

Refco Bank Hid \$1 Billion Loss From Hedge Funds, Arafat Casino

Bloomberg.com

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June 22, 2006

At the Israeli army checkpoint on the edge of Jericho, gamblers from Jerusalem and Tel Aviv streamed into the West Bank town to wager on blackjack, play poker and face off with slot machines at the Palestinian-run Oasis Hotel Casino Resort. The casino was open 24 hours a day, seven days a week.

The party that started in September 1998 ended when a Palestinian uprising scared away customers in October 2000, forcing the casino to close within a month.

The Israeli shells that punched holes in the Oasis's stucco- and-black-glass facade also struck a financial blow to one of the casino's investors, Vienna-based Bawag PSK Bank -- the same bank that backed Refco Inc., the New York-based brokerage that collapsed last October after belatedly reporting \$430 million in hidden losses.

The tale of Refco's bank -- and its role in the biggest meltdown on Wall Street since junk bond scandals felled Drexel Burnham Lambert Inc. in 1990 -- shows how executives gambled with customers' money and may have deceived the elite of the global financial community, including Goldman Sachs Group Inc., whose chief executive officer, Henry Paulson, is poised to become the next U.S. Treasury Secretary.

Charlotte, North Carolina-based Bank of America Corp., Zurich-based Credit Suisse Group and New York-based Goldman were managers of Refco's 2005 initial public offering. They're now defendants in a shareholder lawsuit against Refco.

Investors allege the banks didn't ensure all important facts about Refco were disclosed in offering papers. The firms haven't yet responded in court.

\$14.9 Trillion in Trades

The Refco and Bawag coverups stretched from the Palestinian territories to the Caribbean. Bawag's dealings with Refco led to the demise of a brokerage that processed at least \$14.9 trillion in trades for hedge funds and pension funds; Refco handled more derivatives contracts last year than the biggest U.S. options exchange.

For Refco's shareholders, bondholders and creditors, the cost of the deception may exceed several billion dollars. Bawag also jeopardized the deposits of 1.3 million school teachers, mechanics and other workers across Austria by funneling undisclosed loans to Refco and becoming entangled in Yasser Arafat's casino.

Since Refco's collapse, the disclosure of Bawag's dealings with the brokerage has triggered a wave of withdrawals from the bank. Austrian Chancellor Wolfgang

Schuessel opened a savings account at Bawag in May in a show of support aimed at preventing a run on the bank.

Offshore Accounts

Refco's flameout can be traced to Bawag's use of offshore accounts to disguise its own failed investments while helping Refco conceal as much as \$1 billion in trading losses, according to documents compiled by Austrian and U.S. investigators.

Bawag dumped uncollectible loans into the Refco brokerage account of a British Virgin Islands fund called Liquid Opportunities and then into companies based on the Caribbean island of Anguilla.

“Their risk appetite was very high, and their transparency was very low,” Nicola Venedey, a senior analyst at Moody's Investors Service Inc. in London, says of Bawag.

Venedey says Bawag management's inability to provide checks and balances led Moody's to downgrade the bank's financial strength rating on May 31 to E+ -- meaning “very modest” strength, two notches above the lowest grade -- from C+, defined as “adequate.”

'Bank Within the Bank'

The former top executives at Bawag, Austria's fourth-largest bank, ignored internal procedures when investing in and lending to both the casino and Refco, says Harald Raffay, who has been the head of Bawag's international department since 1996. He says his fellow bankers never informed him of those transactions.

“We're working like dogs, and then it turns out there's a bank within the bank,” Raffay, 58, says.

In 1999, Bawag paid about \$95 million for 10 percent of Refco, the biggest U.S. independent futures brokerage at the time, and then loaned it more than \$1.6 billion over six years in so-called round-trip loans that Refco used to pad its accounts, according to a June 2 settlement agreement with U.S. prosecutors in New York.

After Refco booked its earnings for the year, it repaid Bawag.

“Decisions regarding Refco never crossed my desk, even though it was the most international business,” Raffay says.

Bawag for Sale

Bawag's owner -- the Austrian Trade Union Federation, which consists of 13 groups, including metalworkers, agricultural workers, artists and sports teams -- has decided to

get rid of the bank, founded by Socialist Chancellor Karl Renner in 1922 to provide financial services to workers. It has hired Morgan Stanley to find a buyer.

