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Pennsylvania schools fleeced in latest derivatives scam

by John Hoefle

You'd think by now, with more than $3.2 billion in derivatives losses wracked up by state and local governments since 1992, the high-profile bankruptcy of Orange County, California, and hundreds of well-publicized horror stories, that no local government would be foolish enough to gamble on these dangerous instruments. But some people never seem to learn, including a number of officials of school districts in Pennsylvania.

The Pennsylvania school district fiasco came to light on Aug. 13, when Pennsylvania Auditor General Barbara Hafer held a press conference in Harrisburg, to announce that her office had discovered that a number of school districts in the state had bought mortgage-backed derivatives from First Empire Securities, Inc. of Hauppauge, New York. "Our investigation has identified at least 18 school districts in 13 counties, plus a vo-tech [vocational-technical] school, that have invested more than $59 million in complex mortgage-related securities—often without understanding the risk," Hafer said. The next day, another district was added to her list.

The worst loss was at Bethel Park School District, in a Pittsburgh suburb. The Bethel Park district lost $2 million of the $18 million it had invested with First Empire. Other school districts which lost money on mortgage-backed derivatives included the Greater Johnstown Area School District, which lost $144,643 of the $3.9 million it invested; the Moon Area School District, which lost $20,000 of an $8 million investment; and the New Brighton School District, which lost $90,000. The Admiral Peary Vo-Tech managed to turn a profit of $5,648 on the $4.9 million it invested, compared to the $400,000 it would have earned had it deposited the money in a savings account earning 4% interest, according to Hafer.

The same day, Bethel Park School District filed a federal lawsuit against First Empire, asserting that the securities firm had violated its agreement with the district by selling it unsuitable and unsafe CMO (collateralized mortgage obligations) and REMIC (real estate mortgage investment conduits) derivatives. In addition, Bethel Park charged that First Empire had violated U.S. securities laws, had engaged in churning its account to run up unwarranted transaction fees, and had violated the Racketeer Influenced and Corrupt Organizations Act (RICO).

Stay out of the casino

Whether First Empire is guilty of these charges remains to be seen, but what is clear is that the school districts should never have bought these instruments, no matter what First Empire promised.

Bethel Park's complaint is reminiscent of the old story about the man who goes into the casino, loses his shirt, then complains that the games are rigged. Maybe he was cheated, and maybe not, but it wouldn't have been an issue had he had the sense to stay out of the casino. Even if some of the school districts made money on their derivatives bets, they're in the wrong: Public money has no place in the derivatives casino. Morally, it's the being there that counts, not whether you win or lose.

Derivatives are a suckers' game, designed to separate the mickeys from their money. Over the past several years, the so-called "smart money," the *fondi* of the Club of the Isles international financial oligarchy, has been quietly slipping out of the paper markets and into commodities, such as precious metals, strategic minerals, food and energy supplies. At the same time, to cover their exodus, the Club has engaged in a concerted effort to lure public money into the paper markets. When the global financial system collapses, the Club will control the commodities, and the public will be left holding worthless paper.

Remember Kidder Peabody

The dangers of mortgage-backed derivatives should have been made clear to all with the 1994 collapse of Kidder Peabody, one of Wall Street's blue-blood investment banks and the market leader in the CMO market. CMOs (and the similar REMICS) are a type of mortgage derivative, created by bundling together pools of mortgages, then stripping off and selling various interest-rate and principal components, backed by the revenue stream from the original mortgages. CMOs are especially vulnerable to large-scale home refinancings, in which the loans in the CMO bundle are paid off early, significantly reducing the value of the CMO.

In February 1994, the Federal Reserve, after five years of steadily lowering interest rates to bail out the bankrupt U.S. banking system, began raising rates in an attempt to dry out the derivatives bubble. The interest-rate hike prompted mortgage-holders across the country, to refinance their mortgages, triggering a collapse in the values of CMOs. In domino fashion, the CMO crash bankrupted the $600 million Granite hedge funds run by Michael Askin, then Kidder Peabody itself; other banks and funds also suffered huge losses.

If the derivatives market is not safe for Kidder Peabody, it's certainly not safe for school districts and vocational schools. Government funds do not belong in the casino, and such investments should be outlawed.

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