BUSINESSHERALD

Battle over Wall St enters new stage

Charges against Goldman Sachs will not be last as Govt gets tough

Is the most powerful and controversial firm on Wall St about to get the comeuppance that so many think it deserves?

On Saturday America's Securities and Exchange Commission filed civil charges against Goldman Sachs and one of its vice-presidents, Fabrice Tourre, for allegedly defrauding investors by failing to disclose vital information about a financial product linked to sub-prime mortgages, as America's housing market was starting to wobble.

Goldman's shares tumbled, dragging down sharemarkets.

The instrument in question, structured and marketed by Goldman, was a synthetic collateralised debt obligation, whose performance was tied to that of residential mortgage-backed securities. Goldman told its investors, who included some European banks, that the securities bundled together to form the CDO had been selected by an independent third party, ACA Management.

The SEC alleges the investment bank failed to disclose that another firm, Paulson & Co, a big hedge-fund manager, had a hand in choosing what went into the CDO.

This was a crucial omission, since Paulson & Co — run by John Paulson, who made billions in 2007-08 betting against the housing market — had taken a short position against the CDO. In other words, his firm would profit if the instrument performed poorly.

"The product was new and complex but the deception and conflicts are old and simple," said Robert Khuzami, head of the SEC's enforcement division.

Goldman called the charges completely unfounded and said it would contest them vigorously. Paulson & Co has not been charged; the firm issued a statement saying that ACA, as the third-party collateral manager, had sole authority over the selection of securities in the CDO.

In a more detailed response issued later, Goldman said it had lost money on the transaction and insisted that extensive information about the portfolio was provided to the buyers, sophisticated investors aware of the risks.

The SEC says Paulson had an incentive to select mortgage securities that would bomb.

According to the complaint, Paulson shorted the portfolio it helped to select by purchasing protection against the default of certain layers through credit-default swaps it entered into with Goldman.

The SEC argues these derivatives gave the hedge fund an incentive to select mortgage securities that would bomb. And bomb they did. The deal closed in April 2007 and by the end of January 2008, 99 per cent of the portfolio had been downgraded by credit-rating agencies. Tourre was responsible for the CDO, known as Abacus.

He is alleged not only to have known about Paulson's undisclosed short position, but also to have misled ACA into believing Paulson & Co had ploughed around US$200 million ($282 million) into the equity of the CDO.

The charges could hardly come at a worse time for Goldman.

Over the past year Goldman has been accused of everything from double-dealing for its own advantage to planting its own people in the Treasury and other agencies to ensure its interests were looked after.

One profile memorably likened the firm to a "great vampire squid wrapped around the face of humanity, relentlessly jamming its blood funnel into anything that smells like money".

Goldman has continued to insist that it fared better than most of its rivals because of smart risk management. Its chief executive, Lloyd Blankfein, launched a vigorous defence of the firm's practices in a letter to shareholders.

The charges against Goldman will unleash waves of schadenfreude. Sceptics will say it confirms their suspicions that, for all the talk of helping its customers, Goldman puts its own interests, and those of favoured trading partners, first.

The SEC's move "marks an escalation in the battle to expose conflicts of interest on Wall St" and exposes a cynical, savage culture that allows dealers to deceive one customer to benefit another, said Christopher Whalen of Institutional Risk Analytics.

The charges also have implications for financial regulation.

American senators are caught up in a heated debate over a wide-ranging reform bill, a key part of which covers over-the-counter derivatives, especially CDSs, which many see as having exacerbated the crisis.

Goldman's rivals should not feel too smug. The SEC has been working hard to beef up enforcement. The case is the first to be brought by its new structured-products group. It will not be the last. Goldman's rivals have long been envious of its prowess. Some of them may soon be empathising with its plight.

