MEMORANDUM

To: Members of the Permanent Subcommittee on Investigations

From: Senator Carl Levin, Subcommittee Chairman
Senator Tom Coburn, Ranking Member

Date: April 26, 2010

Re: **Wall Street and the Financial Crisis: The Role of Investment Banks**

On Tuesday, April 27, 2010, beginning at 10:00 a.m., the Permanent Subcommittee on Investigations will hold the fourth in a series of hearings examining some of the causes and consequences of the recent financial crisis. This hearing will focus on the role played by investment banks, using as a case study Goldman Sachs, one of the leading investment banks on Wall Street.

Subcommittee Investigation. The Subcommittee initiated its investigation in November 2008. Since then, it has engaged in a wide-ranging inquiry, conducting more than one hundred interviews and depositions, collecting and reviewing millions of pages of documents, and consulting with dozens of government, academic, and private sector experts on banking, securities, financial, and legal issues.

To provide the public with the results of its investigation, the Subcommittee has held a series of hearings addressing the role of high risk lending, bank regulators, and credit rating agencies in the financial crisis. The fourth hearing on investment banks will be the final in this series. A final report will be released after all hearings are held and upon the conclusion of the investigation.

To date, the Subcommittee hearings have uncovered evidence that, from 2004 to 2007, hundreds of billions of dollars in high risk mortgages flooded U.S. financial markets. Using Washington Mutual ("WaMu") and its subprime lender, Long Beach Mortgage Company, as a case study, the first hearing showed how lenders targeted high risk borrowers and engaged in risky lending practices such as little or no verification of borrower income, minimal documentation, high loan-to-value ratios, negative amortization, teaser rates, and delayed assessments of higher loan payments that could cause payment shock and increased defaults. That hearing also showed how lenders not only ignored signs of massive loan fraud, but also securitized and sold loans known to contain fraudulent borrower information as well as loans viewed as likely to become delinquent.

In its second hearing, the Subcommittee showed that regulators saw the problems at WaMu and understood the risk, but sat on their hands or fought each other instead of using their authority to prevent high-risk mortgages from flooding the financial system. In the third hearing, the Subcommittee provided evidence that conflicts of interest at the credit rating agencies were a central factor in their poor ratings of mortgage products. The documents showed that the credit rating agencies bowed to pressure from investment bankers and, using outmoded data and

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EXHIBIT #1a

financial models, gave AAA ratings to financial products backed by high risk mortgages, labeling them as safe investments despite the risk. Even after the high risk mortgages began incurring record rates of delinquency in 2006, the credit rating agencies delayed adjusting their ratings until July 2007. When they finally initiated a series of mass downgrades, it shocked the financial markets, hammered the value of mortgage related securities, and contributed to the collapse of the secondary markets for subprime mortgage related securities.

Role of Investment Banks. Historically, investment banks helped raise capital for business and other endeavors by helping to design, finance, and sell financial products like stocks or bonds. Today, they also participate in a wide range of financial activities, including trading derivatives and commodities. Large investment banks are often affiliated with major banks or broker-dealers. When a lender like Washington Mutual Bank wanted to package and sell its mortgage loans, for example, it often hired an investment bank like Goldman Sachs to design its mortgage backed securities and sell them to investors. Investment banks perform these services in exchange for fees.

If an investment bank agrees to act as an "underwriter" for the issuance of a new security to the public, it typically bears the risk of those securities on its books until the securities are sold. By law, securities sold to the public must be registered with the Securities and Exchange Commission (SEC). Registration statements explain the purpose of a proposed public offering, an issuer's operations and management, key financial data, and other important facts to potential investors. Any offering document, or prospectus, given to the investing public must also be filed with the SEC. If a security is not offered to the general public, it can still be offered to investors through a "private placement." Investment banks often act as the "placement agent," performing intermediary services between those seeking to raise money and investors. Solicitation documents in connection with private placements are not filed with the SEC. Under the federal securities laws, investment banks that act as an underwriter or placement agent are liable for any material misrepresentations or omissions of material facts made in connection with a solicitation or sale of the securities to investors.

Mortgage-backed securities were generally registered with the SEC, while collateralized debt obligations were generally sold to investors as private offerings. Investment banks sold both types of securities primarily to large institutional investors, such as other banks, pension funds, insurance companies, municipalities, university endowments, and hedge funds.

