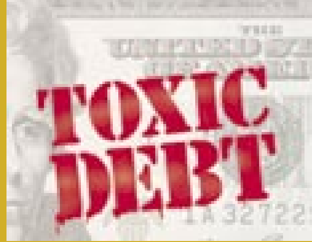
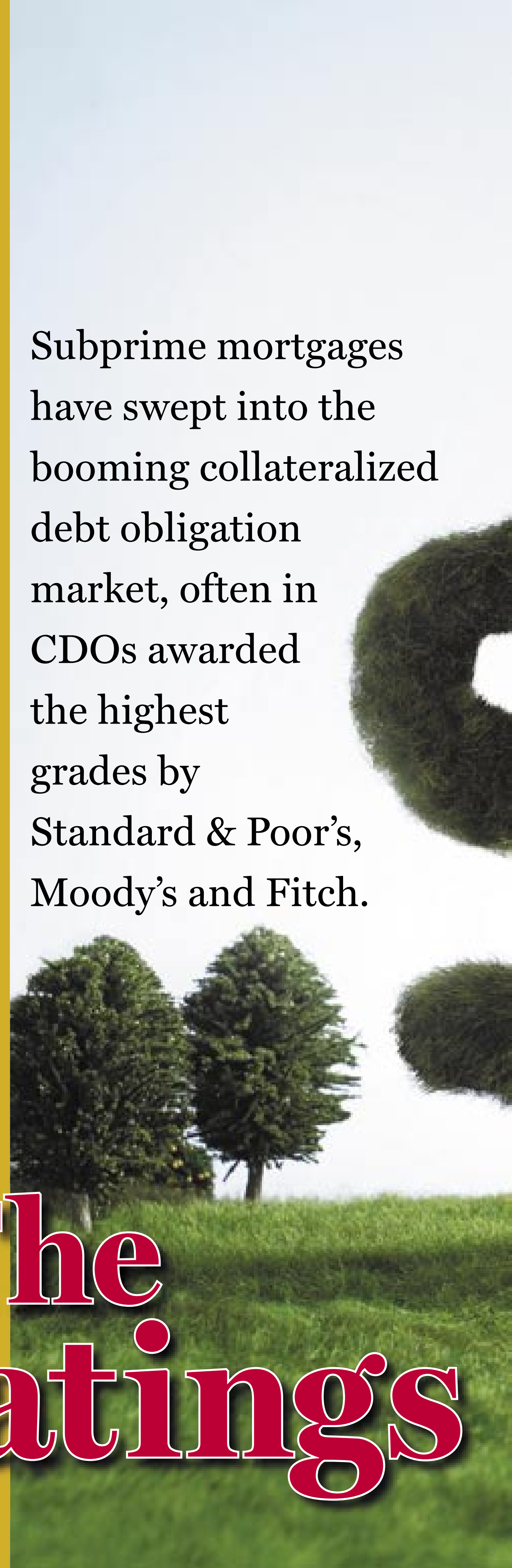



# The Ratings

By Richard Tomlinson and David Evans

**Subprime mortgages have swept into the booming collateralized debt obligation market, often in CDOs awarded the highest grades by Standard & Poor's, Moody's and Fitch.**



The numbers looked compelling. Buy this investment-grade collateralized debt obligation and you'll get a return of up to 10 percent, Credit Suisse Group said. That was almost 25 percent more than the average yield on a similarly rated corporate bond. Investors snapped up the $340.7 million CDO, a collection of securities backed by bonds, mortgages and other loans, within days of the Dec. 12, 2000, offering. The CDO buyers had assurances of its quality from the three leading credit rating companies—Standard & Poor's, Moody's Investors Service and Fitch Group Inc. Each had blessed most of the CDO with the highest rating, AAA or Aaa.

Investment-grade ratings on 95 percent of the securities in the CDO gave no hint of what was in the debt package—or that it might collapse. It was loaded with risky debt, from junk bonds to subprime home loans. During the next six years, the CDO plummeted as defaults mounted in its underlying securities. By the end of 2006, losses totaled about $125 million.

The failed Credit Suisse CDO may be an omen of far worse to come in the booming market for these investments.

Sales of CDOs worldwide have soared since 2004, reaching $503 billion last year, a fivefold increase in three years, according to data compiled by Morgan Stanley. CDO holdings have already declined in value between $18 billion and $25 billion because of falling repayment rates by subprime U.S. mortgage holders, Lehman Brothers Holdings Inc. estimated on April 13. In many cases, investors don't even know that values have dropped. In this secretive market, there is no easy way for them to find out what their CDOs are worth.

