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Orange County bankruptcy forces Senate Banking Committee hearings

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The commercial and investment bankers who create, sell, and trade the $1.3 trillion a day in financial derivatives, may have thought that the Republican takeover of Congress would help blunt further inquiries into derivatives losses. The bankers were particularly happy that the Senate Banking Committee is now under the chairmanship of Alfonse D'Amato (R-N.Y.), who has long been a staunch friend and ally of Wall Street.

But only one month after the GOP sweep in the November elections, Orange County, California was hounded into bankruptcy by over $2 billion in losses resulting from the county's highly leveraged investment fund that was structured to take advantage of declining interest rates. At the time of the bankruptcy on Dec. 6, the fund had about 40% of its investments in derivatives, the financial contracts that derive their prices or values from other, underlying contracts, assets, commodities, or indexes of these. These derivatives were hemorrhaging losses as the U.S. Federal Reserve raised interest rates from 3% in February 1994, to over 6% by December. As a result, Orange County is unable to meet 40% of its near-term funding requirements, and has laid off thousands of county workers, slashing many county services.

Overnight, the Orange County bankruptcy altered the political dynamic the bankers and dealers had so gleefully welcomed in November. This was readily apparent in hearings before D'Amato's Senate Banking Committee on Jan. 5 and 6, held to "examine issues involving municipal, corporate, and individual investors in derivative products and the use of highly leveraged investment strategies."

Further regulations 'not needed'

On Jan. 5, the committee heard Acting Secretary of the Treasury Frank Newman, Securities and Exchange Commission Chairman Arthur Levitt, Jr., Commodities Futures Trading Commission Chairman Mary Schapiro, and Federal Reserve Chairman Alan Greenspan continue the line of argument U.S. regulators began almost two years ago, that further regulations of derivatives are not needed and may actually prove harmful by precluding regulators from responding to rapidly changing financial conditions and activities.

Greenspan, for example, declared, "The decline in the value of many portfolios has been a consequence of the rise in interest rates over the past year. That derivatives have been implicated in many recent losses should not be surprising. Losses to holders of bonds amounted to many hundreds of billions of dollars in 1994. Derivatives, as we know, transfer risk from one market participant to another, and in such a market they inevitably will be involved in large gross losses. Of necessity, they also accounted for large gross gains since contracts tend to cancel each other net, but the gains are less newsworthy."

Newman, who was formerly the manager for risk management of a large bank, stated, "Of late, each time a market participant suffers a large newsworthy loss, the term 'derivatives' is used almost as if it were an explanation. . . . In the Orange County case, the losses were not caused by over-the-counter contracts that market participants normally consider derivatives."

Levitt declared, "Commentators have tended to make the Orange County bankruptcy and derivatives synonymous. I think this is a mistake. Derivatives did not cause the Orange County pool's problems. . . . It would be a grave error to demonize derivatives and blame them for the loss. As I've said on prior occasions, derivatives are not inherently bad or good. They're something like electricity: dangerous if mishandled but bearing the potential to do great good."

Under questioning, Greenspan actually argued that derivatives made Orange County's investment strategy less costly. If Orange County Treasurer Robert Citron, Greenspan declared, "had no derivatives, but insisted upon the same strategy that he was involved with, he would have come up with the same problem; it just would have cost him a little more."

Ayn Rand ideologue Greenspan also reiterated his longstanding warning against meddling in the free market. "Although the convenience and the low cost of using derivative instruments to meet portfolio objectives may have facilitated some investors reaching for more unconventional and possibly riskier strategies, it would be a serious mistake to respond to these developments by singling out derivative instruments for special regulatory treatment. Such a response would create artificial incentives to structure transactions on the basis of regulatory rules rather than of the economic characteristic

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of the transactions themselves. A shift to the use of less efficient instruments as a substitute for derivatives would mean greater cost to hedgers as well as speculators, and a net loss in market efficiency."

Too much to swallow

It was too much for even D'Amato to swallow. D'Amato asked, "Should a broker-dealer . . . watching a tragedy unfold [alluding to Orange County] . . . don't they have some duty" to steer their client away from the tragedy?

The regulators weakly replied that the banks Citron did business with were acting as brokers, not advisers, and could not be expected to shoulder such responsibility.

