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YPFS Lessons Learned Oral History Project: An Interview with James K. Finkel

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Program on Financial Stability

Lessons Learned Oral History Project Interview

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Introduction

The Yale Program on Financial Stability (YPFS) contacted James Finkel by email to request an interview regarding Finkel's time as CEO of Dynamic Credit Partners, a structured credit asset management firm that he co-founded in 2003.[2] Finkel has extensive experience in structuring fixed-income securities, initially as a lawyer and mainly as a transaction manager for investment banks. He began his career in 1986 as a securities lawyer for Cadwalader. In 1992 he began his banking career as a mortgage-backed specialist for Nomura Securities, followed by stints at Myerberg & Company and Bear, Stearns. With Bear Stearns he began a five-year stint in London, split between Bear Stearns emerging market and high-yield bonds and then as head of the CLO group at Deutsche Bank. In 2003 he co-founded Dynamic Credit Partners in New York. Since 2010, he has been a Managing Director at Duff and Phelps, where his responsibilities have included dispute practices, expert testimony, regulatory and transactional advisory and liquidations. Finkel holds degrees from Colorado College (BA), the London School of Economics, University of Miami (JD) and New York University (LLM) in taxation.

This transcript of a telephone interview has been edited for accuracy and clarity.

Transcript: YPFS (Matt Lieber): Please tell us how you came to be with Duff & Phelps, how you came through as a lawyer working early in securitizations for a decade before creating the CDO management firm. So, if you could give us just a short background there.

[1] The opinions expressed during this interview are those of Mr. Finkel, and not those any of the institutions for which the interview subject is affiliated.
[2] A stylized summary of the key observations and insights gleamed from this interview with Mr. Finkel is available in the Yale Program on Financial Stability's *Journal of Financial Crises*.

Finkel: Sure. Well, it is my pleasure, Matt and Steve, thank you for inviting me to this. It is interesting, as a law student, and I was interested in tax law, I was a little bit of a frustrated, perhaps a frustrated wannabe economist. And when I got to my first law firm, it was very old-school law firm, where you actually rotated around the firm for a year. And my elective rotation was in the tax group. And I met a partner who just I knew would be a great mentor. And he happened to be the head of the firm's practice for securitized products on the tax side. So, it wasn't really by choice, it was more by choosing a mentor. And it just happened to be his specialization.

So as a very young lawyer, 26-27 years old, I was exposed to most of all the major Wall Street banks who were our clients putting these early stage mortgage-backed securities deals together. And I had to understand at a basic level, the cash flows, and actually do some calculations that were relevant for tax disclosure. And I was fascinated by it. And it caused me to actually operate some rudimentary spreadsheets, and I quickly became kind of the go-to person for the young structurers. They found me somewhat more accessible and maybe more responsive than the partner for day-to-day matters, and we were the same age group. And I developed strong professional and, in some cases, personal relationships with these people.

After six years, and kind of bobbing and weaving through a couple other interesting areas of international tax, and some white-collar money laundering and tax evasion cases, I thought I was really ready to get into business. I realized that my destiny in life was not to become a partner at a law firm, at least in the tax group, so I started speaking to my clients. And a few of them responded very quickly and got me interviews, but I just did not have a great story yet. But one of them really had a need, and I had done some other work for some of the people there. And also, I had some personal relationships with a few other people there.

Basically what I became at that broker-dealer was a transaction manager, because what I found was- as you appreciate- these securitization transactions have a lot of moving parts between the rating agencies, the trustees, the accountants, the lawyers, and then inside the bank (the structurers, the traders, the salesforce). Part of putting one of those transactions together is keeping all those moving parts synchronized. I was pretty organized and a pretty good communicator. I was able to handle various different types of work as well. And I was really learning the ropes all the way through, as we were doing everything from providing financing to mortgage originators, creating warehouse facilities for their own lending activities, but also acquiring distressed portfolios of mortgages and restructuring them both on the residential and commercial side, and placing the loan pools we financed through to private label RMBS and agency CMOs. I was working on all that I as a go- to guy for three different trading desks, as kind of the transaction manager and banker.

I had a great time and I learned a lot on the job. I still did not really know bond math and concepts like credit spreads. So, I tried to study that a little bit on the side. I mean, can you imagine going to a trading floor when I didn't even really understand what duration was until I got a couple months into it. But it was a great opportunity to grow (and again, I had some great mentors who helped me navigate),but unfortunately, I was in an investment bank that decided to completely commit to commercial mortgage-backed securities, and I ended up on the residential side. Ultimately, in 1994 when interest rates spiked a lot of the trading desks got chopped.

