THE AGE
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MALCOLM MAIDEN
BUSINESSDAY 2

KINGS OF CONFLICT

Reputation, core asset after all of S&P, Moody's and Fitch, is taking a battering over subprime.

THEY are staid, respected, low-profile institutions. At least they were until very recently. Their services are both expensive and indispensable. They have a profound influence on investment markets around the world, and therefore, a profound influence on the wealth or otherwise of investors big and small.

And many people believe they were a key contributor to what we now know as the subprime crisis.

They are credit rating agencies. Globally, there are three of note: Standard & Poor's, Moody's Investors Service, and Fitch Ratings. And over the past eight weeks, their reputation has taken a battering. They have been accused of conflicts of interest and even incompetence. They are being sued in the US and slapped with extra layers of regulation in the European Union. They are being blamed, in part, for events that have bankrupted companies, pushed mortgage holders out of their homes, and that have rocked financial markets worldwide.

And here in Australia they are implicated in losses suffered by some of the smallest and least financially sophisticated institutional investors in the country, including rural shire councils.

It is all a giant mess that has "significantly undermined" the credibility of the rating agencies, according to Melbourne University corporate law expert Ian Ramsay. And, some believe, it may lead to unprecedented legal action in Australia.

The Age has revealed the extent of losses councils have suffered around Australia, which invested millions in complex financial instruments known as "collateralised debt obligations" (CDOs) that were sold to them by Grange Securities, since bought by Lehman Brothers.

What is happening in rural NSW, and in other states, is a microcosm of events taking place around the world. Understand what happened there and you understand the root of the subprime crisis, and how the credit rating agencies were the conduit for the whole thing — how they facilitated it; how they let it happen.

It all begins with a set of guidelines. Councils in NSW, as with many institutions, are restricted in how they can invest surplus money. Property is OK. Deposits with banks, credit unions or building societies are OK. And, crucially, any securities rated at least "A" by S&P, Fitch or Moody's are rolled-gold, guideline-approved OK.

So when broker Grange Securities came courting in late 2006 with Federation, a form of CDO, many rural councils saw no reason not to invest. It was, according to Grange, "linked to the performance" of a portfolio of 40 bonds backed by "diversified US residential mortgage pools" — bonds that were rated AA- or A by S&P.

What does this mean? Basic, "vanilla" CDOs consist of a pool of debt securities, or bonds, that are split up into securities. The bonds, and therefore ultimately the CDOs, can be backed by income flowing from corporate loans, or small business loans, or mortgages. They are then divided into different classes, or "tranches", based on how well protected the yield is. If the loans default, it is the lowest, least-protected tranche — the tranche with the highest yield — that is impacted first. The damage then moves up the ladder of tranches.

Then things get more complicated. Somewhere along the way, someone created a "synthetic" CDO, which was cheaper and easier to put together and sell. In effect, synthetic CDOs involve transferring the risk of defaults from one CDO to another party. They are complex derivative instruments that, fuelled by plentiful mortgages in the booming US property market, became wildly popular in the mid-noughties.

The problem was that much of it was based on puffery and misinformation — on loans given to people who simply could not afford to buy a house. "Subprime" once referred

▶ Continued BUSINESSDAY 4

Ignore denials: State exposed to subprime

Like it or lump it, several Victorian Government agencies have been burnt by the credit crisis.

MICHAEL WEST

WHILE leading banks and insurance companies around the world have conceded billions of dollars in losses on their structured finance holdings arising from the credit crisis, the Victorian Government has clung to the line that it has "no direct subprime exposure".

That none of its agencies owns a home mortgage in Milwaukee misses the point. The credit crisis moved beyond "subprime" residential mortgages in the US last year. It has since engulfed myriad structured finance products that once boasted prime AAA and AA ratings, and for which there are at present no buyers.

As revealed by *The Age*, hundreds of local councils, charities, churches, government agencies and super funds across the nation — including Victoria — are exposed to losses as a result of buying these products from financiers such as Wall Street investment bank Lehman Brothers (then Grange Securities).

The Age has now identified a number of Victorian agencies — including Northern Health, Western Health, Gippsland Ports, East Gippsland TAFE, Benalla & Memorial Hospital and the Metropolitan Ambulance Service — which hold or have held synthetic CDOs (collateralised debt obligations).

The "referenced" assets underlying these securities include securitised bonds issued by US subprime mortgage providers and monoline insurers such as Countrywide and Washington Mutual. To take one example, Countrywide now faces Chapter 11 bankruptcy and US federal probes by both the FBI and the corporate watchdog, Securities & Exchanges Commission (SEC).

