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# Yale Program on Financial Stability
# Lessons Learned

## Chris Ricciardi

By Matthew A. Lieber and Steven H. Kasoff

*Chris Ricciardi was a CDO pioneer who built the structured products units at CS First Boston and Merrill Lynch before moving to the asset management side. Ricciardi began his career structuring novel fixed-income securities at Prudential. At CS First Boston and Merrill, he catapulted each investment bank's lagging unit into the top of the league tables for CDO (collateralized debt obligation) issuance. He was CEO of Cohen & Co. from 2006 to 2011, when he left to co-found investment management firm Mead Park Management. A graduate of the University of Richmond with an MBA from the Wharton School of the University of Pennsylvania, Ricciardi presently serves as CEO and co-founder of Edly ISA marketplace, an income-sharing initiative for financing college tuition. This Lessons Learned summary is based on an interview with Ricciardi.*

### Field general on the move: Merrill's CDO unit, initially hampered by funding limitations, grew rapidly from 2003 to 2006 under Ricciardi.

Two things that stand out about Chris Ricciardi's career are his command of timing and his command of teams. Having developed cutting-edge skills in the intricacies of credit securitization at Prudential, he moved to CS First Boston to develop its asset-backed structuring business—which he did in three years. He then replicated the feat for Merrill Lynch, positioning the investment bank to become a structured credit leader.

Ricciardi described the limitations facing Merrill when he started there. Merrill "didn't have nearly the opportunity because they didn't have any good access to funding." They had to line up the pieces like a broker. Ricciardi developed Merrill's capabilities to underwrite CDOs, working with managers to pick a portfolio. Merrill's trading desk managed the warehouse risk while a deal was in ramp-up phase being structured and marketed.

At the start of 2006, seeking to move beyond CDO underwriting, Ricciardi went to run asset management firm Cohen & Co. Ricciardi described his executive management style, which he had honed in dramatically building out the sell-side units.[1] "I had teams of people who were expert in each of these areas," he explained. "I relied on those people to make the decisions about how best to put together the portfolios and to manage them." These "were seasoned, experienced people who knew exactly what to do." His interaction was "not much more extensive than at the investment bank." Rather, his focus was on "planning and issues relating to giving them the right resources, hiring people, technology."

[1] See "The Next Generation of Dealmakers," *Asset Securitization Report*, December 4, 2006; and Serena Ng and Carrick Mollenkamp, "Pioneer Helped Merrill Move into CDOs," *Wall Street Journal*, October 25, 2007.

Ricciardi downplayed the differences in perspective in moving to the buy side. Building up Cohen & Co.'s CDO management business, Ricciardi noted that he now had one client as opposed to 40 but that the move did not bring eye-opening changes.

### An appealing innovation: CDOs offered investors a long-term leveraged exposure to an illiquid asset class.

Asked why the different tranches of the CDO appealed to different kinds of investors, Ricciardi shared a high-level view on what he called the crucial reason for CDOs.

> The reason that CDOs exist is that they're attempting to provide leverage on an asset class without the risks of using short-term borrowing. They are seeking long-term leverage on an asset class.

The leverage afforded by a CDO was different from the short-term leverage using repo (repurchase agreement) funds or posting margin: long-term leverage.

> Instead, you can use a CDO structure and lock in your leverage. That's what's in it for the equity guys of every CDO. They want to get a long-leveraged exposure without short-term refinancing risk.

In 2006–07, issuance of subprime CDO derivatives was peaking as short-selling volumes shot up. But it was hard for market participants to identify large trends and what was behind the short selling, Ricciardi explained.

> In the middle of it, actually, it wasn't that clear that there's a growing interest in shorting them. Obviously, for the derivative to exist, someone has entered into the short side of the trade. But in derivatives, it's much more common [that it's] someone hedging than someone shorting. Because it was not the greatest way to short something. It's a really messy way to short something. Because the transaction costs are so high, it wouldn't generally make sense unless there's a very big payoff.

Ricciardi criticized the media coverage of short-driven CDO deals such as Magnetar's correlation trade, as well as the emphasis on subprime CDO securitization in much of the public discussion of the Global Financial Crisis (GFC). The volume of shorts exerted a force as a short-term disruption of financial markets, he said, but they were not the cause of the financial crisis. Similarly, he did not find fault with the rating agencies for getting home price levels wrong when mortgage lenders and appraisals had been inflating values. There was excessive home price appreciation in 2007, but no one knew by how much or for how long. It was far from inevitable that home prices would correct within just two years, he noted.

### The "funding mismatch" factor: long-term risk was in the wrong hands.

In Ricciardi's analysis, the main cause of the financial crisis was what he called the "funding mismatch" in large institutions taking long-term credit risk.

> There's over-leverage in the institutions that were taking this risk. They were basically buying long-term assets and funding them with very short-term liabilities.

Ricciardi saw the funding mismatch as a recurring cause of US financial crises, historically. In the subprime securitization case, the investment banks taking long-term exposure to subprime CDOs were reliant on repo funding and unprecedented levels of leverage. They were "putting together a long-term transaction saying, 'over the life of this transaction or 10 years . . .' But they didn't have a way to fund it through the natural life." The funding mismatch made the large investment banks unable to survive the housing market shock.

It was not that the fundamentals of the assets were that far off, Ricciardi said. Peak-to-trough, home prices dropped 25%, an amount that in the equity markets would mean a bear market but not a systemic collapse. The home price index *did* recover fully, Ricciardi noted, and has since added another 25% gain. But in 2007, the risk had become "concentrated in the hands of some investment banks, in particular, that were super high over-leveraged." The result: "They can't handle the down decline. It's not the right place for that risk."

**The size of the total issuance of subprime CDOs did not cause the GFC . . . Rather, highly leveraged positions of a handful of megafirms forced all investors to unload assets for cash—at the market nadir—all at once.**

Ricciardi held that the amount of asset-backed securities (ABS) and mezzanine CDO debt issued was "rather small," too small to have caused the financial crisis. On reflection, he noted that the CDO write-downs "did seem to have a somewhat outsized impact on some financial institutions" and wondered openly how they "could have caused such disruption."

In the time leading up to the GFC, Ricciardi said, there were basically no rules preventing the creation of unlimited amounts of shorts for ABS. And, in fact, it seemed like many multiples more shorts were created relative to the existing cash bonds.

> If the owners of the assets could just hold on for the long term—as the assets were designed to be held—then the values would have recovered as house prices eventually recovered and the major losses could have been avoided.

Instead, the highly leveraged position of the investors with the greatest CDO exposure—banks such as Merrill Lynch, Citigroup, and UBS—forced them to unload the assets at the worst time and take substantial write-downs, revelations of which spurred a credit crunch.

**Limiting some derivative exposures makes sense as a market-stabilizing policy.**

From a policy standpoint, Ricciardi concluded, it makes sense to examine limiting the volume of shorts that can be created by derivatives to the value of the assets they reference. Such a rule, had it existed in 2007, might well have led to a different outcome

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