I was then able to leapfrog through two other investment banks, learning as I grew, getting involved with different types of securitized products involving: perpetual bank debt, emerging market debt, and ultimately high yield. I had five years in London, starting with Bear Stearns, and then Deutsche Bank, which were great experiences, and that led me into my early 40s to the realization that I should try- with that distressed market (experience) that I now had seen on more than one occasion (1994, then the Russian bond defaults in 1998 and the tech bubble in 2001/2002), to take a stab at being on the buy side. I formed Dynamic Credit, grew to five billion under management with 10 CDOs and two credit opportunities funds just over three and a half years. Then the 2007/2008 financial crisis came and we converted to a consulting business doing risk metrics, valuation and expert witnessing, which dovetailed into my career at Duff & Phelps, where I've predominantly been an expert witness in financial crisis-related litigation.

YPFS (ML): OK, I want to ask you, Jim, based on about the CDO management firm you created at Dynamic, if you could clarify, in simple terms, what a CDO manager is. You just said on the buy side, but the CDO manager is really in the middle. So, what was it about securitized CDOs that created this need for CDO manager?

Finkel: Well, I am not sure I agree with you that the CDO manager is in the middle between the buy side and sell side. My view is that the CDO manager is purely on the buy side. Yes, it is involved with the origination of the fund and indeed in a kind of interactive role with the investment banks. But at the end of the day, it's the CDO manager who generally, is tasked with making the investment decisions, what collateral, not only what specific collateral to buy for the CDO, but what are supposed to be the portfolio guidelines for the collateral in total. I suppose, I mean, when other fund managers, when they're forming new funds, whether it's mutual funds or SPACs or whatever, they're interacting with Wall Street as well, but I think, assuming there's a pretty clear line, I know that line got blurred, to some extent in the CDO process, but my own feeling was that we were squarely on the buy side.

YPFS (SK): Clearly it was attractive to be in the business of managing ABS CDOs, judging by the number of people that got in that business in a relatively short period of time and the popularity of the product pre-crisis. Can you briefly describe the economics of, not just the CDO itself, but of the firm, just with rough numbers for a hypothetical firm or for your firm?

Finkel: Sure. We were generating about 20 basis points per running fees on our five billion under management. So about 10 million a year of gross revenue. There were other little bits and pieces, sometimes you could get a little bit of a structuring fee paid up front, but the general fee was almost entirely the running fee, the running senior and junior management fee. And of course, I guess if the long-term performance all worked out, an incentive fee. We chose to stay in the kind of high-grade ABS CDOs, which were very large size transactions, at least a billion dollars, we even did one that was 1.75 billion. So those, on average were more like 10 basis points fees and that kind of counterbalanced with some of the smaller CDO-squareds we did, which were several 100 million in size, and those would pay maybe be 40 or 50 basis points of annual fees. And, that we did run some opportunity funds on the side and, of course, we were making more hedge fund type fees on those, so there is a few million dollars there if those performed well. One of the things that I was very conscious of was: we put some of our own CDO investments into our credit opportunities funds, so we didn't 'double dip' on fees: we waived the fees in our hedge fund, because we were already deriving fees off those CDOs, from the CDOs themselves.

So, I would say at our peak, we were maybe getting close to 12 and a half to 14 million a year, and our margins were relatively good. I think our margins were about 40%, we took our profits and invested them in our own CDO equity, and in our credit opportunities fund. So, my partner and I took out very, very little... I went two and a half years without a paycheck, as did my partner, I maxed out at a $400,000 a year salary, and just plowed everything back into an investment war chest to be able to be aligned with our investors and our deals.

YPFS (ML): Is that standard practice of the CDO managers to have their fund - to invest their profits in their funds?

Finkel: Yeah, most managers make principal investments in their own funds- they have skin in the game. I think we probably went further than most, with how much of our profits we committed to skin in the game versus taking some home. We ended up losing about $7milllion of our own money as our CDO junior tranches evaporated, although we worked out our opportunities fund pretty well with only about a 30% loss of capital.

YPFS (SK): About the profit margins of the business, to reflect on the kind of scale factors for this type of business, can you talk about how many investment professionals you had? And if the financial crisis hadn't happened, and you were able to continue growing from five to 10 to 15 to 20 billion AUM, what would that have meant for needing or not needing to add incremental staff or other resources or expenses?

Finkel: That's a good question. We top ticked at around 32 employees. And my overhead was about eight or eight and a half million from my recollection. And the firm took out limited partnership profits, mostly to cover the taxes on those profits. So, it left us with a couple million net of tax a year to invest in our CDOs. If we had been able to double or triple our AUM size, I think our marginal cost would have stayed about the same we wouldn't have had to go much more than our 30 staff(we might have gone up to 40 employees), so I'm guessing we would have gone to maybe 10 million of overhead. But we would have added on another five million of revenue, at least.

