Refco collapse in US poses some troubling questions

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The demise of US brokerage firm Refco has sent a tremor through financial circles, posing the question as to whether this is merely a "one off" event caused by circumstances peculiar to the company, or a symptom of bigger problems to come.

Refco, which has been in the commodities and financial services business for more than 30 years, all but collapsed last week when it was revealed that the company's chief executive, Phillip Bennett, had hidden a $430 million personal loan from the company. The existence of the loan, which was repaid last Monday, was not revealed in the company's accounts. This has raised immediate questions about why the company's auditors and its backers among investment bankers failed to notice it.

Bennett, who has been charged with securities fraud, enjoyed the support of some of the top names on Wall Street, including Goldman Sachs and Credit Suisse First Boston.

While the loan has been repaid, there could still be repercussions. Bennett used his 34 percent stake in the company, valued at more than $1 billion before it collapsed, as security for a loan. The source of the loan appears to be the Austrian bank Bawag which admitted on Sunday that it was exposed to Refco, having issued credit lines worth almost $510 million. Bawag confirmed that it had made a loan but did not specify to whom it was issued.

In its statement, the bank, which is owned by Austrian trade unions, said the loan was against "recoverable assets" and that for the "remaining credit volume there are securities which we assume to be recoverable". That remains to be seen as efforts are made to assemble a rescue package able to salvage at least some parts of Refco's operations.

While the consensus in financial circles appears to be that Refco's demise will not severely affect the broader market, there are concerns over how the collapse took place and what it signifies for the future.

"Even without any significant damage to the broader market," the *Financial Times* noted, "Refco's nightmare week has left a trail of destruction." Apart from Bawag, the company's shareholders could be big losers. General Motors Asset Management, for example, is believed to have a stake once valued at almost $50 million. The total loss in value if the company goes broke could be as much as $1.5 billion, with up to 2,400 employees threatened with the loss of their jobs.

New York Times financial writer Gretchen Morgenson pointed to a number of disturbing features about the company's demise, in particular the circumstances of its initial public offering (IPO) last August.

"Securities regulators and pundits," she wrote, "say that there will be no financial market tremors emanating from Refco Inc. ... Maybe so, but it seems incomprehensible that a financial domino this big can topple without making a sound. Refco, after all, was one of the largest players in commodities, derivatives and United States Treasury markets, operating in 14 countries and serving more than 200,000 clients. Financial market tremors or not, there is plenty to be afraid of in the Refco mess."

Apart from the failure to notice the outstanding $430 million loan, there was the willingness of "supposedly savvy financial investors" to purchase Refco shares in spite of "hair-raising risk factors" detailed in the prospectus which accompanied its IPO.

Morgenson noted that Refco's internal auditors had reported two significant deficiencies in its internal financial controls. The company lacked "formalised procedures" for closing its books and was unable to

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prepare financial statements "that are fully compliant with all SEC [Securities and Exchange Commission] reporting guidelines on a timely basis." However these deficiencies did not deter investors.

"This is the way investors live now: a financial services company's inability to prepare its own financial statements does not preclude financial institutions from buying its stock."

The apparent willingness of financial institutions to undertake increased risk also attracted the attention of *Financial Times* commentator John Plender. With credit spreads—the difference in the rate of return between the most secure and riskiest assets—widening in the wake of bankruptcy of Delphi, the General Motors supplier, and the troubles at Refco, he posed the question: "Is a financial storm brewing?"

Basing himself on a recent paper by International Monetary Fund economic counsellor Raghuram Rajan, Plender's answer seems to be: very possibly.

According to the prevailing conventional wisdom, changes to the financial system, especially the use of derivatives, mean that risk is now being spread across a greater range of financial institutions than in the past, giving added stability. But in Rajan's view these changes, extending back over the past 30 years, have also "created opportunities to make things worse".

One of the dangers is that financial institutions, under the pressure of competition, will take risks that are concealed from investors. The risks that are most easily hidden are so-called "tail risks"—those which have a "small probability of generating severe adverse consequences and, in exchange, offer generous compensation the rest of the time".

Such investments would allow a particular financial institution to outperform its rivals. But every so often a disaster will strike and the real position will be revealed—too late, however, for investors. Another risk is "herd behaviour" as fund managers follow other investors and push up asset prices well above the level justified by economic "fundamentals".

"These behaviours can be compounded in an environment of low interest rates. Some investment managers have fixed rate obligations which force them to take on more risk as rates fall. Others like hedge funds have compensation structures that offer them a fraction of the returns generated, and in an atmosphere of low returns, the desire to goose them up increases. Thus not only do the incentives of some participants to 'search for yield' increase in a low rate environment, but also asset prices can spiral upwards, creating the conditions for a sharp and messy realignment."

Rajan concluded that while recent trends in financial markets had created more participants able to absorb risk, the financial risks being created by the system are also greater. There was also the possibility that instead of working to alleviate problems when they occur, changes in the financial system may exacerbate them under certain conditions. This could also create "a greater (albeit small) probability of a catastrophic meltdown".

The events of the past two months—the bankruptcy of Delphi and the collapse of Refco—mean that this probability may well have increased.

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