There is now no market for these products although they continue to deliver distributions to their holders and these holders are, in many cases, yet to take write-downs.

In this light, the stubborn denials from Premier John Brumby and his Treasurer John Lenders have proven ever more hollow as evidence trickles in from various Victorian government agencies exposed to losses from this strain of fancy structured products alone.

Initially, the state was said to have had an "extremely limited" exposure to subprime that was "non-direct", then there were said to be "no direct subprime exposures". A few days later came the concession from the First Mildura Irrigation Trust that it had been "impacted by the US subprime market problem" thanks to its CDO holdings. The position was tweaked once again. "Direct exposure to subprimes in the Victorian Government is limited to the First Mildura Irrigation Trust," said the Treasurer.

Then the *Shepparton News* broke the story that Goulburn Valley Health owned $2 million worth of CDOs.

Today, having identified the actual securities held by various agencies last year (most of which are still held and some of which have been "restructured" with the assistance of Lehman into lower-yield securities), we can take the story further.

Northern Health held "Omega" and "Beryl" CDOs arranged by Banque Nationale de Paris and Lehman Brothers as part of a $5.5 million portfolio with Lehman. It confirmed this week it still held CDOs, and said they were "most likely to be redeemable at full face value at maturity (in 2012 and 2014)".

According to internal client documents seen by *The Age*, Western Health had $8 million exposure to Corsair, Federation, Helium, Omega and Zircon CDOs arranged by JPMorgan, Lehman, Merrill Lynch, BNP and Lehman respectively.

Western Health declined to confirm which investments had been held and said it had struck a confidentiality agreement with Lehman. It did not deny that it held CDOs.

According to documents seen by *The Age*, Gippsland Ports held a $2 million portfolio with Lehman that included Corsair and Zircon CDOs. Gippsland Ports declined to comment.

Benalla & Memorial Hospital held $1.5 million in Corsair, Helium and Zircon CDOs. It confirmed it held CDOs and had since "restructured" its portfolio.

Ambulance Victoria confirmed that it held $7.5 million in CDOs and FRNs (floating rate notes) via Metropolitan Ambulance Services. These included the Helium, Herald (arranged by RBC) and Magnolia (arranged by CSFB) series of CDOs.

East Gippsland TAFE held $4 million in Omega and Zircon CDOs and confirmed it still held CDOs.

All of these holdings, combined with the well-documented exposures to CDO of FMIT and Goulburn Valley Health demonstrate that, despite Government denials, Victoria is exposed to losses from subprime and, more to the point, the credit crisis, just like all the other states and most developed countries in the world.

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BROKER COLLAPSE
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Two child-care centre chains in Melbourne and Adelaide are among the biggest debtors of collapsed stock-lending house Primebroker Securities. BUSINESSDAY 3

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IG MARKETS

The rating kings take a battering

◀ From BUSINESSDAY 1

to a class of dodgy mortgages. Now it refers to the financial pain that has flowed from the inability of those mortgage holders to pay back their loans. It has spread well beyond "subprime" mortgages to the complex financial instruments created on the back of those mortgages. It has spread to rural Australia, where councils sank money into products they did not understand.

So, where do the credit rating agencies come into it? Strictly speaking, the role of these agencies is to judge the risk that an entity — such as a security or bond — will default on its debt obligations. The agencies facilitate the pricing of risk. "AAA" means the entity has a negligible chance of defaulting. "BB" or "C" means it has a greater chance. They are priced accordingly — the greater the risk, the greater the return.

This is an imperfect measurement of an entity's value, a fact the agencies have not tried to hide. "The rating agencies have always sought to clarify their role by stating their ratings only measure credit quality," the Bank for International Settlements notes. "They state that a credit rating is not intended to capture the risk of a decline in market value or liquidity of the rated instrument, nor should it be considered an investment recommendation. However, some investors do not seem to understand this point or simply ignore it."

The rise of CDOs and other structured finance products was a boon to the agencies. They started rating CDOs in the late 1990s and synthetic CDOs in the early 2000s. These products were complex, even baffling, to unsophisticated investors. The agencies made these incomprehensible products sellable, and made themselves indispensable, by assigning them ratings.

A "credit default swap" is hard to understand. Triple-A? Everyone understands what that means. Or at least they thought they did.