The uncharted slide of the Credit Suisse CDO points to the critical—and little-understood—role played by rating companies in assessing risk and acting as de facto regulators in a market that has no official watchdogs. Many of the world's CDOs are owned by banks and insurance companies, and the people who regulate those firms rely on the raters to police the CDOs. "As regulators, we just have to trust that rating agencies are going to monitor CDOs and find the subprime," says Kevin Fry, chairman of the Invested Asset Working Group of the U.S. National Association of Insurance Commissioners. "We can't get there. We don't have the resources to get our arms around it."

The three leading rating companies, all based in New York, say that policing CDOs isn't their job. They just offer their educated opinions, says Noel Kirnon, senior managing director at Moody's. "What we're saying is that many people have the tendency to rely on it, and we want to make sure that they don't," says Kirnon, whose firm commands 39 percent of the global credit

PHOTO ILLUSTRATION BY C.J. BURTON

# Charade

rating market by revenue. S&P, which controls 40 percent, asks investors in its published CDO ratings not to base any investment decision on its analyses. Fitch, which has 16 percent of the worldwide credit rating field, says its analyses are just opinions and investors shouldn't rely on them.

The rating companies apply their usual disclaimer about the reliability of their analyses to CDOs. S&P says in small print: "Any user of the information contained herein should not rely on any credit rating or other opinion contained herein in making any investment decision."

Joseph Mason, a finance professor at Philadelphia's Drexel University and a former economist at the U.S. Treasury Department, says the ratings are undermined by the disclaimers. "I laugh about Moody's and S&P disclaimers," he says. "The ratings giveth and the disclaimer takes it away. Once you're through with the disclaimers, you're left with very little new information."

**'The rating agencies run the show,' says a professor. 'This is a financial engineering business.'**

When it comes to CDOs, rating companies actually do much more than evaluate them and give them letter grades. The raters play an integral role in putting the CDOs together in the first place.

Banks and other financial firms typically create CDOs by wrapping together 100 or more bonds and other securities, including debt investments backed by home loans. Credit rating companies help the financial firms divide the CDOs into sections known as tranches, each of which gets a separate grade, says Charles Calomiris, the Henry Kaufman professor of financial institutions at Columbia University in New York.

Credit raters participate in every level of packaging a CDO, says Calomiris, who has worked as a consultant for Bank of America Corp., Citigroup Inc., UBS AG and other major banks. The rating companies tell CDO assemblers how to squeeze the most profit out of the CDO by maximizing the size of the tranches with the highest ratings, he says. "It's important to understand that unlike in the corporate bond market, in the securitization market, the rating agencies run the show," he says. "This is not a passive process of rating corporate debt. This is a financial engineering business."

Credit raters consult with bankers in determining the makeup of a CDO, and banks make the final decisions, says Gloria Aviotti, Fitch's global head of structured finance.

As home buyers and investors grapple with the subprime mortgage crisis (see "The Subprime Sinkhole," page 36), many haven't yet realized the extent to which that turbulence is spilling into CDOs. Foreclosure filings in the U.S. surged to 147,708 in April, up 62 percent from April 2006, as subprime borrowers stopped making mortgage payments, research company RealtyTrac Inc. said on May 15.

**Arturo Cifuentes,** a former Moody's executive, says CDO ratings can be 'trash' if data is uncertain.

EVAN KAFKA

As foreclosures increase, the subprime-backed securities in CDOs begin to crumble. Subprime mortgage securities make up about $100 billion of the $375 billion of CDOs sold in the U.S. in 2006, according to data from Moody's and Morgan Stanley. Seventy-five percent of global CDO sales are in the U.S. Moody's reported in March that about half of the CDOs sold in the U.S. last year contained subprime debt. On average, 45 percent of the contents of those CDOs consisted of subprime home loans, Moody's said.

In a certain class of CDOs, the concentration of subprime is even higher. S&P and Fitch estimate that subprime mortgage securities make up more than 70 percent of the debt in so-called mezzanine asset-backed CDOs, a type of CDO that repackages bonds, mostly mortgage debt, with low credit ratings. Investors bought $59.5 billion of these CDOs in 2006, according to Morgan Stanley. On average, as with all CDOs, more than 90 percent of the value in them is rated investment grade.

Bankers call the bottom sections of a CDO—the ones that are the most vulnerable to subprime and other junk—the equity tranches. They also have another, more-emotive phrase for them: toxic waste. As more home buyers default on their subprime loans, the waste in CDOs becomes more poisonous. "If anything goes badly, the investors in toxic waste take the first loss," says Satyajit Das, a former Citigroup Inc. banker who has written 10 books on debt analysis. "Let's put it this way. There's a revolution. If you don't win, you're going to be the first one in line for the firing squad." (See "The Poison in Your Pension," page 64.)

