Goldman Sachs: The fraud that isn't

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The U.S. Securities and Exchange Commission’s unfathomable and illogical Goldman Sachs case appears to be heading off in two directions. In one, the market-bashing proponents of regulation are driving their anti-capitalist version of the scandal to greater heights, portraying it as an instance of fraud, greed and deliberate deceit that brought down the financial system. The other track runs in the opposite direction, with more and more material coming out that suggests the charges — aside from being inherently illogical — are highly questionable, easily denied and may even be unprovable.

Riding the first track is a trainload of political and ideological warmongers, from U.S. President Barack Obama to beleaguered British Prime Minister Gordon Brown. Mr. Obama spoke of “Wall Street titans [who] still recklessly speculate with borrowed money.” Mr. Brown, sinking in the polls, said “the banks... are a risk to the economy.” Regulators in the U.K. and America are on the rampage, and commentators at The Huffington Post and other bastions of reactive business bashing are running amok.

Ben Stein, writing for BusinessWeek, summed up the dumbed-down version of the case. The SEC, he said, accused “the firm [Goldman Sachs] and one of its young guns of fraud for constructing a synthetic housing-market bond that was sure to fail, selling it to a valued customer who specifically didn’t want that type of bond, conspiring with a short seller of bonds to create a vehicle for his firm to make money off of the security and tricking a rating firm into approving it.”

This version of events, an almost total misrepresentation of the case, is now lodged everywhere as the official version, although even Mr. Stein slips out the back door just in case. “If these allegations are true,” he added, “and maybe they aren’t, this is simply the worst behaviour in finance by a large firm I have ever seen.” And if they aren’t? Then what?

The biggest illogical theme in the Goldman charges is the claim that the mortgage-based investment vehicle put together by Goldman and others in early 2007 was “designed to fail,” as The New York Times put it, and “sure to fail,” as Mr. Stein put it. In the SEC filing against Goldman, however, there is no evidence that the $1-billion ABACUS 2007-AC1 synthetic collateralized debt obligation (CDO) was built to fail.

It is easy now, of course, to make the claim that something that failed, as ABACUS did, was deliberately set up to fail. Since the fact of failure is indisputable, it seems to lend support to the idea that it must have been part of the original intention. But the SEC charges themselves, and subsequent comments by many others, directly contradict the idea that ABACUS was a car designed to run off the road.

The most obvious contradiction is in the SEC review of the case. It explicitly states that the company that picked up $900-million of the risk in ABACUS was the company that selected the
sub-prime mortgage portfolio that served as the basis for the transaction. The SEC statement shows that ACA, an experienced mortgage-investment conglomerate, participated in numerous detailed meetings to select the portfolio, working with Paulson & Company. “On or about February 26, 2007, after further discussions, Paulson and ACA came to an agreement on a reference portfolio of 90 [mortgage-backed securities] for ABACUS 2007-AC1.”

In early 2007, ACA along with many other investors still believed that sub-prime mortgages held value and would continue to perform in the future. The rating agencies also gave ABACUS Triple-A status. Turns out they were wrong. But that doesn’t mean that the ABACUS deal was pre-ordained to collapse, or that Goldman or Paulson or ACA structured it to fail.

That Paulson believed the U.S. sub-prime mortgage market was heading for collapse was apparently well known at the time. In a letter to investors this week, John Paulson explained the role his company played in the market and the ABACUS transaction. “When we expressed our concerns about the mortgage markets many of the most sophisticated investors in the world, who had analyzed the same publicly available data as we had, were convinced that we were wrong, and more than willing to bet against us.”

When Goldman came to work on ABACUS 2007-AC1, all participants would have known that the transaction involved two sides, a long and a short, representing the two divergent views of the market. “All of our dealings,” said Mr. Paulson, “were through arms-length transactions with experienced counterparties [ACA] who had opposing views based on all available information at the time.”

Goldman Sachs, which put together the ABACUS deal, says it lost more than $100-million on it. A German bank, another sophisticated sub-prime mortgage investor, lost $150-million. There were no innocent victims of fraud. There was no fraud, or at least not on the basis of information available so far.

While the Goldman case was being hailed lately as a strong one, The Economic Times reported yesterday that many legal experts see the SEC case as one that “could be difficult to prove in court.” The Times reported that Harvard Law professor Allen Farrell said the SEC suit was based on a strange definition of material information. “We normally think of material information as specific to the mortgages, not somebody’s prediction about the future course of macro-economic events.” The question, he said, is whether the investors — ACA, the German bank — had access to the underlying mortgages. The answer is, yes, they did.

There’s nothing governments would like more than to be able to pin the U.S. subprime mortgage fiasco on fraud at Goldman Sachs and other banks. From what we know of the facts so far, this case doesn’t even come close to doing that.