

Financial Innovation Meets Main Street:

Jefferson County and Municipal Finance in the Wake of the Bubble

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Today I am speaking about an area of risk management, namely in the area of public finance, that is outside my usual area of focus of financial institutions and private markets. However, the number of reports that I am hearing within the public sector about abuses and acts of outright fraud involving complex structured assets caused me to have several conversations with my friend and colleague Alex Pollock. These conversations led us to organize today's program. On behalf of the 55,000 members of Professional Risk Managers International Association, I want to thank Alex and AEI for co-hosting yet another joint session with PRMIA (www.prmia.org).

Over the past year or more, Americans have been reading horror stories about banks and end investors taking gruesome losses on complex structured financial instruments such as collateralized debt obligations ("CDOs"). Most recently we have seen the negative effect of these losses on the GSEs, Fannie Mae and Freddie Mac, as well as on the Federal Home Loan Banks. But while the ill-effects of the securitization boom for private investors are pretty clear, the impact of poor risk management, unsuitable investments and outright swindles conceived by some securities firms, often with the tacit approval of federal regulators and senior managers at these same firms, is also being felt by municipalities, both with respect to issuers of securities and public sector money managers.

We all have read the stories about the State of Florida halting withdrawals from a \$15 billion local government fund in 2007. This was one of the early examples of concerns surfacing related to exposure to subprime mortgages. The fund had invested in SIVs, or Structured Investment Vehicles, to the tune of almost \$2 billion. These funds borrow short and invest them into longer term investments ostensibly to speculate and thereby make money off the spread. The same structured products, the results of these types of investment, were until recently sold to some money market funds.

As the *Economist* commented at the time:

"The fiasco invites comparisons with California's Orange County, which was responsible for America's largest municipal bankruptcy in 1994 after losing \$1.6 billion through ill-advised derivatives trades. In both cases, state-employed neophytes were seduced by complex products peddled by Wall Street—which is again likely to be hit with lawsuits as a result—and failed to appreciate the enhanced risks that come with enhanced returns. Unlike Orange County, however, Florida is no isolated case."ⁱ

At the end of 2007, dozens of municipalities from Norway to Australia, *The Economist* noted, had suffered losses from SIVs. But the tale of woe has only continued to grow.

In 2008, Merrill Lynch (NYSE:MER) agreed to reimburse Springfield, Mass. for nearly \$14 million in losses on risky investments sold by its brokers to the struggling city in the southwestern corner of the state. In a deal brokered by Attorney General Martha Coakley, Merrill agreed to repay the city for all its holdings in specialized investments known as collateralized debt obligations, which plummeted in value in 2007 with the subprime mortgage collapse.ⁱⁱ

Even with these examples, however, some of the best and the brightest on Wall Street continue to buy what can only be described as toxic waste. But even that description masks the true nature of many structured assets. As Frank Portnoy, professor at the University of San Diego, told *Bloomberg Magazine*:

“The murky nature of the CDO market presents danger for the unwary investor, and it’s particularly unsuitable for public pension money,” Partnoy says. “I think ‘smoke and mirrors’ in some sense understates the problem,” he says. “You can see through smoke. You can see something reflected in a mirror. But when you look at the CDO market, you really can’t see enough information to enable you to make a rational investment decision. That hasn’t stopped pension funds from taking high risks with the retirement plans of teachers, firefighters and police.”ⁱⁱⁱ

Just as art dealers prefer private sales to auctions at Christie’s, dealers in complex structured assets like CDOs or credit default swaps (CDS) have created a private, bilateral marketplace where “innovation” is so extreme as to approximate deliberate fraud and transparency is also deliberately limited. The principle of maximizing the “yield to commission” is a normal human trait and one that applies to sales in just about any industry. In the OTC world of complex assets containing subprime debt, however, everybody besides the dealers seems to be the losers. Indeed, the OTC market in complex structured assets seems so deliberately opaque and thus difficult to value as to be on the verge of being deceptive by design—that is, a deliberate criminal enterprise — and until less than a year ago it had the full blessing of politicians and regulators in most of the industrialized nations.

