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How Goldman secretly bet on the U.S. housing crash

Greg Gordon | McClatchy Newspapers

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WASHINGTON — In 2006 and 2007, Goldman Sachs Group peddled more than \$40 billion in securities backed by at least 200,000 risky home mortgages, but never told the buyers it was secretly betting that a sharp drop in U.S. housing prices would send the value of those securities plummeting.

Goldman's sales and its clandestine wagers, completed at the brink of the housing market meltdown, enabled the nation's premier investment bank to pass most of its potential losses to others before a flood of mortgage defaults staggered the U.S. and global economies.

Only later did investors discover that what Goldman had promoted as triple-A rated investments were closer to junk.

Now, pension funds, insurance companies, labor unions and foreign financial institutions that bought those dicey mortgage securities are facing large losses, and a five-month McClatchy investigation has found that Goldman's failure to disclose that it made secret, exotic bets on an imminent housing crash may have violated securities laws.

"The Securities and Exchange Commission should be very interested in any financial company that secretly decides a financial product is a loser and then goes out and actively markets that product or very similar products to unsuspecting customers without disclosing its true opinion," said Laurence Kotlikoff, a Boston University economics professor who's proposed a massive overhaul of the nation's banks. "This is fraud and should be prosecuted."

John Coffee, a Columbia University law professor who served on an advisory committee to the New York Stock Exchange, said that investment banks have wide latitude to manage their assets, and so the legality of Goldman's maneuvers depends on what its executives knew at the time.

"It would look much more damaging," Coffee said, "if it appeared that the firm was dumping these investments because it saw them as toxic waste and virtually worthless."

Lloyd Blankfein, Goldman's chairman and chief executive, declined to be interviewed for this article.

A Goldman spokesman, Michael DuVally, said that the firm decided in December 2006 to reduce its mortgage risks and did so by selling off subprime-related securities and making myriad insurance-like bets, called credit-default swaps, to "hedge" against a housing downturn.

DuVally told McClatchy that Goldman "had no obligation to disclose how it was managing its risk, nor would investors have expected us to do so ... other market participants had access to the same information we did."

For the past year, Goldman has been on the defensive over its Washington connections and the billions in federal bailout funds it received. Scant attention has been paid, however, to how it became the only major Wall Street player to extricate itself from the subprime securities market before the housing bubble burst.

Goldman remains, along with Morgan Stanley, one of two venerable Wall Street investment banks still standing. Their grievously wounded peers Bear Stearns and Merrill Lynch fell into the arms of retail banks, while another, Lehman Brothers, folded.

To piece together Goldman's role in the subprime meltdown, McClatchy reviewed hundreds of documents, SEC filings, copies of secret investment circulars, lawsuits and interviewed numerous people familiar with the firm's activities.

McClatchy's inquiry found that Goldman Sachs:

- Bought and converted into high-yield bonds tens of thousands of mortgages from subprime lenders that became the subjects of FBI investigations into whether they'd misled borrowers or exaggerated applicants' incomes to justify making hefty loans.
- Used offshore tax havens to shuffle its mortgage-backed securities to institutions worldwide, including European and Asian banks, often in secret deals run through the Cayman Islands, a British territory in the Caribbean that companies use to bypass U.S. disclosure requirements.
- Has dispatched lawyers across the country to repossess homes from bankrupt or financially struggling individuals, many of whom lacked sufficient credit or income but got subprime mortgages anyway because Wall Street made it easy for them to qualify.
- Was buoyed last fall by key federal bailout decisions, at least two of which involved then-Treasury Secretary Henry Paulson, a former Goldman chief executive whose staff at Treasury included several other Goldman alumni.

The firm benefited when Paulson elected not to save rival Lehman Brothers from collapse, and when he organized a massive rescue of tottering global insurer American International Group while in constant telephone contact with Goldman chief Blankfein. With the Federal Reserve Board's blessing, AIG later used \$12.9 billion in taxpayers' dollars to pay off every penny it owed Goldman.

