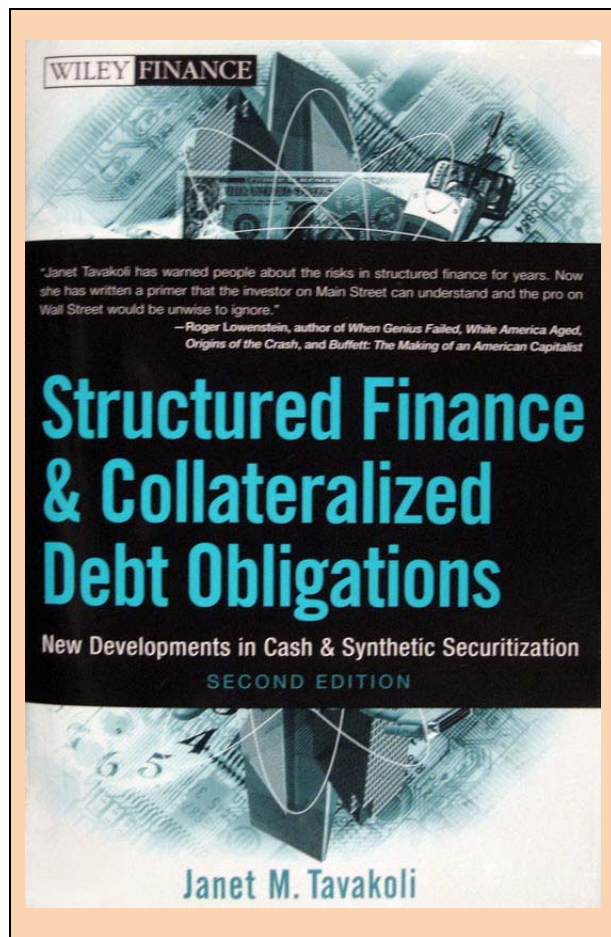


FEATURE ARTICLE I



DERIVATIVES DETOX[®]

BY KATHY GRAHAM

ABSTRACT

Janet Tavakoli was one of the first and few voices speaking up about the risks of structured finance, including derivatives. The 2003 first edition of this book was a beacon warning of the dangers that this product line would play in creating the current global financial crisis. Her new book, *Structured Finance & Collateralized Debt Obligations: New Developments in Cash and Synthetic Securitization, Second Edition* (Wiley, 2008), provides a clear understanding of these products including their proper structures and valuations. This book is a great desktop reference, a fascinating chronological story, a marvelous unveiling of the quagmires to avoid, and a balanced commentary on the major relevant issues encompassing these instruments.

DESKTOP REFERENCE

The scope of products under the generic umbrella of “structured finance” is huge and still growing. For anyone that encounters these instruments as an investor, banker, financial services provider, money manager, or even a reader of the daily news, Tavakoli’s book offers thorough explanations of all of the following products, their definition and uses, pros and cons, and any moral hazards, topped with good advice:

“If you don’t understand what is going on with your cash flows, you are in serious trouble.”
 - Janet Tavakoli on CDO equity structures

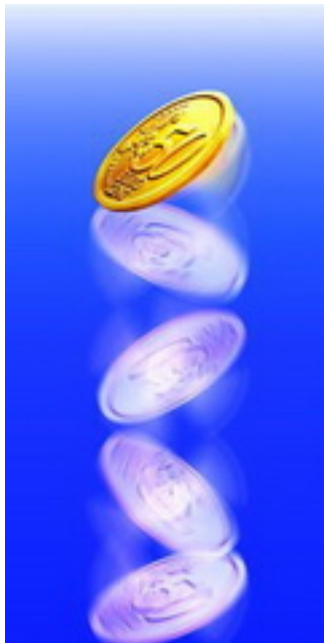
- Collateralized debt obligation (CDO)
 - Collateralized fund obligation (CFO)
 - Collateralized mortgage obligation (CMO)
 - Asset-backed securities (ABSs)
 - Residential mortgage-backed securities (RMBS)
 - Commercial mortgage-backed securities (CMBS)
 - Mortgage-backed CDO
 - Credit derivative, Credit default swap
 - Total return swap aka Total rate of return swap
 - Special purpose entities (SPEs) aka Special purpose vehicle (SPV) aka Special purpose corporation (SPC) with/without capitives
 - Master trusts, Owner trusts, Grantor trusts
 - Real estate mortgage investment conduits (REMICs)
 - Financial asset securitization investment trusts (FASITs)
 - Multiseller conduits, Single-seller conduits
 - Certain domestically domiciled corporations
 - Convertible bonds and asset swaps
 - Marquee deals
 - Credit enhancement
 - Monoline and multiline insurance
- ...and that’s just the first six chapters.