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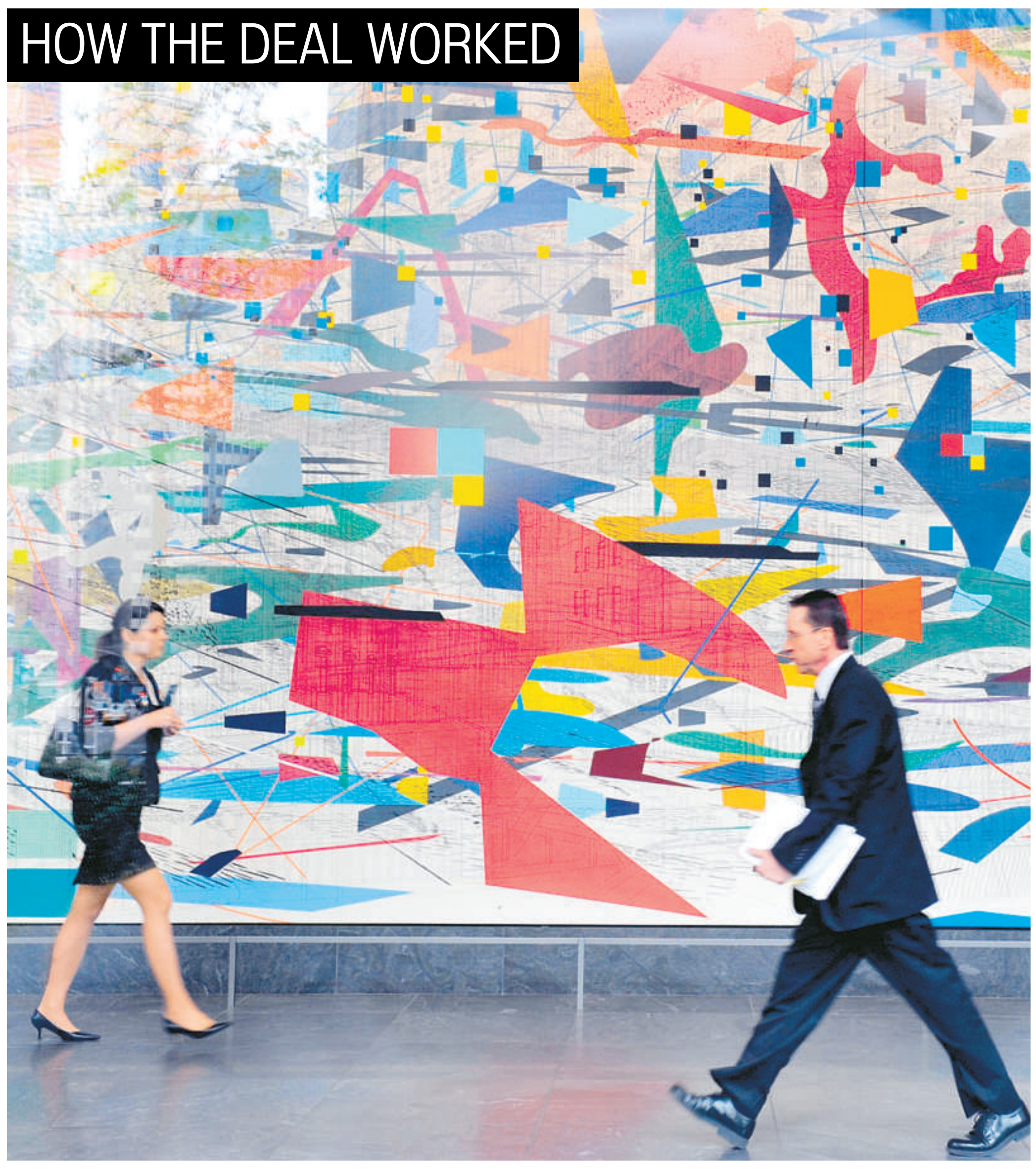
GOLDMAN IN NZ

- Goldman Sachs' presence in New Zealand is with Australasian investment bank Goldman Sachs JBWere.
- It is 45 per cent owned by Goldman Sachs and 55 per cent owned by about 100 local equity partners. It has its own Australasian management and board.
- A spokesman for Goldman Sachs JBWere said yesterday the company was not commenting on the charges facing Goldman Sachs Group.

HOW THE DEAL WORKED


Goldman Sachs headquarters in New York


Goldman Sachs chief executive Lloyd Blankfein


John Paulson

The US Securities and Exchange Commission is accusing Goldman Sachs Group of committing fraud in a complicated transaction involving securities known as collateralised debt obligations. Here's how the deal worked, according to the SEC's complaint:

1 Hedge fund manager John Paulson tells Goldman Sachs in late 2006 he wants to bet against risky sub-prime mortgages using derivatives. The risky mortgage bonds that Paulson wanted to short were essentially sub-prime home loans that had been repackaged into bonds.

2 Goldman Sachs knows that German bank IKB would potentially buy the exposure that Paulson was looking to short. But IKB would only do so if the mortgage securities were selected by an outsider.

