EIR Economics

Kidder Peabody debacle confirms LaRouche forecast

by John Hoefle

The collapse of the mortgage-backed bonds market in the wake of the Federal Reserve's rate hikes, has severely wounded Kidder Peabody Inc., the giant securities firm which is wholly owned by General Electric Corp. (GE). Kidder is the dominant player in the collateralized mortgage obligation (CMO) market, accounting for about one-quarter of that market during 1993 and the first quarter of 1994, more than twice its nearest rival. CMOs are a specialized type of mortgage-backed security, which is a security comprised of bundles of mortgages.

The Kidder case, which involves huge losses and the firings of top executives and traders, is exemplary of the process explained in "The Coming Disintegration of The Financial Markets," a pamphlet published this month by the *New Federalist* newspaper. In that pamphlet, Lyndon LaRouche issues his ninth major economic forecast: that "the presently existing global financial and monetary system will disintegrate during the near term."

"The collapse might occur this spring, or summer, or next autumn; it could come next year; it will almost certainly occur during President William Clinton's first term in office; it will come soon," LaRouche explained in his forecast. "That collapse into disintegration is inevitable, because it could not be stopped now by anything but the politically improbable decision by leading governments to put the relevant financial and monetary institutions into bankruptcy reorganization."

According to Kidder Peabody, Joseph Jett, the firm's since-fired government bond chief, ran up $350 million in phantom trades of government bonds, booking profits on the trades to improve his perceived performance and increase his annual bonus. Kidder claims that Jett began this scam around January 1992, selling "strips" of U.S. Treasury bonds to the Federal Reserve. The strips, which are created when the interest and principal portions of a Treasury bond are "stripped" apart to be sold separately, were to be delivered to the Fed at a future date. However, according to Kidder, the strips were never delivered, but were instead rolled forward to new future settlement dates. Thus, the profits Jett was booking, were on transactions which were never completed. These transactions were supposedly possible because of a glitch in Kidder's accounting system.

That something unusual was going on with the government-bonds trading desk was clear. Jett's desk produced revenues of $30 million in 1992, nearly double the record of $16 million set in 1990. In 1993, Jett posted trading profits of some $200 million, and was named Kidder's employee of the year. That figure rose to an astonishing $100 million for the first quarter of 1994 alone, according to Kidder.

Kidder executives claim that they and the company suspected that something was amiss with Jett's trades, and launched an internal investigation. That investigation supposedly uncovered Jett's scheme, and the company fired him on April 17, accusing him of creating the $350 million in phony trades to cover $100 million in losses.

These charges are now being investigated by the Securities and Exchange Commission, the New York Stock Exchange, the U.S. Attorney in Manhattan, and GE.

Another sacrificial lamb

While Kidder points the finger at Jett, Jett himself is telling a much different story. According to Wall Street insiders and a recent article in the *Wall Street Journal*, Jett has told federal prosecutors that he had been ordered by Kidder officials to dump government bonds in early April in order to alleviate Kidder's gross violation of minimum government-mandated capital standards. Kidder had to dump the govern-

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ment bonds, Jett said, because the market for the firm's prized CMOs had dried up. Kidder, the *Journal* noted, is Wall Street's most highly leveraged firm, with $94 in bonds, stocks and other assets for every $1 in equity at year's end.

The interesting question here is: Was this the work of a rogue trader, or was this a concerted action to cover up the bankruptcy of Kidder Peabody?

Mortgage-backed disaster

Kidder's problems began in earnest in the first quarter, when the Federal Reserve began to raise interest rates. The firm's mortgage-backed securities were lucrative as long as interest rates dropped or remained stable, but would be badly damaged if those rates rose.

The rising rates quickly took their toll on the mortgage-backed securities market. At the end of March, three hedge funds run by David Askin's Askin Capital Management were liquidated. The ramifications of the collapse of these collective $600 million in assets hedge funds, which held $2.5 billion in mortgage-backed securities thanks to borrowings, go far beyond the damage done by those substantial losses, however.

