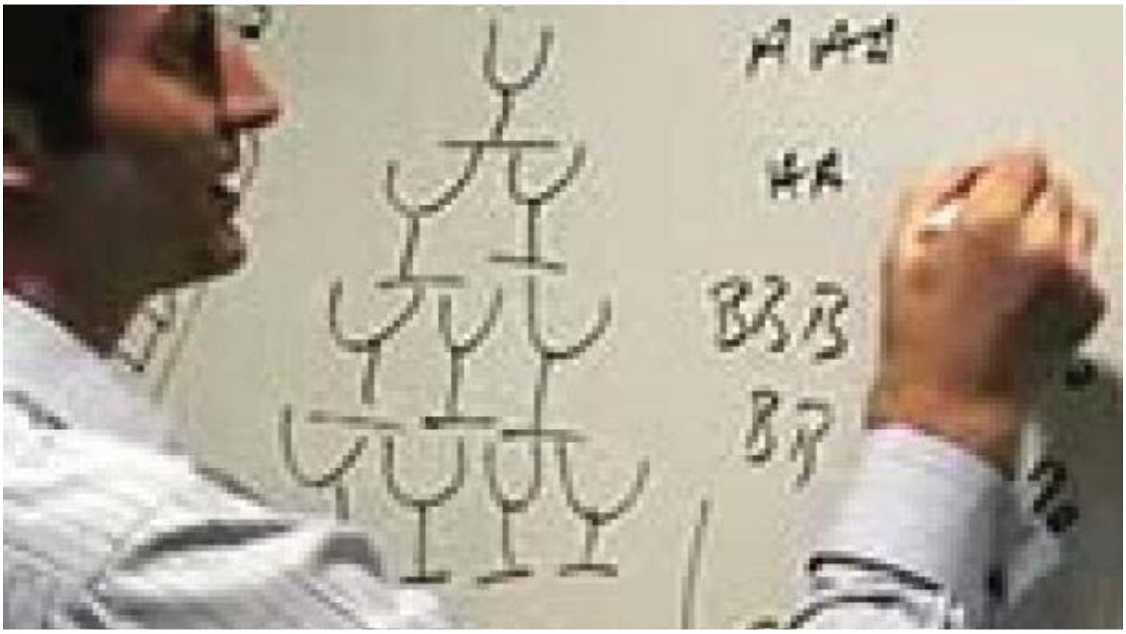
Long Live Synthetic CDOs

By William D. Cohan - Jun 23, 2013

My, how quickly we've forgotten the lessons of the financial crisis. Even though the debt markets have once again mispriced risk -- when junk bonds yield a mere 5 percent, you can be sure serious trouble is brewing -- I am referring instead to the fact that what caused the financial crisis remains unheeded.



For instance, the Financial Times recently made a big deal of how bankers at Morgan Stanley and JPMorgan Chase & Co. tried, and failed, to put together the first synthetic collateralized debt obligation since the onset of the 2008 crisis. The deal fell apart because there wasn't enough investor demand for various tranches of the security.

Fair enough, but any deal can go bust before it's completed (or afterward). The implication in the Financial Times, though, was that synthetic CDOs exacerbated the financial crisis, so the attempted revival of the product was a bad thing.

Nothing could be further from the truth. Just because an innovative financial product might have played a role in a serious market disruption doesn't mean that the product itself is flawed. It more likely means that the rewards bankers received for putting these deals together led them to create more and more of them with lower and lower credit standards.

Familiar Pattern

It's a familiar pattern of behavior on Wall Street: A financial innovation introduced by one firm reaps huge financial rewards, which leads to manic efforts by competitors to offer their own versions. That is followed by a mad rush to cash in by flooding the market with more of that product -- and fewer quality controls.

Think junk bonds in the 1980s, Internet stock offerings in the 1990s and mortgage-backed securities in the 2000s. These innovations were quantum leaps forward in the democratization of capital -- that is, making capital available at a lower cost to people and companies that wouldn't otherwise have access to it. That's a good thing, as Martha Stewart would say.

The synthetic CDO was a similar, albeit more complex, innovation, which allowed sophisticated investors to choose precisely the amount and kind of financial risks they wanted to take. Thanks to a lawsuit brought against Goldman Sachs Group Inc. by the U.S. Securities and Exchange Commission in April 2010, we are familiar with the most infamous synthetic CDO of all time: Abacus 2007-AC1. In that deal, for a $15 million fee, Goldman arranged for hedge-fund manager John Paulson to bet $1 billion that a bunch of mortgage-backed securities would default. At the same time, several European banks --including ABN Amro Bank NV (now part of Royal Bank of Scotland Plc) and IKB Deutsche Industriebank AG -- made the opposite bet that the underlying securities would keep paying the contracted rate of high interest.

Paulson was looking for a way to short the mortgage market, and the European banks were looking for a way to find a higher-yielding security. What's wrong with an investment bank arranging a deal to provide willing, sophisticated customers with the risks they want to take? Nothing.

It's only when things don't work out that people look for someone to blame. But in every trade, there is a winner and a loser. When you buy a share of General Electric Co. stock -- betting that it will go up in price -- the seller hopes its price has peaked and that there is no more upside to be had.

Abacus Deal

Sure, Paulson ended up making $1 billion on the Abacus deal, while RBS and IKB lost about $900 million on their bad bets. (Goldman lost the remaining $100 million because it got stuck with some of the long side of Abacus.) But so what? This happens all day, every day. This is the nature of markets.

As we approach the fifth anniversary of the September 2008 panic, it is worth remembering that financial innovation didn't cause the problem. Of course, the crisis had no single cause -- many things went wrong nearly simultaneously -- yet some provocations rise above the others.

Chief among them was, and remains, an incentive system on Wall Street that rewards bankers and traders who take asynchronous risks (heads, they win; tails, you lose) with other people's money. When you are rewarded with a multi-million-dollar bonus for packaging shoddy mortgages into securities and selling them to investors around the world, that's exactly what you are going to do until the market tells you it can no longer be done.

Bankers and traders did just that on Wall Street in 2005 and

2006. The music stopped in the summer of 2007 when, after the collapse of the two Bear Stearns Cos. hedge funds that were chock-full of CDOs and mortgage-backed securities, the market shut down like a power switch.

By then, Wall Street banks had billions of these unsellable securities on their own balance sheets. Then they made another fateful, but perhaps inevitable, mistake: They used these increasingly risky securities as collateral for the short-term financing they needed to run their businesses on a daily basis.

In March 2008, and again that September, the short-term lenders decided they no longer wanted CDOs and mortgage-backed securities as collateral for overnight loans. The Wall Street firms -- namely, Bear Stearns, Lehman Brothers Holdings Inc., Merrill Lynch & Co. Inc., Morgan Stanley and American International Group Inc. -- that had miscalculated the risks of these securities found themselves bankrupt or almost so. As we know, some of them were rescued and some of them weren't.

But they all suffered from the same affliction, which had nothing to do with financial innovation: poor risk management and the wrong reward system. So long live the synthetic CDO. The truth is, five years on, Wall Street still suffers from inadequate risk management (see: Whale, London) and improper incentives. Until these problems are fixed, the next financial crisis is inevitable.