Investment banks sometimes take on the role of "market makers" for securities and other assets that they sell to their clients, meaning that, in order to facilitate client orders to buy or sell, an investment bank may acquire an inventory of assets and make them available for client transactions. In addition, investment banks may buy and sell assets for their own account, which is called "proprietary trading." The largest U.S. investment banks engage in a significant amount of proprietary trading that generates substantial revenues. Investment banks generally use the same inventory of assets to carry out both their market-making and proprietary trading activities. Investment banks also typically have an inventory or portfolio of assets that they intend to keep as long term investments.

Investment banks that carry out market-making and proprietary trading activities are required—by their banking regulator in the case of banks and bank holding companies, and by the SEC in the case of broker-dealers—to track their investments and maintain sufficient risk-based capital to meet their regulatory requirements. Many investment banks, including Goldman Sachs, use complex automated systems to analyze the "Value at Risk" ("VaR") associated with their holdings. To reduce the VaR attached to their holdings, investment banks employ a variety of methods to offset or "hedge" the risk. These methods can include diversifying their assets, taking a short position on securities, purchasing loss protection through insurance or credit default swaps, and trading on indices whose assets increase in value as the value falls for the assets subject to the hedge.

Structured Finance. Since 2000, investment banks have devised increasingly complex financial instruments to sell to investors. These instruments are often referred to as "structured finance" products.

Residential mortgage backed securities ("RMBS") are one of the oldest types of structured finance products. To create RMBS securities, issuers work with investment banks to bundle large numbers of home loans into a loan pool and then calculate the revenue stream coming into the loan pool from the individual mortgages. They then design a "waterfall" that delivers a stream of revenues in sequential order to specific "tranches." The first tranche is at the top of the waterfall and is typically the first to receive revenues from the mortgage pool. Since that tranche is guaranteed to be paid first, it is the safest investment in the pool. The issuer creates a security linked to that first tranche. That security typically receives an AAA credit rating since its revenue stream is the most secure.

The security created from the next tranche receives the same or a lower credit rating and so on until the waterfall reaches the "equity" tranche at the bottom. The equity tranche typically receives no rating since it is the last to be paid, and therefore the first to incur losses if mortgages in the loan pool default. Since virtually every mortgage pool has at least some mortgages that default, equity tranches are intended to provide loss protection for the tranches above it. Because equity tranches are riskier, however, they often receive a higher interest rate and can be profitable. One mortgage pool might produce a dozen or more tranches, each of which is used to create a residential mortgage backed security that is rated and then sold to investors.

Collateralized Debt Obligations ("CDOs") are another, more complex type of structured finance product that involves the re-securitization of existing income-producing assets. From 2004 through 2007, many CDOs included RMBS securities from multiple mortgage pools. For example, a CDO might contain BBB rated securities from 100 different residential mortgage pools. CDOs can also contain other types of assets, such as commercial mortgage backed securities, corporate bonds, or other CDO securities. These CDOs are often called "cash CDOs," because they receive revenues from the underlying securities and other assets. The most senior tranches of these CDOs may be rated AAA, even if all of the underlying assets are rated BBB.

Investment banks also created "synthetic CDOs," which mimicked cash CDOs, but did not contain actual mortgages or other assets that produced income. Instead, they simply "referenced" existing assets and then allowed investors to place bets on the value of those

referenced assets. Investors who believed the referenced assets would increase in value received revenues from counterparties who paid monthly premiums to the CDO in exchange for obtaining "insurance" that paid off if the referenced assets incurred a loss or other negative credit event. Investors in synthetic CDOs who believed the referenced assets would increase in value were said to be on the "long" side, while investors who believed the assets would fail were said to be on the "short" side. Investment banks also created hybrid CDOs which contained some actual assets as well as credit default swaps referencing other assets.

Cash, synthetic, and hybrid CDOs all pooled the payments they received, designed a waterfall assigning portions of the revenues to tranches set up in a certain order, created securities linked to the various tranches, and then sold the CDO securities to investors. Some CDOs employed a "portfolio selection agent" to select the initial assets for the CDO. In addition, some CDOs were designed so that the assets could be changed over time, in which case a "collateral manager" was typically hired to select both the initial and subsequent assets.

