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Ferruzzi could bring down the derivatives casino

by William Engdahl

On June 8, the Italian holding company Ferruzzi Finanziaria Spa., owned by the Ferruzzi family, announced that it was unable to continue to meet interest payments on its debts and asked a group of creditor banks, led by the octogenarian "godfather" of Italian banking, Enrico Cuccia of Mediobanca, to take over operation of the huge multinational agricultural and chemicals conglomerate.

On July 20, a key figure in the Ferruzzi scandal, Gabriele Cagliari, was found dead in his Milan prison cell where he was awaiting trial on corruption charges. Three days later, the former chairman of Ferruzzi, Raul Gardini, was also found dead from a pistol shot in his home in Milan. Earlier this year, as well, Sergio Castellari, the Italian state official responsible for oversight of a controversial Ferruzzi joint venture with the state-owned ENI, called Enimont, was found dead under mysterious circumstances.

But the astonishing aspect of the Ferruzzi affair is not that the collapse of the huge Italian conglomerate threatens to be the largest financial failure in world history, but that the international financial press, especially in the United States, have been almost silent, other than to give nominal mention or salacious details of the above-mentioned deaths. The reason for this wall of silence, according to international banking sources, has to do with Ferruzzi's huge financial speculation in so-called derivatives, primarily currency "swaps."

What is known about Ferruzzi

Creditor banks and those now running the Ferruzzi group are attempting to drastically downplay the nature of the financial market threat posed by the Ferruzzi collapse. When the company defaulted in June, figures of company indebtedness totaling some 23 trillion liras (approximately $21 billion) were published. This is awesome in its own right and ranks with the failed Canadian real estate conglomerate Olympia & York, which went under a year ago, buried by in a mountain of debts.

It has now been documented that the more accurate figure of combined debts for the entire group of companies controlled by the Ferruzzi group (Ferruzzi Finanziaria, Montedison, Eridania-Beghin Say, Fondiaria, and Serafino Ferruzzi) is nearer the staggering figure of 44 trillion liras (over $40 billion). This would make the collapse of Ferruzzi, almost certain to go into bankruptcy in coming weeks, the largest private corporate failure in world business history, a distinction previously held by Olympia & York. Ferruzzi spokesmen have strenuously denied the higher figure.

From discussions with a number of bankers familiar with the group, *EIR* has learned that Ferruzzi was perhaps the most exposed of all Italian multinationals to foreign borrowing. Far more even than Olivetti or Fiat, Ferruzzi owed most of its debts in dollars, French or Swiss francs, or German marks. While full details are a jealously guarded secret between the creditor bank group led by Enrico Cuccia and the company, it has been reliably estimated by people familiar with the company's total debt structure that more than two-thirds of the total $40 billion in debt (some $27 billion) are in foreign currencies.

Here lies the key to unraveling the mysterious suddenness of Ferruzzi's insolvency crisis. On Sept. 17, 1992, following the European currency crisis, the lira was finally forced to float freely, rather than fix its value to the basket of European currency parities tied to the German mark. Since then, the lira has lost an average of 30% against currencies of its major trading partners. This means that within a matter of weeks after the September lira crisis, Ferruzzi was suddenly faced with owing 30% debt service on $27 billion in total debts.

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That would place an impossible cash flow burden on a company already hit by a severe economic depression in European and North American markets for its chemicals and agrobusiness products.

A colossal 'accident' in derivatives?

Indication of a dramatic cash hemorrhage appeared in the figures for Ferruzzi's short-term debt, which ballooned from 1.2 trillion liras at the end of December 1992 to 4.6 trillion liras just before its default was made public, nearly a 400% increase in only five months. According to European banking sources familiar with the operations of financial derivatives markets, the Ferruzzi case bears unmistakable signs of a "disaster in its derivatives trading," as one senior Luxembourg banker put it.

At this point, the most informed speculation is that Ferruzzi had incurred devastating losses during and after the September lira crisis. It went to its main creditor banks with repeated pleas for injection of new loans and rollover of old ones, in a desperate bid to regroup. By June 1993 it was a lost cause, and Cuccia and the creditor banks were brought in to sort out the mess.

