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Yale Program on Financial Stability

Lessons Learned

James Finkel

By Steven H. Kasoff and Matthew A. Lieber

A Wall Street veteran specializing in structured credit transactions, Jim Finkel was co-founder and director of the structured credit asset management firm Dynamic Credit Partners (DCP) from 2003 to 2009. Finkel started his career as a securities lawyer for the international law firm Cadwalader, Wickersham & Taft LLP, before moving over to the banking side in 1992. He specialized in mortgage-backed securities and collateralized loan obligations (CLOs) for several firms, including Bear Stearns and Deutsche Bank, where he headed the London-based CLO group. In 2003, Finkel returned to New York to launch and run DCP. In 2010, he joined financial consulting firm Duff and Phelps, where he advises clients on dispute practices, expert testimony, regulatory issues, and liquidations. This Lessons Learned summary is based on an interview with Finkel.

Into the fray: Wall Street lawyer dives deep into structured credit deal-making.

Jim Finkel enjoys solving three-dimensional puzzles of byzantine technical rules, complex organizations, and the humans who run them. He started his career in 1986 as a lawyer for a firm servicing Wall Street banks. The client banks were putting together early mortgage-backed security issuances. Finkel found the details and the action of investment deal-making fascinating, so he moved over to the bank side for Myerberg & Company. He described the various facets of the credit underwriting process: “These securitizations 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.”

Finkel described his role as transaction manager in the investment bank—to coordinate with different players the production and marketing of complex structured credit deals. At Myerberg and then at Nomura, he managed a variety of projects, “providing financing to mortgage originators, creating warehouse facilities for their own lending activities, 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 [residential mortgage-backed securities] and agency CMOs [collateralized mortgage obligations].” At Bear Stearns and Deutsche Bank, where he later worked, he was involved in securitized products including perpetual bank debt, emerging market debt, and high-yield bonds. Ready to “take a stab at the buy side,” he joined with a longtime associate to form Dynamic Credit Partners, a collateralized debt obligation (CDO) management firm, in 2003.

Finkel described the nuts and bolts of the CDO management business from his firm’s point of view.

The CDO manager is purely on the buy side, Finkel said, responsible for making the investment decisions for the portfolio of assets within a CDO. Dynamic Credit Partners, during its four years of full operations, did a total of 10 CDOs; it also ran two credit funds and grew to \$5 billion in total assets under management. Revenues came from asset management

fees at 20 basis points. Annual revenues were typically around \$10 million, peaking at \$13 million to \$14 million, with about 30 employees and overhead of \$8 million to \$9 million. DCP invested some of its profits in one of its two proprietary funds.

Most independent asset-backed securities (ABS) CDO managers had a similar cost structure and profit margin. It was more profitable to keep growing. Had DCP doubled or tripled its assets under management (AUM), said Finkel, “our marginal cost would have stayed about the same.” While start-ups and smaller CDO managers struggled to break even, once they achieved scale, they became extremely profitable.

According to Finkel, DCP differentiated itself from its competitors in its measured stance: “We were considered to be slower, more analytical . . . [in contrast to] some of the other managers described as ‘just backing up the truck’ [who bought whatever was coming through the market] . . . We were in a sector which was caught up in a frenzy, but we were trying to hold a line on quality.”

Pressures on CDO managers to grow AUM fast—regardless of quality—were strong, which meant CDOs were marketed without scrutiny and loaded up with risk.

According to Finkel, there was pressure on the CDO managers from the dealers to buy whatever the dealers would produce. “The dealers saw a CDO as a vehicle to sell paper,” Finkel said. These Wall Street firms, he explained, were looking to unload warehouse risk on assets acquired during ramp-up, and they made fees on each securitization.

One person in the market said to me, “Jim, why aren’t you doing \$10 billion instead of \$5 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 wouldn’t do that.

One bank, Finkel recalled, was pressuring DCP to do a CDO with securities that did not match its standards. “We almost canceled a CDO because we were being pressured to acquire collateral . . . we put the deal on ice for a few months.” The bank was trying “to shoehorn [us] into buying their production now.” Finkel doubted that other CDO investment managers stood up to such pressure.

A second source of pressure, Finkel said, came from the finite quantity of underlying MBS assets available. “In pure mortgage-backed securities offerings, a deal would be announced on Wednesday afternoon, and if you didn’t have an order in by Friday morning, you wouldn’t get an allocation.” DCP developed a model that could stress test the assets in a prospective portfolio within 36 hours—to determine if the firm would ask for an allocation or not. Most firms just said yes, buying the tranches without testing them.

In the context of the expansion of mortgage credit during the bubble years, the factor of limited MBS offerings may seem surprising. But it speaks to the powerful global demand for yield on dollar-denominated credit assets in 2005–07.

Not only were the investment banks servicing that demand for yield very profitably, Finkel pointed out, they joined the rush and paid bonuses based on paper profits.

