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Yale Program on Financial Stability

Lessons Learned

Brian Stoker

By Steven H. Kasoff and Matthew A. Lieber

Brian Stoker served in Merrill Lynch's structured credit division for seven years, producing and trading asset-backed securities (ABS). In 2005, Stoker moved to Citigroup as a director of ABS CDO (collateralized debt obligation) and CLO (collateralized loan obligation) structuring. After the financial crisis, Stoker was an analyst at Carlson Capital for three years. In 2011, he joined StormHarbour Securities, serving as a managing director until 2018. From 2019 to 2021, he was director of securitization at Korth Direct Mortgage. Presently, Stoker is a licensed real estate agent in Miami. This Lessons Learned summary is based on an interview with Stoker.

Block and tackle: To produce a CDO profitably, investment banks had structuring units that did the heavy lifting: analyzing prospective deals, obtaining rating agency approval, engineering the security, and marketing the tranches to investors.

Producing a CDO frequently began in response to an incoming call from a portfolio manager or from Merrill's sales desk, related Stoker. Sometimes, the structuring unit was more proactive, reaching out to CDO managers to propose a deal. Then, crucially, the structuring group would "figure out whether the economics of the deal work[ed]," evaluating its expected liability spreads to determine if it would be profitable.

Interacting with the rating agencies during the process "was mostly about following their rules." Stoker pushed back somewhat against accounts of ratings shopping, pointing out that "both sides had veto rights on the deal."

We needed Moody's and S&P on our deals, and if they gave us a bad rating, we were in a world of hurt. We needed to work with them. And they wanted to work with us because they get paid a big fee.

"I don't think we played off Moody's versus S&P," Stoker said. Fitch was trying to get into the CDO ratings market, so "we [w]ould start including them as long as they came up with ratings that matched up with the other rating agencies." Most deals that he worked on had both large agencies involved: "Moody's would rate all the capital structure because they might have been a little easier than Standard & Poor's down the capital structure."

The dealers were strategic, Stoker allowed, but in his account, the interactions with rating agencies were far more subtle than in other reports of ratings shopping. Crucially, the agency had leverage over the dealer too, and any differences between the ratings of one agency and another tended to be marginal.

The dealers marketed the CDO tranches based on established investor preferences, Stoker explained. Banks were happy to hold the AAA tranche, often with monoline insurers providing additional protection (known as the negative basis trade). Insurance companies favored the single-A tranche, which National Association of Insurance Commissioners

(NAIC) rules allowed them to treat as they would a AAA security. Hedge funds pursuing higher returns would take the BBB tranche and equity.

Seeking high profits, dealers migrated from just structuring CDOs for a fee to acquiring CDO tranches, accumulating risk that would come back to bite them.

Stoker described a key incremental step that led dealers to take on risk as they grew their lucrative CDO structuring business. In the early days of CDO structuring at Merrill, he said, “we would sell the AAA to [five or 10] banks *But then it became a competitive advantage for the dealer to buy some of the AAA [italics added].*”

Dealers viewed the move to hold on to AAA tranches as a way to increase the profitability of their CDO business. Because dealers did not need to hold much capital against these AAA tranches, the inherent leverage was very high, resulting in a compelling return on capital. The risk was considered to be minimal, so many dealers accumulated massive quantities within one to two years.

If it looks too good to be true, it probably is: Citigroup used its commercial paper business to create the appearance of “risk-free profits.”

In the case of Citigroup, where Stoker moved in 2005, the firm used its commercial paper (CP) facilities to accumulate AAA CDO tranches.

Citigroup could issue commercial paper . . . CP investors would put up all the money to buy that tranche, to buy the AAAs, but Citigroup essentially insured it. But that insurance did not show up on our balance sheet at all.

Citigroup’s CP-funded asset warehousing “made an infinite percentage return as a percent of capital because there was no capital [usage].” Internal accounting procedures permitted the business unit to immediately book the next five years’ worth of expected profits, providing an even stronger incentive for the individual bankers in those groups. “We’d get paid in full for five years,” Stoker said.

To grow the CP-funded asset accumulation, Citigroup created structured investment vehicles (SIVs), also known as asset-backed commercial paper (ABCP) conduits, Stoker explained. “Citigroup had humongous SIVs that Citigroup effectively backstopped also.” The boom-fueled accumulation of assets was considered a low-risk or risk-free business. It spiked until it was noticed, and then Citigroup’s managers put on limits.

