



Greed Gone Wild

In Goldman Sachs We Do Not Trust

David Dreman 04.16.10, 3:30 PM ET

The firm clearly had its way with the Fed and the Treasury, but now the SEC says it stepped over the line.



Although Goldman Sachs is widely considered to be the smartest and certainly most profitable investment firm in market history, it is also regarded with enormous suspicion and now it's slapped with formal charges. Friday the U.S. Securities and Exchange Commission charged Goldman and one of its vice presidents with fraud in a synthetic collateral debt obligation, Abacus-2007 AC1, tied to subprime lending on mortgage backed securities.

The SEC alleges that Goldman Sachs received \$15 million from a hedge fund manager for structuring and marketing this synthetic CDO to the specifications of the manager and then selling it to its clients. The hedge fund then took bearish positions in specific tranches of the Abacus CDO. Buyers lost \$1 billion on the CDO.

Prior to the subprime crisis, Goldman played a major role in persuading the large debt ratings agencies to upgrade a significant amount of sub-prime mortgages to prime, which were then packaged and sold them as prime. Anyone who bought these was seriously burnt, while anyone who sold them or the derivatives on them, like John Paulson and allegedly Goldman, made many fold their money, as the value of the underlying securities often dropped to near zero.

Goldman has come under heavy fire for originating and selling tens of billions of dollars of mortgage-backed securities and derivatives to its clients--including pension funds, mutual funds, and insurance companies--and then at times shorting them. The SEC launched an industry-wide investigation into these allegations, culminating in today's charges.

CEO Lloyd Blankfein, Goldman's most stalwart defender, has repeatedly denied these accusations. In January Blankfein presented a vigorous defense of his firm's actions before the Financial Crisis Inquiry Commission. The commission pressed Blankfein on the sale of mortgage-backed securities as well as Goldman pushing the rating agencies for the highest ratings on sub-prime mortgage portfolios and then shorting them.

Chairman Phil Angelides said to Blankfein, "It sounds to me ... like selling a car with faulty brakes and then buying an insurance policy on the buyer."

The accusation that Goldman allegedly played a key role in bringing down AIG in September of 2008 also stirs controversy. Previously Goldman demanded full repayment of \$12.9 billion it claimed it was owed by AIG to close an enormous trading position. The trade was on credit default swaps, basically puts they bought on sub-prime mortgage bonds that gave them the original price if the bonds dropped in value for a very small annual premium. AIG had already paid Goldman \$7.5 billion in cash as collateral on its \$20 billion position. AIG contended that Goldman was overestimating the amount owed and wanted to take it to arbitration. Goldman refused and indicated that it would pursue its claim which could put AIG into bankruptcy.

Fearful that AIG's collapse would send the panicked markets over the edge, the Federal Reserve Bank of New York made an emergency loan to AIG on Sept. 16, pumping \$85 billion of taxpayer money into the company and taking an 80% interest. This was followed in November by the New York Fed, headed then by Treasury Secretary Timothy Geithner, buying the \$62.1 billion of swaps with taxpayer money from Goldman and a group of other major investment banks including Societe Generale. The price was no bargain, the full 100 cents on the dollar that holders said they were owed. Gains on the swaps were enormous.

The New York Fed, against the wishes of AIG executives and its legal counsel, told the company to withhold the details of the payments during the height of the raging financial crisis. Details only emerged in January of 2009 when the SEC said that they should make public after discussions with the New York Fed.

The disclosure raised a storm in and out of Congress. First, former Treasury Secretary Henry Paulson, previously headman at Goldman and under whose tenure some of the credit swaps were presumably bought, asked Edward M. Liddy to take the CEO job at AIG in September of 2008, soon after the takeover by the New York Fed. Mr. Liddy, gone from the job now, still owns millions of dollars of Goldman's stock, most of which comes from being on the Goldman's board and serving on its audit committee.

Coincidentally, Stephen Friedman, appointed as Geithner's successor at the New York Fed when Geithner became Treasury Secretary in early 2009, was also a former chairman of Goldman Sachs. He resigned his position at the Fed, effective immediately, only a few months after his appointment in early May 2009. He had remained on the Goldman board even as he was regulating Goldman and got a waiver from the Washington Fed to buy 52,600 Goldman shares, which he did \$78.

Paulson, Liddy and Geithner all said they were uninvolved in the negotiations. Apparently, all the decisions on the Goldman bailout were made by underlings at the Fed after discussions with their counterparts at AIG, while the first team wore ear plugs.

Some thought otherwise. Neil Barofsky, the special Inspector in charge of policing the Troubled Asset Relief Program (TARP) wrote in a Nov. 17 report: "The Federal Reserve provided AIG's counterparties with tens of billions of dollars they likely would have not

received." Further, just prior to the Fed takeover, AIG was negotiating a much lower price for the repurchase of the Swaps, as was a French banking regulatory official on behalf of SocGen, which owned \$11.9 billion of swaps, and BNP Paribas which had \$4.9 billion worth.

Republican and Democratic congressmen were infuriated. They also dismissed the Goldman threat of bankruptcy for AIG. Since the Fed bailout eventually swelled to \$182 billion and it owned 80% of AIG's stock, it's inconceivable that it would have gone into bankruptcy. Even if it did, the result should most likely have been the payment of only pennies on the dollar for the swaps, and that money would have taken years to be paid.

The question over the importance of Goldman's influence over the payment of \$62 billion of taxpayer money to itself and a group of other investment banks remains mostly obscured by heavy volcanic clouds. The saga continues.

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