Goldman's Lies of Omission

***TSF Opinion Commentary* – October 28, 2009**
By Janet Tavakoli

In my opinion, David Viniar's (CFO of Goldman Sachs) comments in the fall of 2008 were a ~~lie~~ (see "~~I apologize to David Viniar and Goldman's Lawyers and~~ Call For More Regulation of Goldman Sachs" – November 5, 2009), and for that matter, Lloyd Blankfein's (CEO of Goldman Sachs) later comments to the Wall Street Journal were disingenuous. In the context of what was happening near the time of AIG's implosion, the key question was "What is going on between Goldman and AIG?" Their rhetoric surrounding this issue is a deft dodge. They may claim they didn't "technically" lie, but Goldman's business exposure to AIG posed both credit risk and reputation risk. They seem to overlook elements of the former and put insufficient value on the latter.

[***Afternote:*** Goldman's exposure *was not*, as Viniar stated in September 2008, "immaterial "whatever the outcome at AIG." Given Goldman's key role in AIG's distress, a reasonable liquidator of AIG may have clawed back most of the $7.5 billion in collateral Viniar claimed as a "hedge." If AIG had gone bankrupt, the underlying CDOs would likely have plummeted further in value—as has happened in past similar market upsets—and his "hedges," even if they remained whole would not have covered the loss. In fact, after the fall of 2008, the CDOs continued to rapidly lose USD billions in value. Secondary market values as of December 2009 for similar CDO product are bid at single digit pennies on the dollar in a supposedly more stable market.

(See also: "Goldman Fueled AIG's Gambles," *Wall Street Journal* December 12, 2009)

Now that the crisis is over, and given the special circumstances of the crisis, and Goldman's contribution to value-destroying securitizations, it is in the public interest to claw back the money paid to Goldman Sachs. AIG did not need to settle for 100 cents on the dollar in November 2008, and in September 2008, a good negotiator would have refused to hand over more collateral, and should have clawed some back (or insisted it was a temporary loan). In late July 2008, SCA settled with Merrill for $500 million on $3.7 B of contracts, or around 13.5%. On August 1, 2008, Ambac settled $1.4 B with Citi for $850 million, or around 60% on the dollar, but unlike SCA and AIG, Ambac wasn't on the brink of insolvency at the time. Calyon, a French bank also involved in AIG's transactions, settled similar contracts with FGIC, another bond insurer, for only ten cents on the dollar in August 2008, yet $13.9 billion of Goldman's contracts with AIG were settled for 100 cents on the dollar in November 2008 via purchases by Maiden Lane III. Ambac recently settled similar credit default swaps for ten cents on the dollar ($5 billion in contracts for around $500 million) as Ambac needed capital, and MBIA has made deeply discounted settlements.

The November 17, 2009 SIGTARP report notes that Goldman refused to negotiate a settlement for AIG's contract because it would have lost money. It is time to ask Goldman to buy back these CDOs from the Fed for 100 cents on the dollar, and there is another large position still held by AIG of Goldman's Abacus CDOs that should also be considered for repurchase by Goldman Sachs, given the public's large investment in AIG.]

Goldman should have plainly stated that it was owed billions in additional collateral from AIG—after already having collected billions—due to credit default swap contracts and other trading positions. Whether or not Goldman thought its credit risk was totally hedged is a separate, albeit important issue, and I'll get to that later.

Among the proximate causes of AIG's failure were previous calls for collateral made by its credit default swap trading counterparties, including Goldman Sachs. They were entitled to pressure AIG on its prices and demand more collateral; I had publicly challenged AIG's prices myself more than a year earlier. These actions gave a major push to AIG's subsequent credit downgrade, which tripped contract triggers that AIG had unwisely permitted its more clever counterparties to insert. (The credit default swap market is not standardized.) This meant AIG had to come up with collateral equal to the entire remaining amount of the credit default swap contract.

Unfortunately, AIG was essentially bankrupt at this point and it couldn't meet its obligations. The government could have stepped in and renegotiated its contracts. [Goldman's "hedges" might have disputed whether a reduced payment triggered a restructuring event, if applicable, in their contracts.] But that isn't what happened.