Dealers made good fees arranging RMBS and CDOs, 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. 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!

Unfortunately, the absence of risk management would soon force some of these same dealer firms into panic selling.

Initially wary, European and Asian investors moved to get in the game, drawn by the high yields, favorable ratings, and surging volumes of subprime CDOs.

In the years leading up to the subprime CDO boom, institutional investors in Europe and Asia were reluctant to dive into the new market and hesitated to buy the novel CDOs backed by US subprime mortgage-backed securities.

Finkel told how DCP in fact completed a number of CDO deals with European investment bank groups as structurers. The European orientation built off of DCP’s personal relationships as well as its relatively tempered approach to the growing exuberance of US markets. In these CDOs, the dealer firm, such as Dresdner Bank and Calyon (of France’s *Crédit Agricole*), bought the senior tranche onto its own balance sheet.

These European relationships, Finkel said, enabled DCP to market extensively its CDOs to European and Asian investors. Earlier in the decade, foreign investors had viewed the US mortgage-backed debt markets with some trepidation. But their demand for yield, together with the favorable ratings, made subprime CDOs too attractive for them to pass up.

Also, Finkel noted, the confidence of European and Asian investors grew as they saw the increasing volumes of securitization occurring. Furthermore, Finkel added, the CDO boom suggested to them the prospect—if they gained experience and came to know the market well—of a future fee business as a CDO asset manager.

“The growth was feeding on itself in different directions,” said Finkel. Asian investors, Finkel continued, tended to be more skeptical and concerned with liquidity risk. But certain Asian accounts that had to buy long-dated assets for pension and insurance funds were the ones that stepped in.

Finkel noted one investor concern that would prove prescient, namely downgrade risk:

In retrospect, those investors were partially right. What everybody was missing was the sensitivity of these asset-backed CDOs to ratings downgrades being deemed defaults and the extreme downgrades that the rating agencies engaged from late ’07 into ’08, which made the deals unwind.

DCP stayed away from synthetic CDOs and subprime shorts because they harbored greater credit risk.

Regarding short selling of subprime RMBS and the short-driven CDOs, Finkel reiterated that his main concern was credit quality, not ulterior motives or conflicts of interest. DCP avoided buying tranches of other mezzanine CDOs, said Finkel, “not because [they] were concerned about groups like [hedge funds] Paulson and Magnetar [Capital], but rather because [they] were concerned about the fundamental nature of the RMBS tranches [within those CDOs].” Finkel described on incident:

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, those deals were all being done with riskier collateral, the BBB collateral, and we just weren’t comfortable with putting BBB credits into a CDO.

To the extent DCP was aware of investors taking short positions, Finkel said, they thought that those were market-spread plays.

The CDO juggernaut was based on a “flawed process,” which tainted many participants in ways that still haven’t all been addressed.

Rewards from DCP’s more cautious approach as a CDO investor were largely, but not entirely, lost to forced wind-downs in 2008. Two of its 10 CDOs still exist, and its credit opportunities funds survived a 30% loss. Most of its CDOs would have paid off, Finkel said, “but [the CDOs] were forced into unwinds in the worst possible market, by the super senior holders, by the investment banks themselves.” Scrambling for cash and safety, the dealers’ risk managers and senior executives were forced to make panic sales.

“It’s a flawed process,” Finkel reflected, “to create a credit product where the pace, velocity, and the volume of it is so high that diligent credit investors don’t have a chance to do their work.” Earlier regulatory interventions might have had a stabilizing effect, he thought, recognizing, however, that in the midst of the boom, “it was just in nobody’s interest to slow it down.”

It is widely recognized that the CDO juggernaut could not have taken off without the participation of credit rating agencies such as Moody’s and Standard & Poor’s, which provided the ratings that investors relied on.

In Finkel’s opinion, the rating agencies should have been taken more to task. Their special status created a perverse incentive for them to sign off on CDO tranches with AAA approvals. US regulators, as Finkel explained, feared that punishing S&P and Moody’s would erode the broader rating function and substantially damage US fixed-income markets across all sectors.

The major dealer firms altered their business models as they chased the CDO boom. They were “riven”—split internally between a CDO unit making wild profits and risk managers

and senior executives who failed to exert appropriate controls. These investment bank dealers were “out of control,” Finkel said, profiting from the short business more than they were manipulated by it. “The left hand didn’t know what the right hand was doing inside the banks.”

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 believed were arbitrage risk-free trades, and present valued them and paid themselves huge bonuses.

According to Finkel, the shorts were not arbitraging the banks, rather the banks were in cahoots with the shorts to a large extent. They were making money in many ways with the short sellers, Finkel said. He thinks that reforms have corrected much of the dysfunction at the investment banks. But it is an episode that has passed, a pattern that may to some degree persist, that people still don’t entirely understand.

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