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Corporate Social Responsibility

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Roundtable Report - Goldman Sachs

Introduction

For my Roundtable report I am reviewing Goldman Sachs in the 2008 Financial Crisis to examine what happened, the underlying factors, the impact, and the long-term outcomes and consequences of the situation. Before I go into the timeline of what happened, let me first briefly describe what happened for some background. In April 2010 the U.S. Securities and Exchange Commission (SEC) charged investment bank Goldman Sachs with crimes of misleading disclosures in connection with ABACUS 2007-AC1, which was a collateralized debt obligation (CDO) that had to do with subprime mortgage risk. Basically, the government accused Goldman Sachs of not telling investors the entire truth about ABACUS. The deal was essentially a bundle of side-bets which value depended on home loans and subprime mortgages. Goldman Sachs was accused of placing bets on the loans' performances without full transparency of everyone involved and the upper hand that they had. Three months later, Goldman Sachs settled for $550 million, which at the time was a record for a penalty payment for a Wall Street firm, but at the same time didn't totally take responsibility for their actions. ABACUS isn't just about a bad deal, but about a pattern of bad decisions made by Goldman Sachs that got exposed because of the 2008 Financial Crisis. When you mix the incentives of people getting paid to push deals fast to benefit them, hiding important facts, and creating conflicts of interests where people designing the product can profit if it fails, you end up with a mess. This doesn't just hurt the transaction but kills the trust of everyone involved, creates a huge market loss, and forces regulators to make changes. A good analogy is like if you are letting a car be designed by a person who will get a bonus for cutting corners, keeping the safety regulation test results a secret, and they also own the local body shop and tow trucking company. When the car ends up crashing or breaking down, the buyer will lose trust in all cars like it, the car designer profits from the repairs and towing service, and the government is then forced to tighten safety laws as a result, while the buyer pf the car is the ultimate loser. Ultimately, ABACUS matters not because all synthetic deals are bad, but because it shows that bad things happen when a company manipulates the process to make an unfair deal that favors them in the end. A skewed system with short-term pay and hidden information equals an unfair outcome. As a result, the long-term response was new laws and regulations being implemented such as the Volcker Rule, FSOC, and living wills. Now with the introduction of the case out of the way, lets dive deeper into each part of it.

Timeline & What Happened?

Now that I have gone over an introduction on the background of the case, let me give a tight narrative of what happened, while also presenting a timeline of events. The tides started to turn in early 2007, when the deal was made. Goldman Sachs sold a complex deal called ABACUS 2007-AC1, which was a synthetic CDO. Goldman Sachs didn’t own real mortgages though, instead it was a set of contracts that essentially copied how a bundle of risky home loans would behave. If the loans held up, the people on the “long” side would get steady payments (similar to interest payments). But if the loans went bad, the “short” side would make the money. Additionally, a hedge fund called Paulson & Co. was betting against those loans and helped choose which loans the deal would track. Another firm, ACA Capital, was shown to the investors as the independent chooser as well. This was clearly illegal due to the misinformation that Goldman spread. The SEC would also later say that Goldman's marketing didn't clearly tell the buyers that Paulson & Co. helped pick the loans and were betting that they would fail. That missing information would definitely make people second guess it. In mid-to late 2007, the performance starts to backfire. The U.S. housing market started to slow down as more homeowners would miss payments and even defaulted. The models that rating firms used to judge safety also stopped working well which added to the spiral. As a result, the mortgage bonds that were tied to ABACUS were downgraded to riskier. The people who were "long" (betting on the mortgages to be okay) lost tons of money during this time. Paulson & Co. which was "short" (betting they would fail) made around $1 billion. This obviously all coincided with the Great Recession of 2008 and as that unfolded the losses would pile in. Fast forward to April 16th, 2010, the SEC filed civil fraud charges against Goldman Sachs alleging that they left out or misstated important facts regarding who helped pick the assets in the ABACUS deal. By July 15th, 2010, Goldman settled for $550 million. Goldman Sachs essentially didn't admit that they were innocent or guilty but just admitted that their marketing materials were incomplete for the deal and that going forward they would be more transparent. ABACUS is essentially a very complicated deal and has hidden/unclear incentives that collided with the sudden drop in mortgage credit tied to the Great Recession of 2008.

This chart visualizes the structure of the ABACUS deal. A complex set of bets on mortgage risk where Paulson was secretly on the winning side, and the investors on the other side (thinking the assets were independently chosen) took the losses.