In addition to designing these structured finance instruments, investment banks paid credit rating agencies to rate the resulting RMBS and CDO securities. Typically the top several tranches in a pool would receive AAA ratings for their securities, with all or most of the remaining tranches assigned investment grade ratings down to BBB. Credit ratings were intended to simplify the review process, help investors identify the riskiness of each security, and facilitate purchasing decisions.

Shorting the Mortgage Market. Commonly, investors purchased RMBS or CDO securities as long-term investments that produced a steady income. They did not seek to sell them, and there was little secondary market in which these securities were bought or sold on a regular basis.

In 2006, the high risk mortgages underlying these securities began to incur record levels of delinquencies. Some investors, worried about the value of their holdings, sought to sell their RMBS or CDO securities, but had a difficult time doing so due to the lack of an active market. Some managed to sell their high risk RMBS securities to investment banks assembling cash CDOs.

Instead of selling their RMBS or CDO securities, some investors purchased "insurance" against a loss by buying a credit default swap (CDS) that would pay off if the specified securities incurred losses or experienced other negative credit events. By 2005, investment banks had standardized CDS contracts for RMBS and CDO securities, making this a practical alternative.

Much like insurance, the buyer of a CDS contract paid a periodic premium to the CDS seller, who guaranteed the referenced security against loss. CDS contracts referencing a single security or corporate bond became known as "single name" CDS contracts. If the referenced security later incurred a loss, the CDS seller had to pay an agreed-upon amount to the CDS buyer to cover the loss. Some investors began to purchase single name CDS contracts, not as a hedge to offset losses from RMBS or CDO securities they owned, but as a way to profit from particular RMBS or CDO securities they predicted would lose money. CDS contracts that paid off on securities that were not owned by the CDS buyer were known as "naked credit default swaps."

Some investors purchased large numbers of these CDS contracts in a concerted strategy to profit from mortgage backed securities they believed would fail.

Investment banks took the CDS approach a step further. In 2006, a consortium of investment banks led by Goldman Sachs among others launched the ABX index, which tracked the performance of 20 subprime RMBS securities. Borrowing from longstanding practice in commodities markets, investors could buy and sell contracts linked to the value of the ABX index. According to a Goldman Sachs employee, the ABX index "introduced a standardized tool that allow[ed] clients to quickly gain exposure to the asset class." An investor – or investment bank – taking a short position on ABX contracts was, in effect, placing a bet that the basket of RMBS securities would lose value.

Synthetic CDOs provided still another vehicle for shorting the mortgage market. In this approach, an investment bank created a synthetic CDO that referenced a variety of RMBS securities. One or more investors took the "short" position by paying premiums into the CDO in exchange for a promise that the CDO would pay off if the referenced assets incurred losses or other negative credit events. If the event of a default, the CDO would have to pay an agreed-upon amount to the short investor to cover the loss, removing income from the CDO and possibly causing losses for the "long" investors. Synthetic CDOs became a way for investors to short multiple specific RMBS securities that they expected would incur losses.

Goldman Sachs. Goldman Sachs was first established in 1869. Originally a private partnership, in 1999, it became a publicly traded corporation. In 2008, it converted to a bank holding company, in part to gain access to Federal Reserve lending programs. Its headquarters are located in New York City's Wall Street and the firm manages about $870 billion in assets. Goldman employs about 14,000 employees in the United States, and 32,500 worldwide. In 2007, it paid about $68 million in compensation to its CEO Lloyd Blankfein.

Goldman Sachs' mortgage department had several trading desks responsible for purchasing and selling virtually all of the firm's mortgage related assets, including RMBS and CDO securities. Goldman Sachs maintained an inventory of RMBS and CDO securities to carry out activities for its clients and proprietary trading for the firm. In 2006 and 2007, it underwrote approximately 86 RMBS and 27 CDOs referencing RMBS assets.[1] Of the 27 CDOs, 84 percent were hybrid CDOs, 15 percent were synthetic, and only about 1 percent were cash CDOs with physical assets.

Mortgage Securitizations. From 2004 through 2007, Goldman Sachs was an active participant in the mortgage market, particularly in the area of securitization. On multiple occasions, it helped lenders like Long Beach Mortgage Company, Fremont Loan & Investment, and New Century Mortgage, securitize billions of dollars in poor quality, high risk mortgages and sold them to investors. In doing so, Goldman Sachs provided these lenders with additional liquidity to make even more bad loans, many of which were included in risky securities. Two examples illustrate Goldman Sachs' role in the securitization process.