Absent a bailout of AIG, Goldman was vulnerable to increasing systemic risk which would have likely affected its hedge counterparties and many of its other trading counterparties. Liquidity was very tight in the fall of 2008. [In March of 2008, Alan Schwartz, then CEO of Bear Stearns, saw tens of billions of dollars of seeming liquidity disappear in hours. Schwartz publicly stated he had ample liquidity, until suddenly he did not.] In September of 2008, Goldman negotiated for additional capital with Berkshire Hathaway and paid up for it. The outcomes for both AIG and Lehman were uncertain.

If AIG had gone under, the already illiquid market would have frozen. Collateral requirements for all trading would have increased (just as they did the week Bear imploded), and Goldman would have had problems collecting from many trading counterparties, if not the exact counterparties "hedging" its exposure to an AIG disaster.

It is never a given that hedges will pay off when the chips are down. A counterparty may dispute whether the contractual definition of a credit event is met, if only to buy time. Even when there is no default at issue, counterparties can try to change the rules when the market is in turmoil. In the fall of 2008, there were already anomalies in the derivatives market. For example, China refused calls for collateral on derivatives contracts in Asia, and its counterparties were forced to renegotiate. The entire market pretended this event didn't cause a cross default.

Goldman was not a disinterested party in AIG's bailout. AIG's bailout—and the way the payouts were handled for its trading counterparties—hugely benefited Goldman Sachs. Goldman received a cash payment worth more than $10 billion from the U.S. Treasury—via AIG—during a system-wide liquidity crunch. Under the circumstances, I cannot think of any scenario that would have provided a more certain and stable outcome for Goldman Sachs.

See also the Bloomberg article and note below.

New York Fed's Secret Choice to Pay for Swaps Hits Taxpayers
Bloomberg News – October 27, 2009
Richard Teitelbaum and Hugh Son

Janet Tavakoli, founder of Chicago-based Tavakoli Structured Finance Inc., a financial consulting firm, says the government squandered billions in the AIG deal.

"There's no way they should have paid at par," she says. "AIG was basically bankrupt."

Citigroup Inc. agreed last year to accept about 60 cents on the dollar from New York-based bond insurer Ambac Financial Group Inc. to retire protection on a $1.4 billion CDO [Ambac said the underlying was worth about zero, and the protection payment would otherwise have been the full $1.4 billion].

JT Note: It is a strong statement to say that a CFO lied to the public, and in my opinion, David Viniar, Goldman's CFO, ~~lied~~ (see "I ~~apologize to David Viniar and Goldman's Lawyers and~~ Call For More Regulation of Goldman Sachs" – November 5, 2009) about Goldman's exposure to AIG while the AIG bailout was in progress in September 2008. Viniar spoke about risk management, but that is a separate issue from whether or not Goldman Sachs would have money at risk due to its direct business with AIG. Goldman Sachs would have been out billions of dollars in collateral had a bankruptcy-like settlement been negotiated with AIG, and that is material (see also the commentary above).

This is what David Viniar said during his Sept 16, 2008 earnings call:

David Viniar - *The Goldman Sachs Group, Inc. - EVP, CFO* Sure. Without giving exact numbers, let me just tell you how we think about this. AIG and Lehman, big important financial institution counterparties to Goldman Sachs. We did and we do a lot of business with both of them, as we do with all other major financial institutions. The way we do business with financial institutions is by having appropriate daily margin terms. That is how we are able to do the volume of business with each other that we do. And that goes for AIG, Lehman, and also Morgan Stanley, and JPMorgan, and Citi, and UBS, and Credit Suisse. That is how we manage our risk. In addition to the margin terms, we augment our risk management with appropriate hedging strategies. You heard at the beginning of my remarks that we believe one of the biggest challenges we have is to avoid large concentrated exposures; and we took that very much into account in managing our credit exposures to Lehman and to AIG, as well as we do with any other financial institution. **Given that, what I would tell you is given the outcome at Lehman and whatever the outcome at AIG, I would expect the direct impact of our credit exposure to both of them to be immaterial to our results. [Emphasis added.]**

Janet Tavakoli is the president of Tavakoli Structured Finance, a Chicago-based consulting firm to financial institutions and institutional investors. She is the author of a book on the cause global financial meltdown: *Dear Mr. Buffett: What an Investor Learns 1,269 Miles from Wall Street* (Wiley, 2009).

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