

I Retract My Apology and Call for More Regulation of Goldman Sachs

TSF – Opinion Commentary – November 22, 2009 (see also [Apology](#))

By Janet Tavakoli

According to SIGTARP¹, both the Federal Reserve and Treasury agreed that an [AIG failure posed unacceptable risk to the global financial system](#) and the U.S. economy. On March 24, 2009, Fed Chairman Ben Bernanke testified before the House Financial Services Committee [P.9]:

[C]onceivably, its failure could have resulted in a 1930's-style global financial and economic meltdown, with catastrophic implication[s].

From July 2007, AIG's financial situation deteriorated while so-called "AAA" collateralized debt obligations (CDOs) dropped in value. AIG sold credit default swaps (CDSs) on these CDOs and had to post more collateral, as the prices plummeted.

Goldman Sachs was AIGFP's (UK-based AIG Financial Products) largest CDS counterparty with around \$22.1 billion, or about one-third of the problematic trades. Goldman underwrote some of the CDOs underlying its own CDSs, and also underwrote a large portion of the CDOs against which French banks SocGen and Calyon, Bank of Montreal, and Wachovia bought CDS protection. Goldman provided pricing on these CDOs to SocGen and Calyon. Goldman was a key contributor to AIG's liquidity strain and the resulting systemic risk. (See "[Goldman's Undisclosed Role in AIG's Distress](#)")

Apocalypse AIG

By mid September 2008, AIG's long-term credit rating was downgraded, its stock price plummeted, and AIG couldn't meet its borrowing needs in the short-term credit markets. According to SIGTARP, "without outside intervention, the company faced bankruptcy, as it simply did not have the cash that was required to provide to AIGFP's counterparties as collateral." [P.9] The Federal Reserve Board with Treasury's encouragement authorized a bailout.²

The Federal Reserve Bank of New York (FRBNY) extended an \$85 billion revolving credit facility, so AIG could make its collateral payments to Goldman and some of its CDO buyers. AIG also met other obligations, such as payments under its securities lending programs owed to Goldman and some of its CDO buyers. (See also: "[AIG Discloses Counterparties to CDS, GIA, and Securities Lending Transactions.](#)")

Goldman "Would Have Realized a Loss"

Fed Chairman Bernanke said AIG's crisis put the world at risk for a global financial meltdown. Goldman purchased little credit default protection³ against an AIG collapse. Even if Goldman escaped a collateral clawback of the billions it held from AIG⁴, the underlying CDOs posed substantial market value risk (SIGTARP P. 17). As for systemic risk, Goldman CEO Lloyd Blankfein worried about untold billions in losses. ([Too Big to Fail](#), P. 382.)

On September 16, 2008, as the FRBNY arranged AIG's \$85 billion credit line, Goldman CFO David Viniar said whatever the outcome, he would expect the direct impact of credit exposure to be "immaterial to [Goldman's] results." The CDOs' (\$22.1 billion) value was down around \$10 billion, and AIG still owed Goldman \$2.5 billion in collateral (hedged and partly collateralized by CDSs on AIG). SIGTARP shows the CDOs' value fell another \$2.5 billion in two months, and AIG's new credit line provided more collateral. The CDOs were losing market value. If AIG had collapsed, the value drop would have been swift and brutal with new protection either unavailable or too expensive, if past CDS market mayhem provided any information. As the *Wall Street Journal* put it, SIGTARP "throws cold water on [Goldman's] claim."

[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.]

Before September 16, 2008, AIG tried to negotiate a settlement for forty cents on the dollar. Other insurers have negotiated [even deeper discounts](#) to settle their CDS contracts on CDOs.

The SIGTARP report shows that the FRBNY's decision to pay 100 cents on the dollar to resolve \$13.9 billion (part of Goldman's \$22.1 billion) of credit default swaps by purchasing the underlying CDOs in Maiden Lane III was important to Goldman Sachs. "Goldman Sachs...did not agree to concessions, because it would have realized a loss if it had." [P.16]

Treasury Secretary Timothy Geithner, then President of FRBNY, [is revealed in this New York Times article with apparent Stockholm syndrome rivaled only by Patty Hearst](#). He seems to echo [Goldman's talking points](#) after discussions with Goldman's CFO. In the fall of 2008, Henry ("Hank") Paulson was Treasury Secretary. Paulson was formerly CEO of Goldman Sachs and held that role when Goldman executed its trades with AIG. Stephen Friedman, a former Goldman Sachs co-chairman, was Chairman of FRBNY. Friedman owned shares of Goldman Sachs, and was a member of Goldman's board, while he held his influential Fed position. He resigned the Fed position in May 2009, but not before [purchasing 50,000 shares](#) of Goldman Sachs, when the public was still in the dark about the terms of the bailout.

Goldman's Turn to Apologize

In light of the SIGTARP report, I withdraw my earlier [apology](#) to Goldman. Public commitments to AIG are currently around \$182 billion. If you wonder what Goldman CEO Lloyd Blankfein meant when he said: "[\[Goldman Sachs\] participated in things that were clearly wrong and we have reason to regret and we apologize for them,](#)" think of Goldman's role in AIG's crisis, Goldman's bailout, and Goldman's ongoing heavy taxpayer subsidies. That way, one of you will be genuinely sorry about it.



- 1 The November 17, 2009 report of the Office of the Special Inspector General for the Troubled Asset Relief Programs, "[Factors Affecting Efforts to Limit Payments to AIG Counterparties](#)." The report does not address the risk of collateral clawbacks by authorities on behalf of AIG or the public, and it does not address the relative size of Goldman's CDS positions and CDO underwriting activity related to AIG's CDSs mentioned in the above commentary.
- 2 Fed and Treasury officials thought AIG's derivatives were "more risky and unbalanced than Lehman's." They were concerned about loss of confidence in AIG's subsidiaries, AIG's failure to perform on annuities and wraps, losses to state and local governments, global banks and investment banks, losses to 401k plans, and the credit markets. The Reserve Primary Fund had fallen below \$1.00 per share after it wrote off Lehman's debt causing a run on the fund, and officials worried about an AIG failure causing further "breaking-of-the-buck." (P. 10)
- 3 SIGTARP says Goldman would have trouble collecting on the credit default protection it bought to protect against an AIG collapse—which by deduction seems to only be around \$2.5 billion. It is usual to have mark-to-market collateral, but it is unlikely this position was 100% collateralized. In November 2008, it seems \$1.2 billion of this hedge was allocated for Maiden Lane III assets and \$1.1 billion to another \$8.2 billion position leaving an apparent slight excess notional amount. But even if it were 100% collateralized, that seeming advantage could quickly disappear in a volatile market when pricing discounted illiquid assets that lack transparency. [P. 16, 17]
- 4 According to SIGTARP, private participants felt AIG's financial condition was so tenuous that on September 15, they refused to fund AIG making the Fed's bailout necessary. Their analysis showed AIG's liquidity needs exceeded the value of the company's assets. [P.8]

Goldman's status in the event of an AIG collapse would have been that of a credit default swap counterparty during a global crisis with very special circumstances. Goldman thought it would get to keep the billions in dollars it received from AIG, if AIG collapsed. That would normally be the case, but these would have been extraordinary circumstances inflamed by value-destroying CDOs over which Goldman had pricing power, and Goldman had underwritten some of the CDOs. Authorities charged with resolving a collapse of AIG may have clawed back a substantial portion of the collateral.

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