

## Goldman's Undisclosed Role in AIG's Distress

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By [Janet Tavakoli](#)

Goldman wasn't the only contributor to the systemic risk that [nearly toppled](#) the global financial markets, but it was the key contributor to the systemic risk posed by AIG's near bankruptcy. When it came to the credit derivatives American International Group, Inc. (AIG) was required to mark-to-market, Goldman was the 800-pound gorilla. Calls for billions of dollars in collateral [pushed AIG to the edge](#) of disaster. The entire [financial system was imperiled](#), and Goldman Sachs would have been exposed to [billions in devastating losses](#).<sup>1</sup>

A Goldman spokesman [told me](#) its involvement in AIG's trades was only as an "intermediary," but that isn't even close to the full story. [Goldman underwrote some of the CDOs](#) comprising the underlying risk of the protection Goldman bought from AIG. Goldman also underwrote many of the (tranches of) CDOs owned by some of AIG's other trading counterparties.

Even if all of Goldman's CDOs had been pristine, it poisoned its own well by elsewhere issuing deals like [GSAMP Trust 2006-S3](#) that—along with dodgy deals issued by other financial institutions—eroded market trust in this entire asset class and drove down prices.

By September 2008, Goldman had approximately \$20 billion in transactions with AIG. Goldman was AIG's largest counterparty, and its trades made up one-third of AIG's approximately [\\$62.1 billion](#) [Note added Nov. 30, 2009: Goldman's trades totaled \$23 billion (as of November 2007). As of November 2008, the remaining amount was \$22.1 billion of which \$13.9 billion was resolved by Maiden Lane III's purchase of \$62.1 billion of CDOs. AIG retained another \$8.2 billion of Goldman's credit default swaps referencing multi-sector CDOs.] in transactions requiring market prices.<sup>2</sup> Societe Generale (SocGen) was AIG's next largest counterparty with \$18.7 billion (as of November 2007). SocGen, Calyon, Bank of Montreal, and Wachovia bought several (tranches) of Goldman's CDOs and hedged them with AIG.<sup>3</sup>

On November 27, 2007, Joe Cassano, the former head of AIG's Financial Products unit, wrote a memo about the collateral AIG owed to its counterparties. Goldman, Soc Gen, Calyon and others required more than \$4 billion. Goldman asked AIG for \$3 billion of the \$4 billion required in collateral calls. ([Click here to view the nine-page memo uncovered by CBS News in June 2009.](#)) By September 2008, Goldman had called \$7.5 billion in collateral from AIG.

AIG lists its transactions as negative basis trades. This suggests Goldman earned a net profit by purchasing—or holding its own—CDO tranches and then hedging them with AIG.<sup>4</sup> [Note added Nov 17, 2009 – The SIGTARP report shows that Goldman held this risk in the form of credit default swaps for which it was a protection seller and it hedged its risk with AIG. Whether the risk was held as cash or credit default swaps, the negative basis trades, profitability, and risk to Goldman Sachs still applies.] As AIG's financial situation worsened, [Goldman bought further protection](#) in the event AIG collapsed.

SocGen's negative basis trades totaled \$18.6 billion. For example, SocGen bought protection from AIG on two tranches of Davis Square VI, a deal Goldman underwrote. According to AIG's

documentation, SocGen got its prices for marking purposes for Goldman's deals from Goldman. As of November 2007, Goldman marked down these originally "AAA-rated" tranches to 67.5%, down by almost one-third.<sup>5</sup>

SocGen's list includes other deals underwritten by Goldman: Altius I, Davis Square II, Davis Square IV, the previously mentioned Davis Square VI, Putnam 2002-1, Sierra Madre, and possibly more. SocGen hedged this risk by purchasing protection (in the form of credit default swaps) from AIG.

Calyon had \$4.5 billion of negative basis trades with AIG. Calyon and Goldman were co-lead on at least two deals: Davis Square II and Davis Square V. According to AIG's memo, Calyon got its prices for these deals from Goldman.