That led Paul Sarbanes (D-Md.) to ask Greenspan, "Are you concerned that millions of people, including widows and orphans, through pensions and so on, have invested in derivatives?"

Greenspan launched into a monologue about derivatives being "more efficient investment products." Sarbanes, clearly irritated, interrupted to ask his question again. Greenspan quietly replied, "Yes, certainly."

Sarbanes then read a quote from the March 1994 *Fortune* cover story, "The Risk That Won't Go Away," about how derivatives are speeding out of anyone's control, including the dealers that create and sell them. Sarbanes also referenced the May 1994 report by the General Accounting Office which warned of the same thing. "My concern in listening to you," Sarbanes told Greenspan, "is that you have an almost sanguine attitude. . . . How do you explain the gap between your testimony, your attitude, and what we're reading in the press?"

SEC chairman Levitt jumped in to save a clearly discomfited Greenspan, claiming that the regulators have come a long way in understanding derivatives in the past two years. Then, Levitt said that if he were given a magic wand that could make derivatives disappear, it would be a "national economic catastrophe."

Later, Sarbanes attacked again, noting that Orange County is "talking now about school districts [that] are going to have to cut back, in fact, one of them is saying they're going to have to ask the parents to help as janitors . . . they say they're going to have to cut services in health, welfare, police, and fire services." Sarbanes quoted from a recent speech by Federal Reserve Board Governor John LaWare, who has, Sarbanes noted, "a lot of jurisdiction in this particular area." Sarbanes then read LaWare's statement: "There is no evidence that gullible widows and orphans are playing the derivatives market unless they are very rich widows and orphans."

"This is the kind of cavalier attitude that I absolutely condemn," Sarbanes told Greenspan. "The fact of the matter is that the money of widows and orphans was being put into these derivatives and other potentially risky investments by people who handled their money. . . . And the consequence of that now is that orphans, children, are going to have an impact on their education, and widows are not going to go to the senior citizens center; they're going to find it closed. I don't think there's any excuse for the kind of attitude that's reflected in [LaWare's] statement. . . . This is a serious problem and it needs to be addressed as a serious problem."

Smaller investors targeted

Barbara Boxer (D-Calif.) had obviously come well prepared for the hearing, and Chairman D'Amato repeatedly allowed her to speak long after her time had expired. Noting that when she was a broker, she was always expected to ascertain the suitability of an investment for a client, Boxer launched a series of attacks on the regulators. She read from a Dec. 20 *New York Times* article, which described how many broker dealers had been unable to convince large municipalities to buy derivatives, and turned to fix their sights on smaller, less sophisticated investors. "The most aggressive sales tactics and the riskiest securities were pitched to smaller towns and less sophisticated finance officers. Many of the derivatives were the leftovers of arrangements tailor-made by Wall Street customers like scraps of fabric after the name-brand suits are cut," Boxer read aloud.

Speaking of how the credit-rating agencies failed to warn of the Orange County situation, Boxer said she "was stunned to learn that Orange County got glowing reviews from Moody's this past summer. . . . How did these credit-rating agencies miss the fact that Orange County was in trouble?" None of the regulators ventured an answer.

Boxer concluded, asking, "And how on Earth can widows and orphans be expected to understand [derivatives] if these credit-rating agencies don't have full disclosure?" Again, none of the regulators provided a direct answer.

The next day, when representatives of financial trade associations testified, Boxer repeatedly brought up the issue of suitability. "I don't see how you take a short-term fund and invest it long term. . . . This was for meeting the *daily* needs of *school districts*, of *children*," she exploded in exasperation when Securities Industry Association President Marc Lakritz argued that Orange County was a sophisticated investor to which no broker should be expected to provide guidance.

By contrast, many Republican senators, such as Phil Gramm (Tex.) and Lauch Faircloth (N.C.), appeared as sanguine as the regulators. Moreover, even Democratic senators agreed that derivatives legislation mandating new regulation is probably not a good idea. "I think Orange County going broke will do more to stop speculation than any legislation we can pass," Boxer declared.

But more financial shocks are coming that will further shift the political sands. When Christopher Dodd (D-Conn.) asked if other municipalities were in the same risky situation as Orange County, SEC Chairman Levitt replied to nervous laughter, "I guess my experience in the securities industry over recent decades suggests that very few problems are unique."