So, it would have been incrementally more profitable to keep growing. The other dilemma for us -- and perhaps in retrospect it wasn't the right thing-- I really thought our investors wanted to see that we were unilaterally focused on the underlying product that was behind our CDOs, which was mortgage-backed securities or mortgage-backed securities housed in other CDOs. So, we didn't, for example, quickly get into other credit- related businesses like CLO management, high yield management, or emerging markets, or anything else. I did make one attempt to acquire a CLO team, but I just did not want to do it kind of half-baked and we did not have the capital to acquire a premier team. I only wanted to do it with super high-quality experienced professionals. Having been a banker in that sector, I knew who the really good players were, and I did not want to dilute the quality of our firm. But I also did not want to dilute the perception of our focus.

YPFS (SK): Most independent ABS CDO managers, ones that were not part of a hedge fund or an insurance company were similar to you, and it was a single product line. Is it your view that they probably had a similar type of cost structure and profit margin?

Finkel: Yes. I would imagine they did.

YPFS (SK): What I want to get at is the underlying pressure: There seems to be a strong incentive with this business model to grow AUM and to do it at a reasonably fast pace. As somebody running the business and feeling the ups and downs of that operating leverage very directly, how did you perceive that sort of pressure?

Finkel: Yes. Yeah, it is interesting, Steve. I would answer that in a couple different ways. We felt that we were more discriminating in what types of CDOs we chose to do. And although we were growing pretty fast-- we got to five billion in 37 months-- we could have done twice as much as that. I had people telling me, "You're hurting your business by not doing twice as many transactions." We just were uncomfortable with having that much capital that we had to commit to the RMBS and CDO product that was coming to the market, and we wanted to be as discriminating as we could be. We were considered to be slower, more analytical, and somehow more discriminating than some of the other managers who were described by others as just "backing up the truck" (other managers who just bought almost whatever was coming through the market to meet the ramp-up pressures of their CDOs in formation). We were in a sector which was caught up in a frenzy, but we were trying to hold a line on the quality, seeking the highest level of quality in that sector. The $7 million of our profits we put into our own CDO equity we thought would pay off, ultimately. Those were supposed to have low double-digit returns. We thought even if they had single digit returns, that would be OK, as an investment for the principals of the firm.

Some of the other competitors of ours did not have credit opportunities funds or hedge funds. And that $95 million fund we had was spinning off a bit of income for us as well. So, we didn't have quite the pressure. But I would say for us, Steve, it was probably more philosophical. (For) my partner and I, making money for ourselves - I know this sounds maybe hard to believe - was not our highest priority. We thought that if we built a quality operation, it would grow, and it would become successful. And to tell you the truth, we paid a lot of money away to our employees. Every year, I paid bonuses out, I would always say to myself, "We're doing really well-- we must be doing really, really well because I can afford to pay this much money out to all these employees." Even if I was not putting much in my own personal pocket. So, I think we might have been a little different than others. But I do believe that pressure to generate fees, Steve, that you are talking about, was very high on other managers.

One person in the market said to me, "Jim, why aren't you doing 10 billion instead of five billion, because when it all falls apart, everybody's going to look the same and you might as well just swing for the fences now." And we just would not do that. And we almost canceled a CDO because we were being pressured to acquire collateral. We had a four- or five-months stalemate with one of the investment banks until we felt we were still exercising our own discretion. We were ready to walk away from a deal and give up the fees.

YPFS (SK): **Can we drill into that as an example? I am interested in hearing about the conflicts that existed in the process of putting together a deal. But before you get to that, could you back up and describe the process - how does a new deal come about? Who initiates it? Who are you talking to? What are the different action items that you are doing at each point in time?**

Finkel: It was interesting because by chance we were able to pull off very early in our existence our first CDO. which was backed by my partner's portfolio that he had amassed at another financial institution. So, we had a good selling point that he had selected the portfolio, he knew the portfolio, and we got the deal done. And breaking through the ice of being a first time CDO manager was huge. Nobody would really have listened to us had we not got that first deal done. But as soon as we got that deal done, we were now an "experienced CDO manager". We were experienced solely by validation that the market bought our deal. Not because we had a long track record of running CDOs. And the invitations and the interest started coming. It was kind of a two-way street. The dealers, as you know, saw a CDO as a vehicle to sell paper into. So, they were willing to promote a CDO and build a CDO that they thought would be a source of a placement of their product into.