Investors have little idea how toxic some of these CDOs are, Drexel's Mason says. "We compose CDOs with a bunch of this stuff," he says. "Now we just jack up the risk, jack up the misunderstanding. We're throwing our money to the wind. We now know the defaults are in the mortgage pools and it's only a matter of time before they accumulate to levels that will threaten the CDO market."

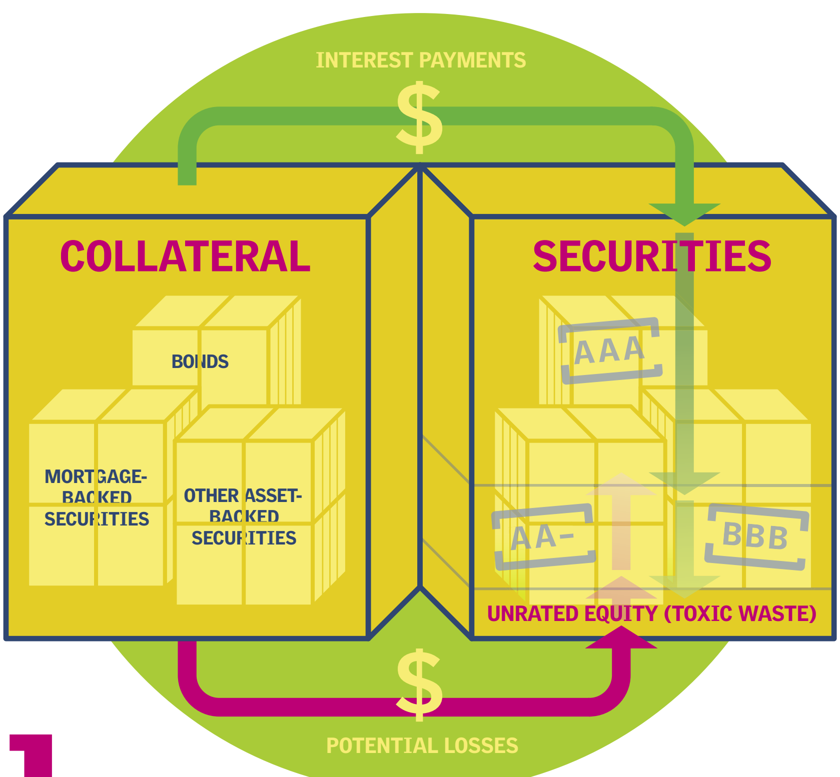
In times of uncertainty, CDO ratings take on even less meaning, says Brian McManus, head of CDO research at Charlotte, North Carolina–based Wachovia Corp. Investors may not know what hit them because there won't be a sudden CDO crash, he predicts. "They don't blow up," McManus says of CDOs. "They just kind of melt."

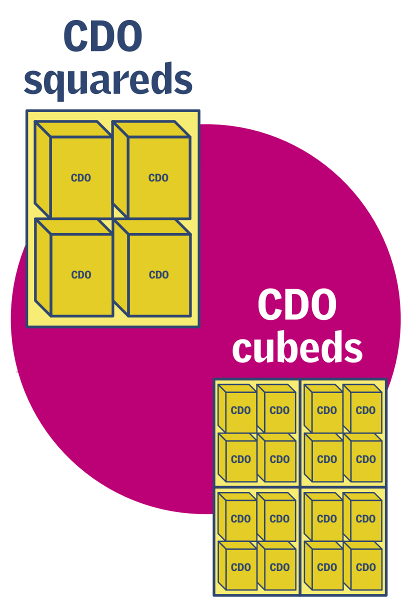
This is not what investors envisioned in 2004 when they started the CDO bull run. In an era of low interest rates, CDOs offered juicy yields. With defaults at historic lows, the risk of something going drastically wrong seemed remote. Why buy a corporate bond yielding 5 percent when you can invest in a CDO with the same credit rating and the promise of a return twice as high? There are two caveats: It's nearly impossible to find out exactly what's in a CDO, and CDOs aren't regulated.

Almost all CDOs are sold in private placements, and their current values aren't posted anywhere.

## Financial alchemy

Wall Street has found a way to transform risky debt into CDOs rated AAA or Aaa.




