# SO IS THERE ANYTHING WRONG WITH AUSTRALIAN SYNTHETIC CDO'S?

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## Non Sub-Prime CDOs

1. Numerous non sub-prime collateralised debt obligations (CDOs) have been issued in Australia over the last six years or so.

2. Some have been listed on the Australian Stock Exchange and some are unlisted. Most are of the synthetic variety. Those listed on ASX have generally been sold to "retail" investors. Unlisted CDO's have been sold in parcels of more than $500,000 and are thus targeted at the "wholesale" market.

3. They have generally been issued by Australian companies "connected" with either an Australian bank or an overseas investment bank.

4. The reason for using the word connected in inverted commas appears below.

5. At the moment it is the sub-prime fiasco which has hit the headlines in relation to CDOs. These are CDOs "referenced" to underlying pools of sub-prime mortgages.

6. There is however a simmering pile of non sub-prime CDOs waiting in the wings with the potential to add substantially to the sub-prime problems.

7. In the current economic climate it is entirely possible that these CDOs will result in a massive movement of value away from investors and towards the banks "connected" with the Issuers which created them.

8. It is well, therefore, to be aware of the structure, terms and potential downside of these non sub-prime CDOs.

## The Issuer

9. The essential nature of an Australian non sub-prime CDO is that the investors make loans to or deposits with the Issuer of the CDO. (It is probable that the payments made by investors to CDO Issuers in Australia are deposits rather than loans but there is some potential for debate on this question).

10. In return for the deposit from the investor the Issuer promises to pay "interest" on the deposit and to repay "the principal" on the repayment date.

11. Generally, the Issuer issues what it calls floating rate notes to the investors as a record of the transaction. As these CDO transactions have amounted to hundreds of millions of dollars the status of the Issuer is of paramount importance.

12. If the investors in a CDO are wronged by the conduct of the Issuer (as for example by breaches of statute or other tortious conduct on the part of the Issuer) then it is the status of the Issuer which will determine whether the investors in that CDO are fully protected by having recourse to an Issuer of substance rather than of straw.

13. In Australia most (if not all) CDO Issuers are hopelessly and deliberately under capitalised.

**Damages**

14. Investors may suffer damage at the hands of a CDO Issuer in numerous ways including;

    a) the issue of CDOs without a prospectus or a product disclosure statement in circumstances where the law requires such a document for the protection of investors;

    b) the making of false or misleading statements in a prospectus or product disclosure statement; and

    c) misrepresentations or nondisclosure by officers or employees of the Issuer or by other parties in the distribution chain.

15. If any of these events have occurred in the issuing of Australian CDOs then, in most cases, the investors will be without an apparent remedy because of the "straw" status of the Issuer companies.

**Issued Capital**

16. The standard model of an Australian CDO is that it has an absolute minimum of paid up capital. Where the Issuer is a foreign company it is often not possible to determine the amount of paid up capital because the Issuer company is incorporated in a tax-haven such as the Cayman Islands.

17. By way of example HY–FI Securities Limited (an Australian company) has issued capital of only $1,000. It is more common, however, for these CDOs to only have issued capital of $1. This is the case, for instance, in relation to Mahogany Capital Limited and Nexus Bonds Limited. (Both Australian companies).

18. On the face of it, therefore, if any of these companies were found liable to pay damages to investors they would have no capacity whatsoever to make that payment.

19. Some investors may have thought that the size of the Issuers capital did not matter because, for instance, they believed the Issuers were subsidiaries of major banks.

20. Most investors in this area know, for instance, that ABN-AMRO NV is "connected" with HY-FI Securities Limited, Lehman Brothers is "connected" with Mahogany Capital Limited and Deutsche Bank is "connected" with Nexus Bonds Limited.

21. But what is the degree of that "connection" and will the connection provide any protection for investors if they happen to be damaged by the conduct of the Issuer?

**Who holds the shares in the Australian CDO Issuers?**

22. In nearly all cases it is not the Bank "connected" with the Issuer which owns the shares in the Issuer. (Macquarie Bank Limited is at least one exception – it issued the "ALPS" series in its own name).