Our situation was a little bit more unusual: I did have one or two core investors, who were able to give me commitments for equity capital. So, I could go the investment bank and say, "Look, I can commit X millions of dollars of the hardest to sell piece, the first loss piece." That would help kind of move me a bit more quickly to the head of the queue. I also knew that I needed to have a marketable team. So, I hired a senior statesman type in the mortgage-backed securities market, kind of a gray-haired person with 15-20 years of institutional buy-side experience. Because I knew that would be the kind of credibility that the institutional investors for CDO debt in particular, the mezzanine debt, and the senior debt- would want to see.

I knew how to profile the firm, to make it marketable and attractive to the dealers. We ultimately did a lot of our deals with the non-US investment banks as structurers/underwriters, the so-called Yankee banks. Groups like Dresdner Bank and Calyon, the French bank. They were willing to put large amounts of capital at risk for warehouses. They were taking down the super senior tranches. And because they were not producing as much mortgage-backed securities or other CDOs, there was a little bit less pressure from them in terms of the warehouse and accumulation process, which we'll get to, for us to buy their production. Because they were not as deep in the RMBS game as some of the core US based groups like UBS and Deutsche Bank and Merrill Lynch and Citi, Goldman, and Morgan Stanley.

So those foreign banks were a good place for us to go to differentiate ourselves and do deals in a slightly more conservative and more evenly paced manner. And the initiation of those transactions was partially helped by my personal experience having worked in Europe and London, so I was known a little bit to some of those desks. I had some relationships there, where knowing a senior person or two of these banks really helped get the approval for the transaction. That is kind of how it started, but there were other aspects to it, you had to decide what type of CDO you want to do, high grade or mezzanine. We were not comfortable with the mezzanine CDOs (holding largely BBB rated RMBS), largely because we thought there was too much ratings downgrade risk to the mezzanine tranches of those CDOs, and that would degrade the entire CDO. Obviously, we are very cognizant about our ability to manage the CDO, in part because we analyzed so many of them.

So, we wanted reasonable flexibility as much as possible within the constraints of the matrix of portfolio requirements driven by the rating agency and to some extent driven by the market. We felt that one of the things that gave us an edge is because we modeled CDOs ourselves and we knew how the moving parts worked of CDOs. We felt that we were in a better position to understand what type of capital structures and collateral constraints we were willing to get into, where we thought we'd have a little bit more latitude and there would be a little less pressure on the deals' performance if there were some choppy waters. Our approach was rolling up our sleeves a little bit more and taking a little bit more command and control of the structuring process to make sure we felt we really knew what we were getting into. Many of the other managers were not doing that. Many of the managers, I know as a fact from speaking to them at the time, were being led into transactions without really having the ability to understand how aggressively structured they were or how little flexibility they had in managing them going forward. So, in contrast to what we discussed at the outset, perhaps our level of involvement did blend into some of what was traditionally fund formation activity, but not all our competitors did that.

YPFS (SK): **It is a good segue to the issue raised a few minutes ago of feeling pressured to buy something out of a dealer's inventory that was doing the CDO for you. I gather that you did a better job at saying no to those situations than many others. Could you comment on what happened and also your perception of what other CDO managers were saying yes to - what was happening in the market?**

Finkel: Sure. I think it differed a little bit if you were doing an ABS CDO or CDO squared. CDO-squareds, obviously being largely populated by tranches of other CDOs, what the investment banks really wanted... There was less outright demand for those tranches, so they were looking for a place to put them. So, a CDO squared would clearly be more pressure from the investment bank for the manager to put that dealer's production into the CDO squared, as much as the investment manager would be willing to take from the dealer's offerings.

This involved the 'warehouse process' where the bank put its capital at risk carrying the CDO's underlying collateral, until the CDO was priced (sold). We started something that helped the dealers a little bit and created high yielding exposures for our credit opportunities fund. It became in late 2005 and into 2006 quite hard to find secondary market opportunities for structured product for credit opportunities funds which had the risk reward ratio that we were seeking, ones that met our yield target on a risk adjusted basis. One of the products I developed was a warehouse risk sharing product, where I was hearing from the dealers that their own risk managers were not letting them set up enough CDO warehouses because they had risk limits.

So I came up with a product that I was taking the first, say, 5%loss piece on the portfolios in CDOs the banks were developing and required to accumulate the underlying collateral in a 'warehouse' facility. And this was pretty novel at the time. A lot of people have done it since. But I think I was one of the first to develop this. We did about 25 of those transactions. So, we took some portfolio risk on our own CDOs through our hedge fund alongside a direct investment vehicle I had set up with one of my investors, and a small position in each at our own risk. Having that early stage first loss exposure as the CDO developed gave us a bit more leverage over the dealer to negotiate what would go into the warehouse, and ultimately the CDO itself.