[1]Goldman Sachs document prepared for the Subcommittee, undated, GS-PSI-00265.

The first example involves Washington Mutual ("WaMu") and its subprime lender Long Beach. An exhibit from the Subcommittee's first hearing shows that WaMu, Long Beach, and Goldman Sachs collaborated on at least $14 billion in loan sales and securitizations,[2] even though Long Beach originated some of the worst performing subprime mortgages in the country. In 2003, WaMu halted all Long Beach securitizations and sent a legal team for three months to clean up the company's problems, before allowing securitizations to resume in 2004. In 2005, Long Beach saw a surge of early payment defaults on its loans and had to repurchase over $875 million of nonperforming loans from investors, as well as book a $107 million loss. Internal audits of Long Beach and examinations by the Office of Thrift Supervision repeatedly identified lax lending standards, poor controls over loan officers ignoring credit requirements, and loans subject to fraud, appraisal problems, and errors. Long Beach securitizations had among the worst credit losses in the industry from 1999-2003, and in 2005 and 2006 Long Beach securities were among the worst performing in the market.

Nevertheless, in May 2006 Goldman Sachs acted as co-lead underwriter with WaMu to securitize about $532 million in subprime second lien, fixed rate mortgages originated by Long Beach. Long Beach Mortgage Loan Trust 2006-A ("LBMLT 2006-A") issued about $495 million in RMBS securities backed by the Long Beach high risk mortgages. The top three tranches, representing 66 percent of the principal loan balance, received AAA ratings from S&P, even though the pool contained high risk, subprime second lien mortgages—loans for which there was little prospect of recovering collateral in the event of a housing downturn—issued by one of the nation's worst mortgage lenders. In this instance, Goldman Sachs was able, with the help of the ratings agencies, to turn two-thirds of that extremely risky debt into AAA-rated securities. Goldman Sachs then sold the Long Beach securities to investors.

In less than a year, the Long Beach loans started to become delinquent. By May 2007, the cumulative net loss on the underlying mortgage pool jumped to over 12 percent, wiping out a significant amount of the deal's loss protection and causing S&P to downgrade 6 out of 7 of the mezzanine tranches of the securitization. The Long Beach securities plummeted in value. Goldman Sachs owned some of the mezzanine securities, but had also placed a bet against them by purchasing a credit default swap that paid off if the securities incurred loss. One Goldman employee, upon learning of the Long Beach losses, wrote in an email to management: "bad news… [the loss] wipes out the m6s and makes a wipeout of the m5 imminent… costs us about 2.5[million dollars]… good news… we own 10[million dollars] protection at the m6… we make $5[million]." Ultimately, in this transaction, Goldman Sachs profited from the decline of the very security it had earlier sold to clients. By May 2008—only two years later—even the AAA securities in LBMLT 2006-A had been downgraded to default status. By March 2010, the securities recorded a cumulative net loss of over 66 percent.

A second example involves Fremont, another poor performing subprime lender. In the first calendar quarter of 2007, Goldman Sachs helped Fremont securitize over $1 billion in high risk loans by creating GSAMP Trust 2007-FM1 and GSAMP Trust 2007-FM2.[3] In March 2007,

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[2] See Exhibit 47b, Subcommittee hearing on Wall Street and the Financial Crisis: The Role of High Risk Home Loans, April 13, 2010.

[3] See Exhibit 93f, Subcommittee hearing on Wall Street and the Financial Crisis: The Role of the Credit Rating Agencies, April 23, 2010.

Fremont reported in an 8-K filing with the SEC that the California Court of Appeals had found sufficient evidence in a lawsuit filed by the California Insurance Commissioner that Fremont was "[m]arketing and extending adjustable–rate mortgage products to subprime borrowers in an unsafe and unsound manner that greatly increases the risk that borrowers will default on the loans or otherwise causes losses." That same month, Fremont received a public cease and desist order from the Federal Deposit Insurance Corporation ("FDIC") due to fraud and lax underwriting standards affecting its mortgage loans. Fremont halted all subprime originations by March 2007. Moody's and S&P rated the Fremont securities, even though analysts at both firms expressed concern about the quality of Fremont loans. Both agencies gave AAA ratings to the top 5 tranches of the securitization. Goldman Sachs sold the Fremont securities to investors, while at the same time purchasing $15 million in credit default swaps referencing some of the Fremont securities.[4] A little over a year later, every tranche in the security was downgraded to junk status. It is unclear what recovery Goldman Sachs received from its credit default swap.

