# Has Anything Changed Since the Credit Crisis?

What we can learn from the failure of MF Global.

Jordan Mamorsky, 02/28/2012

*"Looking ahead, I am certain, very certain of this: we CANNOT let this event destroy the long-term trust and confidence upon which market participants rely."(1)*

*--Gerald F. Corcoran, Chairman and CEO of R.J. O'Brien & Associates speaking on MF Global*

How can $1.2 billion be lost overnight?

Former MF Global executives, appointed bankruptcy trustees, financial regulators, and industry insiders are admittedly without a clue. In today's culture of lax government oversight, exotic derivative structured transactions, and speculative Wall Street gambling, anything goes. Only the investor loses. And in the case of MF Global, they lost over a billion dollars.

2008 was supposed to be the end of the road for balance sheet manipulation, marginalization of risk protocols, and deviant executive breaches of fiduciary duties. Yet, the recent failure and bankruptcy of MF Global suggests that many of the same practices that led to the demise of Bear Stearns, Lehman Brothers, and Merrill Lynch still plague the financial system today.

MF Global was traditionally a future commodities merchant ("FCM") that traced its roots to 18th century London. The story of the proud brokerage's demise includes the firing of whistle-blower personnel, ineffectual regulatory governance, repeated failures to act, and

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dangerous off-balance sheet risk.

Efficient capital markets require investor faith that their money is safe. Accordingly, MF Global's bankruptcy and shortfall of $1.2 billion customer funds only makes it more imperative that investor trust is renewed through reforms of the current financial regulatory regime that include enhanced governance, stricter derivative regulation, and ethical imperatives for Wall Street.

Here's how it unraveled for Jon Corzine and MF Global:

**MF Global's Risky Bet on European Sovereign Debt**

Former New Jersey Gov. Jon Corzine joined a commodities brokerage that was struggling to keep pace in a competitive industry. MF Global was on its heels and had posted consecutive losing years. The company's income depended upon commissions earned from placing commodities futures bets for its clients, execution and clearing services, and from interest on customer accounts.(2) With interest rates remaining at historic lows, MF Global struggled to generate enough income to remain perennially profitable.

Admittedly, Corzine had not been following MF Global's plight prior to joining the company. He joked only days after taking the job in March 2010: "Don't ask me any hard questions. I hadn't heard of this company a week ago."(3)

Presumably in that week, Corzine crafted a plan to rejuvenate MF Global's revenues. In an interview with the *New York Times* in May 2010, he confidently explained that: "I wouldn't have come here if I thought MF Global were going to be the same company in five or 10 years. We have to find other ways of building revenue."(4)

"Other ways of building revenue" were traditional investment banking services such as underwriting, asset management, and trading of complex structured credit derivative products. This would provide MF Global with a far more diversified stream of revenue. However, there was a major catch. MF Global had sparse existing infrastructure to conduct these risky investment banking activities, which normally take decades to perfect. Corzine believed MF Global's transformation to a broker-dealer and investment bank could take only three to five years.(5) Accordingly, he fired traditional commodities brokers and replaced them with former Goldman Sachs, UBS, and Soros Fund Management traders.(6)

Further, inclusive of the new MF Global business plan was a fateful decision in the summer of 2010 to make a major investment in European sovereign debt. European nations issue bonds as debt securities that are actively traded in international markets. Corzine believed quick profits in these securities were possible through off-balance sheet repo to maturity ("RTM") transactions. Similar in purpose to the nefarious Lehman "REPO 105," these unique arrangements allowed MF Global to keep these investments off-balance sheet because of an accounting technicality that enabled the deals to constitute "sales" rather than traditional repurchases under the GAAP rules governing securities transactions.

Corzine routinely transacted with other banks, as counterparties, to "sell" millions of European sovereign bonds, knowing they would be sold back to MF Global in a fixed period of time, on the maturity date. Counterparty banks were required to sell the bonds back to MF Global along with their respective interest rates. Corzine foresaw profits from the "spread" on the difference between the interest rate of the European bonds and MF Global's obligation to pay the interest rate of the RTM deal.