But generally, as there was still significant dealers' capital at risk they would pretty much, through the warehouse approval process, influence what collateral positions you could put in the deal or whatnot. Just because you met the strict criteria of the CDO (i.e. you have the right interest rate, you have the right rating, the right diversity, you've ticked all the boxes of the complex collateral eligibility criteria of a CDO) doesn't mean that the dealer will just accept you putting it in the warehouse. They would say things like, "Well, we don't want to put it in the warehouse, when it comes from another dealer's desk, one of our competitors, because they structure that deal and we don't know their deals as well as we know our own deals. So, we would rather you put our deals in your portfolio. Because we have to manage that risk at the dealer level."

They would make arguments like that. They would say, "Look, you can go buy whatever you want, after the deal prices, you'll have your post-closing one third or one quarter of the portfolio remaining to ramp up." And they would kind of try to shoehorn you into buying their production now, giving you more liberty later. It got, sometimes, pretty contentious, at least in the CDO squareds with at least one dealer that we really were being pushed too hard. But after so many refusals to put items we saw from other dealers into the warehouse, we basically just put the deal on ice for a couple of months. And then sat down and had a real tete-a-tete about how to get the rest of the deal done, giving us some latitude to buy other people's deals, trying to counter some of the dealer's influence exerted in that regard. But I think a lot of other CDO investment managers could not stand up to it.

I think the other dilemma, Steve and Matt, was that, in the pure mortgage-backed securities offerings, a deal would be announced on a Wednesday afternoon and if you didn't have an order in by Friday morning, you wouldn't get an allocation. And with these $1 billion to $2 billion high grade ABS CDOs we had; we only had a couple months to put the money to work. So, you had to really kind of, as discriminating as you could try to be, you were buying the market a little bit. And in that regard, we at least put together a credit model, that we were able within 36 hours to get the dealer to stress test the portfolio and the tranche that we were buying., to see how sensitive it was to negative credit performance. (Even then, we were doing this on limited data which was not able to be independently verified). We would get the results back just in time to confirm our allocation (or not if we did not like the results). So, we would buy our RMBS tranches contingent on getting a positive outcome of those tests. But we were again quite unusual in that regard. Most people just did not have the time or the technology or the infrastructure to do that kind of analysis as the process was just flying. So, pressures were different. There was the volume and timing pressure on the RMBS sales to the CDOs. And then there was the dealer production and inventory pressure on the CDO tranches going into the CDO squareds.

YPFS (SK): And what about the marketing process? You spent a decent amount of time presenting to or meeting with prospective investors in the various tranches of your CDOs. What were your observations from that process?

Finkel: Very interesting. A lot of our investors were European investors, so I was doing some European roadshows, even though our deals were dollar denominated. And that was partially because we have the European banks, Calyon and Dresdner, and their sales forces. Buying a managed CDO for European investor looked like a safer bet than buying a straight RMBS. Most European investors did not feel that they had the expertise to decide whether they should buy a Countrywide deal or a New Century deal or some other straight RMBS tranche. But if they believed their manager was careful and diligent, they would place their trust in that manager and be happy to buy a tranche of their CDO. So, a lot of our marketing was in Europe.

There were some very sophisticated investors in Germany. Some of the large government institutions. We had a little bit of a tough go with one of them. To demonstrate our insight, I tried to explain to them my partner's model and how we would stress test things to see at discounted prices (for riskier investments in our credit opportunities fund)s, even if the position was explicitly rated BB, it would really re rate at a price of 50 cents on the dollar to a BBB or higher level for a return of that 50% price investment. And when I tried to explain that to one of these investors, they kind of concluded that we just completely believed in the rating agency process and did not do our own analysis. They completely misunderstood. It was almost that this was an investor looking to say, "Well, we turn somebody down, because we had to turn down a few managers, we couldn't just buy everybody's deals." So, I thought they had made a twisted interpretation of our investment process simply as an exercise to prove their ‘due diligence’.

We also had other marketing, difficulties - at the time, the dealers were trying to get some of the senior bonds insured by the monoline bond insurers. As much as we went through the process with those monoline bond insurers, they were unwilling to insure our deals because we didn't have enough track record as a manager, interestingly, as we were “too novel." But we ended up working with one who was kind of a lesser graded monoline bond insurer, not one of the major AAA ones. And in the marketing process Steve, every once a while we come across a very skeptical investor who would look at a high grade ABS CDO and say, "I don't understand how you can have a BBB tranche with only 2% subordination below it or 3% subordination below it." And it just seems like extreme leverage. And to us, it seemed like we were, through diversity and through the structure, we were actually insulating, rather than re levering. There were kind of two sides to the coin, and you would try to market based on the diversity and the quality of the portfolio.

But I think in retrospect those investors were partially right. I think what everybody was missing was the sensitivity of all these asset-backed CDOs to ratings downgrades being deemed defaults and the extreme downgrades that the rating agencies engaged in starting in late '07 and into '08, which made all these deals unwind.

