

The Poison in Your Pension

Banks are selling the riskiest CDO portions, known as toxic waste, to public pensions and state trust funds.



By David Evans

Bear Stearns Cos., the fifth-largest U.S. securities firm, is hawking the riskiest portions of collateralized debt obligations to public pension funds.

At a sales presentation of the bank's CDOs to 50 public pension fund managers in a Las Vegas hotel ballroom, Jean Fleischhacker, Bear Stearns senior managing director, tells fund managers they can get a 20 percent annual return from the bottom level of a CDO. "It has a very high cash yield to it," Fleischhacker says at the March convention. "I think a lot of people are confused about what this product is and how it works."

Worldwide sales of CDOs—which are packages of securities backed by bonds, mortgages and other loans—have soared since 2003, reaching \$503 billion last year, a fivefold increase in four years. Bankers call the bottom sections of a CDO, the ones most vulnerable to losses from bad debt, the equity tranches. They also refer to them as toxic waste because as more borrowers default on loans, these investments would be the first to take losses. The investments could be wiped out.

Fleischhacker, 45, says she doesn't associate toxic waste with the equity tranches she's selling. Pension funds in the U.S. have bought these CDO portions in efforts to boost returns. Many pension funds, facing growing numbers of retirees, are still reeling from investments that went sour after technology stocks peaked in March 2000. Fund managers buy equity tranches, which are also called "first loss" portions, even though those investments are never given a credit rating by Fitch Group Inc., Moody's Investors Service or Standard & Poor's. The California Public Employees' Retirement System, the nation's largest public pension fund, has invested \$140 million in such unrated CDO portions, according to data Calpers provided in response to a public records request. Citigroup Inc., the largest U.S. bank, sold the tranches to Calpers.

"I have trouble understanding public pension funds' delving into equity tranches, unless they know something the market doesn't know," says Edward Altman, director of the Fixed Income and Credit Markets program at New York University's Salomon Center for the Study of Financial Institutions.

PHOTO ILLUSTRATION BY C.J. BURTON



“That’s obviously a very risky play. If there’s a meltdown, which I expect, it will hit those tranches first.” Calpers spokesman Clark McKinley declined to comment.

Because CDO contents are secretive, fund managers can’t easily track the value of the components that go into these bundles. “You need to monitor the collateral in your investment and make sure you’re comfortable there will be no defaults,” says Satyajit Das, a former Citigroup banker who has written 10 books on debt analysis. Most investors can’t do that because it’s extremely difficult to track the contents of any CDO or its current value, he says. About half of all CDOs sold in the U.S. in 2006 were loaded with subprime mortgage debt, according to Moody’s and Morgan Stanley. Since CDO managers can change the contents of a CDO after it’s sold, investors may not know how much subprime risk they face, Das says.