### 1 The CDO

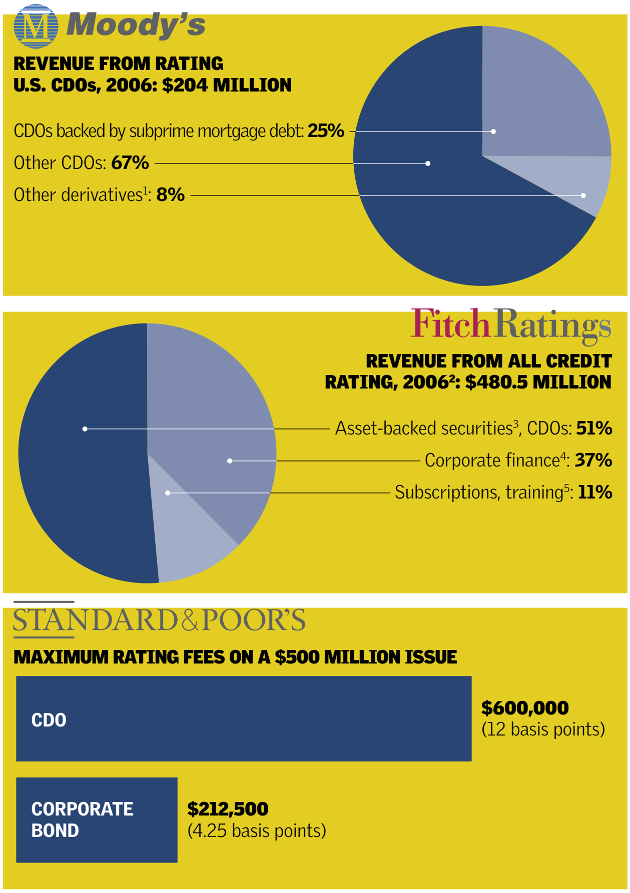
A CDO is a company typically incorporated offshore that buys collateral such as bonds, mortgage-backed securities and loans and sells debt securities with varying degrees of risk.

### 2 How CDOs can multiply

A CDO with collateral consisting of pieces of other CDOs is called a CDO squared. When a CDO is built of CDO squareds, it's called a CDO cubed.

## CDO bonanza

The three largest credit rating companies make an increasing amount of money from analyzing CDOs.




[1]Such as bonds that are linked to derivatives. [2]Year to September 2006. [3]Includes mortgage-backed securities. [4]Includes debt issued by companies and local governments. [5]Credit risk training to corporate clients. Figures do not add up to 100 due to rounding. Sources: Fitch, Moody's, S&P

**'CDOs are the cash cow for rating agencies,' says a former debt trader.**

"There is absolutely no transparency," Das says. "It's difficult to get current values or information about the underlying assets in the CDO."

Financial regulators have effectively outsourced the monitoring of CDOs to the rating companies. No less an authority than the U.S. Office of the Comptroller of the Currency, which regulates banks, depends on the rating firms to assess the quality of CDOs. U.S. banks have invested as much as 10 percent of their assets in CDOs, and the OCC requires that all of those CDOs be investment grade, says Kathryn Dick, deputy comptroller for credit and market risk. "We rely on the rating agencies to provide a rating," she says.

CDOs have been a bonanza for the rating companies. In the past three years, S&P, Moody's and Fitch have made more money from evaluating structured finance—which includes CDOs and asset-backed securities—than from rating anything else, including corporate and municipal bonds, according to their financial reports. The companies charge as much as three times more to rate CDOs than to analyze bonds, published cost listings show. The companies say these fees are higher because CDOs are so complex compared with a single bond.

Structured finance is the largest and fastest-growing source of credit rating revenue. Moody's reported revenue of $1.52 billion in 2006 for credit rating. Structured finance accounted for 44 percent, or $667 million. Company credit ratings were the second-largest source of revenue, drawing $485 million. In the first quarter of 2007, structured finance rose to 46 percent of Moody's rating revenue.

"CDOs are the cash cow for rating agencies," says Frank Partnoy, a former bond trader, now a University of San Diego law professor and author of *Infectious Greed: How Deceit and Risk Corrupted the Financial Markets* (Henry Holt & Co., 464 pages, $27.50). "They're clearly a gold mine. Structured finance is making a lot of Moody's shareholders and managers wealthy."

Shares of Moody's, which is the only stand-alone publicly traded rating company, have more than tripled to $68.60 on May 9 from $20.65 at the beginning of 2003.

S&P charges as much as 12 basis points of the total value of a CDO issue compared with up to 4.25 basis points for rating a corporate bond, company spokesman Chris Atkins says. (A basis point is 0.01 percentage point.) That means S&P charges as much as $600,000 to rate a $500 million CDO. Fitch charges 7–8 basis points to rate a CDO, more than its 3–7 basis point fee to rate a bond, based on the company's fee schedule. Moody's doesn't publish its pricing for any ratings.

Fitch, which is 80 percent owned by Paris-based Fimalac SA, a publicly listed investment company, says that rating structured finance accounted for 51 percent of total revenue of $480.5 million in the fiscal year ended on Sept. 30, 2006. Fimalac's share price has almost tripled in value since the start of 2003, trading at 80 euros ($108.40) on May 9.

New York–based McGraw-Hill Cos., which owns S&P, reports that in 2006, the credit rating company's revenue rose by 20 percent to $2.7 billion.