More recently, in Australia, the state government in New South Wales has launched a crackdown on its investment guidelines after local councils were left nursing aggregate losses of up to \$364 million on investments hit hard by the US subprime mortgage market collapse. Dozens of the state’s 152 local councils, which have made investments directly, incurred losses after making investments in high risk instruments, particularly collateralized debt obligations that turned toxic as the credit crunch deteriorated.

“Some of the councils had invested 50 per cent or more of their total investment portfolio in CDOs in return for forecast returns that were often only a few percentage points higher than mainstream fixed interest investments,” the *Financial Times* reported.^{iv}

There are literally dozens upon dozens of such examples where state pension managers and municipal treasurers have been deliberately defrauded and cheated by unscrupulous securities firms selling CDOs and other derivative securities. But by far my favorite example to date is the travails experienced by the State of Wisconsin.

Back in the Spring of this year, we started to get calls from newspapers and private citizens in Wisconsin concerning a growing financial snafu involving five school districts. It seems that these school districts were convinced to issue over \$400 million in debt and invest the proceeds of the borrowing in CBOs and CDS contracts in order to fund future health care liabilities.

Now you are probably thinking to yourselves, why would a school board engage in a speculative, interest-rate arbitrage in order to generate gains to pay health care benefits in the future. These health care benefits, which are currently vested but unfunded, are promised to retired teachers and other employees of the school districts.

In the next couple of weeks, the school districts in Wisconsin must decide whether to sue some or all of the securities firms and individuals concerned. According to a joint news release between the districts and law firms hired to investigate the investments, a report compiled by investigators says the districts were victims of a complex and convoluted investment scheme with the Royal Bank of Canada Europe Ltd., Stifel, Nicolaus and Company Inc., and financial adviser David Noack, which is believed to have cost the districts millions of dollars.^v

"There were no documents signed by the districts or even presented to the districts prior to closing that disclosed the true risk of the deal," said Shawn Yde, director of business services for the Whitefish Bay School District. "There is no way the districts knew or could have known that they were being victimized." ^{vi}

News reports indicate that the value of the investments made by the school districts has plummeted by 60% over the last year, triggering calls for millions of dollars more in collateral to avoid a drop in income from quarterly dividends. But until recently, school officials had continued to insist that their investments were safe and that district funds were protected. Until the last fiscal quarter, they all also had been receiving surplus payments from the investments that they could use to pay non-pension retirement benefits for their employees. Representatives from all of the districts said in statements released last month that "they had been sold investments far riskier than they had been led to believe by the investment banks involved in the deal." ^{vii}

Not only do the school districts need to post more and more collateral with RBC to cover the declining value of their investments, but the districts must also repay the borrowings made to finance these speculative transactions in the first instance. Not only will the district's retirees now not receive the health care benefits that they were promised, but the taxpayers of these districts must now provide the cash to repay over \$400 million in debt and interest.

How do these situations transpire? Is it really possible that these Wisconsin school districts really went out and borrowed money to speculate on interest rates in order to fund health care costs?

Is it really possible that state regulators and political leaders from conservative states like Wisconsin are so stupid and so reckless as to be ensnared in transactions that, from a distance, look like classic frauds?

Well, yes it is. And Wisconsin is far from the only example.

We need to acknowledge that the same lobbying effort that brought private investors and banks the benefits of SIVs, subprime debt, CDOs, CDS and all other manner of OTC derivative securities was also focused on the states. If you inspect the state lobbying records of jurisdictions where structured assets are causing serious losses to state and local agencies, you will see that the securities industry has been actively lobbying state legislatures for over a decade to permit the use of structured assets and OTC derivatives by state and local agencies, and pension funds.

The deliberate, calculated effort by Wall Street to spread the disease of derivative securities to the public sector paralleled similar efforts to, for example, make the world safe for OTC derivatives in the banking and institutional fund sectors. In each case, Wall Street firms large and small have deliberately sold securities to investors that neither the clients nor often times the bankers themselves are able value or even describe.

Just imagine the lobbying clout displayed by the GSEs until their takeover on Sunday, multiplied several times, and you begin to understand the onslaught by Wall Street that has been directed against some of our least sophisticated and easily swayed public sector officials. State and local agencies don't have the money or the people to compete with the major Wall Street derivatives sweat shops and the banksters know it. That's why they continue to focus huge resources on selling OTC securities like CDOs and swaps to unsuspecting public sector investment officials.