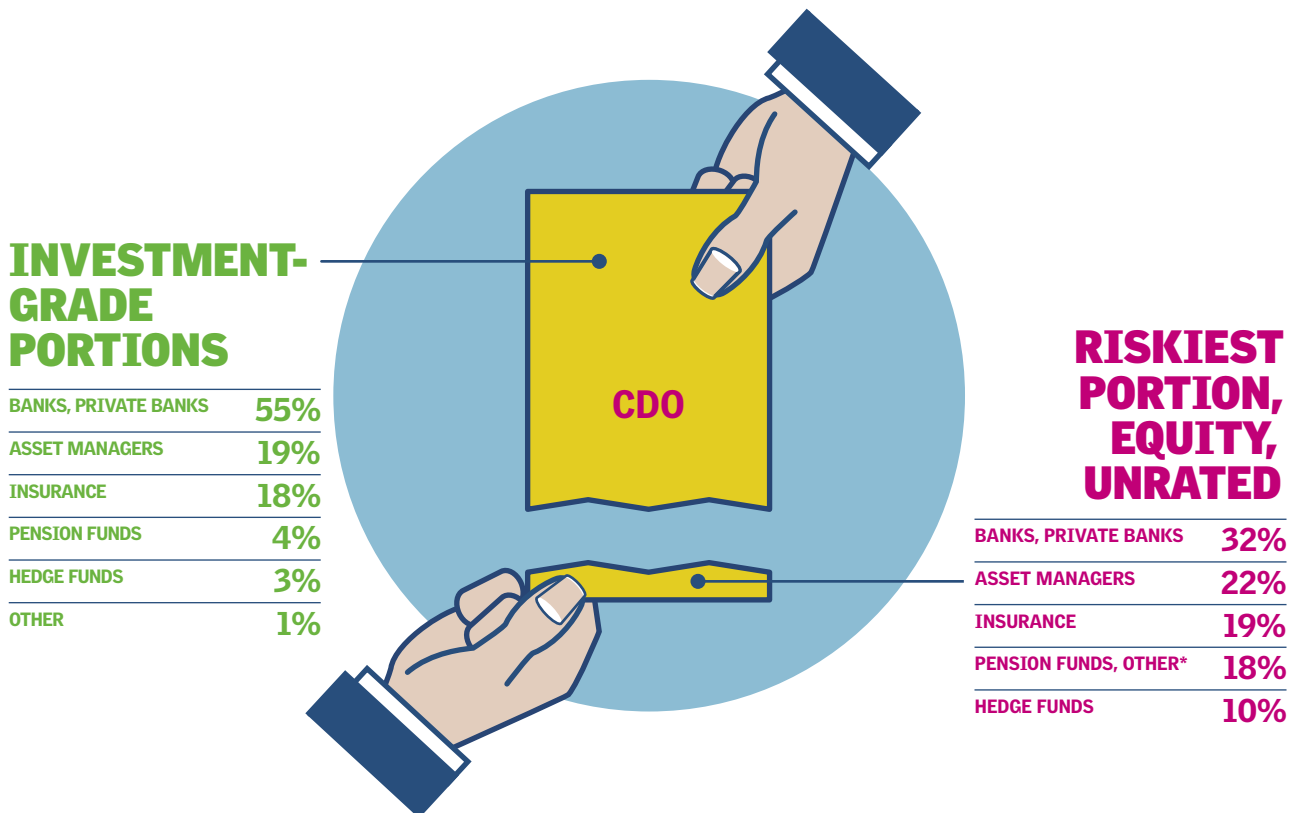
As the \$503 billion-a-year CDO market

thrives, CDO marketers like Bear Stearns and Citigroup find buyers for the portions known as toxic waste, the equity tranches. A typical \$500 million CDO requires a \$40 million unrated equity tranche, says Fleischhacker, who addressed the 12th annual Public Funds Summit, a meeting of pension fund managers, at the Loews Lake Las Vegas Resort on March 12.

Chris Street, treasurer of Orange County, California, the fifth-most-populous county in the U.S., says no public fund should invest in equity tranches. He says fund managers are ignoring their fiduciary responsibilities by placing even 1 percent of pension assets into the riskiest portion of a CDO. “It’s grossly inappropriate to take this level of risk,” he says. “Fund managers wanted the high yield, so Wall Street sold it to them. The beauty of Wall Street is they put lipstick on a pig.”

Buyers of CDOs

Pension funds are among the buyers of CDOs, including the riskiest first-loss portion that’s also known as “toxic waste.”



*Includes endowments, religious organizations and public assets. From 1996 to 2006. Percentages for the equity portion do not add up to 100 due to rounding. Source: Bear Stearns

Seven percent of all the equity tranches sold in the U.S. in the past decade were purchased by pension funds, endowments and religious organizations, Fleischhacker says.