Bawag's hidden dealings also included an investment company founded by the late Palestinian leader Yasser Arafat, more than \$1.3 billion in secret hedge fund losses and a tangle of Caribbean holdings, including phantom bonds Bawag used to disguise bad loans as an investment the bank valued at 350 million euros (\$443 million).

These findings come from interviews and documents gathered in Anguilla, Austria, the Bahamas, France, Israel, Libya, Liechtenstein, Malta, the Palestinian territories and the U.S.

Even as Bawag tries to clean up its accounts for a planned sale of the bank, it's staking out new ventures on the fringes of the financial world.

Last year, it opened an office in Libya, the African nation led by Muammar Qaddafi that was considered a sponsor of terror by the U.S. State Department for 27 years, until May.

'I Knew Nothing'

Bawag's dealings with Arafat and Qaddafi are consistent with its history as a labor union bank allied with the Social Democrat Party, previously the Socialist party, whose one-time leader, former Austrian Chancellor Bruno Kreisky, forged relationships with both Arab officials.

In Vienna in 1979, Kreisky received Arafat, then the Palestine Liberation Organization chief, as a fellow head of state.

Raffay says Bawag's Libyan office is a proper and transparent business move by a bank that was lucky enough to get a license to operate in the country that holds Africa's largest crude oil reserves.

He contrasts the office in Libya with the bank's dealings with Refco and the casino transactions. "I realized I was being cut out of these deals, and now I'm happy," he says. "I can go before a judge and say I knew nothing."

Bawag's Oasis investment became a 120 million-euro liability for the bank, according to Bawag CEO Ewald Nowotny, who was hired in January to clean up the mess.

Riding Shotgun

The casino, which accepted only U.S. dollars, had 124 gaming tables and 278 one-armed bandits. It raked in so much cash, according to casino financial reports, that guards, with Palestinian Authority security personnel riding shotgun, made daily trips in

compact cars to Arab Bank Plc's downtown Jericho branch to deposit as much as \$1 million at a time.

Because the casino was forced to close, Bawag's loss in that investment is about equal to its profit in 2004. The bank earned 113.3 million euros that year. Losses related to Refco and the casino chopped 2005 profit to just 6.3 million euros, the bank said in a statement on June 6.

The public unraveling of Bawag's casino investment, its trading losses and its secret dealings with Refco started on a single day last year, marking the beginning of a crisis that threatened the Austrian bank's existence and forced Refco into bankruptcy.

Loan to Bennett

The day was Oct. 10, when Refco went public with the news it had a hidden deficit. Bawag sold its stake that day in offshore Liquid Opportunities and the related Anguilla companies Bawag used to hide losses, according to evidence gathered by Austrian investigators.

The buyer was Thomas Hackl, Bawag's former head of treasury and investment banking, three people close to the investigation say. Hackl, 41, left Bawag to work at Refco as head of global asset management from 2002 to 2004.

Just hours before Refco revealed its losses, Bawag loaned Refco CEO Phillip Bennett 350 million euros, according to Bawag, which sued Refco in November to get the money back. Bennett used the Bawag loan to pay debts to Refco that he'd been hiding for years, according to court filings in the U.S.

A U.S. grand jury indicted Bennett for fraud in November. He pleaded not guilty and is awaiting trial.

Bawag's relationship with Refco is now being picked apart in a series of civil and criminal probes in New York, Vienna and Washington. Bennett, ousted by Refco's board in October, is the only person criminally charged.

\$683 Million Settlement

U.S. Attorney Michael Garcia in Manhattan accused Bennett, 57, of fraud after Refco disclosed he'd failed to inform investors of loans the company wasn't able to collect.

Others investigating Refco's collapse and Bawag's role in it include the U.S. Securities and Exchange Commission, Austria's Financial Market Authority and prosecutors in Vienna.

Bawag said on June 5 it would pay shareholders, creditors and regulators at least \$683 million as part of a settlement with the Justice Department and the SEC. The agreement

allows the bank to escape criminal charges in the U.S. Federal investigations of the individuals involved are continuing.

Bawag's role in helping Refco hide its debts was egregious in the eyes of U.S. law enforcement agencies because the bank was planning to profit by unloading its own stake in Refco, says Scott Friestad, the SEC official overseeing the agency's probe.

South of France Villa

“The bank's former executives understood that the deceptive year-end transactions would help Phillip Bennett and Bawag cash out their ownership interests at the expense of innocent investors,” Friestad says.

