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The coming derivatives-fueled blowout of global markets shakes Texas

by Brian Lantz

Behind closed doors in Austin, Texas, the talk is of losses, maybe hundreds of millions of dollars, to local, county, and state government. Rumors and "off the record" comments abound, while agency investment officers speak in defensive tones. How much have Texas government entities lost in derivatives investments and trading? Where will it end? Who will take the blame? It is an election year and the stakes are certainly high.

The international derivative markets have been unraveling at an accelerating pace since multibillion-dollar losses shattered the Italian conglomerate Ferruzzi and the German metals firm Metallgesellschaft in the last quarter of 1993. Caught up in the international financial "mudslide," Texas local and state government agencies are gambling away a fortune.

Economist and statesman Lyndon LaRouche has warned of the impending collapse of the derivatives-fed financial bubble and, in June 1994, issued his ninth economic forecast, projecting the impending disintegration of the international financial system (see *EIR*, June 24, p. 24). That is reality. "But seldom is heard a discouraging word," the refrain of an old cowboy song, is the theme of Texas policymakers and pundits.

The financial mudslide

In August, word slipped out that some Texas state agencies and local government entities had been caught in multimillion-dollar losses due to investments in derivative financial instruments. On Aug. 15, Lt. Gov. Bob Bullock and State House Speaker Pete Laney announced that they had asked the state auditor "to survey investment practices of state agencies and other community colleges as to whether they use derivatives and, if so, the kinds of derivatives."

Bullock and Laney cited losses by tiny Odessa College, a 5,000-student junior college in rural West Texas. Odessa College lost $6.6 million from trading in derivatives and had another $22 million in derivatives investments that the college could not afford to sell. In June, Odessa College had no choice but to borrow $5.2 million from a local bank to meet its obligations. The school has since proposed a 7.2% tax rate increase, has raised tuition, and has cut its already impoverished budget.

Who sold Odessa College on derivatives? According to its chancellor, Odessa bought the derivatives in part because the Texas state treasurer had purchased approximately $200 million of the same instruments! Reportedly, the bulk of these purchases were of mortgage-backed derivatives. When interest rates went up, the value of these derivatives contracts collapsed.

Phil and Wendy Gramm

Odessa College was not the only small government entity taken to the cleaners. Ironically, U.S. Sen. Phil Gramm's (R) hometown of Bryan (population, 55,000), has lost at least $1.5 million on derivatives investments this year. In Gramm's "free market," Bryan saw its investment in "inverse floaters" lose half their value in five months. The city of Bryan has sued Government Securities Corp. of Texas for fraud and deceptive practices.

However, the actual culprit is to be found a few steps higher up the ladder. It was Wendy Gramm, Phil Gramm's wife, as chairman of the Commodities Futures Trading Commission from February 1988 to January 1993, who oversaw the explosion of the unregulated derivatives market and *resisted all attempts to take corrective action*. The derivatives markets grew exponentially to $18 trillion in 1994. That compares to approximately $1 trillion in total U.S. corporate financing. Wendy Gramm now sits on the board of the politically influential Enron Corp., which institutionally serves as an outspoken Texas advocate of derivatives speculation.

Large institutions hit

But larger public agencies have also taken big losses, although this has been kept out of the press. The Texas state treasury is out tens of millions of dollars, or more, as a result of the same investments that tiny Odessa College made. How many others followed the state treasurer's lead?

The Teachers Retirement System of Texas (TRS) has been rumored for months to have lost a large, undisclosed amount, according to Austin government sources. Encompassing 28 corporations, the TRS includes a Pension Trust Fund with a book value of $28.8 billion. In September, the system disbanded its high-powered Investment Advisory Committee.

John Young, the chief investment officer of the TRS, told *EIR* that the Teachers Retirement Fund has $1.8 billion invested in derivatives known as Collateralized Mortgage Obligations (CMOs).

Young insisted that the Teachers Retirement Fund had taken no losses and that "the problem is with the users, not derivatives." Young said that their CMOs were long-term investments, and that he believed that they really shouldn't be called derivatives but that they are universally placed in that category. Young does not like to refer to CMOs as derivatives, but he admits that that is indeed what they are.

Young explained that if one includes CMOs in the category of derivatives, then "all of the major pension funds in Austin are invested in derivatives."

Under the Constitution of the State of Texas, the TRS board of trustees is ruled by the "prudent person rule." In making investments, the rule says, the trustees "shall exercise the judgment and care under the circumstances then prevailing that persons of ordinary prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable safety of their capital."

It is worth noting that the Louisiana State Employees Retirement System (Lasers) suffered $43 million in losses in derivative investments early this year, after the state treasurer's office learned about Lasers' huge position in mortgage derivatives. Lasers' board investigated and, applying their own "prudent person rule," ordered its chief investment officer to unload their derivatives.

In addition to the Texas TRS, there is TexPool, a statewide investment pool for Texas government entities. Again, rumors abound, and TexPool officially admits to "book losses" of $50 million on derivatives instruments. More than 1,300 governmental entities are members of TexPool.

"No one expected interest rate increases of 150 basis points in March," TexPool head Randall Corwin explained to *EIR* when queried on recent losses. As with the Texas Teachers Retirement System, TexPool operates under strict state guidelines which officially allow only a small percentage of its $4.5-9 billion pool to be invested speculatively. Fifty million dollars would be a small percentage of TexPool's current $5 billion pool—1%. But $50 million is still $50 million. And is that the whole story?

An emperor without clothes

The State Auditor's office sent its "Survey of State Agency Investment in Derivatives" to 142 Texas state agencies, 19 state universities, and 50 state junior colleges. As of early September, most of these surveys had been returned. A report is due out soon, but may not appear before the November elections. Certainly the survey cannot be relied on in itself.

As TexPool's Corwin asked rhetorically, "What is a derivative?" If anything was learned from the looting of the Texas savings and loan industry, it should be that desperate financial officers and board members can be less than forthcoming. If an investment officer, under duress, can continue to convince himself that he has a "government security," tied to Ginnie Mae or Fannie Mae, he could answer the the state auditor's survey with a simple "No."

Sen. Phil Gramm: His hometown of Bryan, Texas has lost at least $1.5 million on derivatives investments this year.

It is acknowledged that it would be difficult to hide the facts if hard data were demanded—such as the daily computer runs.

Who is culpable?

Sources in state government report that it was under State Treasurer Kay Bailey Hutchinson, now the U.S. senator from Texas, that the bulk of the Treasury's derivatives was purchased. Her husband, Ray Hutchinson, is a partner in Hutchinson, Boyle, Brooks and Fischer, one of two leading bond counsels in Texas. Whether a case against Hutchinson can be made is not known. But it is well documented that George Bush's political machine in Texas has major supporters of radical free-trade and deregulation policies, and is heavily funded by the likes of Kravis and other firms which are the most heavily involved in such speculative activities. Phil and Wendy Gramm are examples of this outlook.

Others are also culpable. Elected officials, who have demanded higher returns from their investment officers to cover mounting tax revenue shortfalls, are afraid that they too will be held accountable. The financial community, whether in Dallas, Houston, or New York, is worried at the fallout from mounting lawsuits nationwide against financial houses which have unloaded derivatives onto local government agencies. The Texas crisis will certainly feed the whirlwind of international financial disintegration, as forecast by Lyndon LaRouche. The big question is whether the elected officials of Texas have the political will to face the music.