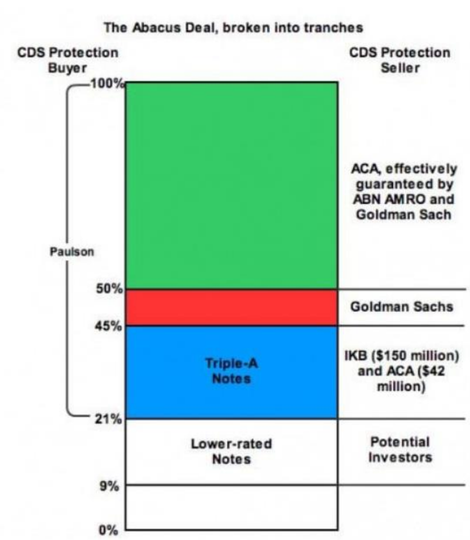

Figure 1

Underlying Factors & Why it Happened

1) Synthetic Credit

As I described before, Synthetic CDOs are in short, a bundle of bets that copy how loans or bonds would perform, without actually owning the loans. With that, investors take the opposite side, which means that the one side gets paid if the loans do fine while the other gets paid if they do bad. Wall Street can thus create contracts that copy the gains or losses of existing house mortgage bonds, which means that the same mortgage risk can be bet on over and over again. During good times this won't create an issue as trade is going steady and buyers will usually not experience any crazy loss even though it is riskier. During bad times though, losses will get amplified as mortgages control a lot and will hurt many contracts at once. The Financial Crisis Inquiry Committee found that these Synthetic CDOs boosted Wall Street to make multiple bets on these mortgages so that when they went bad the damage hit many of the copy bets at the same time. All in all, a Synthetic Credit structure isn't automatically bad, but what matters is who built it and who is on each side of the bet. Transparency is key, and if buyers aren't clearly told about what the roles and incentives are, then there is a problem.

2) Conflicts of Interest

There were clear conflicts of interests which came from the hedge fund that Paulson & Co. helped pick that went into ABACUS while at the same time betting against it. Now inherently this is not automatically illegal, as there is no rule that investors can't take opposite sides. However, the problem lies in the way that buyers weren't clearly told that a short side better helped choose the overall assets. Clearly there is a conflict of interest, which again, by itself is not illegal, but since the buyers did not know this, it then becomes an issue. The buyers thought that the picks were independent, which would severely affect whether they'd buy and at what price. The SEC agreed that Goldman left out and or downplayed the important facts regarding involvement, so investors were misled. By settling, Goldman pretty much admitted that they did this, but did not really take full blame of the manipulation aspect of it.

3) Inconsistent AAA Rating

Around 2006-2007, many investors wanted bonds that were safe but still paid more than treasuries. Investors wanted to make sure they had a AAA rating which essentially meant that they are extremely unlikely to default. So, Wall Street met that demand by slicing mortgages into CDO tranches (loans structured together into layers of safest to riskiest). The AAA rating however relied on big assumptions, such as that defaults wouldn't correlate to each other, home prices wouldn't nationally fall, prepayments would be predictable, and that there would be few risks... and as we obviously know, when the 2008 Financial Crisis happened just about all of that changed. When all those assumptions snapped in half, the AAA tranches were clearly not AAA anymore. So why did the ratings miss the mark so bad? A Senate investigation later on showed the rating process had different limits, such as not taking nationwide housing drops into consideration. The bottom line is that this whole setup was flimsy in the way that they were clearly intended for riskier loans and not something with an AAA rating even though they were given it. The bond looked way safer than it ever actually was.

Higher subordination means more cushion is required to keep a tranche at a given rating. AAA subprime tranches rose sharply, signaling the underlying risk just before the 2007–08 downgrade wave. (Vertical lines mark the peak issuance window, Q1-2005 to Q2-2007.)

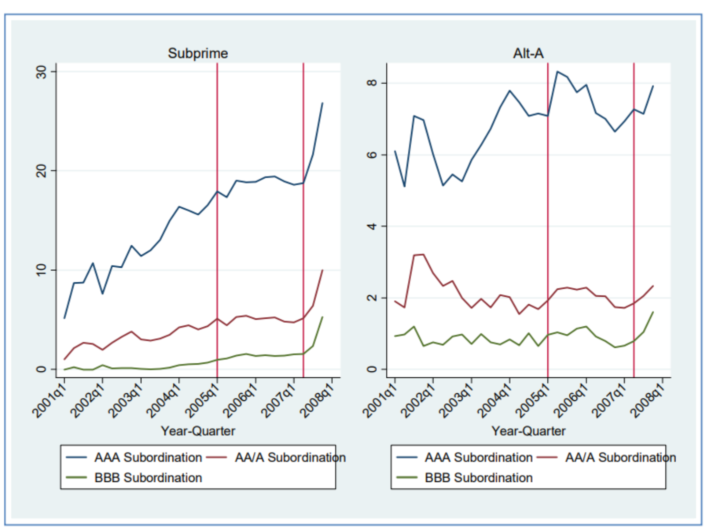

Figure 2

4) Regulatory gaps & Foreshadowing

In 2006, Federal Reserve chair Ben Bernanke said that hedge funds and fancy derivatives are too hard to see into, and that over time people will forget past blow-ups and slack off on risk controls. He was foreseeing the future, and he even proposed that investors, lenders and regulators alike should have clearer information and transparency so they can judge the real risks that are at hand. This shows that this issue was being foreshadowed and that Bernanke was right that when important information is not transparent that there's no way for buyers to really know what they are getting themselves into. ABACUS shows that key details about who was doing what and who benefited were not obvious at all. This was a clear underlying issue, but until everything went haywire due to the 2008 Financial Crisis, no actions were taken.