These decisions preserved billions of dollars in value for Goldman's executives and shareholders. For example, Blankfein held 1.6 million shares in the company in September 2008, and he could have lost more than \$150 million if his firm had gone

bankrupt.

With the help of more than \$23 billion in direct and indirect federal aid, Goldman appears to have emerged intact from the economic implosion, limiting its subprime losses to \$1.5 billion. By repaying \$10 billion in direct federal bailout money — a 23 percent taxpayer return that exceeded federal officials' demand — the firm has escaped tough federal limits on 2009 bonuses to executives of firms that received bailout money.

Goldman announced record earnings in July, and the firm is on course to surpass \$50 billion in revenue in 2009 and to pay its employees more than \$20 billion in year-end bonuses.

THE BLUEST OF THE BLUE CHIPS

For decades, Goldman, a bastion of Ivy League graduates that was founded in 1869, has cultivated an elite reputation as home to the best and brightest and a tradition of urging its executives to take turns at public service.

As a result, Goldman has operated a virtual jobs conveyor belt to and from Washington: Paulson, as Treasury secretary, sent tens of billions of taxpayers' dollars to rescue Wall Street in 2008, and former Goldman employees populate some of the most demanding and powerful posts in Washington. Savvy federal regulators have migrated from their Washington jobs to Goldman.

On Oct. 16, a Goldman vice president, Adam Storch, was named managing executive of the SEC's enforcement division.

Goldman's financial panache made its sales pitches irresistible to policymakers and investors alike, and may help explain why so few of them questioned the risky securities that Goldman sold off in a 14-month period that ended in February 2007.

Since the collapse of the economy, however, some of those investors have changed their opinions of Goldman.

Several pension funds, including Mississippi's Public Employees' Retirement System, have filed suits, seeking class-action status, alleging that Goldman and other Wall Street firms negligently made "false and misleading" representations of the bonds' true risks.

Mississippi Attorney General Jim Hood, whose state has lost \$5 million of the \$6 million it invested in Goldman's subprime mortgage-backed bonds in 2006, said the state's funds are likely to lose "hundreds of millions of dollars" on those and similar bonds.

Hood assailed the investment banks "who packaged this junk and sold it to unwary investors."

California's huge public employees' retirement system, known as CALPERS,

purchased \$64.4 million in subprime mortgage-backed bonds from Goldman on March 1, 2007. While that represented a tiny percentage of the fund's holdings, in July CALPERS listed the bonds' value at \$16.6 million, a drop of nearly 75 percent, according to documents obtained through a state public records request.

In May, without admitting wrongdoing, Goldman became the first firm to settle with the Massachusetts attorney general's office as it investigated Wall Street's subprime dealings. The firm agreed to pay \$60 million to the state, most of it to reduce mortgage balances for 714 aggrieved homeowners.

Attorney General Martha Coakley, now a candidate to succeed Edward Kennedy in the U.S. Senate, cited the blight from foreclosed homes in Boston and other Massachusetts cities. She said her office focused on investment banks because they provided a market for loans that mortgage lenders "knew or should have known were destined for failure."

New Orleans' public employees' retirement system, an electrical workers union and the New Jersey carpenters union also are suing Goldman and other Wall Street firms over their losses.

The full extent of the losses from Goldman's mortgage securities isn't known, but data obtained by McClatchy show that insurance companies, whose annuities provide income for many retirees, collectively paid \$2 billion for Goldman's risky high-yield bonds.

Among the bigger buyers: Ambac Assurance purchased \$923 million of Goldman's bonds; the Teachers Insurance and Annuities Association, \$141.5 million; New York Life, \$96 million; Prudential, \$70 million; and Allstate, \$40.5 million, according to the data from the National Association of Insurance Commissioners.

In 2007, as early signs of trouble rippled through the housing market, Goldman paid a discounted price of \$8.8 million to repurchase subprime mortgage bonds that Prudential had bought for \$12 million.