Public pension funds have bought more than \$500 million in CDO equity tranches in the past five years, according to data from public records requests. The New Mexico State Investment Council, which funds education and government services for children, has \$222.5 million invested in equity tranches. The council decided in April to buy an additional \$300 million of them. That investment would be 2 percent of the \$15 billion it manages. The General Retirement System of Detroit holds three equity tranches it bought for \$38.8 million. The Teachers Retirement System of Texas owns \$62.8 million of them. The Missouri State Employees' Retirement System owns a \$25 million equity tranche. Ronald Zajac, spokesman for the Detroit pension fund, declined to comment on the fund's equity tranche investments.

Kay Chippeaux, fixed-income portfolio manager of the New Mexico council, says it decided to buy equity tranches after listening to pitches from Merrill Lynch & Co., Wachovia Corp. and Bear Stearns. "We got very interested in them just because a broker brought them to our attention," Chippeaux, 50, says. She says the investment is worth the risk because the fund may be able to get higher returns than it can from bonds. The council has purchased equity tranches from Bear Stearns, Citigroup, Merrill Lynch and Morgan Stanley.

The council is relying on advice from bankers who are selling the CDOs, Chippeaux says. "We manage risk through who we invest with," she says. "I don't have a lot of control over individual pieces of the subprime."

As of March 31, the Texas teachers pension fund's CDO investments had returned a total of 6.1 percent since December 2005, spokeswoman Juliana Fernandez Helton says. They include the fund's \$62.8 million in equity tranches, which were purchased from Credit Suisse Group, Goldman Sachs Group Inc., Citigroup and other banks. The Texas fund also bought \$10.1 million in investment-grade tranches from Merrill Lynch and RBS Greenwich Capital Markets, a unit of Royal Bank of Scotland Group Plc.

The Texas fund managers won't put more than 1 percent of the fund's assets into CDO invest-

ments, Helton says. They review CDO managers' capabilities and the design of an individual CDO before making a purchase, she says.

Last September, the Missouri retirement system bought half of the equity tranche of the BlackRock Senior Income Series 2006 collateralized loan obligation, managed by New York-based BlackRock Inc. A CLO is a CDO that invests exclusively in loans, not bonds. The Missouri pension system invested \$25 million of its \$7.7 billion fund. Jim Mullen, fixed-income director of the fund, says he thinks the investment will pay off because he got into that market before most others did. "We tend to be ahead of the curve," he says. The investment didn't require board approval, Mullen, 60, says, adding that he relied on the fund's 12-year relationship with BlackRock.

Das says banks have good intentions when they create a CDO; what they lack is control of the performance of subprime loans and other bad debt. "To just rely on somebody's reputation is absolving your own fiduciary responsibility as a manager," he says. Helton declined to comment in response to Das. Charles Wollman, public information officer for the New Mexico fund, says it evaluates the performance of each CDO at least once a month.

Citigroup spokesman Stephen Cohen says public funds pick CDOs based on their management. "The evaluation centers on the track record and expertise of the manager," he says. Fleischhacker says Bear Stearns provides a prospectus on all CDO transactions, including terms, structure and risk. Credit Suisse, Goldman Sachs, Merrill Lynch, Morgan Stanley, RBS Greenwich and Wachovia declined to comment.

Orange County's Street says he sees similarities between that county's 1994 bankruptcy, which was the largest municipal bankruptcy in U.S. history, and investments by pension funds in equity tranches. In the 18 months before the collapse, Street, 56, who then ran financial advisory firm Chriss Street & Co., alerted the U.S. Securities and Exchange Commission and the Office of the Comptroller of the Currency, or OCC, that the county faced a financial disaster. The manager of the Orange County fund, which included pension money, had borrowed more than \$12 billion and speculated that short-term interest rates would remain low. "The county was earning 8 percent in what was a 3½ percent world," Street recalls telling federal regulators.

'The beauty of Wall Street is they put lipstick on a pig,' a county treasurer says.



'Common misperception'

A Bear Stearns executive said credit rating firms oversee CDOs the way federal regulators monitor banks. The rating companies disagreed.

