supervisory Authority chief Jochen Sanio calls the "black holes" of the financial system, is accounting fraud. And that was exactly the reason Refco CEO Philip Bennett entered into a special working relationship with the hedge fund Liberty Corner Capital of New Jersey. At regular time intervals, the \$430 million deficit was transferred back and forth between Liberty Corner Capital and a Refco unit fully controlled by Bennett. Thanks to this scheme, Refco never had to report the loss.

On Oct. 10, the swindle exploded. Bennett was fired, ar-

rested a day later on suspicion of securities fraud, and set free on a \$50 million bond. Immediately, Refco's stock collapsed by 72%, and was suspended from trading on Oct. 14. The price of Refco bonds has fallen to a fraction of their face value. The rating agency Standard & Poors has downgraded Refco three times in four days, and declared that a default is very probable. Finally, there was a declaration of bankruptcy.

While the U.S. Securities and Exchange Commission (SEC) has started an investigation into the case, there is already hectic activity behind the scenes by the Federal Reserve, trying to prevent Refco from pulling the entire derivatives market into the abyss. Wall Street bankers were called upon to hand over information on their financial relations with Refco. A particular concern is the maintenance of all the outstanding derivatives contracts running through Refco, including the service of all eventual margin calls. This is quite a difficult undertaking, especially when numerous Refco clients, in a panic, pulled out their investments as soon as the difficulties became known. The SEC Chairman Christopher Cox would not directly answer the question of whether Refco's collapse was concealing a "potential systemic risk," but he said: "There is always the possibility of broader effects from individual cases. That is why the SEC maintains a special unit for the purpose of looking over the horizon and around the corners, to discover whether or not such risks are materializing." Michael Greenberger, the former director of the Commodity Futures Trading Commission, identified Refco as a "systemic problem" because of the threat of a "cascade of bankruptcies."

A City of London insider commented that the obvious

“degree of criminality” surfacing at Refco, and the scale of collusion of leading international banks and derivatives traders, are reminiscent of the junk bond pioneer Drexell Burnham Lambert, which collapsed in the 1980s. Others have compared Refco with Enron. The London *Guardian* on Oct. 16 referred back to the LTCM debacle of the Autumn of 1998, and warned that Refco “could be a catalyst for another collapse.” On the same day the *New York Times* called the Refco case “scary,” and pointed out that Refco was operating on a 0.3% assets-to-equity ratio. In February of 2005, Refco had \$150 million in equity supporting \$49 billion worth of assets, and by May it had off-balance-sheet derivatives contracts totalling \$150 billion.

According to its bankruptcy filing, Refco’s liabilities amount to \$48 billion. In total there are more than 1,000 creditors. Among the 50 largest creditors can be found 11 hedge funds, which had invested in Refco bonds. To this group belong three funds of the Capital Group as well as several funds of Jim Rodger. Over the last years Refco was one of the most important players in commodities at the leading futures exchanges. At the end, about 10% of all contracts traded at the Chicago Board of Trade (CBOT) listed Refco as one of the counterparties.

Fears that the CBOT itself could get pulled into the mess, caused CBOT stocks to implode by 8% in a single day after Bennett’s arrest. Refco also handled a very large volume of futures contracts in stocks, bonds, and currencies. For example, Refco controlled 60% of the New York trade of Brazilian and Argentine bonds. Refco was active in 14 countries, employed 2,400 employees there, and had about 200,000 customers. In the manipulation of its balance sheets, the Bermuda-registered Refco Capital Markets, which dealt in OTC (over-the-counter) derivatives, played a decisive role.

Behind Refco stand a row of the leading major banks. Thus, in the last year, Bank of America, Credit Suisse, and Deutsche Bank granted Refco an \$800 million credit. The insurance giant American International Group (AIG), whose longtime chief Maurice Greenberg recently had to step down because of financial irregularities, had routinely serviced Refco with short-term credits. Credit Suisse First Boston (CSFB), Goldman Sachs, and Bank of America are now facing call-action suits as they gave their blessings to the initial public offering (IPO) of Refco on Aug. 11 this year. The buyers of such stock have lost almost their entire investment as a result of the Refco scandal.

Goldman Sachs played a special role with Refco. The U.S. investment bank, after already being part of the Refco IPO, was entrusted on Oct. 13 with the lead in managing the Refco crisis. The private equity group J.C. Flowers, which on Oct. 17 issued a declaration of intention to take over parts of Refco, also belongs to Goldman Sachs’s sphere of influence. The group belongs to Christopher Flowers, a Goldman Sachs protégé.

Austria’s Biggest Banking Scandal Since the War

On the day of his firing, and only hours before his arrest, Refco chief Philip Bennett suddenly paid Refco \$430 million, thereby attempting to settle the hidden deficit. He had just gotten the money for this operation as a loan from a quite unusual source: Bank für Arbeit und Wirtschaft AG (BAWAG), owned by the Austrian Trade Union Federation. This bank administers, among other things, the savings of the trade union members, and also carries out financial business for the Austrian government. On Oct. 10, BAWAG provided a loan of 350 million euros to Bennett personally, in addition to 75 million euros to Refco. The loan was secured with Bennett’s private stock holdings, a 35% portion of Refco, an extremely unusual transaction. However, this collateral in the very same week became almost totally worthless. Should the loans to Bennett and Refco not be paid back, BAWAG therefore will end up owning one third of a bankrupt financial house which is heavily involved in the worldwide derivatives trade. People are now speaking of possibly the worst banking disaster in Austria since the bankruptcy of the Vienna Kreditanstalt in 1931. How could the BAWAG leadership have agreed to such a crazy deal?