Nearly all the insurers' purchases were made in 2006 and 2007, after mortgage lenders had lifted most traditional lending criteria in favor of loans that required little or no documentation of borrowers' incomes or assets.

While Goldman was far from the biggest player in the risky mortgage securitization business, neither was it small.

From 2001 to 2007, Goldman hawked at least \$135 billion in bonds keyed to risky home loans, according to analyses by McClatchy and the industry newsletter Inside Mortgage Finance.

In addition to selling about \$39 billion of its own risky mortgage securities in 2006 and 2007, Goldman marketed at least \$17 billion more for others.

It also was the lead firm in marketing about \$83 billion in complex securities, many

of them backed by subprime mortgages, via the Caymans and other offshore sites, according to an analysis of unpublished industry data by Gary Kopff, a securitization expert.

In at least one of these offshore deals, Goldman exaggerated the quality of more than \$75 million of risky securities, describing the underlying mortgages as "prime" or "midprime," although in the U.S. they were marketed with lower grades.

Goldman spokesman DuVally said that Moody's, the bond rating firm, gave them higher grades because the borrowers had high credit scores.

Goldman's securities came in two varieties: those tied to subprime mortgages and those backed by a slightly higher grade of loans known as Alt-A's.

Over time, both types of mortgages required homeowners to pay rapidly rising interest rates. Defaults on subprime loans were responsible for last year's housing meltdown. Interest rates on Alt-A loans, which began to rocket upward this year, are causing a new round of defaults.

Goldman has taken multiple steps to put its subprime dealings behind it, including publicly saying that Wall Street firms regret their mistakes. Last winter, the company cancelled a Las Vegas conference, avoiding any images of employees flashing wads of bonus cash at casinos.

More recently, the firm has launched a public relations campaign to answer the criticism of its huge bonuses, Washington connections and federal bailout. In late October, Blankfein argued that Goldman's activities serve "an important social purpose" by channeling pools of money held by pension funds and others to companies and governments around the world.

KNOWING WHEN TO FOLD THEM

For investment banks such as Goldman, the trick was knowing when to exit the high-stakes subprime game before getting burned.

New York hedge fund manager John Paulson was one of the first to anticipate disaster. He told Congress that his researchers discovered by early 2006 that many subprime loans covered the homes' entire value, with no down payments, and so he figured that the bonds "would become worthless."

He soon began placing exotic bets — credit-default swaps — against the housing market. His firm, Paulson & Co., booked a \$3.7 billion profit when home prices tanked and subprime defaults soared in 2007 and 2008. (He isn't related to Henry Paulson.)

At least as early as 2005, Goldman similarly began using swaps to limit its exposure to risky mortgages, the first of multiple strategies it would employ to reduce its subprime risk.

The company has closely guarded the details of most of its swaps trades, except for \$20 billion in widely publicized contracts it purchased from AIG in 2005 and 2006 to cover mortgage defaults or ratings downgrades on subprime-related securities it offered offshore.

In December 2006, after "10 straight days of losses" in Goldman's mortgage business, Chief Financial Officer David Viniar called a meeting of mortgage traders and other key personnel, Goldman spokesman DuVally said.

Shortly after the meeting, he said, it was decided to reduce the firm's mortgage risk by selling off its inventory of bonds and betting against those classes of securities in secretive swaps markets.

DuVally said that at the time, Goldman executives "had no way of knowing how difficult housing or financial market conditions would become."

In early 2007, the firm's mortgage traders also bet heavily against the housing market on a year-old subprime index on a private London swap exchange, said several Wall Street figures familiar with those dealings, who declined to be identified because the transactions were confidential.

The swaps contracts would pay off big, especially those with AIG. When Goldman's securities lost value in 2007 and early 2008, the firm demanded \$10 billion, of which AIG reluctantly posted \$7.5 billion, Viniar disclosed last spring.

As Goldman's and others' collateral demands grew, AIG suffered an enormous cash squeeze in September 2008, leading to the taxpayer bailout to prevent worldwide losses. Goldman's payout from AIG included more than \$8 billion to settle swaps contracts.