In a stable market, where prices remained static, the RTM deals could work beautifully. MF Global would receive the bonds back at the same price and, additionally, higher interest payments from its counterparty. Yet, there was a reason the interest rates of the European bonds were so high. They were intrinsically risky bets that could spiral out of control based upon market confidence in the eurozone.

For example, in a stressed European debt market, where bond prices steadily decrease, the RTM transactions created significant liquidity and capital risk. Counterparty banks could demand additional collateral from MF Global through "margin calls" that required the firm to sweeten the pot. Further, if the prices of the bonds severely decreased, MF Global would receive the assets at lower values than they sold them for. Corzine was taking a huge gamble on the European sovereign debt market with $6.3 billion of company funds hanging in the balance.

A year after MF Global made the decision to invest in eurozone bonds, the Financial Industry Regulatory Authority ("FINRA") realized that MF Global was substantially exposed off-balance sheet after a routine review of MF Global's May 31, 2011, financial statement. Accordingly, FINRA and the SEC had "detailed" discussions with MF Global in mid-June 2011 insisting that the firm was not allocating enough capital against the risky RTM European bond portfolio.(7) MF Global was not compelled to reserve any firm capital against its exposure to the European bonds because the RTM deals were graced with precious GAAP "sale" status.

In October 2011, Corzine's hand folded in spectacular fashion. Once the credit rating agency Moody's learned of the RTM portfolio exposure, it downgraded MF Global to "junk" status on Oct. 24, 2011. This, along with weakened market confidence in European debt, precipitated investors to sell their stock, clients to remove their money, and counterparties to demand additional collateral on the $6.3 billion RTM portfolio.(8)

Making matters much worse, the MF Global bankruptcy trustee, James Giddens, reported on Feb. 6, 2012, that MF Global routinely used customer funds to meet margin calls or other obligations to counterparties in conducting regular business.(9) As MF Global's exposure to the European debt market intensified, Giddens explained that the company used much larger sums of customer funds to satisfy various obligations until there was no more cash to keep the firm's doors open. Corzine's MF Global was entirely bankrupt in less than two years. $1.2 billion in customer funds remains unaccounted for.(10)

**Risk Governance Failures**

Former MF Global chief risk officer Michael Roseman explained to the House Committee on Agriculture that Corzine, and the MF Global board of directors, had several opportunities to reduce their exposure to bad eurozone sovereign debt. Nonetheless, MF Global stubbornly stayed the course despite being made repeatedly aware of its growing market risks.

Roseman joined MF Global in August 2008. In his employment with the firm, he provided regular reports to the board and executive officers regarding the firm's various market exposures. He also was charged with establishing risk thresholds for MF Global's European sovereign investments.

Immediately after Corzine's arrival in late March 2010, Roseman received requests to "adjust" the European sovereign trading limits. Roseman stated in testimony to Congress that he shared "different views" with Corzine because of the "continued political and financial uncertainty in the relevant countries."(11) The two first agreed upon a $1.0 billion trading limit in MF Global's European debt portfolio. This number would drastically rise in the coming months.

In mid-September 2010, Roseman expressed "increasing concerns" regarding the capital risk associated with MF Global's European positions. Rather than addressing Roseman's concerns, Corzine convinced the board to raise the European portfolio-trading limit to $2 billion.(12) Remarkably, in November 2010, the European portfolio was "adjusted" once again to $4.75 billion, despite Roseman's warnings of margin calls and price declines.(13)

Corzine and the board fired Roseman in January 2011. Michael Stockman, a former Goldman Sachs mortgage trader, was hired as the next MF Global chief risk officer. According to his Congressional testimony, he "believed that the risk profile associated with the company's European sovereign debt position was acceptable in light of then market conditions."(14)

**How to Restore Trust in the Financial System**

*1. Better & More Frequent Regulatory Audits*

Because MF Global operated as an FCM and a broker-dealer, it was regulated by the SEC and Commodities Futures Trading Commission ("CFTC") along with multiple self-regulating organizations including The Chicago Mercantile Exchange ("CME Group") and FINRA.