“*Super Senior Sophistry*” is a chapter describing how the “Frankensteins of Wall Street,” as *The Economist* dubbed them, created the super senior tranches that are a key driver of a synthetic CDO arbitrage. Others, including *The Economist*, have wondered how such sophisticated financiers thought that they were holding onto to the safest slices of CDOs by keeping the super seniors for themselves. Tavakoli explains their rationale and then hits the reader with two even more shocking facts: rating agencies don’t rate supers and there’s “no market standard definition of super senior risk” nor is there a standard means of pricing super senior risk.

THE CHRONOLOGICAL CHAIN

Structured Finance & Collateralized Debt Obligations is filled with stories such as the senior super situation. As a historical account of the development of structured finance products, her narrative is entertaining while being extremely informative.

One tale explains the unusually large number of financial geniuses present in the modern world using probabilities of a coin toss. Tavakoli states, "If you have 64 people in a room, each tossing a coin, ...the law of probabilities being what it is, *one* person will flip heads *six* times in a row. This person will be dubbed a genius. What genius? What cockamamie twaddle! The next thing you know, another firm has signed the lucky person to a two-year contract at a minimum of \$1 million per year."



The Vatican, money laundering, the major investment banks, hedge funds—all play their parts as Tavakoli weaves through the history of structured finance from its roots to now.

Her description of the current great unravel is illuminating. After detailing the subprime mortgage scenario play by play, Tavakoli mentions that though many of the predatory lending practices that contributed to the subprime problem are not illegal, they do employ "truthiness in lending", which is a term that *Comedy Central's* Stephen Colbert defines as "what you want the facts to be, as opposed to what the facts are; what feels like the right answer as opposed to what reality will support." She concludes by saying, "...if one defines a classic Ponzi scheme as using money from new investors to pay obligations to existing investors,

the lending relationship between investment banks and failing mortgage lenders has devolved into just that. In fact, it had devolved into the largest Ponzi scheme in the history of the capital markets."

From remarks such as these, some might be thinking that Tavakoli is perhaps not understanding the nuances of these products or situations because she is not qualified or perhaps she is just a cynic, seeing negatives where none exist. Those individuals would be wrong on both accounts.



JANET M. TAVAKOLI

Tavakoli has her MBA in Finance from the University of Chicago's Graduate School of Business. She taught Derivatives there as an Adjunct Associate Professor of Finance for several years.

Her past work experience is equally illustrious, including stints as:

- Executive Director, Head of Financial Engineering, Global Financial Markets Division, Westdeutsche Landesbank, London
- Head, Market Risk Management, Capital Markets Group, Bank One, Chicago
- Head, Asset Swap Trading Desk, Merrill Lynch, NYC
- Head, Mortgage Backed Securities Marketing to Japanese clients, PaineWebber, NYC
- Head, Quantitative Research Marketing, Bear Stearns.

Additionally she's provided expert reports on many major litigations involving financial institutions to the tune of over \$1.2 billion in consolidated litigation total claims.

Tavakoli answers the second concern of some herself, "Despite the caveats, I'm an enthusiastic proponent of structured financial products and welcome the growth of new products in the market." As for the future, she's unclear what its composition will be, but does note that "what is needed is effective regulation. Until that occurs, investors will have to fend for themselves."



QUAGMIRES

Ineffective Guardians: According to Tavakoli, senior management, the regulators, Basel II, and the rating agencies have all contributed to the abuse of these new structured finance products.

Because of “poor understanding of the basic mechanics” of these products combined with market pressures to rapidly grow departments to satisfy client needs, management often has a difficult time assessing what the dynamics behind their group making or losing money truly is. Adding to the fog, investors don’t have the ability to check the accuracy of performance reports given to them by managers, who are paid their bonuses based upon that performance.

As for regulators, Tavakoli wonders why the SEC, the Fed, and others were so missing in action when they should have been questioning a number of glaring oddities that were pointed out by concerned professionals from the beginning. She says that “Basel II is part of a series of failure by various financial regulators” because it “has been ineffective in heading off problems such as the global securitization crisis due to securitizing risky product that was improperly rated.”

Tavakoli’s critique of the rating agencies responsible for improperly rating those products is comprehensive. In fact, it’s well worth buying this book if you are an investor just to understand how thoroughly rating agencies were and appear still to be bungling the basics.