But in the marketing process, we had a couple other challenges. We did not have an unlimited basket for equity (first loss tranche) money, I got one partner to commit equity money for me to get the investment bank to sign the deal. They would not sign the deal unless I could show an equity commitment. I ultimately went on the road and sold all the equity myself. And that initial commitment - I never had to draw on their capital, but I still ended up having to share some fees with them because they were there at the beginning and helped get my deal done. But that was a little bit of an unusual situation.

The mezzanine bonds were clearly more legwork in the roadshows. The senior bonds were often done with a smaller group of investors and largely more done kind of on conference calls. And the senior bond investors would have fairly strict criteria. But as you know, a lot of the senior bonds were just the junior AAA's, because the super senior tranche was being completely taken down by the investment bank. So, our own underwriter was our biggest investor by volume.

And this goes to the fee generation point you asked about earlier. The dealers made reasonably good fees arranging RMBS and CDOs, effectively marking up the product on the turn into a new securitization. But beyond that, the structurers and traders were able to convince their banks that they would have 'riskless arbitrage' by taking the super-senior tranche on balance sheet (and financing it at a much lower spread), and then purchasing AAA-rated bond insurance on the position. There would still be a net running 'positive carry' (I knew a salesman who gave his boat that name!) on, say, $900 million of a $1 billion deal. And some people were able to convince their banks that the present value of that future positive carry could be included in the current year's bonus pool!

Building those relationships (in Europe) and also in Asia – I did marketing trips to Asia, and Australia - some of those relationships really grew for us. And through one Asian investor, we ended up having a reverse inquiry to do two single tranche synthetic CDO squareds (which the investor wanted us to take more risk on than we were comfortable, so they could get a higher return for a given rating, so we had to also push back on the investors from time to time). Though actually the marketing process led to reverse inquiry, rather than pitching new deals directly. So, I would say we had investors in probably 15 different countries.

YPFS (ML): **What would you say, Jim, changed the European and the global ex-USA pension and a large-scale institutional investor mindset from what you described as investor trepidation to this really active interest?**

Finkel: Well, look, there was a definite need for yield. You were getting the widest possible spreads for the rating against any other product in exchange for complexity and liquidity risk. And of course, fundamental structural credit risk, but that part of it being poorly understood. So, I would say the drive for yield vis-a-vis the rating was the biggest factor. I think the confidence they had seeing the volumes getting done, they just said, "If so, much of this is getting done, how bad can it be." And there was a little... It is a term we did not know then, but we know it now – "FOMO", right? Fear of missing out also was a little bit of what was going on with those investors. And some of them were even a little bit more intrigued by the whole CDO creation process as an 'easy' accelerator for assets under management. That led to *de novo* thinking like "Hey, we'll buy some of this stuff, get some experience, and maybe we'll become a CDO manager ourselves." And they would sometimes invest on a contingency that they could have a sub-advisory role or some other role in the transaction. So, they could build their own track record of experience, and then try to come up with their own deals.

The growth was feeding on itself in different directions when I think about it. And obviously, the Asian investors were slightly less evolved than the

European investors, they were kind of a step behind. The difficulty for them was that they were a little in some ways more skeptical of the product because of its lack of liquidity. They really wanted to understand that they could trade out on an appreciated basis, make money on these. They did not really have the longer-term resilience that the Europeans had. But there were certain Asian accounts --pension, and insurance companies-- that had to buy long-dated assets. So those are the ones that usually stepped in. But you had more specialty funds, and you had the asset backed conduits, in Europe, as the other types of investors as well at play.

YPFS (SK): **Let us talk about synthetic CDOs because that was big. When you started Dynamic Credit and did your first couple of deals, it was just a cash market. Then between '05 and '06, you had the rise of the Pay-as-you-go default swap; synthetic CDOs were then popularized and became the biggest part of the market. You were observing that, and seeing, on the one hand, it was far easier to do a deal, but on the other hand, there was this awareness that you had hedge funds and others that were shorting these things. How did you feel about that? How do you think about that in terms of risks, in terms of opportunities, in terms of market signals, anything else?**

Finkel: Sure. Well, we really got into doing what I called hybrid CDOs, which was a blend of cash, assets and some credit default swaps. And I consider those still cash CDOs, even though they had a synthetic aspect of them, they were not fully synthetic. They were not 100% collateralized by credit default swaps. And the reason we initially wanted to do those, take advantage of those credit default swaps is because we were a little nervous about the new vintage mortgage loans- the subprime, the Alt-A, and the option ARM- and we were able to take exposure to credit default swaps to get access to older vintage mortgage-backed securities that we thought had more orthodox underwriting. And that is really what drove us to do that. We thought we were really backing into a safer zone. The challenge that came from that, though, was the because of the frenzy of mortgage origination, those older transactions pre-paid, because so many borrowers were able to refinance their mortgages at new cheaper teaser rates. So a lot of that older vintage exposure that we thought we were getting into evaporated in our deals and left us with a need to replace it, unfortunately, with whatever was now available, which was the more current vintage. So, that that approach did not work out as well as we had hoped it would.