Goldman Sachs has stated that it had a process for evaluating lenders and, as a result of its process, terminated relationships with "dozens of originators." It has also stated that it employed internal and third party due diligence reviews of individual loans in mortgage pools backing Goldman Sachs RMBS securities to ensure it did not accept loans with "potentially significant legal regulatory compliance or other issues."[5]

In addition to RMBS securities, Goldman Sachs was active in the CDO market. A September 2007 internal presentation to its Board of Directors listed Goldman Sachs as the fourth largest CDO underwriter in the country, with 14 CDO transactions in 2006 involving $16 billion, and 12 deals in the first half of 2007, involving $8.3 billion.[6] These transactions included about 16 CDOs on the Abacus platform, involving over $10 billion in referenced assets; Hudson CDO involving $2 billion, a $300 million Anderson CDO, and a $1 billion Timberwolf CDO.

Goldman Sachs Shorting the Mortgage Market. Goldman Sachs senior management closely monitored the holdings and the profit and loss performance of its mortgage department. In late 2006, when high risk mortgages began showing record delinquency rates, and the value of RMBS and CDO securities began falling generally, Goldman Sachs Chief Financial Officer David Viniar convened a meeting on December 14, 2006, to examine the data and consider how to respond.

Beginning in early 2007, Goldman Sachs initiated an intensive effort to not only reduce its mortgage risk exposure, but profit from high risk RMBS and CDO securities incurring losses. A presentation to the Goldman Sachs Board of Directors identified a number of actions taken during the year, including: "Shorted synthetics" and "Shorted CDOs and RMBS."[7]

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[4] See Goldman Sachs spreadsheet, GS MBS-E-013648131.
[5] "Goldman Sachs: Risk Management and Residential Mortgage Market," provided to the Subcommittee on 4/24/10, at 3-4.
[6] Presentation to GS Board of Directors, Residential Mortgage Business, 9/17/07, GS MBS-E-001793853, Exhibit 41.
[7] Presentation to GS Board of Directors, Residential Mortgage Business, 9/17/07, GS MBS-E-001793844, Exhibit 41.

The 2009 Goldman Sachs annual report states that the firm "did not generate enormous net revenues by betting against residential related products." Documents obtained by the Subcommittee, however, indicate otherwise. Two top Goldman mortgage traders, Michael Swenson and Joshua Birnbaum, discussed in their 2007 performance self-evaluations the "very profitable year" and "extraordinary profits" that came from shorting the mortgage market that year. One bragged about "aggressively" entering into "efficient shorts in both the RMBS and CDO space," while the other reported that "contrary to the prevailing opinion" that the firm needed only to "get close to home," he "concluded that we should not only get flat, but get VERY short."[8] Goldman Sachs documents show that the firm was short in the mortgage market throughout 2007, and that, twice in 2007, it established and then cashed in very large short positions in mortgage related securities, generating billions of dollars in gross revenues.

At times, the net short position accumulated by Goldman Sachs was as large as $13.9 billion. The short positions held by the firm's mortgage department became so large that according to the Goldman Sachs risk measurements, the positions comprised 53 percent of the firm's overall risk, according to Goldman Sachs own Value-at-Risk (VaR) measures.[9] Senior management had to repeatedly allow the mortgage department to exceed the VaR limits that had been established by the firm.

Beginning in July 2007 and continuing into the next year, credit rating agencies downgraded hundreds of RMBS and CDO securities. On one day in October 2007, they downgraded $32 billion in mortgage related securities, causing substantial losses for investors. A Goldman Sachs manager reacted to the news by noting that Goldman had bet against those securities by purchasing credit default swaps. His colleague responded: "Sounds like we will make some serious money." The reply: "Yes we are well positioned."[10] In the end, Goldman Sachs profited from the failure of many of the RMBS and CDO securities it had underwrote and sold. As Goldman Sachs CEO Lloyd Blankfein explained in a November 2007 email: "Of course we didn't dodge the mortgage mess. We lost money, then made more than we lost because of shorts."[11]

Conflict Between Proprietary and Client Trading. After Goldman Sachs decided to reduce its mortgage holdings, the sales force was instructed to try to sell some of its mortgage related assets, and the risks associated with them, to Goldman Sachs clients. In response, Goldman Sachs personnel issued and sold to clients RMBS and CDO securities containing or referencing high risk assets that Goldman Sachs wanted to get off its books. Three examples demonstrate how Goldman Sachs continued to sell mortgage related products to its clients, while profiting from the decline of the mortgage market.

