

by Chris Wright

# Australia's *immune system* breaks down

Australia was supposed to be immune to subprime troubles, thanks to the healthiest of default figures and minute levels of non-conforming lending. Now however it is paying for underestimating how far subprime contagion could spread and, as elsewhere, the ratings agencies are under fire.

In April, Stuart Fowler was having a conversation with *American Securitization* about the impact of U.S. subprime problems on his business. The co-founder of Basis Capital, an Australian absolute return credit fund with around \$3 billion (US\$2.6 billion) under management and advice, was recalling that his fund had suffered its first month of losses in its history that February, thanks to U.S. subprime mortgage woes. But since then, he reported, the manager had made it all back again and appeared to be well positioned.

But by August one of Basis' two main funds, a structured credit vehicle called the Yield Alpha Fund, was in liquidation and the other had lost half its value. Investors in the yield fund have been told to expect losses of 80 cents on the dollar. Today Basis is trying to split in two its surviving fund, the Pac-Rim Opportunity Fund, to improve liquidity and get moving again.

Basis is not alone. In November another absolute return manager active in the credit markets, Absolute Capital, which is half owned by ABN Amro, appointed an administrator to run its operations after subprime-related losses. The appointment concerns the company as a corporate entity rather than its funds, but that may not appease investors, who have been banned from making redemptions since July. The seemingly impregnable Macquarie Bank has suffered losses in one of its credit market products. And RAMS, a home loan company, raised A\$700 million in its July stock market debut, only to run into trouble the following month when it was unable to roll over A\$6 billion in funding. It since lost 90% of its stock market value and was sold to Westpac, which will sell off the institution's loan book and return the proceeds to shareholders.

Australia was supposed to be immune to subprime. There can surely be no other nation with such a proud and emotional attachment to its real estate, where advancement is tied so closely to land. Australia has some of the healthiest default figures in the world, and non-conforming lending — the Australian equivalent of subprime — is minute by US standards. Back in March the Reserve Bank of Australia pointed out that non-conforming housing loans "account for an estimated 1% of all outstanding mortgages" compared with 15% in the U.S.

It is true that exposure to complex structured credit like CDOs goes a lot further down the investment spectrum in Australia than most countries — even to retail — but it hasn't proven to be so much of a problem at that level, where the structures have always required long-term ownership, so have not needed liquidity. And in any event retail investors have only generally invested in highly rated tranches.

So what happened? Two things: while there are few Australian homeowners with subprime mortgages, Australian fund managers — among the world's most sophisticated — have been active in some markets where with hindsight they should not have dabbled. Second, the global hit to credit markets has created big problems for anyone trying to roll over debt, with Australia no exception. Australia, like many other corners of the world from Florida to Germany to Norway, underestimated the degree to which subprime would prove contagious to much healthier credit markets worldwide.



*CDOs might belong in a hospital, but not in its fund*

Getty

The funds themselves were complex ventures and there is the temptation to say, well, buyer beware. Yet Basis in particular had enjoyed extraordinary success and an utterly unblemished reputation right up until the day it suspended redemptions and never came back. It had become a widespread holding of local councils, hospitals, and retail investors. And it had become so, in very large part, on the back of glowing recommendations from the various independent ratings agencies that crowd the Australian industry.

At the time Basis ran into trouble, the manager, founded in 1999 by Fowler and Steve Howell, had five-star ratings, or some equivalent plaudit, from almost all of the leading researchers in Australia, among them Morningstar, Lonsec, InvestorWeb, Standard & Poor's and Zenith. Each of these groups would have done detailed research on the fund and its investment approach. It is custom for them to return every six months, requesting highly detailed breakdowns of portfolios.

In the aftermath of the Basis collapse, there has been a lot of talk of suing these institutions from financial planners who feel badly misled by the advice they got from these research groups. While no such suit has yet made it to court, antagonism remains high and the whole research model — with the fee often paid by the target of the research — is now in question. Another problem: the investors caught up in Basis and other subprime wobbles were not all sophisticated, but many were highly visible.

For example, the Princess Margaret Hospital Foundation, which manages funds for a children's hospital in Perth, had A\$1.4 million of its A\$12 million portfolio in the Basis fund that collapsed. It's difficult to find a more emotive issue than a children's hospital: how many baby incubators does A\$1.4 million get you? The Victorian Combined Fund, which covers the pension savings of private school teachers, is understood to have A\$22 million invested with Basis.

Then there's Western Health, which operates a network of public hospitals across the state of Victoria and had an investment portfolio of A\$8 million at June 30, according to its annual report. Part of that money was invested in a CDO called Federation managed by Grange Securities, a specialist debt group that has recently become the Australian arm of Lehman Brothers. Western Health is believed to have lost A\$2 million already, on a mark-to-market basis. While A\$2 million doesn't sound like much, Grange is believed to be advising well over 100 Australian funds with A\$1 billion in investments between them.

Local councils have also been affected. Woollahra Council in New South Wales is understood to have A\$9 million, almost a third of its entire portfolio, in CDOs. Other councils had as much as 70% devoted to CDOs.

Two councils in New South Wales and one in Western

Australia were even considering litigation against Grange, according to press reports. The Western Australia Local Government Superannuation Plan had A\$5 million with the firm. Lehman has in fact already bought back some CDOs from local councils after admitting the maturity dates breached some

council investment guidelines "in very few cases."

One effect of this exposure will likely be a greater scrutiny of the ability of local councils to assess complex risk. The New South Wales government is expected to change the

rules on council-level investment in the new year. But then, when councils are advised by professionals who back up their recommendations with glowing independent research reports, how much of the blame do they really deserve? Of course, it's a different matter if they also received warnings not to touch CDOs, but ignored them.

### No free lunch

Shortly after Basis got into trouble, *American Securitization* spoke with Anthony Serhan, Morningstar's head of consulting. "You have to look below the rating and read the report that goes with it," he said. "We are comfortable with the report we had out on Basis. We said there are no free lunches, this thing is highly linked to credit markets and you shouldn't have a lot of money in it."

The reasons Basis' funds collapsed are complex. The debate will go on for years whether it could have survived if some of its bankers had not exercised their right to take over and sell the fund's assets after Basis missed a margin call. Hedge fund managers believe that in these situations banks often make a bad situation worse by creating a fire sale for perfectly good assets that are just stricken by a temporary drop in liquidity; banks, of course, have the law on their side in seizing assets when a margin call is missed.

Nevertheless, the top-drawer ratings that were still sitting proudly on the Basis site as its flagship fund began to fall were an embarrassment to the ratings agencies, and may yet prompt a change to the way that whole industry is run and remunerated. In addition, the country which today has perhaps the world's highest level of intermediation in financial advice has heard calls for financial planning networks to develop their own in-house research capabilities rather than relying on third party reports. If nothing else, this may mark the end of the strikingly close relationship between the ordinary Aussie punter or pension fund and highly structured debt securities. Buyer beware. ▼

*"We are comfortable with the report we had out on Basis. We said there are no free lunches, this thing is highly linked to credit markets and you shouldn't have a lot of money in it."*

*Anthony Serhan, head of consulting at Morningstar.*

*Chis Wright is a freelance journalist based in Singapore. Previously editor of Asiamoney in Hong Kong, he writes for Asiamoney, Euromoney, Institutional Investor and the Australian Financial Review.*