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Article: Bubble trouble [1]

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Last week, Standard & Poor's, the rating agency, was sued by the U.S. Department of Justice (USDoJ) in a Los Angeles federal court for ?knowingly and with intent to defraud, devis(ing), particpat(ing) in, and execut(ing) a scheme to defraud investors in (residential property securitisations) and CDOs, including federally insured financial institutions... and to obtain money from these investors by means of material false and fraudulent pretenses, representations, and promises and the concealment of material facts.?

Even to persons legally trained, this is weighty stuff. One of the most amusing ways I know to frighten an unschooled junior lawyer is to sit him or her down in front of a structure diagram of a securitisation, a jumbled mess of agreements, parties, cashflows, security arrangements, and hedging ? and then change slides to display a CDO, a securitisation of securitisations, a stacked jumble of jumbles. (Instant fun.) Despite the visuals, however, such transactions are conceptually very simple: one takes assets that throw off a steady stream of income (such as residential mortgages), models the cashflows arising from them, and creates debt instruments which match the payments from the assets with the payments on the notes. Those notes or bonds are then sold, with the seller recouping the capital value of the assets in the present in exchange for investors' acquiring the future flows of income.

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