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Goldman Sucks

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The new systemic risk: liability for past sins and heightened clamor for regulation.

We think the SEC has a strong but very narrow case against Goldman Sachs over the construction and selling of the synthetic CDO ABACUS 2007-AC1. Goldman's risk in the SEC's civil suit looks like only about a billion dollars, or at most twice that depending on exemplary damages. But surely the ABACUS case represents a pattern that will be found at other firms. There is media speculation that the SEC is looking into similar situations at Deutsche Bank, UBS and Merrill Lynch (for which, by acquisition, Bank of America would now be liable, just as JPMorgan would be for the sins of Bear Stearns). These and other banks that may be involved have already suffered nearly fatally under the weight of their own losses in CDOs, and now they could face having to absorb their customers' losses as well.

Moreover, we are concerned that the SEC's charges against Goldman were politically timed to add momentum to the Obama administration's drive to rapidly enact draconian new financial regulation. Whether by timing or coincidence, a rush to judgment here -- similar to 2002's WorldCom panic that produced Sarbanes Oxley -- would have a long-term chilling effect on overall economic growth by raising the cost of capital and punishing financial innovation. But more immediately, a full-scale witch hunt on Wall Street that could lead to banks making good on untold billions of customer losses could ignite another liquidity crisis, and throw the world back into recession and deflation.

The case against Goldman

As we read the SEC's complaint, this is a simple fraud case based on failure to disclose material information. It's *only* that, not a broader claim of wrongdoing for the act itself of creating complicated synthetic CDOs referencing risky sub-prime RMBS. The emails revealing the narcissism of the *soi disant* "fabulous Fab" and the SEC's claim that "Synthetic CDOs like ABACUS 2007-AC1 contributed to the recent financial crisis" are just atmospherics.

Update to strategic view

US FINANCIAL STOCKS: The Goldman scandal opens a new dimension of systemic risk for the financial sector -- liability for the sins of the past. And it heightens political clamor for draconian re-regulation. Despite a stellar run as the best performing S&P 500 sector year-to-date, we reiterate our long-term bearish view on the growth prospects for the financial sector.

US STOCKS: An expansion of the Goldman scandal to other firms would raise the specter of a replay to some extent of last year's systemic risk -- and with stocks near peak valuations, would trigger the deep correction we've long anticipated.

GOLD: Gold has been hit by the Goldman scandal, both because of the deflation potential in another round of systemic risk, and the involvement of large gold investor Paulson. The Fed will aggressively counter any deflation potential, so we would look to buy the dip.

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The disclosure issues here are unusual, given that a synthetic CDO is a zero sum game between long and short. Conflicts are inherent, unlike in a plain-vanilla debt underwriting in which borrowers and lenders are aligned in hoping for the best after the deal is done. The synthetic CDO underwriter's duty is, in an important sense, *to maximize conflict* -- so that longs and shorts can most effectively bet against each other, each hoping the other will lose. We recommend Michael Lewis's new book *The Big Short* as an excellent portrait of how investment banks brought equally enthusiastic longs and shorts together in synthetic CDOs, and an anecdotal indication of how very wide-spread it was.

Seen in this zero-sum framework of inherent conflict, there's nothing wrong on the face of it with Paulson & Company, representing shorts, having a hand in the selection of the RMBS referenced in ABACUS, alongside named collateral manager ACA, representing longs. The problem is that, according to the complaint, ACA wasn't told that Paulson would take a short position, and the longs were not told that Paulson was involved at all. So the issue isn't that Paulson was involved, only that it wasn't disclosed.

We don't see how it matters that ACA didn't know. ACA *did* know that it alone was ultimately on the hook for portfolio selection, regardless of the known or unknown motives of whomever it consulted along the way. And given what happened to sub-prime RMBS -- they *all* blew up -- Paulson's input may not have made any difference, anyway.

But it probably *is* material that the longs -- the buyers of ABACUS -- weren't told about Paulson's involvement in portfolio selection. The longs should be sophisticated enough to know that there would be no synthetic CDO for them to go long unless someone, somewhere, thought it was a good idea to short it. Nevertheless they might have at least insisted on better pricing if they knew that the reference portfolio had been selected with the participation of a short.

We don't know where this will lead, but for the moment that's all it's about: just a single issuance by a single firm of a single synthetic CDO, involving what are possibly unique fraudulent circumstances. Even within this narrow sphere the SEC has said it doesn't have facts to support suing other Goldman personnel, nor Paulson.

But it's probably not ending there. It's possible that another suit will emerge in which, in addition to the customer conflict disclosure issue raised by ABACUS, the underwriting investment bank itself will turn out to be an undisclosed short -- a deeper and more pernicious level of conflict. And remember, the fall of Drexel Burnham in 1990 began with narrow SEC civil actions in 1988. After that, claiming a broad pattern of criminality, ambitious US Attorney Rudolph Giuliani destroyed the firm by threatening it with criminal prosecution under RICO, the Racketeering-Influenced Corrupt Organizations statute. Goldman has better political connections than Drexel had, and that may carry the day. And after spending billions to save the banks, the government shouldn't now set out to destroy them. But make no mistake: Goldman is at risk, and it's probably not alone.