DuVally said Goldman has made other bets with hundreds of unidentified counterparties to insure its own subprime risks and to take positions against the housing market for its clients. Until the end of 2006, he said, Goldman was still betting on a strong housing market.

However, Goldman sold off nearly \$28 billion of risky mortgage securities it had issued in the U.S. in 2006, including \$10 billion on Oct. 6, 2006. The firm unloaded another \$11 billion in February 2007, after it had intensified its contrary bets. Goldman also stopped buying risky home mortgages after the December meeting, though DuVally declined to say when.

I'VE GOT A SECRET

Despite updating its numerous disclosures to investors in 2007, Goldman never revealed its secret wagers.

Asked whether Goldman's bond sellers knew about the contrary bets, spokesman DuVally said the company's mortgage business "has extensive barriers designed to keep information within its proper confines."

However, Viniar, the Goldman finance chief, approved the securities sales and the simultaneous bets on a housing downturn. Dan Sparks, a Texan who oversaw the firm's mortgage-related swaps trading, also served as the head of Goldman Sachs Mortgage from late 2006 to April 2008, when he abruptly resigned for personal reasons.

The Securities Act of 1933 imposes a special disclosure burden on principal underwriters of securities, which was Goldman's role when it sold about \$39 billion of its own risky mortgage-backed securities from March 2006 to February 2007.

The firm maintains that the requirement doesn't apply in this case.

DuVally said the firm sold virtually all its subprime-related securities to Qualified Institutional Buyers, a class of sophisticated investors that are afforded fewer protections than small investors are under federal securities laws. He said Goldman made all the required disclosures about risks.

Whether companies are obliged to inform investors about such contrary trades, or "hedges," is "a very hot issue" in cases winding through the courts, said Frank Partnoy, a University of San Diego law professor who specializes in securities. One issue is how specific companies must be in disclosing potential risks to investors, he said.

Coffee, the Columbia University law professor, said that any potential violations of securities laws would depend on what Goldman executives knew about the risks ahead.

"The critical moment when Goldman would have the highest liability and disclosure obligations is when they are serving as an underwriter on a registered public offering," he said. "If they are at the same time desperately seeking to get out of the field, that kind of bailout does look far more dubious than just trading activities."

Another question is whether, by keeping the trades secret, the company withheld material information that would enable investors to assess Goldman's motives for selling the bonds, said James Cox, a Duke University law professor who also has served on the NYSE advisory panel.

If Goldman had disclosed the contrary bets, he said, "One would have to believe that a rational investor would not only consider Goldman's conduct material, but likely compelling a decision to take a pass on the recommendation to purchase."

Cox said that existing laws, however, don't require sufficient disclosures about trading, and that the government would do well to plug that hole.

In marketing disclosures filed with the SEC regarding each pool of subprime bonds from 2001 to 2007, Goldman listed an array of risk factors that grew over time. Among them was the possibility of a pullback in overheated real estate markets, especially in California and Florida, where the most subprime loans had been made.

Suits filed by the pension funds, however, allege that Goldman made materially false or misleading statements in its public offerings, failing to disclose that many loans were based on inflated appraisals and were bought from firms with poor lending practices.

DuVally said that investors were fully informed of all known risks.

"What's going to happen in the next few years," said San Diego's Partnoy, "is there's going to be a lot of lawsuits and judges will have to decide, should Goldman have disclosed more or not?"

(Tish Wells contributed to this article.)

(This article is part of an occasional series on the problems in mortgage finance.)

COMING TOMORROW

Since the economic collapse that swept millions of Americans out of their jobs and homes, Goldman Sachs has moved aggressively to recover its losses. The firm is pursuing marginally qualified borrowers into state courts federal and bankruptcy across the country and seeking to seize their homes. McClatchy examines one couple's multi-year attempt to get Goldman to admit that it had purchased their mortgage.

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