23. No doubt, if the banks did own the shares in the Issuers, then the transactions involving the Issuers would be brought on to the balance sheet of the various banks. Whether this is the only rationale for the Issuer structure is best known to the banks.

24. In most cases the shareholder in each Issuer is a trustee company (generally Perpetual Trustees Company Limited) which holds the shares as follows;

    a) HY-FI Securities Limited – "on trust for selected charities";

    b) Mahogany Capital Limited – "on trust for certain Australian Benevolent Institutions"; and

    c) Nexus Bonds Limited – "on trust for the benefit of certain charitable organisations".

25. So, not only do the Issuer companies have virtually no issued capital, what little capital they do have is not held by the Banks they are "connected" with.

26. The Issuer companies have not disclosed the identity of these various charitable entities which, in most cases, hold a share worth $1 and nor have they disclosed the arrangements (if any) by which these charities came to be the beneficiaries of this largesse by the banks. It is not even clear whether the charities know that they are beneficiaries.

**Special purpose company?**

27. All three of the Issuers referred to above claim in their public documents to be "special purpose companies" as though that is, in some way, important to the CDO transactions.

28. That description has a particular meaning in the Corporations Law of Australia.

29. The term is defined in the Corporations (Review Fees) Regulations 2003 made under the Corporations Act. In general terms, special purpose companies are those set up for charitable purposes where the directors receive no fees and the company works for the good of others.

30. Whatever these Issuer companies are, they are not special purpose companies as that term is used in the Corporations Law.

31. It is certainly the case that a company does not become a special purpose company simply because all of its shares are held on trust for "Australian benevolent institutions "or" selected charities "or" charitable organisations".

32. There seems little doubt that the Issuers are structured in this way i.e. with minimal capital held by a trustee on trust for Australian benevolent institutions, so as to enable the banks to deny any liability for the conduct of the Issuers and perhaps to enable them not to allocate capital in their balance sheets.

33. The statements made in their public documents by each Issuer in this regard are as follows;

    a) HY-FI Securities Limited – "The Issuer is not a member of the ABN-AMRO group of companies…"

    b) Mahogany Capital Limited – "the Issuer is not a related body corporate of Grange or Lehman and its obligations are not guaranteed by Grange or Lehman"; and

    c) Nexus Bonds Limited – "Nexus is not a member of the Deutche Bank Group".

**The factual position regarding control of the Issuers**

34. The following factors impact on the real distance between, for example, HY-FI Securities Limited and ABN-AMRO Bank NV;

    a) ASIC records show that the registered office of HY-FI Securities is at ABN-AMRO Australia Pty Ltd;

    b) in the same way those records show that the principle place of business of HY-FI Securities is at ABN-AMRO Australia Pty Ltd;

    c) from the date of incorporation of HY-FI Securities two of the three directors have been ex senior executives of ABN-AMRO;

    d) a management agreement exists between HY-FI Securities and ABN-AMRO Australia whereby ABN-AMRO carries on the day to day administration and management of HY-FI Securities;

    e) ABN-AMRO Australia set up HY-FI Securities and paid all of the establishment expenses;

    f) ABN-AMRO Australia has agreed to pay all of the general operating expenses of HY-FI Securities. It will only be repaid by HY-FI Securities if and when it is able to do so and then only in relation to some of those expenses; and

    g) a member of the ABN-AMRO group was the arranger for the issue of CDOs by HY-FI Security (ABN-AMRO Australia), the lead manager in the issue (ABN-AMRO Morgans Limited) and the deposit holder (ABN-AMRO Bank).

35. All of this leads ABN-AMRO to say in the HY-FI prospectus that it has not "caused" the issue of the various prospectuses issued by HY-FI Securities Limited and to make the following statement in relation to each prospectus – "to the maximum extent permitted by law, (ABN-AMRO) expressly disclaims and takes no responsibility for any part of this prospectus…"

36. The old saying that to determine the true nature of anything one should follow the money trail holds good for Australian CDOs.