Most of the suspect dealings happened under the management of Helmut Elsner, Bawag's CEO from 1995 to 2003, who got his start in Bawag's branch in Graz, Austria, and whose wife owns a penthouse constructed on the roof of the bank's headquarters in Vienna, investigators say.

Elsner, 72, today spends his time on France's Cote d'Azur, where he drives a red Ferrari and lives in a villa in the hills outside Cannes. He entertains guests at the nearby restaurant Le Moulin de Mougins, which has been awarded two stars by the Michelin Guide.

His lunches typically include mature Bordeaux at about 500 euros a bottle, according to a restaurant staff member who asked not to be named because Elsner is a regular customer.

Reached by telephone inside his gated hillside enclave in May, Elsner declined to be interviewed. “Contact my lawyer in Vienna,” he said.

'Shot at Dawn'

His attorney, Wolfgang Schubert, says that Bawag's transactions were legal and approved by the bank's auditors and the board.

Under Elsner's leadership, Bawag devised a coverup with Bennett, a Briton who studied geography at the University of Cambridge, for their mutual losses, according to the June 2 settlement.

The plaintiffs include Newport Beach, California-based Pacific Investment Management Co., the manager of the world's biggest bond fund, which bought Refco securities with a face value of \$82.7 million from August 2004 to October 2005.

Raffay blames the arrogance of Elsner for the bad investments and coverups. “You speak against him and you were shot at dawn,” he says.

Otto Karasek, the managing director of Bawag Malta Bank, a subsidiary based in the Mediterranean island nation, also points the finger at his former boss. "A lot had to do with the culture of the time and the CEO, Elsner," Karasek says. "You didn't dare speak against him."

Coverup

In April 2003, Elsner retired as CEO after 48 years at the bank. Johann Zwettler, 64, a member of the bank's board, replaced him.

After Bawag lost about 350 million euros on hedge fund trades in 2000, it enlisted Refco's help to cover them up, according to the June 2 settlement agreement. Unlike traditional institutional investors, many hedge funds have the freedom to bet on virtually anything regardless of risk in pursuit of exceptional returns.

Bawag moved its failed investments off the bank's balance sheet and into offshore companies run through accounts at Refco, Nowotny says.

Bawag also helped Refco hide losses by lending the brokerage hundreds of millions of dollars at the end of fiscal years 2000 to 2005, according to an SEC news release issued on June 5.

'Sham Transactions'

Bennett concealed as much as \$970 million in debt and reported healthy finances, according to the shareholder lawsuit.

"The informal structure of these sham transactions clearly reflected their real purpose: to conceal Refco's true financial condition and Bawag's losses from the past trading failures," the lawsuit says. "Indeed, Bawag had to participate in these transactions because, if the Refco Holdings receivable came to light, Bawag's own trading losses would likely also be revealed."

Bennett owned Refco Group Holdings Inc., known as Refco Holdings. Bawag settled that suit as part of the June 2 agreement with U.S. regulators, without admitting or denying the allegations.

The cycle of hedge fund investments, trading losses and coverups that would lead to Refco's collapse and Bawag's putting itself up for sale began in the early 1990s under Bawag's then CEO, Walter Flottl. He'd run the bank since 1972.

\$2 Billion to Son

Flottl, 82, used bank funds to support his son Wolfgang's fledgling Bermuda-based hedge fund, people close to Bawag say.

The younger Flottl, 55, a graduate of Harvard Business School who was then in his early 30s, used the funds to bet, through Refco, on U.S. bonds, takeovers and the movement of currencies.

Austria's banking regulator at the time, the Austrian National Bank, announced an investigation in 1994 following press reports of money transfers to Wolfgang Flottl. It found that Walter Flottl had never informed Bawag's supervisory board about the \$2 billion in investments with his son's firm, people close to the investigation say.

The probe, whose results were never publicly disclosed, didn't find anything illegal, Bawag said in a statement the following year. Wolfgang Flottl said in an October interview he returned all of Bawag's money plus a profit. He's married to Anne Eisenhower, the granddaughter of former U.S. President Dwight Eisenhower.

Risky Ventures

Following the probe, Walter Flottl retired in 1995, handing the bank's leadership to Elsner. The new CEO expanded Bawag's relationship with Refco and started other risky ventures.

Elsner found such an investment in the Palestinian territories. Arafat, as president of the Palestinian Authority, was on the hunt for ways to develop the local economy after the 1993 Oslo Accord created the framework for Palestinian autonomy in the West Bank and Gaza, former Finance Minister Salam Fayyad says.