"The (instruments) were so lacking in transparency, you needed thousands of pages of documentation to explain them," says Rob Ferguson, executive chairman of litigation funders IMF. "They needed a simple thing to whack on the front cover."

But the central question is whether the ratings assigned to the CDOs properly reflected the risk involved: did they do what they were supposed to do? Alan Laubsch, from risk management group RiskMetrics Labs Asia, says they didn't for a relatively simple reason — the risk of defaults was calculated on "recently observed" historical data, in which this year's drop in US housing prices, and the corresponding drop in value of securities and derivatives linked to the US housing market, was unimaginable.

"When CDOs became popular, every rating agency came up with some very simplistic models to figure out what the chance of default on these was," Laubsch says. "The US housing market didn't drop since the Great Depression. So, looking at historical data, it was inconceivable what happened. The problem with any analysis which looks at things on a historical data basis, is that history doesn't always repeat itself."

But the methodology wasn't the only problem — it was the entire business model. An entity is only rated if it pays the credit rating agencies to rate it, building into the model what the European Union has described as an "inherent" conflict of interest.

As regulators in the US have uncovered, it was common for the agencies to modify their calculations without explanation, the result of which may have been to grant clients better ratings on certain securities. And analysts, the supposedly independent calculators of the ratings, were involved in client discussions on fees and market share.

A report on the three major rating agencies, handed down by the US Securities and Exchange Commission in July, highlights all these issues and more (while never naming which agency it is referring to). It highlights staff shortages, painting a picture of institutions struggling to cope with the boom in CDO-related work.

And it quotes from internal emails — "it could be structured by cows and we would rate it" — that reveal the goings-on inside these supposed bastions of corporate impartiality. In one email, written in mid-December 2006, an agency analyst refers to the CDO market as "an even bigger monster".

"Let's hope we are all wealthy and retired by the time this house of cards falters. ;o)."

Sadly for the analyst in question, this was not to be.

When Grange was selling Federation in late 2006, around the time *that* analyst wrote *that* email, an "A" rating granted by the respected S&P counted for a lot. So much, in fact, that even six months later, when things had turned nasty in the US home market, Grange's new parent Lehman Brothers could always point to the fact that the now-tarnished CDOs were high-rated assets.

"Some commentaries have sought to lump all grades of CDOs . . . in a single basket," Lehman told clients in a briefing note in July 2007, according to documents lodged with the NSW Federal Court this week.

"This approach is the same as taking a triple-C rated corporate bond and triple-A rated (government) bond and saying the risk and characteristics of both bonds are the same . . . it is not valid to take the vast majority of CDOs that (Lehman) has issued at AA-rating or better . . . and say they are subject to similar risks to the very low-grade CDOs that invested primarily in subprime mortgages."

"By the time NAB and Stewart 'fessed up, the house of cards had faltered and then some."

A bit over a year later, that advice has wound up in a revised statement of claim lodged this week by Wingecarribee Shire Council, which says it lost millions on the CDOs in question. The council is suing Lehman Brothers, the first council to make such a move. Others are considering similar action.

And of course, NSW shire councils weren't the only ones to glean confidence from the bestowal of shiny ratings on rickety securities. "This is something that has happened not just in Australia, but throughout Asia and the world," Laubsch says.

A month ago, the European Union admitted its own legislation led to "excessive reliance" by banks and financial institutions on credit ratings. And in a high-profile Australian example, National Australia Bank said it was likely to write off 90% of the value of its US mortgage-backed investments — worth more than $1 billion — all of which had AAA ratings.

In unveiling the loss, NAB chief John Stewart was candid about the bank's internal failings, saying the securities had passed internal risk checks. But again and again, he pointed out the fact that the now near-worthless securities had been given AAA ratings. "AAA means they have a one in 10,000 chance of default," he told reporters. It was clear, he added, that the rating agencies that had assigned the CDOs AAA status had "let the whole industry down". "(They) didn't do a thorough job."

By the time NAB and Stewart 'fessed up, the house of cards had faltered and then some. Worldwide, the agencies are under attack for their role in the subprime mess.

The International Organisation of Securities Commissions, which describes itself as "the leading international policy forum for securities regulators", is scrutinising the rating agencies' performance against their own codes of conduct, and will report its findings later this month. The Financial Stability Forum, a group comprised of representatives from reserve banks, treasury departments and regulators from 11 Organisation for Economic Co-operation and Development countries, is also looking at the sector.