"The outside agencies that oversee these structures are the rating agencies."

Jean Fleischhacker
Senior managing director
Bear Stearns

"It's not accurate. We don't provide any oversight."

Gloria Aviotti
Managing director of global structured finance
Fitch

"It's a common misperception. All we're providing is a credit assessment and comments."

Yuri Yoshizawa
Managing director of structured finance
Moody's

"We disagree. We rate the transactions that issuers bring to us based on our published criteria."

Chris Atkins
Vice president for corporate communications
Standard & Poor's

Those returns ended when rates rose in 1994. Street's warnings went unheeded. Orange County's investment losses totaled \$1.69 billion.

Street says the big risks taken by public pension funds managers to juice up their investment performance with CDO equity tranches could result in big losses. Those tranches are filled with risky debt, which is sometimes in the form of subprime mortgages, he says. "Very few pension plans could meet their fiduciary duty by buying portfolios of subprime loans," he says. "They spiked up the yield, but that yield means nothing when the defaults start to mount, as we know they will. The funds will take big losses."

Foreclosure filings in the U.S. jumped to 147,708 in April, up 62 percent from a year earlier, as subprime borrowers stopped making mortgage payments, according to data released by research company RealtyTrac Inc. on May 15. As foreclosures rise, the subprime-mortgage-backed securities in CDOs begin to crumble.

At its sales presentation at the pension conference in Las Vegas, Bear Stearns has set up a booth stacked with literature about CDOs, including a

14-page primer titled *Collateralized Debt Obligations (CDOs): An Introduction*. Fleischhacker stands in front of the display of brochures after she speaks. "They should be looking at these types of asset classes," she says. "They're eager to learn. We're doing lots of education."

Fleischhacker tells the public pension managers that a CDO is like a financial institution: Both have strict oversight, she says. "The outside agencies that oversee these structures are the rating agencies," she says, comparing them with the Federal Deposit Insurance Corp. and the OCC, which regulates banks. (For more on credit rating companies and CDOs, see "The Ratings Charade," page 50.)

Fleischhacker's comparison is disputed by Gloria Aviotti, Fitch's group managing director of global structured finance, which includes CDOs. "It's not accurate," she says. "We don't provide any oversight."

Yuri Yoshizawa, group managing director of structured finance at Moody's, says people often think of credit raters as investor advocates or oversight groups. "It's a common misperception," he says. "All we're providing is a credit assessment and comments."

Darrell Duffie, a professor of finance at the Stanford Graduate School of Business in Stanford, California, says he's concerned about public pension trustees' getting their CDO education from the banks that are selling the investment. "Either they need to be very sophisticated themselves or they have to know that they're getting into something that could be quite risky," he says. Pension fund managers should get advice from independent financial consultants, Duffie says.

Some public fund investors are forbidden from buying junk-rated or unrated portions of CDOs. Wall Street has come up with ways to sell dressed-up CDO toxic waste so that it qualifies as investment grade. One is called principal protection. Bear Stearns offered this hypothetical example at its Las Vegas presentation: A pension fund wants to buy \$100 of CDO equity. Instead of buying it directly, the fund buys a zero-coupon government bond for \$46 that will be redeemed for \$100 in 12 years. That bond is paired with a \$54 investment in CDO equity. Zero-coupon bonds pay no interest; the investor is paid the full face amount—that's \$100 in this hypothetical situation—when the bond matures.

“Principal protection is guaranteed,” Fleischhacker says. “It’s AAA since you’re buying a U.S. Treasury.” If there are no defaults, this method of investing in CDO equity would return 9.3 percent annually, she says.

The presence of the zero-coupon bond ensures the pension fund will recover its \$100 investment even if the equity tranche becomes worthless. While the fund wouldn’t lose any money if that happened, there would be no return on the investment for 12 years.

