

## **Dancing in the Dark with Goldman Sachs**

Watching Lloyd Blankfein, the CEO of Goldman, squirm under the hot lights of the U.S. Senate Subcommittee's hearing a few weeks ago must have brought back unpleasant memories for some of Goldman's investors in derivatives trades. The last time they remember squirming like that is likely when they themselves were watching their own investments disintegrate in the sub-prime meltdown.

Blankfein repeatedly tried to explain to the Senate panel the difference between playing "the big short" and what he considers a moderately short position given the rest of Goldman's portfolio in 2007. No easy task, to be sure. After all, Mark Pryor the Senator from Arkansas is a member of the subcommittee. His entire line of questioning to Mr. Blankfein seemed to consist of reading from the S.E.C.'s complaint of fraud in the ABACUS 2007-AC1 CDO deal and then asking, "True or False". Most others on the panel were only slightly more enlightening.

Yet Goldman's explanation of the difference provided keys to understanding the CDO transaction itself. Though not in the way Mr. Blankfein probably intended. On the face of it, Goldman's role in the CDO transaction makes no financial sense for Goldman. At a time when, by all public accounts, they are moving to short the sub-prime/CDO market, Goldman takes a long position in this deal? And they lose \$90 million? Gee, we thought these guys were really smart.

Lord, Lord.....no make that Lloyd, Lloyd...you reminded us that there are two ways to get more short in a market. One is to take up more short positions; the other is to reduce your long positions. Thank you for pointing this out. So using Goldman's logic, let's try to examine its motivation for the ABACUS 2007-AC1 CDO deal.

Goldman claims to be a mere facilitator in this deal. Approached by one of its customers, John Paulson – a now famous short seller - Goldman merely set up the deal by finding investors on the other side (the long side). Further, they claim to have been caught up in the disaster that struck the long-side investors. But why go long for Goldman in the first place? There are a number of possibilities.

First, John Paulson is a customer. He wants the deal. And while he is famous now for having made billions in the sub-prime meltdown, he was not a household name in 2007. But, he was to Goldman Sachs. So they do the deal hoping to keep Paulson's transaction fee of \$15 million for a nice, but untidy, piece of work. Maybe, they might pick up another fee or two on related transactions. This in itself is market neutral and the true function of an investment bank. Goldman intended to sell off the \$90 million piece, but couldn't find a buyer. Oh well, market makers take risk and they got burned.

Other scenarios take us back to the lesson Mr. Blankfein tried to teach us in the hearing. If Goldman wanted to reduce its overall long position in markets, one way to do so might be to sell off a long position as part of the CDO transaction. Lo and behold they did so. The collateral used in ABACUS was another soon-to-be-semi-toxic AAA security by the

name of Greywolf CLO 1. This security was underwritten by.....are you ready?.....Goldman Sachs. Maybe Goldman planned to avert a potential loss here by selling this piece of paper valued at \$192 million from its own inventory into the CDO. If Goldman internally estimated the potential loss on Greywolf CLO 1 at, say 50%, then we have a reason for Goldman to have taken the \$90 million long position in the ABACUS CDO. For a bit more detail on Greywolf, see:

<http://www.reuters.com/article/idUSTRE63M4U820100423>

And please don't forget that Goldman wanted to sell off their \$90 million long in ABABUS. There is no reason to doubt them on this point.

For the last scenario we have to go to the dark side to investigate. John Paulson's funds were buyers of CDS (Credit Default Swaps) protection ("insurance") from Goldman Sachs. These funds truly knew what "the big short" was. In fact, the CDS structures that are part of ABACUS are created between Goldman and Paulson. Payouts when the CDO blows up were routed through them. Was Goldman using ABACUS to cancel out or eliminate their already existing CDS liability (long positions) with Paulson?

Unfortunately CDS contracts are private contracts between two parties. They are in the dark. Who can examine all of Goldman's CDS long positions, both before and after, the ABACUS deal? The S.E.C.? The U.S. Attorney's Office? Right now, no evidence is available. The possibility that this could have occurred is reason enough to place all of these types of derivative contracts onto exchanges or into clearing houses and make them transparent. The social benefit gained from derivatives like CDSs, CDOs, CLOs, CMBS - and any other Cs with a few Rs thrown in - is dubious at best. The private gains and losses that can be 'earned' by using these derivatives in the dark are huge.

Mr. Blankfein also tried to instruct us that the investors in these derivatives are sophisticated market participants who should be able to protect themselves. The evidence suggests otherwise. The big loser in the ABACUS 2007-AC1 deal was ABN AMRO Bank N.V., certainly a large bank at the time. They became part of Royal Bank of Scotland, who in turn collapsed in the meltdown. According to the S.E.C. filing, ABN lost \$841 million on this transaction. They took this risk for 17 basis points (0.17%). The risk was taken for an income stream of approximately \$1.5 million dollars per year. Sophisticated, indeed. I wonder how they liked their dance.

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