Goldman Sachs: Reasonable Doubt

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By Janet Tavakoli

In August 2007, I publicly challenged the fact that AIG took no write-downs whatsoever for its credit default swaps on underlying mortgage related "super senior" positions. I used the example of its aggregate $19.2 billion in credit default swaps on super senior positions backed by BBB-rated tranches of residential mortgage backed securities. I spoke with Warren Buffett, but only about what I had already told the *Wall Street Journal* (*Dear Mr. Buffett* Pp. 164-165, 246).

I met with Jamie Dimon, CEO of JPMorgan Chase, adding that the difference was material. JPMorgan Chase's credit derivatives positions exceeded those of all other U.S. banks combined at the time. JPMorgan was not a participant in the problematic deals, and it was not a recipient of AIG's settlement payments, but stability in the credit derivatives markets was an important issue. Dimon was dismissive of my concerns. In August of 2007, a potential implosion of AIG was too horrible to contemplate.

Unbeknownst to me, in July 2007, Goldman Sachs and AIG began a prolonged battle over prices and collateral payments for pre-2006 vintage deals on which Goldman had bought protection.

Fraud Audit

Was the risk that Goldman hedged with AIG as bad as Goldman Sachs Alternative Mortgage Products' GSAMP Trust 2006-S3? Any risk manager worth their salt would have reasonable doubt about this deal and conduct a fraud audit. A fraud audit doesn't mean you are accusing anyone of fraud, only that the audit will be thorough, because there are indications of grave problems. If there is fraud, however, the audit should be rigorous enough to uncover it.

If the aggregate $19.2 billion CDS position were derived from BBB rated tranches similar to one from GSAMP Trust 2006-3, the supposedly super safe "super senior" tranche would be worth zero. Every underlying BBB tranche would have permanent value destruction and zero value. AIG would owe a credit default swap payment for the full amount $19.2 billion. Since there is doubt about the collateral of every deal of this ilk, super senior tranches of mezzanine CDOs in the secondary market are currently valued at zero.

No wonder Goldman Sachs bought protection from AIG on mortgage backed deals—and then bought protection on AIG. Goldman may not have contributed to the aggregate $19.2 billion position, but this mezzanine super senior risk was visible to all of AIG's counterparties.

Sophisticated counterparties like AIG are supposed to protect themselves, and have little chance for recovering damages. But now the American taxpayer has stepped in to make payments for AIG. U.S. taxpayers have a right to recover money paid out for derivatives on deals that include phony collateral.

Maiden Lane III now owns the underlying CDOs for AIG's cancelled credit default swaps. One can now investigate them—and all of the underlying collateral.

The government's 100% payout to AIG's counterparties was a gift, and the negotiations were done in secret. The monoline insurers were in a similar situation with a variety of deals from a variety of counterparties. (*Structured Finance* Pp. 405-427) For example, in 2008, Citigroup Inc. accepted 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 "super senior" was worth about zero, and the protection payment would otherwise have been near the full $1.4 billion. Citigroup got a relatively huge payout, since other "high grade" deals have been settled for as low as ten cents on the dollar.

The irony is that Goldman Sachs may not have been involved in the worst of the deals, but its officers had unusually high profile in AIG's damage control. Goldman's deals with AIG may have all been completely proper, but deals like GSAMP Trust 2006-3 indicate that Goldman should not be exempt from the general fraud audit of mortgage securitizations that all of the former investment banks [Lehman, Bear Stearns, Morgan Stanley, Goldman Sachs, Merrill Lynch, and some foreign banks doing business in the U.S. (*DMB* Pp. 97-107.)] should undergo.

Goldman Worried About "Untold Billions in Crippling Losses"

When Goldman's CFO David Viniar made his remarks about Goldman's exposure to AIG on September 16, 2008 it was in the heat of the AIG negotiations. He said Goldman's exposure to AIG was not material. (*DMB* P. 167*)* Goldman's hedges were a separate issue and may have paid out (due to triggers) even post bail-out, albeit Goldman had high anxiety about its counterparties' ability to pay at the time.

On September 16, *Bloomberg*'s Erik Holm and Christine Richard wrote of the dire global market consequences of an AIG failure. For example, Bank of America had just agreed to merge with Merrill Lynch & Co., which held $6 billion of super senior exposure to collateralized debt obligations hedged with an insurer. I told *Bloomberg*: "It's impossible [without more disclosure] to know which insurance company they're referring to, though if it is AIG, it may have emboldened AIG to go to the Fed." AIG's downgrade would result in another write-down for Merrill. Merrill later received a $6.3 billion bailout payment from AIG.

Goldman was not disinterested about the billions in collateral owed by AIG (if it extracted too much in advance, payments could be clawed back). *WSJ*'s Serena Ng reported that even before AIG collapsed, Goldman received $7.5 billion in collateral from AIG. After the bailout and before year end 2008, Goldman got another $8.1 billion from AIG [Note added Nov. 17, 2009. The SIGTARP report states that on the $13.9 billion position bought by Maiden Lane III, AIG had already received $8.4 billion (including $7.5 billion before September 2008) in collateral, and of the previously mentioned $8.1B, $5.6 billion were net additional payments for the $13.9 billion in securities purchased by Maiden Lane III from Goldman.] just for the credit swaps and billions more for other financial positions.

Goldman's CEO Lloyd Blankfein knew that if AIG failed, Goldman's counterparties would suffer collateral damage (*DMB* P. 167), and Goldman would be exposed to "untold billions in crippling losses." (*Too Big to Fail*, P. 382, Andrew Sorkin, Viking 2009 The quote marks refer to the book's text, not to a quote from Blankfein. *WSJ* had previously reported Goldman's concern.)