The EU, in effect, blames the agencies for subprime, acknowledging that it was "generally accepted" that the agencies underestimated the credit risk of structured credit products (like CDOs), and that their ratings "failed to reflect early enough" the worsening market conditions. It concluded that the rating agencies shared "a large responsibility for the current market turmoil".

They aren't the only ones, of course. A slew of lawsuits have begun in the US against investment banks like Citi and Merrill Lynch, against hedge fund operators, home loan lenders, and others. The rating agencies are being sued by pension funds and, in a move announced a few weeks ago, by the State of Connecticut. This lawsuit, while not directly connected to the subprime fallout, has only added to their recent reputational damage.

"We are holding the credit rating agencies accountable for a secret Wall Street tax on Main Street — millions of dollars illegally exacted from Connecticut taxpayers," said headline-friendly Connecticut Attorney-General Richard Blumenthal.

The agencies have pledged to fight the claims, which they say are without merit.

As Wingecarribee prepares its case against Lehman, talk is building of possible legal action in Australia against the credit rating agencies. Such a move is fraught with problems. IMF is not looking at it and, Ferguson says, "they seem a very difficult group to challenge".

Why? After Enron collapsed, US investors tried suing the agencies for taking too long to downgrade Enron corporate debt. In a landmark decision, the judge ruled the agencies were expressing opinions, and so were protected under freedom of speech laws.

Nonetheless, several bodies in the US are pressing on. And law company Slater & Gordon, which says it has been approached by a "large number" of investors burned by CDOs, is looking at whether there is a case for an Australian lawsuit against the agencies.

Senior associate Ben Phi believes some of the councils may have "valuable claims" against rating agencies, "depending on their particular circumstances".

"In order to bring a claim against a credit rating agency, it would be necessary to show that the credit report was misleading, and that the investor reasonably relied on that report when deciding to invest," Phi says. "We are aware that a number of local councils are required to invest in products that carry a minimum credit rating, and they in particular may have a valuable claim against a ratings agency."

NAB has not ruled out legal action. When asked about the prospect, it said it was looking at a "range of options" on its battered CDO portfolio. "(We) will continue to monitor the market and regulatory responses to recent financial market conditions," the bank said.

In Australia, that "regulatory response" includes a joint review of the agencies by the Australian Securities and Investments Commission and Treasury. A crucial aspect of the review will be the question of licensing — whether the financial services licence exemption granted to rating agencies is, in the words of Corporate Law Minister Nick Sherry, "still current or justified".

Last month, at an Investment and Financial Services Association conference on the Gold Coast, ASIC commissioner Belinda Gibson acknowledged the "questions raised" about the quality of the ratings processes, identifying the agencies as one of ASIC's current priorities.

"There is a wider market issue about the extent to which investors rely on the ratings agencies for their investment decisions, and whether the level of diligence and discussion undertaken by the agencies warrants this reliance," Ms Gibson said.

The Age believes that ASIC and Treasury will release a consultation paper within weeks, and the final report is due by the end of the year.

The agencies have pledged to co-operate. "We want to provide as much transparency as possible with regard to Moody's policies and practices," Moody's said in response to the ASIC/Treasury review. "Moody's will co-operate fully with any review initiated by the Government."

The services of S&P, Moody's, and Fitch are believed to cost hundreds of thousands of dollars — up to $1 million, in fact, to rate a complex, high-profile issue.

S&P, which has the biggest presence in Australia, is owned by the McGraw-Hill group of companies, which made $US1 billion ($A1.2 billion) in net income in 2007. S&P has about 130 employees in Australia, or did at the end of last year. According to its latest financial statements, lodged with ASIC, S&P Australia made $5.4 million in profit in the year to December 2007 — a huge fall from the $13.1 million recorded in 2006. This drop in profit and revenue it attributed to "the turmoil in global financial markets", despite the fact that its parent company, the global S&P group, managed to raise operating income by 13% over the same period, with operating profit of $US1.3 billion.

Fitch Group, which is owned by French company Fimalac, recorded an 18% drop in profit in the six months to March 31, to €79.2 million ($A137 million). Fitch Australia, according to financial statements lodged with ASIC, had just 23 staff at September 30, 2006, and lost $2.23 million in the nine months to September 30, 2006 (the latest information available).

"Perhaps the agencies' best defence is investors only have themselves to blame if they rely too much on ratings."

Moody's Investment Services is listed on the New York Stock Exchange, and generated $US1.1 billion in operating income last year. It generates 60% of its business in the US, and classifies Asia Pacific as an "emerging market". It has about 60 "ratings professionals" in Australia.

