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## Fallout From Telecom Losses Landed in Unexpected Places

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LONDON -- This past June, British private-equity firm **Candover Investments PLC** got some unwelcome news from its asset managers: It was a bondholder in WorldCom Inc., and those bonds probably soon would be worthless.

For senior executives at Candover, that came as a surprise. The firm's main business is buying companies, whipping them into shape and selling them at a profit. But Candover had invested some spare cash in a product known as a collateralized-debt obligation, or CDO, backed by dozens of junk bonds and borrowings, aiming to earn an attractive yield.

The CDO, created by a unit of British bank **Barclays PLC**, ran into trouble when WorldCom in June disclosed billions of dollars in fraudulent accounting. In September, Candover said it had written off its entire \$12 million investment in the CDO -- just about wiping out the pretax profit Candover reported for the first half of last year.

### DEBT DISCOVERIES

- [Accounting Rules Obscure Debt Losses](#)<sup>1</sup>

the past two years: Who has been left holding the huge losses caused by telecom-industry bankruptcies?

According to ratings firm Standard & Poor's, a record \$157.3 billion of debt defaulted globally during 2002, beating the previous high of \$117.4 billion in 2001. More than a third of last year's defaults came from telecom companies, with WorldCom and its subsidiaries responsible for more than \$30 billion on their own. Analysts estimate that global outstanding-telecom debt amounts to more than \$500 billion, of which around a quarter is considered high risk.

Candover's experience represents a small piece of a puzzle that has confounded analysts for

### FINDING THE LOSSES

- [Page One: Former WorldCom CEO Built An Empire on Mountain of Debt](#)<sup>3</sup>  
12/31/02
- [Heard on the Street: Backing Corporate Bonds Can Be Risky Business](#)<sup>4</sup>  
11/05/02
- [Heard on the Street: Some Holders of CDOs Post Losses, But Many Wonder Why More Don't](#)<sup>5</sup>  
05/14/02

### COMPANIES

Dow Jones, Reuters

#### Barclays PLC ADS (BCS)

PRICE	23.08
CHANGE	0.58
U.S. dollars	1/24

#### J.P. Morgan Chase & Co. (JPM)

PRICE	23.81
CHANGE	-1.32
U.S. dollars	1/24

#### Citigroup Inc. (C)

PRICE	35.79
CHANGE	-1.35
U.S. dollars	1/24

#### Bank of America Corp. (BAC)

PRICE	69.62
CHANGE	-1.98
U.S. dollars	1/24

#### Toronto-Dominion Bank (TD)

PRICE	21.90
CHANGE	-0.38
U.S. dollars	1/24

#### Deutsche Bank AG ADS (DB)

PRICE	42.20
CHANGE	-1.49
U.S. dollars	1/24

#### ABN Amro Holding N.V. ADS (ABN)

PRICE	15.26
CHANGE	-0.53

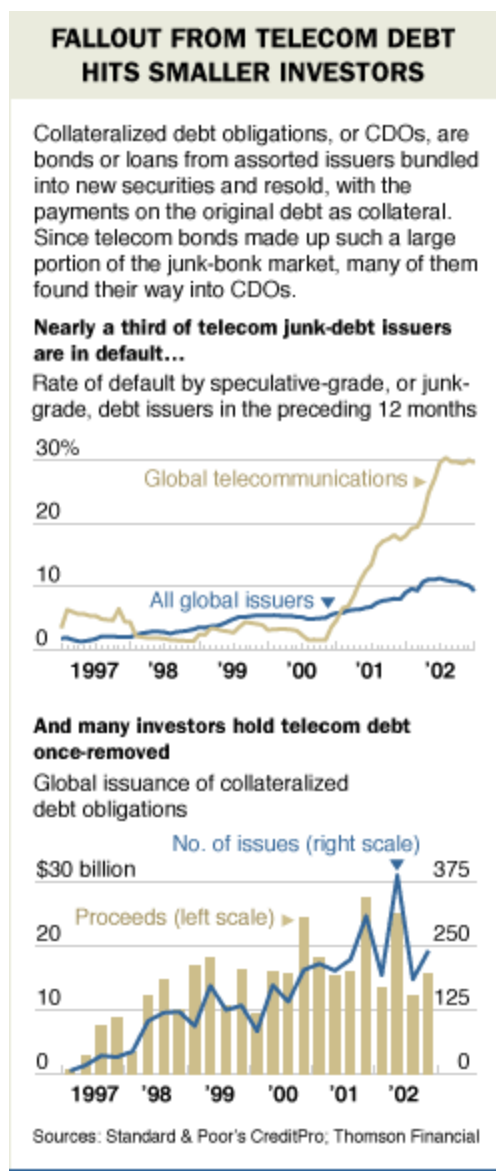
Some of that, of course, is held by banks and other lenders. In its third-quarter financial results, **J.P. Morgan Chase & Co.** reported total exposure to the telecom sector of \$8.83 billion, of which \$752 million was considered nonperforming, up from \$258 million a year earlier.