37. In circumstances where these CDOs are set up for the advantage of the Bank "connected" to the Issuer it may be hard for the Bank to argue that it does not control the Issuer and in turn that it did not "cause" the issue of the prospectus in relation to that CDO. Each case will, of course, turn on its own facts.

**Listing on ASX**

38. Issuers of CDOs cannot achieve quotation of their debt securities on ASX unless the Issuer is shown to have net tangible assets of at least $10 million or provides a guarantee for that amount.

39. None of the Australian CDO Issuers have any material net assets. So how did they manage to list their CDOs?

40. Each of them was given an exemption by ASX from this requirement of the listing rules.

41. In addition to the $10 million requirement, listing rule 1.8 condition 3 (d) provides that an Issuer will not obtain listing of its debt securities unless the "structure" of the Issuer is appropriate for retail securities.

42. All listed Australian CDOs are retail securities and therefore this listing rule had general application. An Issuer with a structure denying retail investors a meaningful right to sue for damages should not have obtained a listing for their CDOs.

**What is a CDO?**

43. In Australia the precise terms vary from Issuer to Issuer but there is an underlying core structure which is common to nearly all Issuers.

44. At the heart of every CDO, where the Issuer has been separated from the Bank, lies a credit default swap between the Issuer and the Bank.

45. It is through this credit default swap that the Bank extracts its benefit from the CDO transaction.

**Credit Default Swaps**

46. In very general terms a credit default swap involves a protection seller providing risk cover to a protection buyer for a nominated amount in relation to a referenced risk.

47. The protection buyer pays a premium to the protection seller for each year of the term of the credit default swap and in return, if the referenced credit event occurs, then the protection seller pays out to the protection buyer according to the terms of the credit default swap.

48. By way of example a creditor of BHP might enter into a credit default swap whereby he pays an agreed amount per year for an agreed number of years in return for protection against the inability of BHP to repay his debt.

49. Whether such an arrangement is called insurance or risk minimisation or whatever the result is that the owner of the BHP debt has moved some of his risk to the other party to the credit default swap.

50. The protection seller may not be required to secure his ability to pay should the credit event occur and therefore the protection buyer takes a serious counterparty risk in that regard. (In some cases the swap contract may require the protection seller to put up security if its position under the swap worsens during the term of the arrangement).

51. In many cases the protection buyer does not actually own any debt in BHP but wishes to take a punt on the likelihood of that debt being paid going up or down. This is a synthetic rather than a cash transaction.

52. These credit default swaps are generally characterised by:

    a) the parties to them being sophisticated, high wealth individuals or corporations;

    b) the precise terms of the swap being negotiated between the parties;

    c) the size of the deal i.e. generally in the tens if not hundreds of millions of dollars; and

    d) a serious counterparty risk that, when called upon to do so, the protection seller may be unable or unwilling to pay up.

**CDO Transaction – Between Issuer and Bank**

53. In the case of a synthetic CDO the Bank "connected" to the Issuer enters into a credit default swap with the Issuer upon the following typical terms agreed between the Issuer and the Bank:

    a) the bank becomes the protection buyer;

    b) the Issuer becomes the protection seller;

    c) the parties agree on the term of the credit default swap (generally 5 to 10 years);

    d) the parties agree on a nominal amount (i.e. the amount to be raised by the Issuer from the investors);

    e) the parties agree on the "premium" to be paid by the protection buyer to the protection seller and the frequency of that premium (i.e. quarterly,

semi-annually or annually) (i.e. the amount equal to what the Issuer is to pay the investors above the Bank Bill Rate);

f) the parties agree on the reference entities (typically 70 to 120 well known international companies); and

g) the parties agree on the credit events which will give rise to an obligation on the part of the protection seller to pay the protection buyer.

54. It is this credit default swap arrangement between the Bank and the Issuer which is at the heart of the synthetic CDO. It's terms are then replicated as between the Issuer and the investors so that what could have been achieved in one step is achieved in two i.e. the bank could have entered into individual credit default swaps with each investor but that would involve;

a) the bank directly contracting with each investor rather than with a corporate structure of its own creation;

b) numerous contracts rather than a single contract; and

c) a counterparty risk, in that each investor may be unable to pay up when called upon to do so.

