Senate committee details Wall Street criminality

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Goldman Sachs and Deutsche Bank AG, two of the largest investment banks in the world, profited from the sale of securities they knew to be worthless, and Goldman later "misled" congress about its activities, according to a report published Wednesday by the United States Senate Permanent Subcommittee on Investigations.

The Senate committee, headed by Michigan Democrat Carl Levin, concluded that Goldman Sachs "used net short positions to benefit from the downturn in the mortgage market, and designed, marketed, and sold CDOs [mortgage-backed securities] in ways that created conflicts of interest with the firm's clients and at times led to the bank's profiting from the same products that caused substantial losses for its clients."

Levin's report goes further than the Financial Crisis Inquiry report, issued January 27, which stopped short of naming individual cases of malfeasance. The 635-page report offers specific details about offenses committed by Goldman Sachs, Deutsche Bank, Washington Mutual and Moody's rating agency, but does not have the authority to call these actions criminal, according to Levin.

Levin's report presents the doings of individual organizations—including credit rating agency Moody's, subprime leader Washington Mutual, Deutsche Bank, and Goldman—as case studies, pointing to the much broader criminality throughout the whole of Wall Street.

In addition to selling worthless securities to investors, the report concluded that Goldman attempted to manipulate the mortgage-backed securities market as a whole in 2007 by artificially inflating prices in order to drive out competitors who had taken "short" positions on mortgage-backed securities.

Goldman traders were encouraged to offer prices that would "cause maximum pain" and "have people totally demoralized," according to internal emails. In earlier testimony before Levin's committee, Goldman traders denied that they had attempted to manipulate the market, and claimed that their emails to the contrary were exaggerations.

During the course of the housing bubble, Goldman Sachs was among the largest issuers of Collateralized Debt Obligations (CDOs) and Residential Mortgage Backed Securities (RMBS), which were groups of bad mortgages bundled together to hide their real likelihood of default.

But in 2006, as Goldman "saw evidence that the high risk mortgages underlying many … CDO securities were incurring accelerated rates of delinquency and default, Goldman quietly and abruptly reversed course."

"Over the next two months," the report said, Goldman "rapidly sold off or wrote down the bulk of its existing subprime RMBS and CDO inventory, and began building a short position that would allow it to profit from the decline of the mortgage market. Throughout 2007, Goldman twice built up and cashed in sizable mortgage related short positions. At its peak, Goldman's net short position totaled $13.9 billion."

As a result, in 2007, Goldman's bets against mortgage-backed securities "produced record profits totaling $3.7 billion for Goldman's Structured Products Group, which when combined with other mortgage losses, produced record net revenues of $1.2 billion for the Mortgage Department as a whole." That year, Goldman CEO Lloyd Blankfein received a $67.9 million bonus.

The document examines in detail the contents and sales of four Goldman Sachs mortgage-backed assets. The report notes, for example, that in the sale of one of the CDOs, "Goldman took 100 percent of the short side

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of the $2 billion CDO, betting against the assets referenced in the CDO, and sold the … securities to investors without disclosing its short position. When the securities lost value, Goldman made a $1.7 billion gain at the direct expense of the clients to whom it had sold the securities.”

In the case of another security, known as Timberwolf, Goldman “knowingly” sold assets “to clients at prices above its own book values and, within days or weeks of the sale, marked down the value of the sold securities, causing its clients to incur quick losses and requiring some to post higher margin or cash collateral. Timberwolf securities lost 80 percent of their value within five months of being issued and today are worthless.

The documents fully repudiate the claim made by Blankfein under oath that “we didn’t have a massive short against the housing market, and we certainly did not bet against our clients.”

In a press conference to announce the findings, Levin said that Blankfein and Goldman “attempted to mislead the Congress and I believe they did mislead their clients in very significant ways.” He added that he would not “make the determination as to whether or not he [Blankfein] committed perjury,” but said he had turned over transcripts of Blankfein’s testimony to the Justice Department.

The report details, in the strongest language yet, Goldman’s use of its Abacus mortgage-backed security to defraud investors of $1 billion, which ended up in the pockets of its secret partner, billionaire hedge fund manager John Paulson. “In the case of Abacus, Goldman did not take the short position, but allowed a hedge fund, Paulson & Co. Inc., that planned on shorting the CDO to play a major but hidden role in selecting its assets”, the report said. “Goldman marketed Abacus securities to its clients, knowing the CDO was designed to lose value and without disclosing the hedge fund’s asset selection role or investment objective to potential investors. Three long investors together lost about $1 billion from their Abacus investments, while the Paulson hedge fund profited by about the same amount. Today, the Abacus securities are worthless.”

The majority of the $1 billion loss was incurred by ACA Financial Guaranty Corp, a bond insurer, which made a $909 million investment in the security. In July 2010, Goldman Sachs paid the SEC $550 million in a settlement over the Abacus CDO, shielding it from further prosecution. A spokesmen for ACA said he could not comment on the report’s findings.

In another section, the report describes how Deutsche Bank, the German Investment bank, profited off of the collapse of the housing bubble, with its top CDO trader, Greg Lippmann, helping to earn $1.5 billion for the bank by short-selling mortgage-backed securities.

“At one point, Mr. Lippmann was asked to buy a specific CDO security and responded that it “rarely trades,” but he “would take it and try to dupe someone” into buying it. He also at times referred to the industry’s ongoing CDO marketing efforts as a “CDO machine” or “ponzi scheme.”

Two and a half years after the financial crisis, the banks are doing better than ever. JPMorgan Chase, the second-biggest US bank, said Wednesday that its first quarter profits set a new record. Profits at the bank hit $5.56 billion, up 68 percent from a year ago, in the bank’s second consecutive record quarter. The other banks, including Goldman Sachs, are expected to report similar figures in the coming weeks.

Marketwatch, the sister news agency of the *Wall Street Journal*, observed bluntly that, based on earlier experience, Levin’s report will not result in prosecutions, despite the hundreds of documents that would point to criminal wrongdoing.

The site concluded that, “Goldman and Deutsche Bank AG … are embarrassed today, but they know that the damage is mostly in the realm of public relations.”

“History,” the site added, “is on their side. On Wall Street money talks, bankers walk.”

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