Almost half of that growth was from increased sales of structured finance ratings, it says. McGraw-Hill's shares have more than doubled in value since 2003, trading at $68.97 on May 9.

Michael Milken, the junk bond king, created the first CDO in 1987 at now-defunct Drexel Burnham Lambert Inc., says Das, author of *Credit Derivatives: CDOs & Structured Credit Products* (John Wiley & Sons Inc., 850 pages, $120). Until the mid-1990s, CDOs were little known in the global debt market, with issues valued at less than $25 billion a year, according to Morgan Stanley. Drexel and other investment banks realized that by bundling high-yield bonds and loans and slicing them into different layers of credit risk, they could make more money than they could from holding or selling the individual assets.

Investment-grade CDOs that include subprime assets offer debt returns that exceed yields on junk bonds. In May, BBB-rated portions of CDOs—the lowest investment grade—paid 7–9 percentage points above the London interbank offered rate,

# Fitch's CDO Cash Cow

Ask Victor Ganzi, chief executive officer of Hearst Corp., why the private New York–based media company bought 20 percent of Fitch Group last year and he talks about collateralized debt obligations. "That's where the opportunities lie for Fitch," Ganzi, 59, says.

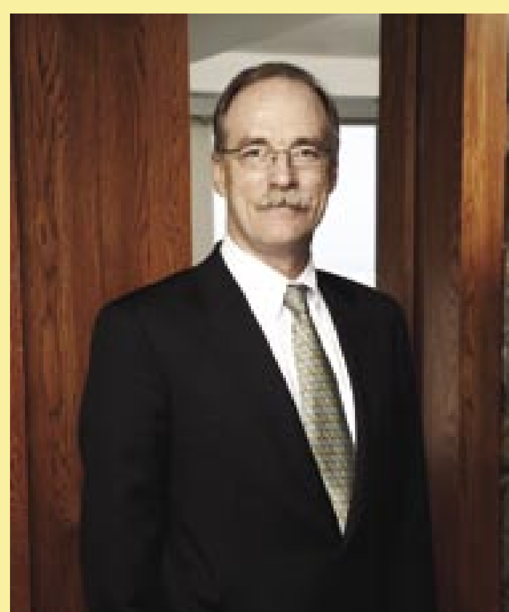
Fitch has shot ahead of smaller competitors in the past decade to become the world's third-largest rating firm. Fimalac, the company's owner, has bought up smaller rivals. Fitch, with 16 percent of the global credit rating market, trails S&P, with 40 percent, and Moody's, with 39 percent. That doesn't concern Ganzi or Stephen Joynt, Fitch's CEO. They say structured finance, such as CDOs, is the fastest-growing source of credit rating revenue and gives Fitch the chance to compete on level ground with its two rivals. Structured finance accounted for more than half of Fitch's $715 million sales in 2006. Fitch says pretax income from all credit rating rose 14 percent in the year ended on Sept. 30, 2006, to $480.5 million.

Last year, Fitch set up Derivative Fitch, a subsidiary that rates CDOs, to increase the company's market share. In 2006, Fitch rated 53 percent of all structured finance sales, including CDOs, the company says.

Hearst eventually wants to buy control of the rating company, Ganzi says. "We would not in any way restrict ourselves to 50 percent," he says. To get there, Ganzi will have to persuade Marc Ladreit de Lacharrière, the 66-year-old French investor who controls Fimalac, to put more of Fitch on the block. And that won't be easy. Ladreit de Lacharrière owns about two-thirds of Fimalac, which owns 80 percent of Fitch. Hearst bought the 20 percent ownership last year for $593 million. The French investor says the sole reason he sold part of Fitch was because he needed a U.S. partner for the New York–based rating firm. He adds with a smile that he has no plans to sell any more to "les Anglo-Saxones." Robin Monro-Davis, Fitch's CEO from 1997 to 2001, says Lacharrière's investment history is uneven. "He's a very good negotiator, but don't look for long-term logic from Marc," Monro-Davis, 66, says. "His strategic vision varies according to what he owns."

During an investment career spanning more than four decades, Ladreit de Lacharrière's holdings have included a magazine directed at French teenage girls, a petrochemical storage company, a market research group and a maker of hand tools. In 1992, he bought IBCA, a small London-based credit rating company founded by Monro-Davis. In 1997, Fimalac bought Fitch for $175 million from Van Kampen Asset Management Co., a family-owned investment firm in Grand Rapids, Michigan. He merged Fitch with IBCA. Since 2003, Ladreit de Lacharrière has sold Fimalac's other subsidiaries. Ladreit de Lacharrière says it would take his death to allow Hearst to buy control of Fitch—and only if his four children agree to sell. Ganzi says Hearst is prepared to wait. "We're very patient in that regard," he says, referring to a corporate tradition inspired by a maxim often expressed by William Randolph Hearst, the company's founder: "You must keep your mind on the objective, not on the obstacle."