**CDO Transaction – between Issuer and Investors**

55. There are two aspects of the CDO transaction between the Issuer and the investors.

56. First, in a typical transaction, the investors deposit their funds with the Issuer. Those funds may then be placed on deposit by the Issuer with the Bank (or the Issuer purchases a Bank issued instrument) and the Bank pays the Issuer the going Bank Bill Rate. The Issuer may provide a security over the deposit or the bank instrument to a trustee for the investors.

57. The cash sits in the Bank deposit or the Bank instrument throughout the transaction. It is not invested in anything. It is certainly not invested in any of the debt of the portfolio of companies referred to in the prospectus.

58. It is obvious that the investors could have made this type of investment directly with any number of Banks around the world and they would have received the Bank Bill Rate.

59. That is the first aspect of the transaction and does little or nothing for the investors which they could not have done for themselves. On the other hand it placed the investors funds within the possession or control of the Bank.

60. The second aspect of the CDO transaction between the Issuer and the investors is as follows:

a) the investors effectively agree to take on the obligations of the Issuer set out in the credit default swap between the Issuer and the Bank;

b) the agreement between the investors and the Issuer mirrors the terms of the credit default swap between the Issuer and the Bank as to amount, term, premium, referenced entities, default events and so on; and

c) it is the premium paid by the bank to the Issuer which provides the Issuer with the ability to pay the "interest" above the Bank Bill Rate to the investors.

61. The Issuer gets an interest payment from the Bank on the deposit and a premium from the Bank on the credit default swap. It amalgamates these two payments and pays that amalgamated amount to the investors as "interest" on their investment. (i.e. the Bank Bill Rate plus the margin).

62. As and when default events occur they are mirrored in both the agreement between the investors and the Issuer and that between the Issuer and the Bank so that, if sufficient credit events occur to deny the investors all repayment, then the funds on deposit are:

a) forfeited by the investors to the Issuer under the CDO; and

b) paid by the Issuer to the Bank under the credit default swap.

63. The reality is that the investors have, in effect, entered into a credit default swap with the Bank and what is more they have secured their payment to the Bank, if things go wrong, by paying their money in advance to the Issuer for deposit with the Bank.

64. The CDO transaction has the following advantages for the Bank:

a) it enables the Bank to effectively enter into credit default swaps with numerous retail investors (and in some cases with investors who have a little more than $500,000 to invest and who would accordingly be "wholesale" investors);

b) the Bank obtains upfront counterparty security should the deal go against the investors (something it would not necessarily get in a credit default swap); and

c) it puts a distance between itself and the investors by injecting the "Issuer" between the investors and the Bank.

65. If the CDO transaction goes against the investors then the benefit goes to the Bank and this is why it is clear that the Issuer is the creature of the Bank.

66. In some cases the Bank may enter into another credit default swap wherein it is the protection buyer and some other entity is the protection seller on the same terms as are contained in the swap between the Bank and the Issuer.

67. In such a case the Bank acts as a middleman – if the deal goes wrong for the investors value flows from the investors to the Issuer, from the Issuer to the Bank and then from the Bank to that other entity.

**A Realtime Example**

68. In September 2003 HY-FI Securities Ltd issued a Prospectus for what it called "High Yield Fixed Interest Securities."

69. It is not immediately clear why the Issuer thought that the securities it was issuing were "fixed interest". As will appear the interest was anything but "fixed" (for a start interest which is described as Bank Bills plus a margin can never be fixed).

70. The Prospectus offered $40 million of Series 3 securities and $30 million of Series 4 securities.

71. There was a provision which allowed the Issuer to accept over subscriptions.

72. In the event investors put $58 million into Series 3 and $78 million into Series 4.

73. In accordance with the Prospectus the Issuer placed these two amounts (totalling $136 million) into separate deposit accounts with ABN-AMRO Bank which undertook to pay the 90 day Bank Bill Rate to the Issuer upon those deposits.