Goldman Abhors Conflicts of Interest (for Others)
The public wanted to know if Goldman Sachs was one of AIG's large credit derivatives counterparties, since it was involved in the bailout negotiations. In September 2008, AIG's fresh credit rating downgrade (from AA to A) triggered a clause, requiring it to provide 100% collateral for many of its CDS contracts. It meant AIG had to quickly come up with tens of billions for some of its counterparties, and it was unable to do it. It was in that context that David Viniar made his remarks on September 16, 2008. Viniar's remarks obscured the fact that Goldman was not disinterested. (*DMB* P. 167*)*

Goldman's board first learned of its ongoing collateral dispute with AIG in November 2007, and Goldman bought protection against the possibility that AIG would fail (*TBTF* P. 175 only $1.5 billion was in dispute at this early stage).

In July 2008, PricewaterhouseCoopers (PWC), the auditor for both Goldman and AIG, briefed Goldman's board about Goldman's hot dispute with AIG over its portfolio value. Goldman wanted more collateral, and AIG resisted. The amounts in dispute had grown larger. Lloyd Blankfein said AIG was "marking to make-believe." (*TBTF* P. 175) Goldman's co-president, Jon Winkelried, questioned PWC about its conflict of interest. Goldman increased its hedges; it paid $150 million for credit protection on $2.5 billion of debt. It also extracted billions more in collateral from AIG.

Goldman's Conflicts of Interest
Gary Cohn, president and COO of Goldman Sachs, boasted that Goldman over-hedged its exposure to AIG and might make $50 million if AIG collapsed (*TBTF* P. 382). [Note added November 17, 2009. The SIGTARP report states that Goldman would "not agree to concessions, because it would have realized a loss if it had." This suggests that Goldman was underhedged and would have suffered material losses without the government bailout. The report also questions Goldman's prices of the CDOs and even its ability to collect on its hedges on AIG bankruptcy risk if AIG had collapsed.] That is splendid information, since some (or all) of those hedges may have paid out given the circumstances of the AIG bailout. Participation in the bailout negotiations gives one a chance to structure the bailout in such a way to trigger as many hedge contracts as possible and get a double whammy. Whether or not it maximized its outcome, Goldman was not disinterested.

Stephen Friedman, a Goldman Sachs board member and then also Chairman of the Board of the New York Fed, bought shares of Goldman Sachs before the public knew that Goldman Sachs would receive full payments from AIG with public funds. Things were looking up for Goldman Sachs, and Friedman was in a better position than the public to know that. The public was still in the dark.

360 E. RANDOLPH STREET - SUITE 3007 • CHICAGO, ILLINOIS 60601
OFFICE 312.540.0243
www.tavakolistructuredfinance.com

David Viniar, Lloyd Blankfein, and Ralph Cioffi
David Viniar and Ralph Cioffi, formerly co-head of Bear Stearns Asset Management and now fending off a dispute with former investors, have something in common. After I publicly opposed his proposed Everquest IPO, Cioffi claimed it had little exposure to subprime, because he was "hedged." In my experience, one usually addresses a deal's gross exposure, and then talks about being hedged. (*DMB* P. 133) As it happened, Cioffi was underhedged.

In Viniar's case, Goldman was apparently overhedged [Note added November 17, 2009. The SIGTARP report states that Goldman would "not agree to concessions, because it would have realized a loss if it had." This suggests that Goldman was underhedged and would have suffered material losses without the government bailout. The report also questions Goldman's prices of the CDOs and even its ability to collect on its hedges on AIG bankruptcy risk if AIG had collapsed.] if AIG collapsed (assuming Goldman's other counterparties didn't collapse since AIG, Lehman, and Merrill were having problems causing system-wide stress, and assuming no disputes over whether or not conditions of payment were met). Yet the magnitude of Goldman's gross exposure and $7.5 billion in previous collateral payments and prospective billions more owed by AIG was an important consideration at the time—irrespective of the quality of the hedges—given Blankfein's, and Friedman's potential roles in the bailout negotiations. Henry ("Hank") Paulson, then Treasury Secretary and a former Goldman CEO, was CEO of Goldman at the time it put on its trades with AIG. He was an important influence and participated in negotiations of the Merrill / BofA merger.

Ralph Cioffi had more in common with Goldman than disclosure style. *Reuters'* Matthew Goldstein reported that in March 2007, the funds Cioffi managed became the largest single investor in one of Goldman's toxic CDOs. The funds made a $300 million investment in Timberwolf I, a $1 billion Goldman deal. It was managed by Greywolf Capital, a firm founded by former Goldman bond traders. Within two weeks of the purchase, Goldman began marking down the value of the securities it just brought to market.

Sorkin states that Goldman worried as early as November 2007 about a possibility of AIG's failure (*TBTF* P. 175), and if AIG failed in September 2008, Blankfein worried about billions in crippling losses. In a recent *Wall Street Journal* interview, Blankfein said he didn't suspect AIG had problems producing collateral: "I never had reason to suspect….[I]t never occurred to me." Yet, it seems nothing about AIG's potential bankruptcy or bailout was immaterial to Goldman Sachs.

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), *Structured Finance & Collateralized Debt Obligations* (Wiley 2003, 2008), and *Credit Derivatives & Synthetic Structures* (Wiley 1999 and 2001).

See Also

New York Fed's Secret Choice to Pay for Swaps Hits Taxpayers *Bloomberg News*, Oct. 27, 2009
Goldman's Lies of Omission *TSF*, Oct. 28, 2009

Other Important Disclosures