Austrian investor Martin Schlaff helped bring Bawag together with Arafat's advisers to build a casino in Jericho, according to Palestinian Authority records that list Schlaff as a board member and officer of the casino.

Schlaff was one of Bawag's biggest customers. Schlaff declined to answer written questions submitted to Michael Fink, his spokesman in Vienna.

On Dec. 17, 1996, Palestine Commercial Services Co., an investment company controlled by Arafat, signed an agreement with a group of Austrian investors, including Bawag, according to a report on the investment's history and financial value commissioned by the Palestinian Authority.

Oasis

The casino would be owned by CAP Holding AG, a Liechtenstein-based company whose shareholders were Bawag, with 11 percent; Vienna-based Casinos Austria International, with 16.5 percent; Palestine Commercial Services, with 23.1 percent; and a company called MS Privatstiftung -- controlled by Schlaff -- with 49.5 percent, according to Palestinian Authority and Casinos Austria documents.

Casinos Austria ran the Oasis, along with 62 other casinos in 17 countries and nine gambling ships.

On Sept. 13, 1998, the Oasis opened; its staff grew to about 2,000 by June 2000, when the InterContinental Hotel opened adjacent to the casino. The resort has 181 rooms, 14 suites and three swimming pools on lush grounds surrounded by desert with views of the hills across the border in Jordan.

In its first full year, 1999, the Oasis took in \$152.9 million in gaming revenue and turned a profit of \$60 million, according to an assessment of the investment by Standard & Poor's for the Palestinian Authority.

Bennett and Elsner

Richard Lehrner, the casino's head of finance and administration at the time, declined to comment.

At the same time Bawag was working with Arafat, the Austrian bank established its first formal links with Refco. Eighteen days after the casino opened, Refco promoted Bennett, then its chief financial officer, to CEO.

The next week, Bennett and Elsner announced they were setting up a joint venture to provide clearing services for futures and options traded on European exchanges. Bawag was able to handle trades for some of Refco's customers, including 20,000 financial institutions, and Refco aimed to profit from widening its client base in Europe.

Wolfgang Flottl was also back in the bank's good graces, and in 1995, Elsner began lending him hundreds of millions of the bank's money to invest, Nowotny says.

Flottl's losses trading Bawag's money would total at least 1 billion euros, Nowotny says.

Asian Crisis

By the late 1990s, Refco also faced hundreds of millions of dollars in losses from customers crippled by the Asian currency crisis that exploded in 1997, according to U.S. prosecutors. It turned to Bawag for fresh financial support. That's when Bawag paid about \$95 million for its stake in Refco.

``This significant infusion of capital complements a number of important recent management changes at Refco and positions us well to achieve our strategic goals," Bennett said in an announcement six days later.

What he and Elsner never announced was that, behind the scenes, Refco and Bawag had started working together to make Refco's bad debts disappear before the end of the fiscal year, the June nonprosecution agreement says.

Bennett, faced with unpaid debts from clients, had taken the customers' obligations and moved them to a company he owned called Refco Group Holdings, the SEC's settlement with Bawag shows.

Round-Trip Loans

A firm owned by the CEO owing money to Refco would raise suspicion and possibly trigger a requirement under U.S. securities law to disclose debts to so-called related parties. Bennett needed to give the appearance that an outside company owed the money to Refco, the SEC says.

On Feb. 24, 2000, Bawag and Refco made the first of six annual round-trip loans, according to e-mails contained in the shareholder lawsuit. Bawag wired \$300 million to Bennett's holding company, which Bennett then used to temporarily pay a portion of his holding company's debts to Refco.

At the same time, Refco wired \$300 million to Bawag, according to Bawag's June 2 nonprosecution agreement with the U.S. attorney. The effect was to make it appear that Refco had money on deposit at Bawag, rather than the truth -- that the firm's CEO owed money to Refco, SEC court filings show. On March 2, after the fiscal year had passed, they reversed the transfers.

Seven months later, on Sept. 28, violence erupted in Jerusalem as Ariel Sharon, then head of Israel's opposition Likud Party, visited the plaza that contains al-Aqsa Mosque, the third-holiest site in Islam, and the Western Wall, the most sacred location in Judaism.

Casino Closed

An uprising spread throughout the West Bank and Gaza, and in the following month, the casino closed. The hotel stayed open, with managers herding guests, including women and children, into the basement for hours at a time during gun battles.