74. By the Prospectus the Issuer had promised to pay the investors the 90 day Bank Bill Rate plus 1.35% in relation to Series 3 and the 90 day Bank Bill Rate plus 3% in relation to Series 4.

75. It is clear that the investors could have made a deposit directly with ABN-AMRO Bank or with any other Bank and received the 90 day Bank Bill Rate.

76. Accordingly it is the balance of the transaction which requires examination. Why did the investors get an extra 1.35% in Series 3 and an extra 3% in Series 4 and, given that the Issuer had no capital or assets other than the investors money, where did the extra payments come from?

77. The Prospectus contains a mechanism whereby the investors could, depending upon events, lose the whole of their investment.

78. They were compensated for taking this risk by the payment of 1.35% of the total amount of the risk per annum for 5 years in the case of Series 3 and by the payment of 3% for 5 years in Series 4.

79. In relation to Series 3 that mechanism worked as follows;

a) on the basis that $40 million of securities would be issued a "portfolio size" of $1.6 billion is set so that each of the 70 companies in the portfolio (details of which companies are set out in the Prospectus) are each allocated $22.9 million of the portfolio;

b) provision is made in the Prospectus to adjust these figures if there is an over subscription and to do so proportionally;

c) as there was an over subscription to $58 million from $40 million the portfolio size became $2.32 billion and each of the 70 companies was allocated $33,142,857;

d) a "protection" amount of $89 million was set for Series 3 with a provision that, if there was over subscription, then it would be increased accordingly;

e) the protection amount for Series 3 was therefore $129,050,000;

f) if one of the 70 companies defaulted on its debt obligations during the 5 years of the agreement (and in circumstances where the debt had no ongoing value) the protection amount was reduced by the amount allocated to that company (remembering that the same amount i.e. $33,142,857 was allocated to each company) so that after the first default the protection amount became $129,050,000 less $33,142,857 or $95,908,143;

g) a second default of that type would reduce the protection amount to $62,765,286;

h) a third default of that type would reduce it to $29,622,429;

i) it is at the fourth of these defaults that the investor's principal is reduced. The fourth loss of $33,142,857 eradicates the balance of the protection amount (i.e. $29,622,429) and eats into the $58 million of investors funds by $3,520,428;

j) this reduces the investors funds to $54,479,572;

k) thereafter interest was to be paid on that figure (this is another reason why the interest was not "fixed");

l) at this rate by the sixth default from the 70 companies all of the investors funds would be wiped out; and

m) It is in return for this risk that the investors are paid 1.35% of their $58 million for each of the five years of the life of the CDO (i.e. $783,000 per annum at most).

**The Series 4 Transaction**

80. On the basis of a final issue of $78 million to investors the portfolio size for Series 4 was set at $4.16 billion and the amount allocated to each of the 70 companies accordingly $59,428,571. The protection amount was $153,400,000.

81. As can be seen from these figures it only required three total loss defaults to wipe out the protection amount and eat into the $78 million in investors funds by an amount of some $25 million.

82. A fourth total loss would eradicate all of the investors investment.

**Were these good deals for Investors?**

83. The true answer probably is that God only knows!

84. Who else would know whether one or more of the 70 companies in the reference basket would have a credit default during the five years after the transaction was set up?

85. The rating agencies only look backward and say what defaults have happened in the past – they themselves warn that the past may be no help in divining the future.

86. One thing is clear and that is that the Issuer and the Bank decided upon;

a) the portfolio size;

b) the amount of protection in each series;

c) the allocation of that protection to each company;

d) the choice of the number of companies (i.e. 70 rather than 60 or 80);

e) the identity of each company within the chosen number of 70;

f) the premium to be paid in each series;

g) the default events; and

h) the amount of loss on each event.

87. It is probable that ABN-AMRO Bank, despite it's databases, financial models and algorithms still had no precise idea of the risk involved. However one thing is certain, the investors had virtually none.

88. The only real clues as to the amount of risk involved lies in the identity of the 70 companies included in the portfolio.