RICHARD TOMLINSON



Fitch CEO **Stephen Joynt** says rating structured finance, including CDOs, is very lucrative.

DANIEL BYRNE


Fitch's **Gloria Aviotti** says her firm talks with banks as they create CDOs and doesn't advise them.

MICHAEL LEWIS

**'If the input data are a little bit uncertain, your numbers are going to be trash,' says a former Moody's vice president.**

according to Morgan Stanley. That amounted to an annual return of about 13 percent, based on May bank lending rates.

Most CDO tranches promise returns at a fixed spread over Libor. That means their value isn't affected by changes in interest rates the way the value of a fixed-rate bond would be, says Arturo Cifuentes, a managing director at R.W. Pressprich & Co., a New York–based fixed income brokerage that buys and sells CDOs. "CDOs offer you a possibility to invest in risk which you cannot do in any other way," he says. Cifuentes says CDOs have been good for investors and financial markets. "For the most part, the CDO experience has been a happy one," he says.

That euphoria has blinded investors—and the rating companies—to the true risk of CDOs, Partnoy says. A $1 billion CDO named Timberwolf, sold in March by New York–based Goldman Sachs Group Inc., included a $30 million tranche. It's rated investment grade, BBB, by S&P and Moody's and pays 1,000 basis points, or 10 percentage points, more than the three-month forward Libor. That's more than double the return on corporate bonds with the same rating. Timberwolf's offering statement warns that the CDO may include subprime mortgage debt. "When you see something that's priced at a 1,000 basis point spread, you know it's pretty risky," Partnoy says. "The rating agencies might not figure that out for a while."

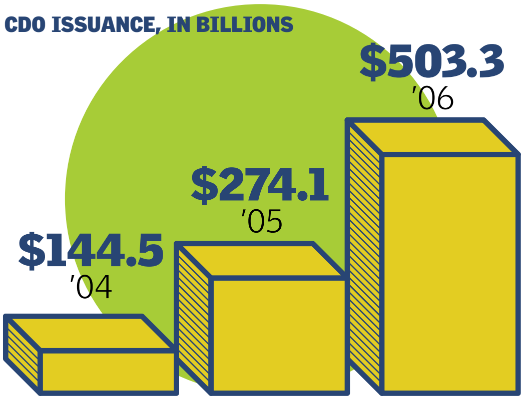
CDO ratings may mislead investors because they can obscure the risk of default, especially compared with similar ratings for bonds, says Darrell Duffie, a professor of finance at Stanford Graduate School of Business in California, who's paid by Moody's to advise the company on credit risk. "You can't compare these CDO ratings with corporate bond ratings," Duffie says. "These ratings mean something else entirely." Corporate bonds rated Baa, the lowest Moody's investment rating, had an average 2.2 percent default rate over five-year periods from 1983 to 2005, according to Moody's. From 1993 to 2005, CDOs with the same Baa grade suffered five-year default rates of 24 percent, Moody's found. Non-investment-grade CDOs, rated Ba, had an almost identical default rate of 25.3 percent in the same period. "In CDO-land, there's almost no difference between Baa and Ba," says Cifuentes, a former Moody's vice president who helped develop the company's original method of rating CDOs in the late 1990s. Cifuentes highlighted this point when he ran a day-long seminar for 45 U.S. bank regulators in Washington on April 10.

American Express Co. learned about risky CDOs the hard way. The New York–based company invested in high-yield CDO transactions starting in 1998. By 2001, American Express reported losses of more than $1 billion from those investments.

Chief Executive Officer Kenneth Chenault told shareholders in a July 2001 conference call that the company didn't understand CDO risk. He said when his traders first bought CDOs, defaults were at historically low levels. "Many of the structured investments were investment grade, so they thought they had a reasonable level of protection against loss," he told investors. "It is now apparent that our analysis of the portfolio did not fully comprehend the risk underlying these structures during a period of persistently high default rates." As a result, he said, American Express would stop buying CDOs.

## CDO boom

Global sales of new CDOs have more than tripled since 2004.




Source: Morgan Stanley


Chenault declined to comment for this story.

Some investors have always been wary of CDOs. Joe Biernat, head of research at London-based European Credit Management Ltd., says he avoids CDOs. The investment firm, owned by Wachovia, specializes in mortgage- and asset-backed securities and manages about €21 billion for institutional clients. "We have never invested in CDOs because we like clarity," Biernat says. "You may be buying more of the worst stuff to get the kind of yield that you want."