Her critique offers ways that investors can protect themselves until effective regulation surfaces.

Fraud: One of the reasons Tavakoli mentions effective regulation as necessary is because it helps break the fraud triangle, which is need, opportunity, and the ability to rationalize one’s behavior. Her approach is common sense based: financial systems need to be systems that people can trust to manage their money wisely but, on the other hand, there are and probably will always be people who try to help themselves to more of other people’s money than is due them. Given the complexities of modern finance and how smart financiers are, effective regulation to decrease opportunity combined with vigilance by all parties is required to keep the system trustworthy.

Gray-area Opportunities: Another area that Tavakoli tackles are those gray-area opportunities, the ones that sometimes are legal and sometimes—and in other places—are illegal. Acknowledging that ethics are a slippery slope because they’re impacted by location and era, she still strives to point out where they occur, even when only ignorance—not intent—causes the possible opportunity to defraud.

BALANCED COMMENTARY

Even though *Structured Finance & Collateralized Debt Obligations* is a valuable purchase solely because it provides all of the aforementioned attributes, there is yet one more reason to read this book. Tavakoli’s commentary on various money management related topics is extremely insightful because it’s presented in an easy to comprehend manner by someone who understands human nature and complex financial matters.

The limitations and uses of models are one such topic covered. “The irony of the complex CDO market is that the basic principles of sound finance are often violated in ways that models cannot capture,” states Tavakoli. Throughout the book, she constantly explains how the models miss the pertinent facts and what can be done instead to capture the true dynamics of these products.

Portfolio diversification myths and many other subjects are also analyzed, so many that *HQ Financial Views* has assembled a panel of financial experts (their bios and commentary topics are on next page) to share their insights—and hear yours—on this book at their blog, www.hqsearch.com/blog. See you there!

Read the insights of three experienced finance professionals commenting on Janet Tavakoli's book *Structured Finance & Collateralized Debt Obligations* at <http://www.hqsearch.com/blog...> then join in to share your thoughts.

BLOG STAR
PEG SWANTON
Fraud: Is it or Isn't It?

Margaret M. (Peg) Swanton is the president and owner of Tactics, Inc.—a management consulting firm established in 1995. Peg, who has more than 25 years of professional experience, is a University of Chicago MBA and a CPA. She began her professional career by successfully implementing and operating an ERP system at a manufacturing firm. She observed that good information systems combined with good business processes made it possible to quickly identify and stop fraud, waste and errors in the normal course of business.



In the 1990's, she began working as a management consultant, found fraud on her first project and decided to focus on fighting fraud. Already a CPA, she became a Certified Fraud Examiner. Some of her projects still involve designing accounting and financial reporting systems; others are investigations of fraud allegations or business disputes.

Peg has excellent business analysis and reasoning skills, is able to rapidly identify critical business issues and determine how to resolve them whether the project is the design of a new accounting system or a fraud investigation. She and Tactics, Inc. have a solid history of successfully completed projects – on-time and on-budget. Peg can be reached at 312-987-1800.

Peg's blog concentrates on the fraud aspects of this current economic situation.

BLOG STAR
TIMUR GÖK
The Mother of All Derivatives

Timur Gök is on the faculty of the Department of Finance at Northern Illinois University where he teaches courses in corporate finance, international finance and business economics in the undergraduate, the MBA and the Executive MBA programs. Before joining NIU, he was Director, Domestic Finance at Deere & Company. He began his professional career at the University of Florida, where he taught economics.



He is a former Fulbright Scholar and holds a M.A. degree in Economics from Washington University in St. Louis and an Advanced Professional Certificate in Finance from New York University. He is a member of the American Finance Association and Financial Executives International (FEI) and is the Regional Director of the Chicago Chapter of the Professional Risk Managers' International Association (PRMIA).

Timur has chosen as his blog topics the history of the “mother of all bombs,” the issue of regulation, bubbles, and bail outs.

BLOG STAR
LISA A. GARLING
Musings from a Corporate Banker...

Lisa A. Garling has 15 years of leveraged lending experience with a major international bank in Chicago. She has held senior roles there in credit risk assessment, cross functional team leadership, loan portfolio and relationship management. Her MBA is in Finance from the Kellstadt Graduate School of Business at DePaul University and her BA is in Economics from the University of Michigan. Garling is a member of the Turnaround Management Association and Chicago Financial Women.



Her blog musings focus on the impact past, present, and future that those sophisticated financiers that created the super seniors have had on the traditional banking industry.