

Madoff collapse has global impact

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18 December 2008

Bernard Madoff's fraudulent investment firm, which collapsed last Thursday when its owner and founder was arrested, has ensnared victims around the world. These include some of the largest international banks, hedge funds, charities, pension funds, wealthy investors and some of more modest means. Madoff admitted that his firm was "a giant Ponzi scheme" and owed at least \$50 billion.

The scandal, the world's largest ever fraud, will mean the widespread destruction of wealth, not just in the United States, but internationally. It will lead to billions of dollars in write-downs and losses for financial institutions, bankruptcies for weaker and smaller banks, and financial devastation for pensioners, hospitals, universities and philanthropic organisations whose assets were placed with Madoff. Even now, a week after the collapse, the full extent of the losses is unclear.

It has sparked fears about the financial viability of hedge funds and other investment firms, leading hedge funds to limit withdrawals. It threatens a chain of defaults by financial institutions and businesses that have invested in hedge funds which could, in turn, bring down other investors, including major infrastructure and industrial corporations which have made loans to them.

Madoff, who was well connected to rich investors, politicians and regulators, ran a \$17 billion investment business for wealthy clients alongside his stock brokerage firm, ostensibly investing in blue chip stocks and options. But the warning signals were there for anyone who was watching. Madoff had for years been paying a 10 percent to 12 percent return to his clients, in good times and bad. The secretive nature of his operation and his astounding ability to generate such consistent returns aroused the suspicion of some prominent individuals and firms within the milieu of high finance.

His investment arm was not even registered with the US Securities and Exchange Commission (SEC) until September 2006. A number of financiers alerted the SEC to the likelihood that Madoff was running a scam, but were given short shrift by regulators. One hedge fund operator sent a letter to the SEC warning, "Madoff Securities is the world's largest Ponzi scheme."

Last year, a hedge fund advisory firm, Aksia, warned clients against Madoff in part because his accounts were audited by a

three-person firm, one of whom was his secretary and another a 70-year-old retiree in Florida, and the Madoff business empire was its sole audit client. The auditors are now also under investigation.

Nevertheless, Madoff was considered a leading light on Wall Street with a reputation in certain wealthy circles as a financial wizard. New clients lined up to invest in his funds, which were closed to all but those with personal connections to his existing clients. Major banks and hedge funds funnelled money invested by their own clients into Madoff's operation.

It now appears that Madoff, in a classic Ponzi scheme, was paying existing clients with new clients' money. No one knew precisely what he was doing because he refused to allow clients to access their accounts online or to allow potential investors access to his books for "due diligence."

It all worked as long as there was plenty of cheap credit and hedge funds and banks seeking lucrative investment opportunities were piling up profits. Things started to go wrong when the credit crunch began to bite, new clients dried up and existing clients sought to withdraw their funds. Early in December clients of Bernard L. Madoff Investment Securities LLC requested some \$7 billion in redemptions.

When Madoff realised the game was up, he tried to distribute his remaining \$300 million as "bonuses" to his business associates and family members in December of this year, instead of his normal time for handing out bonuses, which was February. When his two sons, who held high positions in his family-based business, questioned him about such an unusual and early payout, he reportedly admitted the real state of affairs, and they turned him in.

The Fairfield Greenwich Group, a US fund manager, whose founder, Walter Noel, has ties to international wealth, has suffered the largest losses. It had \$7.5 billion of its \$17 billion invested with Madoff.

Fairfield and its Sentry Fund raised funds for Madoff and acted in partnership with European banks such as Europe's largest bank by market capitalization, the Spanish Banco Santander, and the Swiss Union Bancaire Privee, as well as Swiss money manager Genvolor, Benbassat et Cie., to market Madoff-based funds. They in turn repackaged Madoff's investments and sold them to "funds of hedge funds" firms that cater to wealthy investors.

Fairfield earned \$160 million of its \$250 million revenues in

2007 from Madoff-related business, promising its clients that they took more care of their money than other firms. Its web site said that it "employs a significantly higher level of due diligence work" than that carried out by other money managers.

Other big losses within the US include Rye Investment Management, part of Massachusetts Mutual Life Insurance's Tremont Capital, which has lost at least \$3 billion. Tremont's hedge fund subsidiary reported that it had lost all \$3 billion of its clients' money because Madoff was its sole fund manager.