According to CME executive chairman Terrance Duffy, CME Group regulations worked *flawlessly* in the MF Global crisis: "CME was the only one that gave a very detailed outline of what we did minute-by-minute to show that our (self regulatory organization) worked flawlessly, Duffy said. "You cannot prevent against fraud."(15)

However, CME was responsible for conducting audits of MF Global books, namely, ensuring

that customer capital was not commingled with the firm's proprietary interests. Duffy testified to the House Committee on Agriculture Congress on Dec. 8, 2011, notably stating that, "Our clearing house rules require that money and other customer property must be separately accounted for and may not be commingled with the Funds of the FCM or be used to margin, secure, or guarantee any trades or contracts."(16)

Why couldn't CME enforce these rules in their audits and investigations of MF Global? Because CME was not required to regularly audit MF Global. Its last official audit of the firm was Jan. 31, 2011.(17) CME Group, along with the SEC and FINRA, stormed into the MF Global offices the week of October 24, 2011, only after it was becoming obvious that MF Global could no longer function as a "stand-alone business."(18)

Higher frequencies of *on-site audits* are necessary, just not by the CME, but by the CFTC and SEC. Audits should accelerate once a firm is placed on credit watch or is downgraded by Moody's, S&P, or another ratings agency.

*2. Smarter Corporate Governance*

Moreover, as demonstrated by the marginalization of MF Global's risk personnel, independence among the board of directors and risk management is paramount. There must be appropriate governance checks and balances in which the board, risk, and other important officers and executives have authority and independence.

Dodd Frank has made certain structural improvements, but these regulations can be enhanced to curtail powerful CEOs (like Corzine) from employing excessive leverage, marginalizing risk personnel, and employing complex off-balance sheet arrangements to camouflage increased market risk. Possible improvements include an enhanced shareholder role, stricter fiduciary standards, and mandatory risk thresholds for securities that are downgraded by ratings agencies and other industry benchmarks.

*3. Reform of GAAP & The Repurchase Market*

The repurchase market remains an amusement park for accountants and finance desk personnel to devise exotic off-balance sheet transactions that artificially lower exposure, leverage, and risk. GAAP should not be a creative playground for internal accountants to create new deals that receive "sale" status. GAAP should be reformed to ensure investment banks, FCMs, and broker-dealers cannot use complex off-balance sheet transactions to hide toxic assets, risky bets, and bad deals, even if they are properly disclosed to investors in fine print or footnotes. Investors deserve and should receive straightforward estimations of balance sheet risk and exposure. Moreover, investment banks should be forced to maintain long-term financing through their own prudent policies rather than in complex off-balance sheet counterparty arrangements.

**Conclusion**

The success of the investment banking system rests upon the bedrock of investor trust and confidence. The MF Global crisis is yet another example of private and public institutions with a short memory. Private investment banks are stewards of investor capital and have a fiduciary duty to protect client interests above all else. MF Global is a sign that the premise of restoring investor faith, prudence, and ethics to Wall Street may have been lost in the rubble of the 2008 credit crisis, replaced with a stubborn gambler's mentality.

2012 must not be the year to "double down." We can no longer cling to the myth that excessive risk, plastic leverage ratios, and exotic derivative transactions result in efficient capital markets. Regulators must take a defiant stand. The SEC must defend its mission statement of "protecting investors" and "maintaining fair and orderly markets" through smarter, tough new rules of the game. Likewise, the CFTC must ensure it adopts new governance and oversight measures that mirror its regulatory objective of protecting "market users and the public from fraud, manipulation, abusive practices, and systemic risk related to derivatives."

The promise of these agencies must be renewed. We can become accustomed to failures like MF Global and egregious losses for investors or take decisive action to facilitate the restoration of investor trust and confidence in our banking system. Governance, ethics, and adherence to strict fiduciary responsibilities must reverse the current race to the bottom.

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