Hudson Mezzanine 2006-1 ("Hudson 1") was a synthetic CDO that referenced $2 billion in subprime BBB-rated RMBS securities. This CDO was underwritten and sold by Goldman Sachs in December 2006. Goldman Sachs selected the referenced assets, collaborating with its

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[8] 2007 performance self-evaluations by Michael Swenson, Joshua Birnbaum, GS-PSI-01974, 2400, Exhibit 55b-c.
[9] See Goldman Sachs Market Risk Report, 8/14/07, GS MBS-E-012380294, Exhibit 35.
[10] Email exchange between Michael Swenson and Donald Mullen, 10/11/07, GS MBS-E-016031234.
[11] Email from Lloyd Blankfein to David Viniar and others, 11/18/07, GS MBS-E-009696333.

mortgage traders to identify BBB rated assets on its books. About $800 million in subprime RMBS securities and $1.2 billion in ABX index contracts were referenced in the CDO. Goldman executives told the Subcommittee that the company was trying to remove BBB assets from the company books during this period of time. Goldman Sachs was the sole short investor in this proprietary deal, buying protection on all $2 billion in referenced assets and essentially placing a bet that the assets would lose value. Goldman Sachs personnel placed a high priority on selling the Hudson securities. Evidence of this is illustrated by the Hudson 1 deal being pushed ahead of a client transaction. One Goldman Sachs employee noted that a client was "upset that we are delaying their deal. They know that Hudson Mezz (GS prop deal) is pushing their deal back."[12] Less than 18 months later, the AAA securities had been downgraded to junk status. Goldman Sachs as the sole short investor would have been compensated for these losses, and investors who purchased the Hudson securities would have lost an equivalent amount. Goldman Sachs profited from the loss in value of the very CDO securities it had sold to its clients.

Anderson Mezzanine Funding 2007-1 was a synthetic CDO referencing about $300 million in subprime RMBS BBB securities. Goldman Sachs structured the deal and participated as one of the short investors, buying loss protection for $140 million, or nearly 50 percent, of the referenced assets. During the first calendar quarter of 2007, Goldman Sachs underwrote and sold the Anderson CDO securities. Most of the referenced assets were subprime RMBS securities, backed by high risk mortgages. The largest originator of the high risk mortgages was New Century Mortgage, a lender which was known for poor quality loans and which Goldman Sachs knew was in poor financial condition. Goldman senior managers directed their sales force to sell the Anderson securities quickly due to "poor subprime news." In fact, Goldman manager Jonathan Egol advised Goldman personnel to sell the Anderson securities before completing an Abacus deal: "Given risk priorities, subprime news and market conditions, we need to discuss side-lining this deal ([Abacus 2007-]AC1) in favor of prioritizing Anderson in the short term."[13] The top rating given to the Anderson securities was BBB; about 7 months after the securities were sold, Anderson was downgraded to junk status.

A third example involves Timberwolf I, a hybrid cash/synthetic $1 billion CDO squared, which Goldman Sachs underwrote and sold in the first calendar quarter of 2007. A significant portion of the referenced assets were CDO securities backed by subprime RMBS mortgages. Some of the referenced assets were backed by Washington Mutual Option ARM mortgages, high risk mortgages whose value was dropping as housing prices declined. A memorandum sent to the Goldman Sachs Mortgage Capital Committee indicated that the Timberwolf CDO would contain 50 percent CDO securities and 50 percent collateralized loan obligation ("CLO") securities, but Goldman Sachs told the Subcommittee that, since the value of the CLOs had improved, the firm had sold the best-performing CLO securities separately. In the end, Timberwolf referenced assets consisted of 94 percent CDO securities, including about $15 million in Abacus CDO securities. Goldman Sachs was the short investor for many of the Timberwolf referenced assets, including the Abacus securities, betting that they would decline in value.

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[12] Email to Daniel Sparks, 10/16/06, GS MBS-E-010916991.

[13] Email from Mr. Egol to Goldman Sachs personnel, Re: Abacus AC1, 3/2/07, GS MBS-E-002676413.