And we were aware of groups shorting, whose philosophy was to short credit into CDOs. We never thought that we would ever short a credit into ourselves from our hedge fund, for example, into our own CDOs. We honestly believed that everything we were putting in our own CDOs - except for our last deal, which had an explicit long/short strategy, which I'll get to in a minute - we really felt that we could stand behind every credit that we put in our deals. We only ever lost faith in one investment, where we did feel a little bit guilt-provoked to buy it because it was a CDO that was being done by a manager who was actually also one of our big CDO equity investors in our own deals. And we felt duty-bound to buying some of their paper. We were nervous about it, and we were hoping that that deal would ultimately accumulate to a more safer portfolio. It did not, and we ended up buying, with our own money, the position out of that CDO warehouse and taking close to a seven-digit loss- which was very painful.

But we always wanted to believe that we were putting everything into our deals that we were comfortable with. To the extent that we knew that others were doing deals where, an investment banker would come to us and say, "Look, we have a deal ready to go, we just need you to step in as a manager." One dealer said, "We'll do 50% of the equity tranche, as well, at the underwriter level." We couldn't make any sense of those transactions and only much later realized they were largely dumping grounds for short sellers. But really for us, Steve, those deals were all being done with riskier collateral, the BBB collateral, and we just were not comfortable with putting BBB credits into a CDO. We only were comfortable with high grade ABS CDOs, or CDO-squareds, where we felt we could create an exposure which would pay off if the deal did poorly through things like creatively structured ‘turbo’ features which would pay us off early if things went a bit south (the problem was that things went too far south too fast, and our cleverly created exposure got wiped out, too).

So interestingly, we did not resist doing those mezzanine ABS CDOs because we were concerned about groups like Paulson and Magnetar being the short sellers into them. Rather, we were much more concerned about just the fundamental nature of the RMBS tranches that went into the CDO deals themselves. At the time, you have to understand as well ... most of us in the market had 20 years -- senior people had 15, 20 years -- of experience, where we were insiders, right? And this is the whole Big Short story, that the people who were successful at seeing the problems in the market were outsiders who had not been immunized to 20 years of good performance of this type of product. And the data coming from the investment banks was never unreliable in the past. So, to extent we knew that there were people taking short positions into CDOs we thought that those were more, if anything, market spread plays. We did not think that they were taking a bet on a massive blow up. If we had thought that short sellers were making such incredible great fundamental credit (rather than technical spread) trades, we never would have done any more long-only CDOs, we would have backed out of the market.

We thought that they were arbitraging on a spread basis more than just having a belief that this stuff was going to blow sky high. So, for all those reasons, we had our view of what kind of deals to do and which ones to stay away from.

YPFS (SK): **We should probably wrap up in a few minutes. Matt, what do you want to cover in the last couple of minutes?**

YPFS (ML): **Thanks, Steve. Jim, based on your story- if I get it- you were more cautious, in your firm, the way you managed the CDOs you put together, than your competitors were. But you ended up being wiped out all the same, even though you had better fundamental analysis in the products you are putting together. Is that right? And what does that say?**

Finkel: About two of our 10 deals still exist; we might be overseeing some of the only CDOs, one a CDO squared, left in existence. One deal is backed by trust-preferred securities, and they are pretty long dated, they are still performing. So, we didn't completely wipe out. We've always believed that, had the deals been allowed to run - the tranches we bought ultimately mostly paid off -- most of our CDOs would have ended up largely working out. But they were forced into unwinds in the worst possible market, by the super senior holders, by the investment banks themselves, who had the ability once you hit a certain level of defaults to blow the deals out. And this was because their risk managers and senior executives (and bank regulators) were hitting the panic button-- we certainly were not terminating these deals by our own decisions.

Looking back at it, one of the struggles I had was, I knew that these deals were very susceptible to downgrade risk, the downgrades in our portfolios. But we could never measure how rapidly the rating agencies would downgrade the RMBS, under what scenarios. It was not as visible of a metric as I would have liked. And I suspect the rating agencies, when caught a bit overexuberant in their ratings, also reversed course perhaps too violently.

YPFS (ML): Were you thinking about the possibility of a ratings downgrade?