Because there are so many moving parts to a CDO, rating companies have to assess not only the chance that something may go wrong with one piece but also the possibility that multiple combinations of things could falter. To do that, S&P, Moody's and Fitch use a mathematical technique called Monte Carlo simulation, named after the Mediterranean gambling city. The rating companies take all the data they have on a CDO, such as information about specific bonds and securitizations and the remaining types of loans to be purchased for the package. The firm enters data into a software program, which calculates the probability that a CDO's assets will default in hypothetical situations of financial and commercial stress. The program effectively rolls the dice more than 100,000 times by running the information randomly. The rating companies base their simulations and ratings of each tranche on assumptions about default and recovery rates that may be incorrect, Cifuentes says. "The danger with Monte Carlo is that it gives you a false sense of security," he says. "If the input data that you use is a little bit uncertain, your numbers are going to be trash, but they will look convincing."

**'The regulators seem to be fairly sanguine about all of this,' says a former banker.**

**Joseph Mason** of Drexel University says the credit rating companies' disclaimers make their analyses almost useless, giving investors little information.

BILL CRAMER

Credit rating companies may have miscalculated the potential toxicity of securities backed by subprime loans, McManus says. "With CDOs, they underestimated the volatility of the subprime asset class in determining how much leverage was OK," he says.

The rating firms use irrelevant or incomplete data to calculate the probability, or so-called correlation risk, that various assets in a CDO will default at the same time, Das says. "The models are fine," he says. "But they have an input problem. It becomes a number we pluck out of the air. They could be wrong, and the ratings could be misleading. I'm not even sure we understand the networks of links between the subprime tranches."

Stephen McCabe, a London-based managing director at S&P in charge of rating structured finance, defends his firm's evaluations, which are based in part on Monte Carlo simulation. "It's always an opinion, but it's based on some very deep mathematical analysis and some quite-complicated modeling."

Kimberly Slawek, group managing director at Derivative Fitch, the subsidiary of Fitch that rates CDOs, says her firm does the best it can. "It's not an exact science," she says. "This is very much our opinion as to the creditworthiness."

Kevin Kendra, London-based managing director at Derivative Fitch, says he runs a two-year training course on the rating firm's model for analyzing CDOs. In the first year, he teaches recruits about Monte Carlo simulation, including the use of correlation variables in determining risk. Correlations mean, for example, that when a German auto company defaults, other German car manufacturers suffer a higher chance of failing. "I spend the second year teaching them how to not believe the outputs of these models," Kendra says. "I want them to understand the strengths of the model, but also why the model may or may not apply to the assets that they're trying to analyze." Kendra says he's not telling them to ignore the computer model; rather, he's suggesting that they should understand it and also use their own judgment.

S&P's McCabe says his company's model is valuable, even if it isn't perfect. "There can be times when the model will spit out something and the people on our credit rating committee will just say, 'We're not comfortable with that,'" he says.

Complicating the rating companies' challenges in evaluating CDOs is the unusual role they play in putting them together. Potential conflicts of interest in the ratings game aren't new. The three largest raters are always paid by the issuers of the debt they're rating. Conflicts in rating CDOs are more acute because the raters work with financial firms in creating these debt packages, says Karl Bergqwist, a senior manager at Gartmore Investment Management Plc in London. "When you assign a traditional rating on a company or a bank, it is as it is, and you just make an assessment," says Bergqwist, who worked at Moody's until 1994. "When you move into structured finance, the agencies are effectively involved in structuring these transactions."

Fitch rates the top tranches AAA. The riskier mezzanine tranches usually get investment grades down to BBB–. The lowest portions, the toxic waste, which offer the highest potential return and biggest risk for investors, go unrated. These sections are also known as equity because their holders are the first to suffer losses and the last in line to collect in the case of a collapse triggered by defaults of the underlying debt, just as shareholders stand behind bondholders when a public company goes bust.

Fitch's role in helping to put together a CDO came to light in a civil court case. American Savings Bank of Hawaii Inc. sued UBS PaineWebber Inc. in 2001, claiming that in 1999 UBS had incorrectly said a CDO it had sold was investment grade when it wasn't. In the lawsuit, American Savings challenged Fitch's ratings of Zurich-based UBS's CDO. The 2nd U.S. Circuit Court of Appeals required Fitch to turn over internal documents. The court found in 2003 that Fitch had advised UBS on how to structure the CDO to get the ratings the bank wanted. Fitch itself was not a party to the lawsuit.

"Fitch played an active role in helping PaineWebber decide how to structure the transaction," the court found. "Correspondence indicates a fairly active role on the part of the Fitch employee in commenting on proposed transactions and offering suggestions about how to model the transactions to reach the desired ratings." The case was settled out of court, says UBS spokesman Doug Morris. Fitch's Aviotti says that although her company talks with financial firms as they create CDOs, Fitch doesn't structure CDOs. "We do as we do, which is not advise," she says.