**The HY-FI Portfolio**

89. The reference entities are in the HY-FI portfolio are 70 international companies.

90. The default events are;

a) the bankruptcy of a portfolio company;

b) the failure of a portfolio company to pay an amount of at least US$1 million on time; and

c) a reorganisation by the portfolio company of at least US$10 million of its debt so as to alter the interest rate or the time for payment where those alterations are caused by a deterioration in credit quality.

91. The companies in the portfolio are skewed to those operating in the US – 38 of them are US companies.

92. There are also several companies in the list which may be affected by the sub-prime crisis. They are;

a) MBIA Inc;

b) PMI Group Inc;

c) XL Capital Limited; and

d) Radian Group Inc.

93. One company in the portfolio (Parmalat spa) has already defaulted (with a 90% loss of value) so if the four sub-prime related companies were to default so that their debt lost all value then all of the Series 4 investors would lose their funds and part of the Series 3 funds would also be lost.

94. As the Series 3 and Series 4 funds are five year terms they will terminate in September 2008.

95. At the present time the highest bidder on ASX for the Series 3 notes is $95 and the highest bidder for the Series 4 notes is $90. The face value of all of the notes is $100.

96. If any of the four sub-prime related companies are down rated by the rating agencies then that may flow through to the rating of the HY-FI notes and thence into the ASX price for those notes.

97. A down rating will not have any affect on the default mechanism but will rather reflect the market's view of the possibility that one or more of the companies in the portfolio will default before the term of the CDO has expired.

98. The investors in Series 3 and Series 4 will therefore need to wait for events leading up to September 2008.

99. If sufficient of the portfolio companies do default so as to mean that all of the investors money has been lost then ABN-AMRO will be in the fortunate position that it will not have to pursue the investors for their undertaking. It will simply be able to take the money from the deposits. There is no counterparty risk for the Bank on the credit default swaps it entered into with HY-FI Securities Limited.

**Other CDO Portfolios**

100. The portfolio for the Mahogany notes Series 1 issued by Mahogany Capital Limited in October 2004 contains the following companies;

a) Countrywide Home Loans Inc;

b) Federal Home Loan Mortgage Corporation;

c) Federal National Mortgage Association;

d) MBIA Inc;

e) MGIC Investment Corporation;

f) Radian Group Inc;

g) The Bear Sterns Companies Inc;

h) PMI Group Inc; and

i) XL Capital Limited.

101. The default date for these notes is December 2009 so these investors have nearly two years to wait.

102. The list for the Mahogany notes Series 2 issued in January 2006 includes;

a) Ambac Assurance Corporation;

b) Countrywide Home Loans Inc;

c) JP Morgan Chase and Co;

d) MBIA Insurance Corporation;

e) Merrill Lynch and Co Inc;

f) MGIC Investment Corporation;

g) Morgan Stanley;

h) The Bear Sterns Companies Inc; and

i) The PMI Group Inc.

103. The term for the Mahogany Series 2 notes is a minimum of five years and a maximum of 10 years. Noteholders will therefore have to hang on until at least January 2011 before they will know how much of their original investment will be repaid.

104. The list for Nexus Bonds Limited includes the following;

a) Ambac Financial Group Inc;

b) Countrywide Home Loans Inc;

c) MBIA Inc;

d) PMI Group Inc;

e) Radian Group Inc; and

f) XL Capital Limited.

105. All of these portfolio companies may default as a result of the sub-prime crisis. If, for instance, the purchase of Countrywide by Bank of America does not proceed then Countrywide may then default.

106. If the monoliners (AMBAC, MBIA, MGIC, Radian, PMI and XL) are down rated by the rating agencies, and if there is no US government bail out for them, then they may default.

107. The difficulties facing Merrill Lynch, Bear Sterns and Morgan Stanley are well known.

108. No doubt these portfolio companies were not deliberately chosen so as to help protect the Banks from the sub-prime fallout although they may well have that precise effect.

109. If, on the other hand, this group of portfolio companies (i.e. those potentially affected by the sub-prime crisis) is contained in all or nearly all CDO portfolios then the question will need to be asked in each case as to whether the choice of portfolio companies was made so as to favour the Banks.