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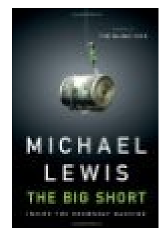
[About us]

Recommended Reading



The Big Short by Michael Lewis, Norton, 2010

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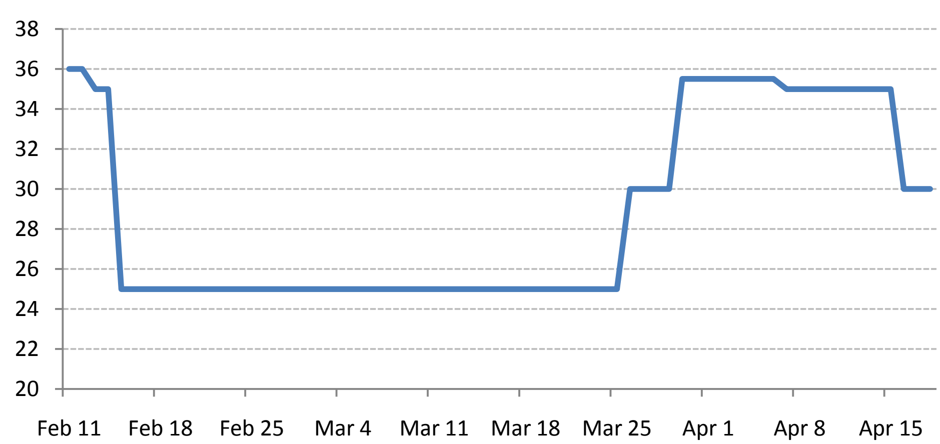
The threat of new financial regulation

With federal control of health insurance a *fait accomplis* (see "Obamacare: Do Markets Care?" March 18, 2010), financial regulation is the next battleground for anti-growth policy. We have been concerned all year that Republicans, under the influence of Tea Party populism, would join with Democrats -- or at least not resist them -- in enacting new laws that would cripple the effectiveness and competitiveness of US financial markets (see "On Obama's Bank Regulation Proposal" January 21, 2010). The Goldman scandal only raises our concerns, as it will make it politically much more costly to be seen as taking an anti-regulation position seemingly in defense of Wall Street criminality. Chris Dodd's (CT-Dem) Restoring American Financial Stability Act of 2010 passed his Senate Banking Committee on a straight party-line vote, and will likely be voted by the entire Senate this week. Reacting to the Goldman scandal Dodd said Friday, "we don't need to know the outcome of this case… Wall Street financial firms continue to game the system. We must pass Wall Street reform."

We aren't going to cover here every potential anti-growth pitfall in Dodd's bill. It's far from a done deal. As one indication of that, the online political futures contracts at Intrade only assign about a 30% chance to any legislation including the "Volcker rule" passing this year (please see the chart below). And the Dodd bill is still subject to amendment in the Senate even if it survives a filibuster attempt, and then reconciliation in conference with the House's version passed late last year.

We will say as a general matter that in the name of ending the doctrine of "too big to fail" -- which Dodd's bill does not actually do -- it enables significant new government control over the commanding heights of the nation's financial system and capital markets. It vests regulators, including a new all-powerful Financial Stability Oversight Council, with unlimited rule-making authority including imposing differential capital requirements,

Probability of "Volcker rule" enacted this year
Futures-implied



Source: Intrade

Key documents

SEC versus Goldman Sachs & Co. and Fabrice Tourre

Restoring American Financial Stability Act of 2010

Wall Street Reform and Consumer Protection Act of 2009

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disposing of assets of failed firms without respect to bankruptcy laws, prohibiting proprietary trading and ownership of investment management operations by banks, dictating exchange-listing of certain derivatives, asserting bank regulatory power over non-financial firms, and breaking up firms deemed too complex and risky even if they are otherwise healthy, without judicial appeal.

We can’t know now exactly what harm will come from this, because it is, in essence, a regulatory blank check that has yet to be filled in. But we can't see any good coming from it, because with the financial system still destabilized from last year's global credit crisis, a formless, open-ended new regulatory regime only adds to already considerable uncertainty. And while regulations designed to rein in risk-taking may potentially reduce the frequency and severity of financial panics, they may in fact fail to do so. And either way, between panics, they will surely impose higher costs of capital and frictions against financial innovation. Maybe we worry too much about anti-growth impacts, because Wall Street is very good at managing around regulation. But as Ayn Rand once wrote, "a blank check is always made out to the sum of everything you've got."

Bottom line

The Goldman scandal opens a new dimension of systemic risk for the financial sector -- liability for the sins of the past. And it heightens political clamor for draconian re-regulation. Despite a stellar run as the best performing S&P 500 sector year-to-date, we reiterate our long-term bearish view on the growth prospects for the financial sector. An expansion of the Goldman scandal to other firms would raise the specter of a replay to some extent of last year's systemic risk -- and with stocks near peak valuations, would trigger the deep correction we've long anticipated. Gold has been hit by the Goldman scandal, both because of the deflation potential in another round of systemic risk, and the involvement of large gold investor Paulson. The Fed will aggressively counter any deflation potential, so we would look to buy the dip.