

By Chris Wright

Few others have as voracious an appetite for structured products as Australian investors — be they institutional, local governments, or even retail buyers. Yet one hedge fund wobble aside, they seem to be shrugging off the subprime traumas that roiled U.S. markets.

Did Down Under Dodge the Subprime Bullet ?

Australian investors have a lot in common with their U.S. counterparts. Measured as a proportion of the population, the two countries have the highest levels of share ownership, some of the most sophisticated pension funds and the most developed listed-property and mortgage-backed securitization markets in the world.

But there's one big difference. In Australia, the purchasers of complex structured credit go much further down the scale of expertise than is common in the U.S. or, indeed, almost anywhere else. Collateralized debt obligations, the preserve of institutional investors in most of the world, frequently make their way to Australian local councils. Most surprising of all, several of the world's biggest banks have successfully packaged and sold CDO deals of varying transparency and merit to retail investors.

One would think that the recent subprime problems in the U.S. would have had a dampening effect on these unsophisticated buyers of structured paper. For a variety of reasons, that hasn't been the case. But it's revealing to see how a market develops when the regulator — in this case the Australian Securities & Investments Commission — concludes that once an investment's parameters are thoroughly disclosed, buyer beware becomes the operative guideline.

Separate Structures

To understand how the Australian structured debt market works, it is useful to think of two separate components: structures related to real estate and structures related to credit. "They don't bear any resemblance to each other," says Satyajit Das, a Sydney-based consultant and author of the book *Traders, Guns and Money*.

Australia has one of the largest real estate markets in the world outside the U.S. and Europe, embracing residential mortgage securitization, commercial MBS and some subprime, known locally as non-conforming mortgage securitization. The residential market in particular has proven popular. "It has very good default characteristics in global terms," says Das, "which makes it very attractive as an asset class. And until recently it was paying yields considerably higher than comparables in international markets or than the default statistics would support."

A popular Australian stereotype, with some accuracy behind it, is that its citizens are obsessed with property and to some extent measure achievement through ownership of land. Pretty much every other option is exhausted before most Australians will default on a mortgage and surrender a home.

This combination of low default and high yield has allowed issuers to launch securities internationally as well as domestically. Local banks use U.S. dollar and euro placements of mortgage-backed deals as a handy method of gaining term funding, taking advantage of the currency basis swap price levels that are available from time to time between those currencies and the Australian

dollar. German Landesbanks, for example, are a keen market for the more highly rated tranches.

The residential side is about three-quarters of the securitized real estate market and commercial accounts for most of the rest. “The last bit, which everybody has spent the last three months asking stupid questions about, is the subprime problem in Australia,” says Das. “The answer: there is no subprime

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Satyajit Das, author, Traders, Guns and Money

problem comparable to the U.S. market, for the simple reason that the non-conforming market is much smaller and nowhere near as aggressive as the U.S. practice has proven to be. For one thing, it’s less developed. For another, lenders haven’t pushed the underwriting standards to the same level they did in the States. What passes for product innovation in the States hasn’t surfaced in the same way here.” Non-conforming loans in Australia typically don’t feature low introductory interest rate periods, or high-risk repayment options such as negative amortization periods.

This much has been confirmed by the Reserve Bank of Australia, the country’s central bank. Its twice-yearly publication, the *Financial Stability Review*, addressed the subprime issue in March, saying that non-conforming housing loans “account for an estimated one percent of all outstanding mortgages, well below the 15% subprime share in the United States.”

It added: “While the 90-day arrears rate on securitized non-conforming housing loans in Australia has increased over the past few years and is higher than for other housing loans, at 5.25%, it is about half the equivalent arrears rate on subprime loans in the United States.”

Corporate Credit

On the real estate side, there’s been no contagion. But it’s the

other arm of the Australian structured debt market where things get interesting: CDOs and CLOs.

In most CDO and CLO issues purchased by Australians, be they retail, local council or institutional, the underlying credits have very little to do with Australia. Mostly, they are international credits, and the products have found traction because of the Australian passion for yield and because of a scarcity of assets generally.

One of the drivers of this situation is the Australian pension regime, where a system called the Superannuation Guarantee requires employers to contribute 9% of an employee’s salary into its pension fund, which Australians call superannuation. The compounding effect of this enforced saving has driven Australia to become the fourth largest investment market in the world, despite a population of barely 20 million people. It is also part of the reason why the Australian stock market has had one of the most sustained bull runs in the world, as a flood of liquidity has had to find somewhere to be invested. Inevitably, as the investment pool grows, more and more of these assets must go overseas, and the pressure to deliver a meaningful return pushes large amounts into structured debt products.

