Lessons from Goldman Sachs case

BY

Ramki

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Background

- During the housing boom, in 2006 alone Goldman underwrote $26B of CDO's (Credit default obligations) or CDS (Credit default swaps)
- But by clever use of a financial product called **Abacus** Goldman and its client Paulson famously cleaned up on the collapse in the housing market.
- The fund manager made $20 B in 2007 and 2008- while many bit the dust
- AIG had insured $6 B of Abacus securities
- AIG also went down and is being propped by the US Govt with tax payers' money- $150B is being sunk
- US Govt has been investigating what led to the financial crisis
- Now SEC says Goldman Sachs is also responsible for the financial crisis

The case

- SEC filed a civil suit on Apr 16 10 on Goldman Sachs
- Essentially the charge is Goldman built a financial equivalent of a time bomb and sold it to unwitting investors.
- This is the first time SEC has gone after a Wall street firm.

The details

- SEC accuses Goldman Sachs of :
- Failing to disclose conflicts of interest in mortgage loan investment it sold, as the housing market was faltering.
- One of its clients (Paulson & co one of the world's largest hedge funds , owned by Paulson a Billionaire, which paid Goldman $15M for structuring the deals in 2007) helped create and then bet against subprime mortgage securities that Goldman sold to investors.
- Investors lost over $1 B;
  - and sure enough
- Paulson made $1 B!

The basic problem-1

- CDO's were financial weapons of mass destruction invented by Wall street
- CDO is nothing but securities formed by slicing and dicing home loans ; when the housing market collapsed, the CDO's lost all their value, led to failure of many banks and also brought down AIG which had insured them
- The problem is Wall street also created securities that allowed investors to make side bets on the housing market.
- Known as **synthetic CDO's** they did not raise any money for home loans or serve any other broad economic purpose!
- **This was pure speculation or Gambling**

The basic problem-2

- Synthetic CDO's were just like casinos offering blackjack along with slot machines .
- CDO's had peaked at $534B in 2006;
- Synthetic CDOs were around 10%

What people say

- An independent banking analyst :" This litigation exposes the cynical, savage culture of Wall street that allows a dealer to commit fraud on one customer to benefit another!"
- "The scandal was not that Goldman was short. The scandal is that Goldman sold the contents of Abacus as being handpicked by managers at funds management firm ACA when in fact it was handpicked by Paulson; they were saying Paulson had a long position when in fact he was entirely short!"
- An SEC director says: **"The product was new and complex but the deception and conflicts were old and simple."**

What Goldman Sachs says

- “The credit default swaps we bought were hedges (short positions) to offset our long positions.
- We did not profit from the mortgage melt down.
- We will defend our case”

The guys behind

- In late 2006 itself, Frenchman Fabrice P. Tourre (who works in London office of Goldman) and his colleague Jonathan M. Egol saw looming disaster in American Housing market and masterminded a series of mortgage deals known as Abacus investments.
- Egol a specialist in analytical finance devised Abacus
- Egol and Fabrice were way ahead of their time and they saw the writing on the wall early
- The allegation is that Tourre and Goldman defrauded investors with complex deals. (Egol is not charged)

Did the top guys know?

- Lloyd.C Blankfein, Chairman and CEO took an active role in overseeing the mortgage unit.
- In addition the President, CFO also visited the mortgage unit frequently and spent many hours.

What next?-1

- Britain's PM and two members of US Congress are asking for investigations into the bank's role;
- Germany is considering legal action.
- Abacus is just one of 25 securities worth $10.9 B that Goldman issued during the mortgage mania!
- So the other securities are also likely to be investigated
- On 27 Apr, Tourre and 3 other executives will testify before a Senate panel committee.
- Congress weighing tougher rules for complex investments like those involved in Goldman fraud.

What next?-2

- Other banks are also are involved?
  - UBS put together $15.8B of CDO's.
  - JP Morgan chase and Citi created more than $9B
- Other banks are also likely to be investigated by SEC
- Rajat Gupta (Former CEO McKinsey & co) may also be questioned;
  - He was on the board of Goldman
  - He is also being investigated for Galleon scam involving Rajaratnam ;
  - Rajat and Rajaratnam were co-investors in a PE fund

Lessons for us

- New frauds happen whenever fancy new financial engineering products come up ; Complex products which no one understands are fertile grounds for frauds
- Greed is the cause of all frauds!
- To say the truth is the most difficult thing
- SEC and US Govt will take steps to prevent such things in future and companies will find a way to get over those regulations also over time
- In Lehman Bros it was Repo 105; In Goldman it is Abacus –next time it will be something else

Most important: No lessons will ever be learnt!

Sources

- MSN India
- NY times
- Smart pros
- Bnet