Two years ago, few questioned the accuracy of the ratings processes the agencies used. Professor Ramsay recalls attending an International Organisation of Securities Commissions conference in 2005 where the issue of conflicts of interest within credit rating agencies was raised. "It wasn't such a big issue," Prof Ramsay says. "It seems like a generation ago now."

Now, everything is being questioned. Among the other faults uncovered in the SEC report, one crucial failing was the area of "surveillance" — the tracking of a security after it is granted that initial rating. Surveillance was poorly documented and two of the agencies had no formal procedures in place. Securities given high ratings were allowed to disintegrate before being downgraded — the NSW Cole Commission noted that some Grange Securities CDOs were still rated "A" by S&P, even when they were worth just 15% of their original value.

Laubsch says the agencies were slow to respond to what was "clear deterioration" in the subprime market. They did not start the bulk of their subprime ratings downgrade until mid-July 2007, despite clear warning signs (not least the implosion of the two Bear Stearns subprime hedge funds in May).

The agencies have since moved to shore up their processes and rehabilitate the thing on which their whole business model depends: their reputations.

"We haven't waited for the (ASIC/Treasury) review to take steps that we believe will help improve our credit ratings process," says John Bailey, managing director of S&P in Australia and New Zealand. Bailey says that in February, S&P announced action to "further strengthen" its credit ratings process, enhance its analytics and provide more transparency to the market.

Moody's released an update last month on measures that it says settle the concerns expressed by "both the private and public sectors", including improving surveillance, separating non-rating and rating activities to prevent conflicts of interest, and improving transparency.

Fitch did not respond to questions.

Perhaps the agencies' best defence, in the end, is the argument that investors only have themselves to blame if they rely too much on ratings. They are, after all, just that: credit ratings. They are not recommendations to buy or sell. They are not audited opinions of a company's financial soundness.

"I don't think it's as simple as blaming the credit rating agencies," Laubsch says. "We have to learn to ask, 'if there's extra return, where is the risk?' And don't rely on any single information source; get as many perspectives as possible."

Westpac chief executive Gail Kelly has not commented on the woes afflicting Westpac's Melbourne-based competitor, NAB. But late last month, she made a not so subtle reference to the situation. Kelly produced a note from November 2006 recording a discussion among Westpac executives about CDOs, and whether the bank should invest in them.

Among the factors considered was Westpac's lack of knowledge about CDOs, and the reliance on rating agencies that would result. Part of the discussion went: "Product knowledge is important. Some of the asset classes mentioned are not ones where we have a natural competitive advantage. Relying on the rating agencies is one of the mistakes we've made in the past, where the minimum rating of A- was not the protection we thought it was."

As Kelly observed, the investments were not made.

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Adviser warns on Telstra directors

By MATT O'SULLIVAN

HAND-PICKED Telstra director John Mullen faces a battle for his board seat after an influential adviser to large shareholder, CGI Glass Lewis, urged it to vote against him.

CGI Glass Lewis has also raised concerns that the pay deal for Telstra's chief executive, Sol Trujillo, does not include an incentive plan after next June.

The adviser said this highlighted the need for clear succession plans for Mr Trujillo, whose pay of $13.4 million this year was almost double the median for bosses at companies of a similar size. The lack of an incentive plan beyond June stokes speculation about when the American plans to leave.

In urging a vote against Mr Mullen, CGI said the commitments of his job as DHL Express chief executive meant he might not be able to give Telstra the "attention, priority and time" it demanded. A non-executive director also needed to set aside extra time in case of a crisis.

Mr Mullen joined Telstra's board in July, finally fulfilling Telstra's wish, stated shortly after the appointment of John Stewart, to have 10 directors.

"We have seen executives having to give up their non-executive roles ... often at a time when their ... contribution may most be needed," CGI said in a report to clients. "A previous non-executive director of Telstra, the former Coles CEO John Fletcher, is a case in point."

Mr Mullen has his hands full managing DHL Express, the global courier company which this week announced it was cutting almost 10,000 jobs and closing three-quarters of its outlets in the US.

Telstra last faced a revolt against a board nomination two years ago when the Federal Government went against the company's wishes to install Geoffrey Cousins, a former adviser to John Howard. Cousins would have missed out on a board seat had it not been for the Government voting in his favour.

Although CGI has advised clients to support Telstra's remuneration report, it has raised concerns about Mr Trujillo's contract.