Expectations of yield are traditionally very high anyway: blue-chip stocks frequently pay a dividend yield of more than 6%; listed property trusts, the Australian version of Reits, higher still; and the cash rate, at 6.25%, is also one of the highest among developed markets. As a result, Australian investors, particularly retail, have long had a familiarity with structuring. For many years there has been a vibrant market in hybrid securities such as convertibles, which have been launched and backed by some of the most highly rated blue-chips in Australia and have attracted a devoted retail following.

This explains why, in 2002, Deutsche Bank was able to launch a product it called Nexus. Targeted at retail investors, it was a CDO. The structure has since drawn criticism for being inappropriate for retail — it didn’t

name any of the underlying credits it was exposed to, citing confidentiality reasons — but it sold well and was swiftly followed by others. Nexus went through four incarnations in the next few years, subtly changing each time to give the investor more transparency and protection but less yield. Other products were launched by ABN Amro, Macquarie Bank, Grange Securities and Westpac.

These transactions have dried up recently but that’s be-



Australians have flocked to structured credit

cause the terms are no longer practical, not because they didn't sell. When Deutsche priced its first Nexus portfolio in 2002, it had an investment-grade portfolio of 40 names and yielded 100 basis points. That time has passed. "Now when you look at an investment-grade portfolio, to get 100 basis points would be extraordinary," says Andrew Baume, director of cross-market structuring at Deutsche Bank in Sydney.

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Paul Cordeiro, director of retail structured products, ABN Amro

But should retail have been there in the first place? The whole sector suffered a major PR problem when the Italian dairy group Parmalat defaulted. Its securities were within the reference baskets of some of the CDOs that had gone to Australian retail, among them the HY-FI series that had been sold by ABN Amro a matter of weeks earlier. But despite the grim portents of that default, it has not been followed by others. Three and a half years later, the HY-FI deal, which like many of these products is listed, is trading at a premium to its net asset value. "The timing was very unfortunate for ABN Amro," says one competitor. "If you lend money eventually you will get a default, that's the way it is, but it hit them earlier in the life cycle of that product than was ideal. But it's going to repay people; they will have received their principal and interest as expected."

"... I think they get that."

One of the Deutsche CDOs, the fourth and most recent one, also suffered a default. That deal was capital protected, so investors will get their initial capital back. At this point, it looks likely to make a modest return, albeit below the cash rate.

No one has been wiped out or even lost money on these deals to date, and their backers insist they have no problem with the way they were sold or the people they were pitched to. For Baume, the fact that all the CDOs were rated is key. "Investors understand that they have an exposure to a wide range of companies — that somebody who is an expert has ranked and given an underlying rating to them, then looked at the collection of that package and re-rated it," says Baume. "Not every investor understands how the CDO evaluator model works at S&P. But they understand they have a risk against underlying investment-grade credits. I can't speak for every investor but I think they get that."

He also points to the fact that, around the time Deutsche was being scrutinized for the sale of its first CDO, the listed insurer, HIH, was going under. "They were a licensed regulated insurer in Australia," says Baume. "Most people could buy them, but at the end of the day did they understand them? Familiarity and understanding are different things. The fact that the CDO

concept is unfamiliar to many people doesn't mean it's less suitable, per se."

At ABN Amro, Paul Cordeiro, director of retail structured products, is also happy with the way products were sold. "The retail CDO market in Australia attracted a lot of attention a few years ago not because Australia was the first market to sell CDO risk to the retail market but because the transactions we were selling were fully described and disclosed to the investor, hence the underlying CDO was clearly visible to investors," he says. "I believe the disclosure laws in Australia and New Zealand are more rigorous than many other countries where CDOs have been sold to retail."

Although issuance has tailed off as the yield has become harder to generate, more of these deals will probably follow when conditions turn around again. "The retail market will come back when conditions are right," says Baume.

Attractive Yield

The other pocket of investor interest that catches the eye is local government councils and other small institutions. Here again, the attraction is yield. "When you think about all the institutions we talk about — the small state authorities, church groups, councils — they're all patient, long-term investors whose alternative investment is a bank bill deposit," says Baume. "They think: what's my risk in only earning a bank deposit rate versus a triple-A enhanced return?"

There is no hard data on the extent to which these councils invest in products like CDOs, and few are prepared to talk about their investment approaches. But it is widely believed in the Australian market that they represent an avid customer base for such product — provided it is rated.

That said, not everyone has the greatest confidence in these groups' ability to assess risk. "Local governments are the biggest investors in structured products and the least able to understand them," says one person who works closely with the funding arms of local governments and councils, asking not to be named. "You have to dredge down to the bowels of the product to understand what it is you've bought or are being asked to buy," he adds, and he isn't greatly confident that all the buyers do that much dredging.