What is to be done in the face of this deliberate attack on public sector investment funds by Wall Street? Let me make some suggestions:

First, given the relative inexperience and lack of financial savvy evidenced time and again by public sector agencies, it seems to me prudent for the states to impose (or restore) draconian restrictions and limits on the types of securities and derivatives that a public agency may purchase as an investment. Instruments such as CDOs, CDS, instruments using the words "swap" or "total return," or requiring the use of a contract approved by the International Swaps and Derivatives Association (ISDA), should be prohibited for purchase by any public sector agency.

Second, I believe that state pension as well as private mutual funds should be prohibited by law from investing in any securities that are not registered with the SEC and either traded on an exchange or in a formal, standardized OTC market. These changes would

literally force the extinction of the private-label securitization and OTC derivatives markets as we know them today and compel a level of disclosure that at least gives public sector investors a fighting chance to understand that which they buy on behalf of their citizens. If private investors and hedge funds want to traffic in the financial detritus that Wall Street touts seem to favor, so be it, but we must take action to protect state agencies and pensions from the predations of Wall Street's "yield to commission" culture.^{viii}

Third, I believe that we need to strip the protection of arbitration from all securities firms in their dealings with public agencies and pensions. Let us never forget that state and local agencies and pension funds represent all of our citizens, virtually all of whom are not competent to make investment decisions. When a securities firm preys upon public agencies legally charged with acting as fiduciaries for the public, they are attacking our entire society. The individuals and firms who are involved in these hateful activities should be vulnerable to all forms of civil and criminal claims.

Indeed, speaking as someone who worked as an investment banker and supervised other bankers as a general securities principal, I believe that all securities claims by public agencies should by law be excluded from NASD arbitration. I also believe that securities firms found to have defrauded a state agency and every registered person working for that dealer should be banned from the investment world permanently. Do that and you may begin to get Wall Street's full attention.

Fourth, I would like to see the securities laws amended to allow for claw-backs of all commissions paid to individuals involved in fraudulent activities targeting public agencies, pensions as well as private investors. If a broker or investment banker defrauds an investor but then changes his or her place of employment, the damaged parties should have the right to pursue these individuals in the courts and not in arbitration. Again, individuals found to be involved in defrauding a public agency or pension should be permanently banned from the securities business.

By making clear that the securities industry will not countenance fraud or other deceptive activities, the vast majority of individuals on Wall Street who follow the rules and try to serve the best interest of their customers would benefit. But more than simply rooting out dishonest individuals, Wall Street needs to do some considerable soul searching as to whether selling toxic waste in the form of CDOs and other complex structured assets is really in their own self interest. One need only review the failure of Bear, Stearns and the slow motion liquidation of Lehman Brothers to appreciate that the leading firms in the OTC derivatives business are slowly being destroyed by the very monster the industry worked so hard and so long to create.

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ⁱ “Freezing in Florida: State investment pools rue their brush with structured finance,” *The Economist*, December 6, 2007.

ⁱⁱ Healy, Beth, “Merrill to repay Springfield for losses: Deal will give city nearly \$14m back,” *Boston Globe*, February 1, 2008.

ⁱⁱⁱ Evans, David, “Banks Sell 'Toxic Waste' CDOs to Calpers, Texas Teachers Fund,” *Bloomberg Magazine*, June 1, 2007.

^{iv} Smith, Peter, “Australian state government takes on CDOs,” *Financial Times*, April 3, 2008.

^v Shields, Yvette, “Several Wisconsin School Districts May Sue Firms Over OPEB CDOs,” *Bond Buyer*, August 27, 2008. *See also*, Petrie, Joe, “Report: Investments misled Waukesha School District; Waukesha joins others in state in action that could seek \$120 million,” *Greater Milwaukee Today*, August 21, 2008.

^{vi} Hetzner, Amy, “Five school districts consider lawsuit in investment downturn: Value of investments has declined by \$120 million over 2 years,” *Milwaukee Journal Sentinel*, August 20, 2008.

^{vii} *Ibid.*

^{viii} See Whalen, Christopher, “[Yield to Commission: Is an OTC Market Model to Blame for Growing Systemic Risk?](#),” *Journal of Structured Finance*, Summer 2008 [ISBN: 978 1 84374 219 7]