A senior executive in Goldman Sachs sales expressed concern about what representations might be made to clients about the Timberwolf CDO squared, but other Goldman personnel urged the sales force to treat Timberwolf securities as a priority. An email from Dan Sparks, head of the Goldman Sachs mortgage department, urged Goldman personnel working on a potential Korean sale to "[g]et 'er done," and sent a mass email to the sales force promising "ginormous credits" for selling the securities. A congratulatory email was sent to an employee who sold a number of the securities: "Great job … trading us out of our entire Timberwolf Single-A position." In mid-spring, Goldman Sachs sold about $300 million of Timberwolf securities to Bear Stearns Asset Management, one of the offshore hedge funds that collapsed during the summer. Within five months of issuance, the CDO lost 80 percent of its value, and was later liquidated in 2008. The AAA securities issued in March 2007, were downgraded to junk status in just over a year. The Goldman trader responsible for managing the deal later characterized the day that Timberwolf was issued as "a day that will live in infamy."[14] A senior Goldman executive described the deal as follows: "Boy that timeberwof [sic] was one shi**y deal."[15]

Abacus 2007- AC1. In addition to the Hudson, Anderson, and Timberwolf CDOs, Goldman Sachs developed and sold a series of about 16 Abacus synthetic CDOs. One Abacus transaction in particular, Abacus 2007-AC1, has attracted attention due to allegations that Goldman Sachs failed to disclose that its portfolio of referenced RMBS assets was selected in part by a hedge fund betting against the CDO. On April 16, 2010, the SEC filed a civil complaint against Goldman Sachs and one of its employees, Fabrice Tourre, in connection with this transaction.

Abacus 2007- AC1 is a $2 billion synthetic CDO which closed on April 26, 2007. The referenced assets were primarily BBB rated RMBS securities backed by subprime mortgages. Goldman structured, served as the placement agent, and sold this CDO's securities to investors, including a German bank, IKB.

Documents indicate that Goldman Sachs initiated this transaction at the request of Paulson & Co., a hedge fund ran by John Paulson, who had very negative views of high risk residential mortgages, RMBS securities, and the housing market. Goldman records refer to Paulson & Co. as the "sponsor" of the deal, and internal Goldman documents indicate that the deal was structured so that his company could serve as the "short" investor – that is, the investor who would buy loss protection that would pay off if the referenced assets lost value. In order for the transaction to go forward, Goldman Sachs had to find one or more investors willing to take the "long" side – that is, bet that the referenced RMBS securities would increase in value. In early 2007, that was becoming increasingly difficult as confidence in the mortgage market began to erode.

The investor Goldman Sachs located, IKB, indicated that it was interested only in CDOs that, unlike prior Abacus transactions, made use of an independent portfolio selection agent to select the referenced assets. Goldman Sachs determined that it would use an independent portfolio selection agent and eventually settled on ACA Management, LLC, an established company that had selected assets for other CDO transactions. Internal Goldman memoranda

[14] Email from Mr. Bieber, "Re: Timberwolf," 9/17/07, GS MBS-E-000766370.
[15] Email from Mr. Montag, "Re: Few trade posts," 6/22/07, GS MBS-E-010849103.

indicated that it planned to rely on ACA's reputation to encourage investors to buy the CDO securities.

The documents also indicate that, rather than develop a portfolio of assets, Goldman Sachs asked ACA to work with Paulson & Co. to review a portfolio of RMBS securities that had already been identified. ACA representatives told the Subcommittee that they were not told that Paulson & Co. would be taking a short position in the CDO, but instead believed that Paulson & Co. would be investing in the equity tranche of the CDO, so that its interests were aligned with those of other Abacus investors. The documents indicate, however, that Paulson & Co. helped to select the assets even though it intended to take the short position only on the referenced assets. In January and February 2007, ACA and Paulson & Co. held several meetings and finally came to an agreement on a list of 90 RMBS securities for the Abacus CDO.

Goldman Sachs asked Moody's and Standard & Poor's to rate the Abacus transaction. Eric Kolchinsky, then a Moody's managing director who oversaw its CDO ratings, told the Subcommittee in sworn testimony at an April 23, 2010 hearing on credit rating agencies, that he did not know of Mr. Paulson's involvement with the Abacus CDO, did not know of his involvement with selecting the referenced assets, and believed his staff did not know either. He said that he would have wanted to know that fact before rating Abacus, explaining: "It just changes the whole dynamic of the structure, where the person who's putting it together, choosing it, wants it to blow up." Both Moody's and Standard & Poor's gave AAA ratings to several of the Abacus CDO tranches.