Impact & Long-term outcomes

1) On Investors & Trading Partners

The people who took the “long” side of ABACUS (betting the mortgages would be good) lost a lot of money when the mortgages went bad because of the 2008 Financial Crisis. Later on these people would learn the truth that the “short” side people essentially bet against the deal and helped to choose what went into it. It felt like a bait-and-switch because the deal was shaped to not be in their favor and they were not aware of that. This has caused investors to be way more cautious and skeptical going forward, especially about custom deals.

2) On Goldman Sachs

Goldman Sachs definitely recovered from this situation as their net income was still in the billions in the years following this. The $550 million settlement was ultimately pocket change for them. Goldman Sachs reputation following ABACUS did go down severely with the public eye even though they kept making a profit. After the 2010 SEC case, national reputation surveys put Goldman near the bottom of major U.S. companies. An example is the Harris Interactive rankings for 2011 where Goldman was ranked 58th of 60, or in 2013 where they scored below 50 which was ranked as critically bad. Other media coverage also continued with negative images. A 2009 Rolling Stones article by Matt Taibbi even described Goldman Sachs as a "great vampire squid wrapped around the face of humanity", essentially implying that Goldman uses its influence in finance to take advantage of any money-making opportunity and manipulate people in a predatory way. It also didn't help that when Goldman settled the SEC case, they acknowledged that their marketing materials were "incomplete" but didn't take full responsibility for their actions. The bottom line is their public reputation was damaged for years, but they still remained a top Wall Street company.

3) On Market Practices & The Financial System

The SEC ruling made it very clear that in any complex deal going forward, transparency and important facts needed to be crystal clear. Things such as who is the long/short, who influences the assets, if any side companies are involved, and how the bank is positioned in all of it. Banks responded well in general (including Goldman) and made it clear on the front pages what was going on in each deal. At the end of the day, ABACUS didn't cause the financial crisis, it instead showed how it happened. When information is hidden, incentives are misaligned, and manipulation is being done, extra private profits can then turn into people's lives being ruined. As a result, many reforms were made such as the Volcker Rule, the FSOC, and living wills. The Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010 introduced The Volcker Rule, which helped ensure that deposit backed banks wouldn't be able to do proprietary risky trades. Banks can still help clients trade, but their control has to align with the laws. The FSOC ensured that there would be a council of regulators that could scan for emerging trade risks and designate oversight through reports and recommendations. Their goal isn't to micromanage everything, but to instead make sure that everyone sees the leverage and transparency. Living wills put the biggest banks in check by putting in a way for them to be safely wound down when bankrupt, without taxpayer bailouts. All of the biggest firms have to file living wills, and even though they won't stop a bad deal from being sold, they make a huge failure manageable and less risky. Risk and manipulation can still emerge in other ways, but these reforms helped to minimize what they could to try to contain the issue. In the end though, did these reforms work? Most research I found says a little bit. There has been more transparency, more capital, and more reporting. Since 2008 we had the 2020 COVID Pandemic, which presented financial problems in a different way; but the big banks and dealers help up much better than in 2008. Regulators though are still pushing for more reform, especially with wanting big financial firms to stop going through bailouts and crashing the whole system.

Conclusion & Overall Outcome

The main players in the ABACUS case each faced different outcomes in the conclusion of this case. As I've stated many times, Goldman settled with the SEC, but Goldman VP Fabrice Tourre who specifically worked on ABACUS was found liable on many securities' fraud counts tied to ABACUS in a civil trial case that the SEC took him to in 2013. In 2014 he was ordered to pay over $800,000 without help from Goldman, and later he would leave the company. Paulson & Co. which was the short-side hedge fund that I mentioned earlier was not charged at all by the SEC, even though the reportedly profited around $1 billion from the situation. In 2016 though

Paulson and Goldman were sued by ACA Capital (they insured the bonds for ABACUS), and the case was settled for an undisclosed amount. ACA pursued the lawsuit because they said they were misled about who influenced the portfolio and what Paulson's position was in the whole thing. As I talked about before, investors on the long side suffered immense and heavy losses, being a very unfortunate situation for a lot of people who were misled into the deal to begin with. A lot can be learned from this situation, such as the design of an investment deal, having full transparency in writing, having regulators in place, and limiting the power that big firms have. The 2008 Financial Crisis exposed a lot of misconduct, conflicts of interest, and corruption; and although Goldman Sachs is still alive and well, they were put on full blast to the world for their wrong doings.

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