"That raises questions ... as to both the company's and the CEO's expectations in respect of the ongoing top management role in the company beyond that date," the adviser said.

"We believe that the company has a responsibility to advise shareholders of succession planning with respect to the CEO, particularly given the stage the company is at regarding its transformation strategy. We will monitor this situation."

Telstra initially sought a five-year commitment from Mr Trujillo but he was unwilling to give any more than three years. He has to give only 30 days' notice should he want to quit.

His salary has caused an uproar among shareholders at Telstra's last two annual meetings. Last year almost two-thirds of shareholders voted against the remuneration report.

RiskMetrics, the other major proxy adviser, has recommended shareholders support Telstra's executive pay, but has noted that some investors may want to vote against it because of "shortcomings" in the awarding of Mr Trujillo's long-term bonuses.

Shareholders will vote on the pay card and Mr Mullen's nomination at Telstra's annual meeting in Melbourne next Friday.

Telstra declined to comment yesterday.

Busy weeks for telco as cuffs fall

◄ From BUSINESSDAY 1

... and there's a lot of growth ahead of us in terms of what we're going to be able to do, so it is an important part of our media-comms strategy — I want to be absolutely clear, there's no doubt about that," Trujillo says.

McDonnell is sceptical about how Telstra would benefit by "trying to compete away a business that is only just emerged into profitability, and it still owes them a lot of money".

One advantage of the Foxtel relationship for Telstra is that it owns the cable Foxtel uses to supply half its 1.6 million customers (its uses satellite for the rest). As well as getting a percentage of Foxtel's cable TV customer revenue, it also means the pay TV operator will not launch its own rival broadband service (which has happened to many incumbent telcos overseas).

ABN Amro telecommunications analyst Ian Martin says it would suit no one at Foxtel to change that arrangement at the moment, and that Telstra should instead look at the capabilities it has that would enable it to do something in addition to what Foxtel is doing.

Martin says Telstra's main incentive for expanding into IPTV in the future would be to ensure its networks were fully utilised — crucial if Telstra invests in the NBN — and so it could use its extensive, detailed customer database to offer targeted advertising to companies, "whether through Sensis or somebody else".

"In either case I think it's probably better to do the subscription (TV) stuff through Foxtel and then look at how it can do targeted media and advertising: a) when it's got a broadband network that allows it to do it; and b) in areas where it understands what its customer base is prepared to pay more for," says Martin.

Trujillo confirms Telstra's IPTV ambitions, but stresses the company is looking at developing a service that complements its current offerings, such as Foxtel.

"We have lots of thoughts and lots of ideas but ... we don't talk about things until we're ready to do something about it." Foxtel, ironically, is set to beat Telstra to IPTV by launching a service in the second half of 2009 to allow subscribers to download additional programs on demand, even if they do not get their broadband through Telstra BigPond.

Investors flocking to the Melbourne Convention Centre on Friday, if previous years are any guide, will almost certainly be more concerned about executive remuneration and dividend certainty than the expiry of the Future Fund and Foxtel restrictions.

But their importance will not be lost on the Telstra board. The latter certainly won't be lost on News Ltd and ConsMedia.

With VANESSA O'SHAUGHNESSY

Move to lift credit rating agencies from D to AAA

THIS week the crunch finally came for credit rating agencies — those indispensable yet fallible institutions pilloried worldwide for their role in the subprime crisis.

The European Union revealed a long list of new rules for them, claiming agencies had led a "charmed existence".

In the US, a billionaire hedge fund manager rejected criticism of his own corner of the financial universe, telling a House oversight committee that credit rating agencies were the culprits in the global financial crisis. They are the ones, he said, who allowed "sows' ears to be sold as silk purses".

And, in Australia, Corporate Law Minister Nick Sherry released a report on the agencies (and research houses) prepared by Treasury and the Australian Securities and Investments Commission. He said that — based on the findings — he would end the licensing "relief" enjoyed by the agencies.

Yes, it has been an especially challenging week for rating agencies, whose businesses rely on credibility and reputation. And it will probably get worse over the weekend, with their role a likely topic at the G20 leaders summit in Washington.

Why all this criticism and why now? The timing, in the EU's case at least, may have to do with that very meeting. Europe, like Australia, wants to be seen as a leader in fixing problems exposed by the crisis.

Under European proposals, agencies must use a different rating category for complex "structured" instruments, explain what lies behind their ratings and adhere to strict, new registration requirements.