When we got to \$40 billion or \$35 billion, somebody at the bank finally noticed and said, “Hey, that’s a lot.” They started to impose rules.

The SIVs had not been consolidated as part of Citigroup’s balance sheet, Stoker said, but that changed in late 2007 or 2008. “I don’t think they were trying to hide it. I’m sure they were following the rules, but the rules allowed them to book it that way.”

In 2006, Stoker recalled, investors' debates about housing prices were intensifying. "I didn't have to debate it," he said, "because I was not buying or selling anything. I was just processing spreadsheets and papers." By the end of the year, reports indicating a bad end to the housing boom were resonating on Wall Street.

I came into the office after New Year's in January 2007. I got sat down by the head of our trading desk and his boss, and they said, "Get all these deals done tomorrow, all of them." We pushed real hard to get them done as fast as we could. We tried to do the riskiest ones first, but the losses were piling up fast.

Throughout 2007, Stoker's group at Citigroup struggled desperately to reduce the firm's massive subprime exposure in its CDO warehouse. In March, Stoker recalled, his group marked one warehouse down \$100 million—"and we hadn't even marked down the whole portfolio." Stunned by the losses, they complained to the trading desk. "What's going on here? But it got real bad."

He recalled his alarm on hearing the firm's then-CEO, Chuck Prince, say later in the year about leveraged buyouts—"As long as the music is playing, you've got to get up and dance."

My reaction was, "I need to slip a note under his door and say, 'You got to pay attention, dude. This is a big freaking problem.'"

Stoker's astonishment reflected his reality as a midlevel employee in one of the world's largest banks. For seven months, he and his group had been aware of Citi's exposure to massive subprime losses and had been striving desperately to clean it up. "In July, he was still dancing," said Stoker. "And I was thinking, 'Man, this is bad. We got \$40 billion of the stuff with a commercial paper exposure.'" He was struck by the CEO's seeming ignorance:

These banks are so big. I was disappointed that the information didn't travel up to senior executives very well, nor was it connected. Nobody told the CDO desk or told Chuck Prince that, "Hey, by the way, these things are starting to go bad. You're retaining a lot of the 'super senior.' You have a lot of exposure there. You have humongous warehouses."

Within giant financial organizations, circumstances can look very different from different perspectives.

It is well accepted that the crisis tarnished Wall Street's image in the public's eye. The legacy is raft with stories of greedy bankers devising complex and faulty products that they then foisted on their clients. Stoker took issue with this sullied image, noting that there was logic to the appeal of securitization. He also defended employees like himself. In his perspective, from the midlevel working ranks, transparency and diligent compliance efforts were what stood out.

In general, Wall Street has a bad name, but I thought everybody was up front. I didn't see fraud or stealing going on. Everybody was first class, trying their best, and banks [were] spending billions to comply with every rule. There were no tricks, and nothing

hidden . . . I thought the securitization market was transparent and a first-class place, actually.

Stoker's emphasis on transparency and rule-driven behavior in the structured credit world—seemingly idealized at first glance—comes from his firsthand experience. When asked to address the troubling facts of mismanagement at leading Wall Street firms during the period, Stoker expressed disappointment at the lack of communication between different units and levels of the giant organizations and reflected on how his reality did not square with the CEO's contemporaneous comments.

“Cognitive dissonance,” he said, is a concept that he thinks describes the crisis period well. Stoker saw cognitive dissonance in the incongruence of his experience with the widespread sense of a Wall Street driven by greed. “You hear something so many times in the press about how terrible Wall Street is,” Stoker explained. The stories make people think “that there was terrible stuff going on, but it was not true. I don't think it was true at all.”

But cognitive dissonance could just as well describe the rejection by senior executives and the CEOs of urgent new information from midlevel managers until it was too late.

Stoker's takeaways may be out of step with much of the post-crisis common lore and a good deal of the evidence on the record. It is also true that not much of that record comes from midlevel employees like him. Further, it is useful to remember that behind every nefarious story, there are often thousands of employees going about their jobs the best that they can and, even in the midst of a crisis, doing their best to follow the rules.

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