Finkel: Yeah, we were thinking about it. And I had kind of philosophical challenges with my team. I tried to get them to measure that risk, and they said it was unmeasurable. And I was concerned about it. Ultimately, we ended up doing our last deal, a long/short CDO squared, where we took a large set of negative bets inside the CDO against certain high grade or certain mezzanine ABS CDOs that we thought were poorly structured or had overly risky collateral. We were thinking that those credit default swaps on those deals would ultimately yield us some great returns. And they did - we made an incredible killing for that CDO-squared. The CDO paid $1 million dollars of premium and collected $80 million of revenue, of capital, from unwinding about $100 million of credit default swaps in just about a year and a half's time. We put those on in early '07 and we unwound them by the end of '08.

Unfortunately, in the CDO, all that return went solely to pay down the AAA tranche, which was great for the dealer who we did the deal with, it was great for Deutsche Bank as it largely covered the loss on their super-senior tranche. But the tranche that was paying for that credit protection, that million dollars of premium, was the equity tranche taking it out of their excess spread return, and they got no benefit from it. And I had made an attempt in structuring the deal to negotiate with the dealer that if those short positions were unwound, the equity should get some piece of that action in recompense for their giving up their current return. But the AAA investors had too strong of a negotiating ability in the deal, and I could not get that kind of balanced allocation of capital structured in the deal. That was a big regret of mine. It was a very smart deal, but the end result of it was unfair to the tranches that paid for that protection.

It would be like me paying insurance premium on your house, and then your house blows up, and you get all insurance proceeds to rebuild your house and

I do not even get my premium back. But, I'd say the biggest regrets were that we were a bit overly reliant on the data from that 15-20 year history of being immunized to quality performances of residential mortgages, and we all had too much reliance on the rating agency process (which also was grounded in that data). And really, at the end of the day, too little flexibility, really because of the way that the AAA bonds were held in the hands of institutions that did not have the staying power to see their way through the crisis. They did not have the economic patience because the 100-year flood had arrived (some people say that structured credit is the 100-year flood that comes every 10 years, but I disagree!).

YPFS (ML): **Could you in conclusion compare your take with the Lewis Big Short thesis? It sounds like you are comfortable with the idea of outsiders and insiders, and he is got insurgent shorts against the Wall Street dealer firms. But is there anything missing from the popular narrative, from the elite "informed-public" view of the subprime collapse that you think we ought to drill into that has not been told?**

Finkel: Well, I think it is twofold. I think the rating agencies should have been taken more to task. The problem for the government, the prosecutors, for the DOJ others to really take the rating agencies to task, was the moral hazard of destroying a pillar of the fixed income market. If you destroy S&P or Moody's, for their abuse in the CDO and mortgage-backed market, who's going to be left to rate the trillions of dollars of bonds, the corporate bonds that are held by pension funds for "Mom and Pop's" pension and are behind "Mom and Pop's" insurance policy?? So, there was just too much moral hazard there, and I think the public doesn't really understand that. And I think the other issue is that the Wall Street banks as well, the public does not completely understand how the left hand did not kind of know what the right hand was doing inside the banks.

And as people still don't totally understand that the banks went from the storage business (where they used to hold loans on the balance sheet) to being just in the moving business--they were just moving risk for a fee. And they had insidious ways of profiting. They built what they believe were arbitrage risk free trades, and present valued them and paid themselves huge bonuses in the investment banks. A lot of that has, through reform, has been corrected. But I do not think it was the shorts arbitraging the banks. I think the banks were readily cahoots with the shorts to a large extent. You have to realize they were making money in many, many other ways, with these short sellers. I think that is a large part of it.

And at the end of the day, I think it's a flawed process to create a credit product where the pace, velocity and the volume of it is so enormously high, that even really reputable and diligent credit investors just don't have a chance to do their work. I do not think the public appreciates that there might have been ways to put brakes and governors on the system through regulation. And it was just a nobody's interest to slow it down. Put it this way, there were too many economic forces at work to keep it speeding along and not enough power to slow it down. And it didn't surprise me that the first blow-up in the market with the Bear Stearns' hedge funds and only what - three or four weeks afterwards - did the rating agencies come out for the first time and massively downgrade RMBS and CDOs, or start to. Again, the rating agencies did not want to make the first move due to moral hazard and losing their valuable position as a financial service provider for a fee. They wanted to let the market make the first move. And then, when the market did move, that allowed the ratings agencies to come in and really begin the process that ultimately destroyed the ABS CDOs and the CDO squareds with the ratings downgrades. Anyway, those are kind of my thoughts on those points.

YPFS (ML): Super. Well, thank you, Jim Finkel, for your extensive insights and for sharing your time for participating in the program.

Finkel: Sure. I hope I have added value to your innovative research.

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