Goldman's list of negative basis trades prominently featured many of Merrill's CDOs (as underlying risk), and Merrill had its own list amounting to around \$9.9 billion (as of November 2007). In Sept 2008, at the time of AIG's near collapse, Bank of America had just agreed to merge with Merrill, which held [\\$6 billion of super senior exposure](#) to CDOs hedged with an insurer, now revealed to be AIG. Both Ken Lewis, then CEO of BofA, and Hank Paulson received tough questions about the merger, but not tough enough. Lewis later testified that Hank Paulson (then Treasury Secretary and formerly CEO of Goldman at the time of the AIG related trading activity) [urged him to be silent](#) about Merrill's troubles. Merrill later received a \$6.3 billion bailout payment from AIG.

Bank of Montreal had \$1.6 billion in negative basis trades with AIG, and at least two Goldman transactions (Davis Square I and Putman 2002-1) made up 6 of its 9 positions with AIG. Wachovia had 6 trades with AIG, all related to Davis Square II, a deal that Goldman underwrote.

[Goldman questioned PriceWaterhouse](#), Goldman's and AIG's common auditor, about prices. Goldman wanted lower prices, which meant that AIG would have to produce more collateral. When AIG was downgraded in September 2008, AIG was required to put up an aggregate amount of \$14.5 billion in additional collateral to equal the full difference between original prices and market prices. But "market prices" in this illiquid market were influenced by Goldman Sachs.

Goldman was right to question the prices, make calls for collateral, and protect itself. Goldman's activity was not the same as that of an arsonist buying fire insurance, but its trading activities with AIG and others were accelerants of AIG's problems.

During AIG's bailout, Goldman had influence over the decision to use public funds to pay 100 cents on the dollar for these CDOs (the underlying risk of the credit derivatives), but none of the information about the volume of Goldman's trades with AIG—or the Goldman CDOs hedged by AIG's other counterparties—was made public.

Goldman's public disclosures in September 2008 obscured its contribution to AIG's near bankruptcy and the need to bailout Goldman's trading partners in AIG related transactions. Goldman's trading activities played a starring role in the near collapse of the global markets.

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1 Goldman's current and former officers were influential in varying degrees in AIG's bailout. Hank Paulson was then Treasury Secretary and a former CEO at the time Goldman put on its trades with AIG and underwrote deals bought by some of AIG's counterparties. Lloyd Blankfein was CEO of Goldman and was influential in the bailout discussions. Stephen Friedman, then Chairman of the NY Fed, also served on Goldman's board.

2 AIG's [Nov 2007 report](#) showed Goldman's positions at \$23 billion, but something may have happened before Sept 2008 to reduce that amount. AIG was required to price these credit derivatives using market prices, and if applicable, AIG had to provide collateral if the prices moved against it. Terms varied, but after the downgrade, AIG owed collateral for the full mark-to-market value to several counterparties. This is the difference between the original value and the price that Goldman and others put on the credit default swaps.

3 AIG's other trading partners for the CDSs requiring mark-to-market prices included French banks Societe General (SocGen) and Calyon, Bank of Montreal, Wachovia, Merrill Lynch, UBS, Royal Bank of Scotland, and Deutsche Bank.

4 AIG may have used the term "negative basis trade" loosely. Whether Goldman was an intermediary (stood between AIG and yet another counterparty), or whether it booked negative basis trades, Goldman had to manage its risk in the event AIG went under.

5 SocGen's total margin calls were not available in the [November 2007 memo](#). It is possible that like Calyon—and like [troubled Citigroup](#)—SocGen provided a liquidity put on commercial paper (CP) distributed by Wall Street firms to a variety of investors. Calyon agreed to buy the CDO's commercial paper (short term debt backed by the longer term tranches of the CDOs) if demand in the market dried up when it came time to roll the CP. Calyon hedged the risk of the liquidity puts by purchasing credit default protection from AIG.

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