Askin, who was one of Kidder's top five mortgage derivatives accounts, specialized in a high-risk type of mortgage-backed security known as "toxic waste." Collateralized mortgage obligations are created when bunches of individual mortgages are grouped together, then repackaged into different bundles (interest and principal payments, for example). The payment stream from each bundle is then pledged as backing for a new security—the CMO—which is then sold to investors.

CMOs can be more or less risky, depending upon the mortgages underlying them, and other variations such as fixed- or floating-interest rates. The less-risky CMOs are relatively easier to sell, while the riskiest CMOs are more difficult to sell. In order to make the CMO market function, the securities firms had to find someone to buy the riskiest CMOs—the toxic waste which nobody wanted.

Askin was the biggest buyer of such toxic waste, and bought much of it with money borrowed from his securities firm clients, including Kidder Peabody, Bear Stearns, and The Equitable's Donaldson Lufkin and Jenrette. When Askin and his toxic waste machine went under, much of the CMO market went under, too.

The combination of rising interest rates, falling securities values, and the disappearance of the major toxic waste buyer, threw the over-leveraged CMO market into turmoil. With prices dropping rapidly, everyone wanted to sell, and few wanted to buy. The market ground to a halt.

Whereas $79 billion in mortgage derivatives were issued in the first quarter of 1994, only $12 billion were issued in the second quarter. Kidder, which issued $65 billion of the securities in 1993, issued $20 billion in the first quarter, but just $3.2 billion in the second quarter. The mortgage-bond group produced profits of about $40 million for the first five months of 1994, compared to $300 million in 1993.

Heads roll

This was the environment in which Kidder, with a $12 billion portfolio of mortgage-backed bonds, and a toxic waste portfolio of some $700 million, was operating.

Such an environment certainly makes plausible Jett's claim that he was ordered to dump government bonds in order to offset the paralysis in mortgage bonds.

That Kidder is in serious trouble, was also made clear by the actions of parent GE, which has pumped $550 million in cash into the company over the last few months. Since buying Kidder for $600 million in 1986, GE has pumped $1.5 billion into the dying firm.

Kidder, like GE, has historically been controlled by the House of Morgan, and is not new to scandal. In 1991, the firm was fined $30,000 by the National Association of Securities Dealers (NASD), and was ordered to review its compliance procedures related to mortgage-backed securities. The NASD's action arose out of a scam by since-departed bond trader Ira Saferstein. Among other Kidder employees who were fined was Edward Cerullo. Cerullo was, until July 22, Kidder's number-two executive and the head of the fixed-income department. He was also Jett's boss, and the man who Jett says ordered him to dump the government bonds.

In addition to Jett and Cerullo, Kidder chairman Michael Carpenter and bond-derivatives chief Marvin Mullin, the firm's number-three executive, have lost their jobs. Carpenter was ousted in June, replaced by an executive from GE, while Mullin was ousted Aug. 3. Mullin had headed Kidder's government desk until last year, when he moved to the firm's new derivatives group.

Another recent removal was Clifford Kaplan, who supposedly structured a derivatives deal without being properly licensed by the state. Kaplan was also working for Knox Partners, the U.S. unit of La Compagnie Financière Edmond de Rothschild Banque. Kaplan was fired in January.

Interest rate swaps trader Neil Margolin was fired in April, for supposedly hiding $11 million worth of losses from a derivatives deal with NationsBank.

Peter Bryant, an options trader in Kidder's London office, was fired in July, for allegedly hiding some $6 million in losses.

Together, these incidents give the picture of a firm untroubled by moral considerations and honesty, and of an environment in which making money, at whatever price, is paramount. One must wonder about the role of the Federal Reserve in this fiasco, since it was the Fed to whom Jett was supposedly selling the phantom strips. Given the Fed's propensity for covert bailouts of the financial system, one must wonder if the Fed knew what was going on at Kidder, and if all the flurry of investigations and finger-pointing isn't just another coverup of that bailout.