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The YPFS Lessons Learned Oral History Project

A Special Project: *Inside the CDO Machine*

Rosalind Z. Wiggins* and Andrew Metrick†

In this issue of the *Journal of Financial Crisis*, we feature *Inside the CDO Machine*—a special undertaking recently completed under the auspices of the Yale Program on Financial Stability Lessons Learned Oral History Project by Steven H. Kasoff, a Yale School of Management Fellow and former equity partner and head of real estate and structured products investments at the Elliott Management Corp., a global hedge fund. For the project, Kasoff undertook a series of interviews with industry professionals to focus on one of the critical derivatives products of the Global Financial Crisis (GFC), collateralized debt obligations (CDOs), and how they became so important to the events of the crisis.

As the *Inside the CDO Machine* project materials evidence, in the decade prior to the crisis, new complex products, including CDOs, were developed that took advantage of the mortgage boom and responded to the great investor demand for high-yield securities. "ABS CDOs became the main investment vehicle for the riskiest investment-grade securities in the private-label mortgage market."[1]

In its final report on the causes of the GFC, the Financial Crisis Inquiry Commission (FCIC) found, among other things, that CDOs "turned out to be some of the most toxic assets during the crisis"[2] and were key elements in spreading risk throughout the financial system and in accelerating the crisis.[3]

> These CDOs—composed of the riskier tranches—fueled demand for nonprime mortgage securitization and contributed to the housing bubble . . . Many of these risky

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1 See Greg Feldberg, Larry Cordell, and Danielle Sass, "The Role of ABS CDOs in the Financial Crisis," *Journal of Structured Finance* 25, no. 2 (Summer 2019): 10–27 [URL: https://papers.ssrn.com/abstract=3443043].

2 Financial Crisis Inquiry Commission (FCIC). Website: Resource Library: CDO Library. http://fcic.som.yale.edu/resource/staff-data-projects/cdo-Library.

3 FCIC, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (Washington, DC: US Government Printing Office, 2011); see "Chapter 8: The CDO Machine" (127–55) and "Conclusions of the Financial Crisis Inquiry Commission" (*xv*–*xxviii*).

assets ended up on the balance sheets of systemically important institutions and contributed to their failure or near failure in the financial crisis.[4]

Scholars estimate that during the GFC, "write-downs on ABS CDOs [totaled] $410 billion . . . with $325 billion assumed by AAA and 'super-senior' securities, which had minimal capital, margin, or liquidity requirements."[5] Under then-existing regulations, some firms investing in these securities were permitted to take on excessive leverage, "imperiling their solvency and placing them at the center of the financial crisis."[6]

As a former peer, Kasoff had unique access to the *Inside the CDO Machine* project participants; could garner their confidence; and understood their language, nuances, and anecdotes. This entrée allowed Kasoff, along with Matt Lieber, one of our Lessons Learned interviewers, to question at length six individuals in key roles in the CDO business as it evolved, exploring developments from inside the industry. In addition, Kasoff contributed his own extensive interview.

Drawing upon his own experiences and these interviews, Kasoff has written a monograph, "Anatomy of a Trade: The Making of a Subprime CDO," a detailed and insightful parable that illustrates the insiders' points of view—the motives, structural maneuvering, and evolution of this pivotal market. The form also makes the complicated topic accessible for most readers and highlights the usefulness of the interviews as source material. This main work includes a glossary of key terms and is accompanied by a companion piece, "Wall Street's Subprime Debacle: Firsthand Accounts from *Inside the CDO Machine*," which provides details about the project and participants:

Inside the CDO Machine

- *Wall Street's Subprime Debacle: Firsthand Accounts from Inside the CDO Machine*—
  by Matthew A. Lieber and Steven H. Kasoff
- *Anatomy of a Trade: The Making of a Subprime CDO*
  by Steven H. Kasoff
- Lessons Learned Interview Summaries
  - Steven H. Kasoff
  - James Finkel
  - Sohail Khan
  - Stephen King
  - Eric Kolchinsky
  - Chris Ricciardi
  - Brian Stoker

[4] FCIC 2011, 155.

[5] Cordell, Feldberg, and Sass 2019, 10.

[6] Cordell, Feldberg, and Sass 2019, 10.

The full-length *Inside the CDO Machine* project interviews are available on the Lessons Learned website. We urge you to explore them for their rich insights. Also available on the website are dozens of other Lessons Learned interviews.

The Lessons Learned Oral History Project grew out of the Yale Program on Financial Stability (YPFS), which began in 2013 with the mission to preserve, create, and share knowledge about financial crises and how regulators and policymakers prevent, diagnose, and combat these rare and unprecedented events. You may learn more about YPFS from our program website, and you may access our published cases in the Journal of Financial Crises.