EU internal market commissioner Charlie McCreevy called for the world to follow Europe's lead.

Just a few hours later, Senator Sherry expressed a similar hope but with Europe substituted for Australia. Australia's "new" supervisory regime would be taken to the G20, he said, and used to take a "global leadership position".

Australia's report was always due this month but releasing it as the Prime Minister flew to Washington aids Kevin Rudd's attempts to paint Australia as a global regulatory leader.

Yes, everyone wants to be seen to be cracking down on the rating agencies that, while not entirely to blame for the subprime mess, were a key factor.

How so? The credit ratings issued by the agencies are based on the risk that an entity — a bond or security — will default on its debt obligations. AAA is low risk, BB a greater risk.

It is clear that, despite awarding investment-grade ratings to complex instruments such as collateralised debt obligations (CDOs) and credit default swaps, the agencies failed to detect and warn of problems in these investments.

Worse than that: they facilitated the sale and spread of those instruments. As the ASIC/Treasury report noted, the instruments' complexity only increased investors' reliance on credit rating agencies. A council in NSW had no hope of understanding a synthetic CDO but it could surely understand a triple-A rating.

Meanwhile, agencies allowed internal conflicts of interest to grow. Their business involves companies paying the agencies for "independent" ratings — a model that has inherent conflicts that must be rigorously managed.

For instance, the analyst who crunches numbers must be cloistered from clients and fee discussions. Rating changes must be properly explained and ratings, once issued, monitored to ensure their accuracy. As a US Securities and Exchange Commission report highlighted in July, agencies substantially failed in all these areas.

The joint ASIC/Treasury report points out that, if required to hold an Australian Financial Services Licence, the agencies must have arrangements to "avoid, control and manage" conflicts of interest, and ensure they have "adequate" levels of trained staff, resources and risk management systems.

This is why Senator Sherry will require agencies in Australia to be licensed. He will also require them to issue annual reports showing they comply with a new code of conduct set out by the International Organisation of Securities Commissions (IOSCO), which has looked at the issues surrounding credit rating agencies in detail.

This is an acknowledgment of the global nature of the operations — and the failures — of the agencies. The three big agencies in Australia — Standard and Poor's, Moody's and Fitch, dominate all over the world — and all over the world there are ideas on how to reform them.

Part of the problem lies outside the agencies. As the ASIC/Treasury report notes, investors erred in trusting ratings too much. Credit ratings, after all, are not investment advice. "Institutional investors have relied too heavily on credit ratings in their investment guidelines and choices," the report says. "Examples include substituting ratings for independent risk assessment and due diligence, and relying exclusively on ratings for valuation."

The agencies pledge cooperation. "Strengthened market confidence in the opinions of rating agencies is an important aspect of working through these challenging times," Fitch said this week. Moody's wants to provide "as much transparency as possible". Standard and Poor's managing director for Australia, John Bailey, called for "internationally consistent regulation".

Getting that right will be crucial, because the agencies are essential. If investors can't trust ratings, they are less likely to invest. Reforming the agencies, then letting them go about their business, is an important step to get the world working again.

Hardie ex-CFO denies deceit

By ELISABETH SEXTON

THE first defendant to take the stand in the corporate regulator's case against James Hardie has finished his evidence after agreeing that an "honest" presentation to the board would have included details of reservations by outside experts about calculations on the amount of money a new asbestos compensation trust needed.

The board approved the trust in 2001.

In his four days in the witness box, James Hardie's former chief financial officer, Phillip Morley, denied that he misled the company's directors and the public about expert reviews of his calculations, and denied that he tailored his funding projections to suit James Hardie.

The Australian Securities and Investments Commission is suing 10 former executives and directors, claiming they breached their duties to James Hardie by misleading the public about the adequacy of the trust's funds.

Much of Mr Morley's cross-examination related to a cash-flow model he presented to the directors at a February 2001 meeting when they approved the establishment of the trust.

Mr Morley said he relied on James Hardie's financial controller, Stephen Harman, to liaise with accounting firm PricewaterhouseCoopers and consultants Access Economics about independent verification of the model.

Mr Harman had told him the two firms had reviewed the "logical soundness and technical correctness" of the model, and Mr Morley had not read the reports from PwC and Access confirming this.

Under cross-examination by Tom Bathurst, QC, for former directors Michael Brown, Michael Gillfillan, Meredith Hellicar and Martin Koffel, Mr Morley agreed that PwC had expressed concerns about the limitations in its brief.