**Information Asymmetry**

110. In those Australian CDOs, where the Issuer has produced a prospectus, considerable information has been provided to potential investors.

111. There is, nevertheless, a clear information asymmetry between the Issuer and it's "connected" Bank on the one hand and retail investors on the other.

112. It is not beyond belief that the Banks have their own complete databases on all of the companies in the various portfolios and in some cases may even have acted as bankers or advisers for one or more of those companies.

113. An intending investor, trying to assess the risk against receipt of the margin over the Bank Bill Rate, may well have asked himself - "as the Issuer and its connected bank set up the transaction and offered it to me are they likely to have organised it in such a way as to benefit themselves or me as an investor?"

114. That would have been an appropriate question as the CDO is not a win/win transaction – as one party to the credit default swap wins the other loses.

115. Information asymmetry always leads to the possibility of;

a) mis-selling, where the retail investor believes it is getting something different than what it was actually bargaining for; and

b) misrepresentation, as representatives of the Issuer describe what the prospectus "really" means.

**Could this asymmetry have been reduced**

116. Part of the information given by Issuers to investors is the rating ascribed for their product by various rating agencies.

117. The extent to which this rating information is helpful to an investor is a topic in itself and for another day.

118. The question is whether there is any other information which might have been given to investors to assist them in determining whether they should undertake the investment.

119. Rating agencies are at pains to emphasise that their ratings are backward looking – they are based upon what has happened in the past and, as the rating agencies themselves say, are not necessarily a good guide to what may happen in the future.

120. It is notorious that the debt of senior international companies trades on the open market.

121. That market ascribes a real time value to the debt in a free, open and well informed market.

122. That debt market is often well ahead of the ratings.

123. Would it not have been possible for all of the selling documents for these CDOs to include a table showing the then highest bid for the debt of each of the portfolio companies as at the issue of the prospectus.

124. If that table showed that the debt of the portfolio companies was worth say 80% of its face value then this would be a much more meaningful piece of information than that provided through some Gaussian algorithm.

125. If, on the other hand, the list showed that the companies were trading at or in excess of 100 cents in the dollar then this would inform the potential investor of the up to date, market view of the safety of the investment.

126. The utility of this approach lies in the fact that the market is arms length from the transaction, in theory at least, contains perfect information from all possible sources and, in most cases at least, is immunised from manipulation.

**Summary**

127. The problems in the sub-prime CDOs in Australia are just emerging. They have nothing to do with tranching - the non sub-prime CDOs are not tranched – losses are equal for all investors in each CDO and in some cases may involve total loss of the investment.

128. It will be no answer from the Banks for them to say that their structures are designed in order to provide a non recourse arrangement between the Issuer, the Banks and their assets on the one hand and the investor on the other.

129. Non recourse is contractual. There was no need for it to be structural i.e. it was not necessary for the investors to deal with a $1 company in order to ensure the non recourse nature of their investment.

130. In many cases the market value of Australian CDOs have been seriously and, in some cases savagely, reduced. That does not necessarily mean that there will be a total loss or even, in some cases, a partial loss. Such loss will not depend upon the price at which the CDOs trade or upon the rating which they have from time to time. Loss will depend solely on the default events in the synthetic mechanism included in each of the CDOs.

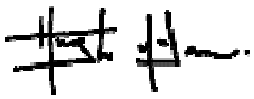
131. What the market price is saying is that the market believes there is a good chance some of these default events will occur.

132. The three CDOs which have been chosen for examination in this report were chosen at random. Each of them was "likely" to return all investors funds except if there was a systemic credit default such as that triggered by the sub-prime crisis (which itself is an example of the various systemic credit problems which beset the market from time to time). Each of them issued a complete prospectus with full information about their product.

133. The point is however that such a systemic event has occurred and may in certain circumstances lead to loss on these three and numerous other CDOs.

134. Whether all Australian CDO investors realised that they were providing risk cover of a knock out nature (i.e. where they could lose all of their investment in certain circumstances) rather than investing in a fixed interest transaction with a margin above Bank Bill Rates remains to be seen.

Yours faithfully



**Hugh McLernon**
**Executive Director**