U.S. dollars 1/24

\* At Market Close

Others with significant exposure to the sector include **Citigroup Inc.** and **Bank of America Corp.**, **Toronto-Dominion Bank** of Canada and an array of European banks including **Deutsche Bank AG** and **ABN Amro Holding NV**. Countless others around the world are also suffering varying degrees of pain.

Banks, however, shielded themselves from much of the fallout by using highly engineered financial products to shift part of the risk to myriad other investors, many of which would previously not have had access to this market. Among the investors: insurance companies, pension funds, hedge funds and an assortment of other unlikely buyers such as Candover.



Increased scrutiny by regulators and investors could force some of these heretofore anonymous buyers to own up to their losses, though it could remain hard to identify holders of this toxic debt. Investors rarely disclose specific holdings and often bundle any gains or losses with those of other investments, and accounting standards provide latitude in how and when companies should write down soured holdings.

"The risk is out there somewhere," says Simon Harris, head of corporate banking at financial consultant Oliver Wyman in London. "It didn't all get buried in a mine in Azerbaijan."

Candover bought a \$12 million stake in Blue Eagle, a CDO created and managed by Barclays Asset Management, in December 2000. At the time, investing in CDOs was still a relatively new idea, though it already was becoming a big business. CDOs are created by securities and asset-management firms, which bundle dozens of bonds or loans representing different sectors into a single entity and issue new bonds backed by these securities. With telecom bonds representing such a large proportion of the overall market for high-yield debt, many CDOs have contained large amounts of them. While precise figures are hard to come by, at least \$400 billion of so-called collateralized debt obligations have been created since about 1996.

**'Equity' Tranche**

The CDOs usually are divided into several tranches with differing degrees of risk and interest-rate yields. The lowest tranche, also known as the "equity," offers the

highest potential returns but is the first to suffer losses if securities in the CDO portfolio default.

The theory is that many securities would need to default before losses reach investors in the top tranches.

Institutional investors see the products as a way to balance their portfolios with new types of risk, often yielding more than traditional securities with the same credit ratings. CDOs are among a range of credit derivatives that allow banks to offload some of their lending risk. Others include "credit-default swaps," which banks buy to insure themselves against defaults in their credit portfolios.

Candover's investment in Blue Eagle, which represented about 3% of its total net assets, was in the risky equity tranche. To minimize potential losses, Blue Eagle's managers at Barclays promised that if a particular bond or loan began to perform poorly, they would replace it with a different bond or loan.

But the managers also promised that telecom debt -- still considered attractive by many when the CDO was created -- would always constitute at least a fifth of Blue Eagle's portfolio. So the managers kept buying telecom debt even as other investors turned their backs on the sector. In one such purchase in May, Blue Eagle invested \$10 million in two WorldCom bonds, which the company had issued to refinance existing debt and battle declining revenue in its long-distance business; WorldCom filed for bankruptcy-court protection in July.

A person familiar with the situation says Candover's executives paid scant attention to what was going in and out of the CDO. A Candover spokesman declined to comment on the matter; most available details about the investment come from the Candover earnings news release disclosing the write-off.

Because WorldCom's collapse was so sudden, Barclays had little time to cut its exposure. This, along with a handful of other mostly telecom-related defaults, left a hole in Blue Eagle's portfolio and meant that any incoming revenue had to be diverted to the more highly rated slices of the CDO, leaving nothing for Candover and others with the equity piece.

Finally, with four defaults and another five bonds in Blue Eagle's portfolio looking shaky, Candover chose to write off its investment even though there is a chance that it could recoup some money in the future.

According to Fitch Ratings, some 70 CDOs around the world held about \$570 million in WorldCom debt as of June. Other CDOs are likely to come under pressure as telecom and other corporate-debt defaults filter through the market in the year ahead.

S&P's downgrades of CDOs more than tripled in the past year, and the rating agency remains cautious. "Although we may be past the most vicious stage of this cycle, we do not expect the gloom to lift much in 2003," says Barbara Ridpath, S&P's chief credit officer for Europe. "Companies in many sectors, including banks, insurers and utilities, are facing a very tough market -- and any external shock such as war with Iraq will only make it worse."

#### **More Risk**

In the U.S., CDOs pop up in the investment portfolios of many insurance companies, though for only 14 life insurers did they represent more than 1.5% of total investment holdings as of June 30, of which six had CDOs representing 4% or more of the total, according to data firm Capital

Access International.

Perhaps more worrisome, a growing number of insurers world-wide have taken on more risk by selling insurance to protect against others' losses on CDOs and other derivatives. In August, Financial Security Assurance Inc., a U.S.-based unit of Franco-Belgian bank **Dexia SA**, said it had paper losses of around \$51.5 million stemming from its exposure to seven CDOs. In Europe, France's biggest reinsurer, **Scor SA**, recently ceased underwriting credit derivatives after suffering losses that it estimates at around €130 million (\$137 million).

Meanwhile, the market for derivative products continues to expand. According to the British Bankers Association, the overall size of the global credit-derivatives market has grown to nearly \$2 trillion from \$180 billion in the past five years, and growth continues.

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