Goldman Sachs prepared marketing materials for the CDO, including a term sheet, flip book, and offering memorandum. None mentioned Paulson & Co. or its role in the asset selection process. Instead, the materials emphasized the role of ACA as an independent portfolio selection agent.

The CDO closed and its securities went on sale in April 2007. IKB, the German bank, purchased $150 million in AAA-rated Abacus securities. ACA purchased about $42 million in AAA securities and sold protection on about $900 million of the deal. Paulson & Co. paid Goldman Sachs $15 million for structuring the deal. Within months, however, the mortgages started defaulting, and Abacus started incurring losses. Six months later, in October 2007, 83 percent of the securities were downgraded, including the AAA securities. By January, 99 percent were downgraded. IKB and ACA lost over $1 billion, while Paulson & Co. pocketed a similar amount.

In the Abacus CDO transaction, one set of investors wanted the referenced assets to increase in value, while the other wanted them to decrease in value. Goldman Sachs knew that the referenced assets in the CDO had been selected in part by an investor who wanted the assets to decrease in value, without informing the other investors. A Senate committee examining a similar situation in the 1930s, made this observation:

> "[Investors] must believe that their investment banker would not offer them the bonds unless the banker believed them to be safe. This throws a heavy responsibility upon the banker. He may and does make mistakes. There is no way that he can avoid making mistakes because he is human and because in this world, things are only relatively secure.

There is no such thing as absolute security. But while the banker may make mistakes, he must never make the mistake of offering investments to his clients which he does not believe to be good."

By the end of 2007, Goldman Sachs personnel were reporting client anger from losses incurred in connection with Abacus and other CDOs. One employee wrote to Mr. Sparks as follows: "Real bad feeling across European sales about some of the trades we did with clients. The damage this has done to our franchise is very significant."[16]

Subcommittee Findings. Based upon the Subcommittee's ongoing investigation, we make the following findings of fact regarding the role of investment banks in the recent financial crisis.

(1) **Securitizing High Risk Mortgages.** From 2004 to 2007, in exchange for lucrative fees, Goldman Sachs helped lenders like Long Beach, Fremont, and New Century, securitize high risk, poor quality loans, obtain favorable credit ratings for the resulting residential mortgage backed securities (RMBS), and sell the RMBS securities to investors, pushing billions of dollars of risky mortgages into the financial system.

(2) **Magnifying Risk.** Goldman Sachs magnified the impact of toxic mortgages on financial markets by re-securitizing RMBS securities in collateralized debt obligations (CDOs), referencing them in synthetic CDOs, selling the CDO securities to investors, and using credit default swaps and index trading to profit from the failure of the same RMBS and CDO securities it sold.

(3) **Shorting the Mortgage Market.** As high risk mortgage delinquencies increased, and RMBS and CDO securities began to lose value, Goldman Sachs took a net short position on the mortgage market, remaining net short throughout 2007, and cashed in very large short positions, generating billions of dollars in gain.

(4) **Conflict Between Client and Proprietary Trading.** In 2007, Goldman Sachs went beyond its role as market maker for clients seeking to buy or sell mortgage related securities, traded billions of dollars in mortgage related assets for the benefit of the firm without disclosing its proprietary positions to clients, and instructed its sales force to sell mortgage related assets, including high risk RMBS and CDO securities that Goldman Sachs wanted to get off its books, creating a conflict between the firm's proprietary interests and the interests of its clients.

(5) **Abacus Transaction.** Goldman Sachs structured, underwrote, and sold a synthetic CDO called Abacus 2007-AC1, did not disclose to the Moody's analyst overseeing the rating of the CDO that a hedge fund client taking a short position in the CDO had helped to select the referenced assets, and also did not disclose that fact to other investors.

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[16] Email to Daniel Sparks, 10/12/07, GS MBS-E-013706095.

(6) **Using Naked Credit Default Swaps.** Goldman Sachs used credit default swaps (CDS) on assets it did not own to bet against the mortgage market through single name and index CDS transactions, generating substantial revenues in the process.