"Had you known about them, an honest presentation would have required you to disclose them to the board?" Mr Bathurst asked.

"Had I known about it, yes," Mr Morley replied.

Mr Morley agreed that the reviews were limited to checking the "arithmetic" within the model and ensuring it had no "bugs" that would affect its calculations.

He denied that failing to point out the limitations amounted to misleading the directors because he had told them the two firms had checked the "technical correctness and logical soundness" of his model.

When Mr Bathurst asked whether the limited review was a waste of time, Mr Morley replied: "It was a request from the public relations people."

Mr Bathurst asked: "The statement that it had been reviewed or checked without stating that the checking was limited to arithmetic or bugs would be quite misleading, wouldn't it?"

"Well I didn't know what they were going to finally put in the press release," Mr Morley replied.

The case is continuing.

New deal: Wesfarmers hopes to placate shareholders by reducing the complexity of its incentive pay scheme.

Wesfarmers to sidestep revolt on incentive pay

By ARI SHARP
RETAIL REPORTER

THE new head of Wesfarmers' remuneration committee has refused to commit to heeding shareholders' rejection of the company's incentive pay scheme, but aims to reduce the program's complexity.

At the annual meeting on Thursday, 50.3% of shareholders voted against the company's remuneration report, which had come under fire for the lack of transparency in determining the pay of chief executive Richard Goyder.

Mr Goyder's pay includes a long-term incentive that depends on his achieving a five-year target for return on equity. But the company has refused to reveal what the return on equity hurdles are due to commercial sensitivity.

Bob Every, the new chairman of the company's remuneration committee, said yesterday the non-binding vote from shareholders was "obviously a message the board and I need to take seriously".

But Mr Every said he was "not committing either the committee or the board to major changes at this stage until we've had time to properly consider the issues raised".

The new pay structure followed a review carried out in the wake of the company's acquisition of Coles Group last November. Mr Every said the transition from the old to new incentive structures was complex but necessary.

"My first priority will be to reduce its complexity so people understand more clearly what we're trying to achieve, and how we're going about it," he said.

At the meeting, outgoing chairman Trevor Eastwood lashed out at proxy advisory firms such as RiskMetrics that had recommended shareholders reject the remuneration report.

"I am not sure that the regulators, in introducing a shareholders' vote on remuneration, intended that so few people, who may not even be shareholders, should have such power," he said.

Under the pay scheme, Mr Goyder received a base salary of $3.15 million, up to $3.78 million in short-term incentives and potentially hundreds of thousands of shares as part of the long-term incentive.

Wesfarmers shares fell 26¢ to $17.80.

Centro suit judge stands down

By ELI GREENBLAT
PROPERTY EDITOR

FEDERAL Court judge Ray Finkelstein has recused himself from hearing three shareholder class actions against the embattled Centro group of properties, after he disclosed a self-managed superannuation fund he is linked to lost more than $19,000 in Centro stock.

His resolution to stand down from judging the potentially billion-dollar lawsuit against Centro, which is still in its early stages, could delay the complex trial even further and push its conclusion well into next year and possibly 2010.

Justice Finkelstein said in the Federal Court yesterday that motions for his recusal were brought on the basis of the ownership by Motown Investments, the trustee of a self-managed superannuation fund of which he is a member, of shares in Centro Properties.

Also, the trustee was a member of the group on whose behalf one class-action is brought. Justice Finkelstein said on August 8, 2007, Motown bought 2400 shares in Centro at a cost of $19,608. As at June 30, the value of those shares fell to about $600. That value has since fallen to $200.

He said Motown's stake in Centro was a very small percentage of the overall portfolio.

Justice Finkelstein said due to an administrative oversight it did not immediately come to his attention that Motown held Centro shares.

Share fund makes regular payout

INVESTMENT managers are braving volatile equity markets to seed funds as they try to attract an ageing population.

Suncorp/Tyndall has released a share income fund for retirees who want long-term income streams.

Investors in the Tyndall Australian Share Income Fund will receive the dividend yield of the S&P/ASX 200 Accumulation Index, plus 2%, over rolling five-year periods.

The fund's managing director Brett Himbury said it reflected Australia's demographic shift.

Retirees typically favour funds with regular income because they no longer have the security of a salary.

Mr Himbury said that although equity markets were difficult, dividend income streams were strong.

Suncorp/Tyndall's task was to choose investments where dividends were maintained despite the declining economic environment, he said.

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