Crisis meeting on Wall Street

Emergency bailout for bond market speculator

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Wall Street was the scene of an extraordinary six-hour meeting Wednesday of the most powerful bankers and speculators, convened to devise a rescue operation for Long-Term Capital Management, a hedge fund whose collapse threatened to destabilize the US and world financial system.

The Federal Reserve Bank of New York was the scene of the meeting, which brought together Sanford Weill, chairman of Travelers Group; Jon Corzine, senior partner of Goldman Sachs; David Komansky, chairman of Merrill Lynch; and Douglas Warner, chairman of J. P. Morgan & Co.; and representatives of a dozen other companies.

What brought them together was the common fear that default of LTCM, which has borrowed heavily from nearly every major Wall Street bank and investment firm to finance its speculative forays, could trigger a chain reaction collapse in financial markets around the world. One published estimate was that LTCM was involved in a staggering $1 trillion worth of deals involved derivatives, swaps and other complex financial instruments.

By the end of the day, the Wall Street barons had agreed to pump about $300 million apiece into LTCM, for a total injection of $3.75 billion, and take control of the company. The new investors will own 90 percent of LTCM and appoint a new management committee to run the Greenwich, Connecticut firm.

While Long-Term Capital Management is virtually unknown to the general public, it has become in only four years a major vehicle for speculation in the international financial markets, specializing in complex computer-guided gambling in the bond market. Its operations were phenomenally profitable, and it tripled the value of its capital from 1994 to 1997.

The limited partnership was founded by John Meriwether, a bond trader who was forced to quit Salomon Brothers in 1991 after a scandal involving attempts to corner the market in one kind of US Treasury bill. Meriwether teamed up with several other former Salomon traders, two prominent economists, Myron Scholes of Stanford and Robert Merton of Harvard, and David Mullins, former vice chairman of the Federal Reserve.

LTCM catered to the elite investor. The minimum investment was $10 million, and investors had to turn over their money for at least three years, while receiving little or no information about the nature of the fund's operations. The partnership was not legally required to give an accounting to any regulatory agency or even to its own investors.

Despite these onerous conditions, so much investment capital poured into the firm that in 1995 it stopped accepting new investors, and at the end of 1997 it refunded $2.7 billion in 'excess' capital. LTCM's standing in the financial world rose even higher when Scholes and Merton, two of the limited partners, were awarded the 1997 Nobel Prize for economics for their work on the pricing of options and derivatives.

LTCM was able to parlay this prestige into virtually unlimited access to borrowed money. It leveraged a paid capital of only $4.3 billion at the beginning of 1998 into $125 billion in investments, mainly purchases of bonds and bond derivatives (financial instruments whose value is derived from the value of a bond or bond index). Its investments ranged from Russian and US Treasury bills to Danish real estate mortgages to derivatives based on the value of the

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British pound.

As long as the financial markets soared upward, gambling with borrowed money was virtually a sure thing. LTCM borrowed money to buy bonds and derivatives, then used the rising value of these financial instruments to borrow more money. But with the onset of the Asian crisis, and especially after the financial turmoil spread to Russia this summer, LTCM's operations came under increasing pressure and the firm's leveraging began to work in reverse.

As bond prices plunged, the value of the collateral for its loans declined, and its lenders began asking for more collateral--the equivalent, in the 1998 bond market, of the margin calls that were the driving force of the 1929 stock market crash. LTCM was compelled to sell off much of its holdings at fire-sale prices in order to raise cash to satisfy its creditors. Each new sale increased the firm's losses.

In early September Meriwether sent a letter to investors revealing that 44 percent of LTCM's capital had been wiped out in the previous month. By the time of the bailout Wednesday, that figure had reached 90 percent. Only $250 million in capital remained as the base of holdings of $80 billion.

The bailout organized by the Federal Reserve Board was the first of its kind for a firm engaged purely in financial speculation, and generated widespread concern on Wall Street and among financial analysts around the world. While one of the most ambitious and risky of the hedge funds, Long-Term Capital Management is typical of thousands of such firms whose operations amount to legalized gambling, in which bets of billions of dollars are placed on tiny, minute-to-minute movements in the prices of stocks, bonds and currencies, or on financial indexes and instruments derived from them.

This entirely unproductive and parasitic financial manipulation accounts for the vast bulk of financial transactions under capitalism. The total value of over-the-counter derivatives contracts, worldwide, was estimated at some $62 trillion in 1997, up from $20 trillion in 1992, and dwarfing the combined total of trading in all stock, bond and currency markets.

American banks, investment firms and hedge funds have successfully blocked all efforts to regulate the casino-like trading in these arcane financial instruments. Last week the American Bankers Association, the International Swaps and Derivatives Association, the Securities Industries Association and five other trade groups issued a joint statement hailing the decision of Republican-controlled House and Senate committees to forbid any federal regulation of derivatives at least until next year.

Meanwhile the Office of the Comptroller of the Currency, the principal bank regulatory agency, said that banks were becoming increasingly reliant on the use of derivative products whose performance had never been tested by a serious economic downturn. Acting Comptroller Julie Williams said that the lax credit standards at many major banks were 'unsettling' and that the provision of reserves to cover loan losses was at the lowest level in a decade.

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