The answer lies in the ties over many years which bind several BAWAG managers with the global derivatives casino. Already back in 1994, BAWAG hit the headlines, when it became known that the son of the then head of BAWAG, Walter Floetl, had channelled about \$2 billion to a hedge fund located in the Caribbean, for derivatives speculation. When this came out in public, the contracts had to be dissolved, and Refco participated in that delicate action. BAWAG at that time was supported by Bayerische Landesbank from Germany, which bought up 46% of BAWAG’s shares. In May of 1999, BAWAG started another adventure: It bought into Refco with a 10% share, and was in this way again in the derivatives business. A year later BAWAG merged with the Austrian Postbank. In 2004, the trade union federation bought back the shares of BAWAG owned by the Bayerische Landesbank. In the same year BAWAG sold its Refco shares to a New York investment house. There have been cross connections between BAWAG and Refco for a decade.

A special role in this was played by a certain Thomas Hackl, a former leading derivatives trader at the Baden-Württemberg Bank in Stuttgart. In 1991, Hackl moved to BAWAG, only to become Vice-President of the Refco group in 2002. Already in 1999, BAWAG and Refco jointly established a private bank in Liechtenstein, the Bank Frick & Co., where Hackl sits on the supervisory board. Financial supervisors in Austria have now started an investigation into the entire affair. Meanwhile it turned out that turbulent scenes were taking place at BAWAG headquarters on Oct. 10. In the evening of the day when the news on the Refco scandal became known, BAWAG tried to cancel the whole

credit deal. But the money had already landed with Bennett.

The accounting manipulations at Refco; the role of the hedge fund Liberty Corner Capital in concealing the speculative losses at Refco; the extreme dependence of the leading global derivatives exchange, the Chicago Board of Trade, on a single enterprise like Refco; the blindness or complicity of the major bankers which participated in the Refco IPO; and finally, the “bank robbery” at BAWAG; are simply symptoms of the rotten state of the world financial system. For every such case popping up in public, there may be a hundred similar cases still waiting to be uncovered. In September, the managers of the Bayou Management hedge fund had to admit betraying their customers for years. In early October, the Man Group, the largest hedge fund group in the world, was caught helping another hedge fund, Philadelphia Alternative Asset Management, to fake its balance sheet. The latest case is Wood River Capital Management, now the target of another SEC investigation. The hedge fund had invested two-thirds of its entire capital—with a significant part being delivered by the U.S. investment bank Lehman Brothers—into the stocks of a single and relatively small technology firm, named “Endwave.” Unfortunately, the firm ran into trouble during the Summer, thereby losing 75% of its stock value.

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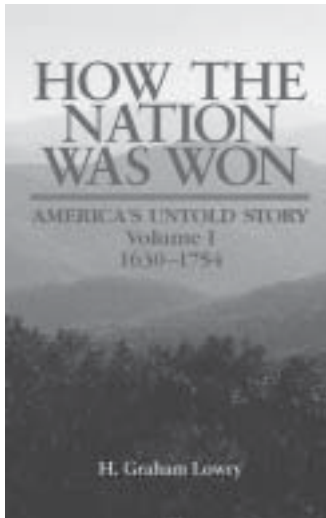
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Documentation

Jochen Sanio: Should Hedge Funds Be Regulated?

The following is the advance text of a speech given by Jochen Sanio, president of the German Federal Financial Supervisory Authority, at the “Top Ten Financial Risks to the Global Economy” Conference organized by the Global Markets Institute (Goldman Sachs), and held on Sept. 22, 2005 in New York City. It reflects an ongoing discussion within the banking community which seldom reaches the media in the United States.

It is indeed very interesting that you have asked me, of all people, to comment on whether hedge funds should be directly regulated or not. I have had a clear opinion on this issue since 1998, the year of the LTCM crisis, and I do not think that I will change it in the foreseeable future. I am, and I always will be, an advocate of direct regulation. If you call me a hardliner, I wouldn't be offended. My opinion has nothing to do with the recent highly emotional debate in Germany about “locusts,” as hedge funds have been called by certain politicians in my country. I am not an entomologist, I am a supervisor, and as a supervisor my interest is financial stability. And I am deeply concerned about the systemic risk posed by hedge funds. But let me emphasize at the start that today I am speaking purely in a personal capacity. Any views I offer you in this session are entirely my own.

In the relatively short time I am allotted today, I will explain some of my concerns. Hedge funds do handle huge amounts of money, and their highly leveraged business carries enormous risks. Those risks should be reflected in the capital that hedge funds hold. The idea that hedge funds have enough capital today, as an adequate cushion for crisis situations, appears entirely counter-intuitive. If a hedge fund cannot fulfil its obligations, large counterparties could be affected. This has already been pointed out in the LTCM report of the Basel Committee on Banking Supervision, which was published in the Year 2000. The counterparties that are most vulnerable to contagion are prime brokers. There seem to be signs that prime brokers have recently become more aggressive in soliciting hedge fund business which obviously is a growing source of income. It would be rather worrying if the trend towards an erosion of collateral continued. Therefore, it would be foolish to believe that prime brokers are able to replace supervision—even though this idea seems to be very tempting.