Israeli shells punched holes the size of basketballs in the hotel's side, which has since been repaired with plaster and paint.

With no customers at the gaming tables, the value of the casino plummeted. Still, Bawag engineered a transaction that -- for accounting purposes anyway -- transformed a stricken investment into one worth 120 million euros, Bawag's nonprosecution agreement says.

This accounting alchemy was accommodated by the Liquid Opportunities fund. First, Bawag shifted its casino holding to a Refco account administered by Liquid Opportunities, the nonprosecution agreement says.

Liquid Opportunities

Then, following the transfer, Liquid Opportunities updated its records to reflect an increase of 120 million euros in the value of Bawag's Refco account, the agreement says.

At the time, 120 million euros was the equivalent of \$108 million -- eight times what the stake was actually worth, according to S&P's assessment.

Oasis Hotel Casino Resort had a fair market price of \$120 million, S&P found. That would value Bawag's stake at about \$13.2 million. Nowotny says the 120 million-euro figure includes the casino investment and unrelated liabilities.

By the end of 2000, Bawag also used Liquid Opportunities and offshore accounts at Refco to cover up the bank's hedge fund losses. That year, Bawag made its final loan to Wolfgang Flottl: this time, 350 million euros, according to the nonprosecution agreement.

Flottl wagered that the yen would rise, Nowotny says. In the last quarter of 2000, the yen fell 9.1 percent versus a basket of currencies in eight straight weeks of declines, its longest continuous drop in half a decade. Flottl told the bank that he had lost almost all of the money.

Secret Deal

With Bawag's hedge fund failures totaling more than 1 billion euros by December 2000, Elsner made a secret deal with the trade unions, Nowotny says. The unions agreed to guarantee Bawag's debts, allowing it to repay the money.

Elsner and Bennett might have succeeded in hiding their losses if Refco hadn't begun preparing in 2004 for an eventual public offering of its stock.

Bennett started the process by arranging the sale of Bawag's 10 percent stake in Refco to investor Thomas Lee in a leveraged buyout. As part of the deal, Bennett also paid back loans to Bawag, bringing the total payout to Bawag to at least \$952 million.

Refco raised the money by selling bonds -- debt that would later be passed on to buyers of \$583 million in Refco shares when Lee and Bennett took the company public in August 2005.

Endgame

The endgame for Refco began on Oct. 6, 2005, when Bennett asked Bawag to lend 350 million euros to his company, Refco Group Holdings, according to Bawag's lawsuit against Refco.

Hackl, the Bawag banker who'd moved to Refco, helped a Refco employee contact Bawag to arrange the loan, Hackl said in an Oct. 26 interview.

On Oct. 10, Bawag agreed to lend Bennett the money. That same day, Hackl bought Bawag's stake in Liquid Opportunities and the Anguilla companies the bank had used to hide its hedge fund losses, three people with knowledge of the Austrian investigation say.

Hackl then sold the holdings back to Liechtenstein-based foundations controlled by Bawag, the people say.

The loan was wired into an account at Refco Capital Markets Ltd., a Bermuda subsidiary, at 6 a.m. New York time on Monday, Oct. 10. Less than two hours later, Refco announced that Bennett had hidden losses.

Customers fled, and the brokerage filed for bankruptcy protection in November. Bawag sued Refco for fraud on Nov. 16, and, the next day, CEO Zwettler resigned.

Forgiveness of Debt

The new management under Nowotny negotiated settlements with Refco's shareholders and regulators in the U.S. in order to reassure customers in Austria and stem the tide of withdrawals.

It disclosed the secret shift of Bawag's hedge fund losses and, on June 6, said it had written down the casino investment as a loss against its 2005 earnings.

On June 16, the bank said the trade unions had covered the full 120 million euros.

With the casino closed in Jericho, one of the remaining tourist attractions is a testament to such forgiveness of debt: a sycamore tree on the road that links the casino and the downtown Arab Bank branch.

By local tradition, the town's chief tax collector, Zacchaeus, climbed this tree some 2,000 years ago for a better view of Jesus, who was coming through Jericho. Jesus ordered the tax collector down from the tree, winning a spontaneous pledge, according to the Bible's Book of Luke.

``If I have cheated anybody out of anything, I will pay back four times the amount," Jericho's tax man said.

At Bawag and Refco, exacting that kind of justice may also take divine intervention.