"There is no question that Ferruzzi has already defaulted on a huge amount of its derivatives contracts," noted one banking source. "If you see insolvency in your company, you naturally default first on derivatives, which are 'off-balance sheet,' long before you default on your actual bank loans. But the international banks holding Ferruzzi's defaulted derivatives contracts, mainly currency swaps, are refusing to admit the default."

The reason for the refusal to admit derivative default is that Ferruzzi's creditor banks are desperately trying to "unwind," that is, to secretly disengage themselves from the mountain of Ferruzzi derivatives contracts, in hopes that news of the huge derivatives default does not leak out and create a panic reaction.

"If news of the Ferruzzi derivatives default were to get into the international press, bankers are privately terrified this would give heavy ammunition to more conservative European central bankers, such as the Swiss and Germans, who are keen to close down the derivatives speculation altogether via transaction tax or such steps," a Luxembourg banker told *EIR*. "But the other factor behind their secrecy is to keep the estimated $7 trillion international market in swap contracts from going into a panic liquidation which could create a global financial gridlock."

Such a derivatives "unwinding" at Ferruzzi, according to experts, could take as long as one year to complete. In 1990, the far smaller Bank of New England was declared insolvent and taken over publicly by bank regulators nine months after the same regulators had secretly worked inside the bank to unwind its derivatives trades. Only then was the bank declared in official receivership.

But keeping the Ferruzzi derivatives default problem hidden from view will be orders of magnitude more difficult. The trail of dead bodies, all individuals who had intimate knowledge of Ferruzzi affairs, has drawn international attention to Ferruzzi.

There are indications that some of the largest American banks and derivatives speculators may have more than a little at stake in keeping secret the scale of Ferruzzi's derivatives dealings. Most of Ferruzzi's non-lira debt and also sales, some 30% of their total, was in dollars. Three New York banks—Citicorp, Chemical and Chase Manhattan—had extensive dealings with Ferruzzi. Citicorp during the 1980s advised Ferruzzi chairman Raul Gardini on a far-flung international strategy of corporate takeovers, one factor which built up the company's traditional bank debt. Some European banking sources speculate that Ferruzzi turned increasingly to more and more high-risk and unregulated derivatives speculation internationally in a desperate attempt to cover its huge losses, especially in the past year.

One question is, to what extent were American banks like Citicorp and Chase and investment banks like Goldman Sachs and Morgan Stanley, all of which had close ties to Ferruzzi, involved with the collapsed Italian giant company in off-balance-sheet derivatives trading?

The only public hint of the danger came from the July 19 Wall Street weekly *Barron's*. Buried on page 34 was the following curious note: "The financial crisis at Ferruzzi Finanziaria is not just causing worry among the company's bankers, but also in the multitrillion-dollar financial derivatives market, where Ferruzzi has been a heavy user of currency and commodity swaps. Pay attention to the Ferruzzi story, now lightly covered in the U.S. press. It could get ugly and affect global markets." *Barron's* and the *Wall Street Journal* have not uttered a word since about Ferruzzi and derivatives.

Other facts have emerged which suggest that there exists a secret high-level international effort to clean up the Ferruzzi derivatives mess, by means other than a mere conventional corporate insolvency restructuring by creditor banks. On July 2, the Federal Reserve held an unscheduled full board meeting. Press queries as to the reason were greeted by stony silence and feeble efforts to claim they had "forgotten" that July 5 was an American holiday. The last time the Fed called an unscheduled meeting was in August 1984 to arrange the emergency bailout of the Continental Illinois Bank, the birth of the ill-conceived "too-big-to-fail" practice of the Fed which has cost American taxpayers untold hundreds of billions in bailouts costs of ill-run banks since.

Another curious fact is that the Bank of Italy has involved itself directly in the Ferruzzi affair. Within days of the June 8 Ferruzzi loan default, the Bank of Italy stepped in and has played a leading role in supervising the process. This alone is confirmation that something of extraordinary financial dimensions is involved with the Ferruzzi collapse. "The Ferruzzi affair will be compared with the Bank Herstatt collapse of the mid-1970s," commented one banking analyst to *EIR*.