If a fund manager puts all of the same hypothetical \$100 into zero-coupon bonds only, it would more than double its money in 12 years, Das says. “I would have thought with pension fund money, they don’t really want to lose principal,” Das says of this equity tranche sales technique. “And clearly here the principal is very much at risk. You’ve got a highly leveraged bet on no defaults, or very minimal defaults.”

Chippeaux says she concluded the principal-protection plan was good for her fund in New Mexico at a time when the state required that public funds buy only investment-grade debt. Chippeaux says she knows there are subprime loans in the New Mexico fund’s CDO investments. Wollman says he’s confident New Mexico

doesn’t hold many of the poorest-performing subprime loans that were made at the height of the real estate boom in 2006. “One of the things that’s going to be helpful to us is that we don’t have a lot of exposure to 2006 subprime loans,” he says. “I think that is going to help us deflect any exposure should subprime collapse.”

Pension fund managers face the same hurdle as all CDO investors: The market has almost no transparency, with both current prices and contents of CDOs almost impossible to find, says Frank Partnoy, a former debt trader who’s now a law professor at the University of San Diego. The murky nature of the CDO market presents danger for the unwary investor, and it’s particularly unsuitable for public pension money, Partnoy says. “I think ‘smoke and mirrors’ in some sense understates the problem,” he says. “You can see through smoke. You can see something reflected in a mirror. But when you look at the CDO market, you really can’t see enough information to enable you to make a rational investment decision.” That hasn’t stopped pension funds from taking high risks with the retirement plans of teachers, firefighters and police. ▶

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‘They’re getting into something that could be quite risky,’ one professor says of pensions.

BLOOMBERG TOOLS

Tracking Underlying Loan Performance

You can use the Delinquency Report (DQRP) function to display a list of structured finance deals ranked by their collateral performance. For data on delinquencies and foreclosures on subprime loans in specific residential-mortgage-backed securities, first type DQRP <Go>. Click on the arrow to the right of Sector, and select Residential. Click on the second arrow to the right of Sector and select Res B/C to display securities in which the majority of loans are classified as subprime or B- or C-rated, as shown below. The 60D+ column shows the percentage of collateral-backed loans for which the borrower is 60 days or more behind in payments or is already in default or the property is owned by the lender. Click on a deal to see additional details for that security using the Collateral Performance (CLP) function.

For a calendar of new and recently issued CDOs, type MCAL <Go> for the Structured Finance New Issue Calendar function and then 7 <Go>. For a guide to the collateral codes, type CDO <Go> 4 <Go>. To access a menu of CDO issuers, type CDO <Go> 1 <Go>. To see a list of an issuer’s deals, type its ticker followed by <Mtge> <Go>. For headlines of Bloomberg News stories on CDOs, including daily CDO Alert stories for Europe and the U.S. that list the biggest planned sales of CDOs, type NI CDO BN <Go>.

JON ASMUNDSSON

Sector:	Residential	Res B/C	Delinquency Report							
Issuance Year:	All	Ticker:	Series:	2000 records displayed of 2404						
Deal	Rep. Date	30Day	60Day	90Day	Forecl.	REO	60D+	WALTV	FICO	
Weighted Averages		3.26	1.58	2.48	4.20	1.86	10.13	76.83	638	
ACE 2006-SD1	04/2007	5.40	6.16	26.31	17.13	4.98	54.68	75.65	540	
INHEL 2001-A	04/2007	10.73	7.12	13.85	20.28	7.30	48.55	80.51		
SASC 2003-GEL1	04/2007	2.74	2.44	28.68	9.35	7.62	48.29	91.70		
MSDWC 2001-NC3	04/2007	6.66	4.49	26.11	8.03	8.94	47.57	77.54		
INHEL 2001-B	04/2007	8.77	8.74	12.82	21.75	4.71	47.42	80.07		
INHEL 2000-C	04/2007	13.17	9.09	11.62	16.29	10.04	47.04	77.96		

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