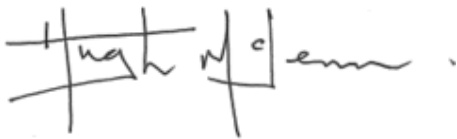


Have we seen the beginning of the end for synthetic Australian CDO's?

1. In our paper dated 12 February 2008 entitled "Is there anything wrong with Australian synthetic CDO's?" we attempted to explain our view as to the essential nature of synthetic Australian collateralised debt obligations.
2. If that nature is explained in gambling terms it would run something along the following lines "I (the CDO issuer) bet you (the purchasers of the CDO's) \$100 million that at least 7 of the companies in my list of 150 companies will suffer a default on its debt within the next 5 years. If you accept the bet I will pay you \$1 million per year for each of those 5 years or until you lose the bet."
3. Because no-one can foretell the future from what has happened in the past and because there are so many imponderables regarding what might happen to a list of 150 companies over a 5 year period it would be idle to deny that many Australian synthetic CDO's are a form of gambling.
4. How, for instance, could any investor have answered the following questions in relation to many of these CDO's:
 - a. What is the true current financial position of each of the 150 default companies?
 - b. What economic conditions will apply during the following 5 year period?
 - c. What is the likelihood of any one company in the list of 150 companies defaulting on its debt within the 5 year period?
 - d. What is the likelihood of any 7 such companies defaulting within that period?
 - e. If one company within the 150 defaults is it likely that other similar companies in the group will also default i.e. is there sufficient diversification in the choice of 150 companies?
 - f. Is 7 defaults a fair number for the bet or should it be 8 or 9 or 20?
 - g. Is the payment of \$1 million per year fair for the bet or should it be double or triple or five times that amount?
5. Of course these CDO's were not sold as gambling instruments - they were generally described as floating rate notes and some were even listed on the Australian Securities Exchange.
6. In our paper dated 18 February 2008 entitled "How the essence of CDO's confuses even the experts" we attempted to explain why this description of CDO's as floating rate notes was a serious misnomer.
7. In any event these bets were laid by many august institutions in Australia in circumstances where it is entirely uncertain as to whether those institutions realised they were having a punt.

8. In our paper dated 25 February 2008 entitled "Diversification in Australian CDO's – fact or fiction" and in the updates thereto dated 18 March 2008 and 27 June 2008 we warned of a lack of diversification within the reference baskets of these Australian synthetic CDO's.
9. We argued that the lack of diversification arose from the fact there were so many companies susceptible to the US subprime crisis that if one failed it was likely that many others around it would also fail from the same cause.
10. Unfortunately that list of susceptible companies was much more than 7- in fact about 32 companies were identified as being within that sub group.
11. Two of the companies within the sub group have already failed in spectacular fashion i.e. Countrywide Home Loans and Bear Stearns. In both cases however these companies were "saved" by the intervention of a purchaser (in the case of Countrywide it was Bank Of America and in the case of Bear Stearns it was J.P Morgan).
12. It seems reasonable to think that the "system" intervened to prevent these 2 companies from defaulting on their debt and thereby igniting a global financial meltdown.
13. On 7 September 2008 the US secretary of the Treasury announced the appointment of conservators to both Freddie Mac and Fannie Mae.
14. These appointments amounted to a credit event in relation to those companies with the result that those CDO's which had these 2 companies within their default baskets have now suffered two credit events out of the necessary seven before all of the funds invested in those CDO's are lost.
15. A credit event occurs when one of the default companies becomes subject to the appointment of an administrator, provisional liquidator, conservator, receiver, trustee, custodian or other similar official for it or for all or substantially all of its assets. (Refer article 4.2 (b) of 2003 ISDA Credit Derivatives Definitions).
16. It seems therefore that these credit events are beyond dispute.
17. A question does arise as to the extent of the default. Australian synthetic CDO's are of two types:
 - a. those where the default of the referenced company amounts to one complete credit event and;
 - b. those where a default amounts to part of a credit event depending upon the value of the defaulted debt after the default (i.e. if the debt is thought to have half of its value then there will be half of one credit event).
18. The conservatorship of Freddie Mac and Fannie Mae will therefore amount to either two separate full credit events for some CDO's and two partial credit events for the balance.
19. Those in the first category will be most likely to suffer a ratings downgrade by the ratings company which rated the initial issue.

20. Those in the second category may not suffer a rating downgrade because the remaining value in the debt of Freddie Mac and Fannie Mae after the appointment of conservators remains high.
21. One rating agency (Standard and Poor's) said on 9 September 2008, for instance, that "Standard and Poor's notes that one third of Asia-Pacific synthetic CDO transactions have been structured using a fixed recovery rate assumption for the underlying CDS and that the credit event could have a negative rating impact on these transactions".
22. Standard and Poor's pointed out that 189 CDO transactions in the Asia-Pacific area are likely to be affected whereas few if any CDO transactions in the US and Europe will suffer any downgrades.
23. This statement seems to indicate that the synthetic CDO's sold in Australia and New Zealand are of the more speculative type i.e. those that suffer a complete credit event even when the defaulting debt might be worth 70% or 80% of its previous face value.
24. It has long been thought that those constructing these synthetic instruments had much more success in selling the more speculative type transactions in the Asia-Pacific region than they did in the more sophisticated US and European markets.
25. That being the case it is likely that Australian synthetic CDO's will fail well before those sold in the US and Europe.
26. There are many other companies within the sub group of 32 default companies which are teetering on the brink e.g. Lehman Brothers, Radian Group, Rescap and Washington Mutual.
27. This leaves to one side the other 120 other companies which are in the default baskets and whose debt may succumb to the credit crisis over the next four or five years.
28. Remembering that a credit event will occur when the debt of a reference company is reorganized i.e. payment date extended, interest rate reduced or other arrangements made then it does seem very likely that many of these synthetic CDO's will eventually cause complete loss to their investors.
29. As many of the investors are local councils, non profit organisations, and semi-government bodies, this will be a dark day for Australian investors.



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