In Britain, Kingate Global Fund Ltd, the \$2.8 billion hedge fund run by Kingate Management Ltd, has lost \$2.5 billion. Ascot Partners has lost \$1.8 billion, Access International Advisors \$1.4 billion, and Maxam Capital Management LLC \$280 million.

While many of Madoff's clients were institutional investors, some of his victims were smaller investors, including charities, pension funds and individuals whom he knew socially and who had placed their nest eggs with him. Austin Capital Management, which managed funds on behalf of the Massachusetts state pension fund, has lost \$12 million, and the Chase Family Foundation, which donates \$12.5 million annually to charities, will be forced to close as all its money was invested with Madoff.

Fairfield's links with European financial institutions have led to major losses for their fund management subsidiaries, with European losses expected to reach \$11 billion.

The Spanish banks, Banco Santander and Banco Bilbao Vizcaya Argentaria (BBV), have lost \$3.1 billion and \$405 million respectively.

The UK banks HSBC and RBS have lost \$1 billion and \$600 million, reportedly from loans to institutional clients, mainly hedge funds that wanted to invest in Madoff's funds. Bramdean Alternatives Ltd, a fund headed by well known fund manager Nicola Horlick, has lost \$21 million, 10 percent of its holdings. This leaves her clients, including local authority pension funds in Merseyside and Hampshire, in dire straits.

The French bank BNP Paribas lost \$468 million and Natixis (CNAT PA) \$611 million, while Austria's Bank Medici has lost \$2.1 billion and the troubled Dutch-based Fortis Bank Nederland faces up to \$1.3 billion in losses.

Numerous Swiss banks and money managers have lost money. According to the Swiss newspaper *Le Temps*, total losses may be as much as \$5 billion. Those who have reported losses include Union Bancaire Privee and Genvalor, Benbassat et Cie., each with \$1 billion, and Banque Benedict Hentsch, with \$48.8 million in losses.

Benedict Hentsch had recently agreed to merge with Fairfield Greenwich and is now trying to get out of the deal. Reichmuth & Co, a Swiss private bank, has lost \$325 million and EIM Group, a fund of hedge funds, \$230 million.

Geneva is a major promoter of funds of hedge funds, which often exist within private banks and are sold to their clients and

wealthy families. According to the *Wall Street Journal*, Madoff funds were marketed as so-called black boxes and any attempts to scrutinise them were rebuffed. The investment climate in Switzerland, famous for its banking secrecy, suited Madoff conduits to a T.

The fact that Madoff's fraudulent activities had such a big impact on European banks is the result of a five-year boom in hedge funds that has led to an exponential growth in fund-linked derivatives, products provided by banks that guarantee capital for clients or promise high returns. Under the typical terms of these deals, if the US authorities recover any of the money, the banks will be reimbursed first before their clients.

Japan too has been hit by the scandal. Nomura has lost \$302 million. Aozora, part-owned by private equity firm Cerberus Capital Management LP with numerous connections to its sister companies, has lost \$137 million. Aozora, a mid-size bank already hit by its involvement with Lehman Brothers and another Cerebus-controlled outfit, GMAC LLC., is one of Cerebus's key investments.

While the declared losses are mounting, less than half of the \$50 billion has been accounted for, as fund managers seek to avoid the publicity and withdrawal of funds that such losses are likely to precipitate. It will take months to unravel the full consequences of Madoff's fraudulent activities, which appear to have been going on for years.

As the scandal unfolds, it sheds a revealing light on the social connections and financial relations between institutions and moneymen, and the reckless and semi-criminal methods employed by some of the most prominent banks.

Far from being sober, well run operations, many more closely resemble gambling syndicates driven by self-enrichment at the expense of their clients and society as a whole. They have placed their clients' money wherever they could get the best commission, barely bothering to check the books of shady outfits such as that run by Madoff.

The Madoff scandal is, moreover, an exposure of complicity and corruption on the part of government regulatory agencies, which have, on a world scale, been transformed by years of "free market" deregulation into partners and facilitators of financial skulduggery on the part of the financial elite.



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