From a regulatory perspective, it's all about ratings. Local governments can't invest in equities but can invest in an investment-grade debt product. And since many CDO products do have a high rating, there's no regulatory barrier. The rating issue is at the core of the banks' argument that there's no problem selling these things to anyone. The buyer, they say, can effectively sub-contract the assessment of risk to the rating agency.

But is that enough? "In all markets, and this is not true of Australia alone, the vast majority of investors who buy CDOs don't really understand the risks," says Das. "They buy them by looking at the ratings. But that in my view grossly underestimates two elements of the transactions: one is you need to understand the modeling of a structure to decide how that rating was arrived at, so you understand the default assumptions being made.

The other is the mark-to-market effect. If you're retail, and you hold to maturity and bought one of the better rated tranches, there's a reasonable chance you won't make a cash loss. If you sell before maturity, that could be a different story."

Baume thinks it's useful to consider it from a council's point of view. "In Australia, councils are generally in surplus, whereas in the U.S. they are usually in deficit," he says. "They are interested in capital preservation and have a relatively long-term view. They are not concerned about tying money up for three to five years and are relatively indifferent about mark-to-market."



Even critics of the purchasing behavior of local councils have to concede that none has yet suffered significant losses as a consequence, albeit in an utterly benign credit environment. Since they have typically opted for higher-rated tranches, the only impact subprime problems in the U.S. have had is in the volatility they have created in credit pools globally.

No Basis for Panic?

Beyond these, there is a group of specialist, professional structured debt investors who do grapple with the world markets, including unrated and sub-investment grade securities. They were in many cases exposed to the U.S. problems, though the impact has varied depending on their precise approach.

One, Basis Capital, is a Sydney-based specialist debt investor whose high and stable returns have brought this complex area of investment to a broader audience. Basis now has over \$3 billion under management and advice — small change by U.S. standards but big numbers for an alternative asset class in Australia.

February presented the manager with one of its biggest ever challenges. Co-founder Stuart Fowler describes an illiquid market with dealers running big proprietary positions with large warehouses open to acquire securities and securitize them into CDOs. "As soon as the wind changed direction, the banks were the first ones running for the exit door," says Fowler. "As liquidity providers to the market, as soon as those guys start running and depressing prices, it becomes a problem."

In particular, says Fowler, indices that reference the 2006 mortgage production in the subprime space caused problems because many dealers were caught on the wrong side, to the point that the spread widened drastically to almost 2000 basis points on what was originally a reference pool of triple-B- securities. "You had all the negative publicity out of a whole lot of originators going broke, a new index created at arguably the worst possible time and very vocal hedge funds saying the U.S. economy and house prices will roll over — in which case you would expect the subprime market to fall over too."

In the fallout, as asset-backed securities were being sold off, all sorts of related securities were also depressed, regardless of the strength of the collateral manager. But in Basis' most exposed fund, the result was that it lost only 1.14% in February, its first month of losses in the 38-month history of the fund. It has since made it all back. It managed this partly because the fund also invests in the European and U.S. CLO markets which were at all-time tight spreads; partly because it had short positions in place to protect the portfolio; and partly because only 4% of the fund's net asset value was exposed to 2006 subprime mortgage collateral.

Fowler doesn't say as much, but fund managers in this space tend to argue that this is exactly the reason people should get their structured debt exposure through professional managers rather than through products with no active management, such as the static CDOs that were sold to retail investors. Groups like Basis have professional managers who do nothing else but work out the dynamics of complex investment. Fowler does not criticize the sale of these products to retail and other unsophisticated buyers, "so long as those customers are made to understand it's a hold-to-maturity type product where you are being paid some sort of illiquidity premium. You may get volatility on the way through but if you hold on, most likely you will come out the other side okay." Basis locks clients in to its funds.

Other Australian fund managers active in the area, such as Grange Securities, also weathered the storm reasonably well. One manager of structured debt funds puts it this way: "We're seeing it more as an opportunity. The pricing in that sector creates a whole lot of possibilities if you wade into the market in a considered and informed way."

In short, despite the uncommonly broad investor base for structured credit in Australia, none of the various markets — not retail, not small local government institutions, not professional funds — is likely to have been given pause by the subprime traumas that hit the U.S. in February. Whether investors escaped harm by luck or judgment is another question, but expect them to keep coming back to ever more complex securities. ▼

Chris Wright is a freelance journalist based in Singapore. He writes regularly for Asiamoney, Euromoney, Institutional Investor, and the Australian Financial Review newspaper. He has previously been editor of Asiamoney in Hong Kong, Corporate Finance in London and New York, and a section editor on the Australian Financial Review in Sydney.