Yuri Yoshizawa, group managing director for structured finance at Moody's, says a credit rating company's close relationship with CDO issuers doesn't compromise objectivity. "I think if we have the ratings wrong, we don't have a business," she says. "If we put something out there just because the issuer wants it and it's wrong, then there's absolutely no reason for anybody to rely on or give voice to our opinions."

The banks and rating companies have stretched the frontiers of CDOs with products known as CDO squareds and CDO

## Meltdown

A collateralized debt obligation dubbed SPA was sold to investors through Credit Suisse. The CDO fell apart.


[1]The size of the senior class decreased because some principal was repaid. The mezzanine losses were larger because of unpaid accrued interest. [2]Estimated by Moody's; MBIA pays investors $177 million. [3]As rated by Moody's, Fitch and S&P. [4]By Fitch and A3 by Moody's. [5]By Fitch and Baa3 by Moody's. Sources: Bloomberg, Fitch, MBIA, Moody's

**Janet Tavakoli**, a consultant to CDO buyers, says some ratings are 'smoke and mirrors.'

JEFF SCIORTINO

cubeds. As the names suggest, a CDO squared is formed by bundling together a bunch of CDOs, and a CDO cubed, which can contain thousands of different securities, is formed by lashing together a bunch of CDO squareds.

Some investors love these fat packages of CDOs because they offer even higher returns than plain CDOs. "The nirvana is higher risk-adjusted returns," says Andrew Donaldson, CEO of CPM Advisers Ltd., a London-based credit investment firm that manages about $2 billion. CPM buys and sells CDOs, including CDO squareds. "CDO squareds give another dimension to achieve portfolio diversification," he says.

Investors shouldn't put much credence in the risk that rating companies assign to CDO squareds and cubeds, says Stanford's Duffie. "The complexity of analyzing that is beyond current methodology," he says.

The grades that rating companies give CDO squareds and cubeds are worthless, says Janet Tavakoli, founder of Chicago-based consulting firm Tavakoli Structured Finance Inc., which advises investors on CDO purchases. "Ratings on these products are based on smoke and mirrors," Tavakoli says.

The inner workings of CDOs are normally invisible to the public. The demise of the $340.7 million CDO Credit Suisse sold in December 2000 was documented in a 38-page report dated March 26 that Moody's stamped as confidential. *The Enhanced Monitoring Report*, which is written for clients who pay an extra $10,000 to $130,000 for such studies, provided further background about the CDO called SPA.

This ill-fated CDO included a collection of subprime mortgage-backed securities and junk bonds. S&P, Moody's and Fitch stamped 85 percent of the CDO with an AAA or Aaa rating because that portion was guaranteed by bond insurer MBIA Inc. On April 24, Moody's withdrew its rating on the major part of SPA, saying in a two-sentence note that investors in this tranche had been paid in full.

What Moody's didn't say was that Armonk, New York–based MBIA paid the investors after the CDO had collapsed because many of its underlying securities had defaulted. MBIA spokesman Michael Ballinger says the insurer paid investors in the AAA or Aaa tranche $177 million. The tranche had suffered about $73 million in losses, which MBIA covered. Moody's spokesman Anthony Mirenda and Credit Suisse spokesman Pen Pendleton declined to comment on SPA.

Moody's also didn't say what became of SPA's uninsured mezzanine tranches, which the credit rating company had rated as investment grade. Investors in these tranches lost all of their money, Ballinger says. The losses totaled $38.5 million including unpaid accrued interest, based on the numbers in the Moody's report. The unrated equity, or toxic tranches, also lost everything—$17.2 million. Moody's estimated that SPA's remaining assets, which MBIA took over, were worth $104 million. "Because of the difficulty in obtaining accurate and timely market prices, some of the prices may be inaccurate or stale," Moody's wrote in a footnote in the confidential report. Mirenda declined to comment on the report.

With no regulation and little transparency, the CDO market thrives, and credit raters are helping lead the way, the University of San Diego's Partnoy says. Investors haven't been deterred by American Express's $1 billion loss. Nor have the March and April studies by Moody's and Lehman showing the concentration of subprime debt in CDOs slowed down CDO sales.

Former banker Das wonders why few people are probing the potential dangers for CDO investors. "I think the regulators seem to be fairly sanguine about all of this," he says. "The thing that I find quite bewildering is the lack of urgency and focus." He says subprime mortgage defaults have just started to soar. "The fuse has been lit," Das says. "Somebody should be trying to find where this wire is running to."

**'Fitch played an active role in helping Paine Webber decide how to structure the transaction,' a U.S. court found.**

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