3 Goldman Sachs knows that not every asset manager would be willing to work with Paulson, according to the complaint. In January 2007, Goldman approaches ACA Management, a unit of a bond insurer. ACA agrees to be the manager in a deal, and to help select the securities for the deal with Paulson. Goldman never tells ACA or other investors that Paulson is shorting the securities, and ACA believes that Paulson in fact wanted to own some of the riskiest parts of the securities.

4 Goldman puts together a deal known as a "synthetic collateralised debt obligation" designed to help IKB and Paulson get the exposure they want. IKB takes US$150 million of the risk from sub-prime mortgage bonds in April 2007. ABN Amro takes some US$909 million of exposure as well, and buys protection on its exposure from ACA Management affiliate ACA Financial Guaranty Corp, in May 2007. Goldman's marketing materials for the deal, dubbed Abacus, never mention Paulson's having shorted more than US$1 billion of securities. Goldman receives about US$15 million in fees.

5 Months later, IKB loses almost all of its US$150 million investment. In late 2007, ABN is acquired by a consortium of banks including Royal Bank of Scotland. In August 2008, RBS unwinds ABN's position in Abacus by paying Goldman US$840.1 million. Most of that money goes to Paulson, who made about US$1 billion total.

Source: Reuters / HERALD GRAPHIC

Fraud case no barrier to bonuses

by Ruth Sunderland

Days after being accused of securities fraud by United States regulators, Goldman Sachs is expected to earmark about US$5 billion ($7 billion) for staff pay and bonuses this week, fuelling the controversy over bankers' rewards in the teeth of the financial crisis.

Chief executive Lloyd Blankfein is expected to unveil revenues of US$11 billion for the first quarter of this year on Wednesday, up from US$9.4 billion in the same period of 2009.

About 47 per cent of that will go into a "compensation pool" for bosses and employees.

The bank has been aware of the Securities and Exchange Commission's (SEC) investigation for two years but has not spoken to investigators since September 2009 and is thought to have been surprised by the fraud complaint.

The charges are likely to have incurred the ire of US investor Warren Buffett, who lost more than US$1 billion on paper in 24 hours on warrants held by his Berkshire Hathaway investment fund as Goldman shares plunged.

Buffett endorsed the bank by loaning it US$5 billion at the height of the crisis at 10 per cent interest. He is an outspoken critic of Wall St sharp practice and excessive pay.

Senior Goldman executives have held talks with major investors, thought to include Buffett, over the SEC accusation.

Blankfein is also anticipating tough questioning later this month on Capitol Hill. Along with other financiers, he is expected to testify before the Senate's permanent subcommittee on investigations.

The panel's head, Democratic senator Carl Levin, said it had discovered levels of greed that were "frankly disgusting".

Goldman made record profits of US$13.4 billion last year, after net revenues more than doubled to US$45.2 billion, racking up at least US$100 million in net trading revenues every other working day.

— *Observer*

$16m better off on emissions tally

by Brian Fallow

The latest official estimates have shaved nearly two million tonnes off New Zealand's projected net emissions of greenhouse gases over the 2008 to 2012 period.

At today's carbon prices and exchange rates that would leave the country's financial position under the Kyoto Protocol $231 million in the black, $16 million better than the estimate a year ago.

The projections include the estimated effect of the Emissions Trading Scheme (ETS) scheduled to kick in on July 1.

Without the ETS, instead of being 11.4 million tonnes on the right side of the country's Kyoto obligation it would be 22 million tonnes in deficit, costing $446 million at today's carbon prices, Climate Change Minister Nick Smith said.

The biggest change from last year's estimates relates to emissions from agriculture.

They are expected to be 6.4 million tonnes or 3.5 per cent lower than the previous projection because recovery from a widespread drought has been slower than expected and in some regions further drought has occurred.

Sheep numbers fell 5 per cent, beef numbers were stable and dairy numbers lifted 4 per cent, compared with last year's estimates.

The drop in agricultural emissions has been offset by a fall of 5.1 million tonnes or 6 per cent in the net removal of CO_2 by forests.

More accurate land use mapping has shown the area of "Kyoto" forest is smaller than previously estimated. The mapping also shows some deforestation of native forest that had not been accounted for.

Smith said the position will not be crystallised until after Kyoto's first commitment period ends in 2012. He said that while the country would be in surplus, that did not mean the Government would be.

The owners of Kyoto forests (established since 1989 on land not previously forested) are eligible to claim credits for the carbon removed while trees grew. To the extent they take up their credits, and the associated liability on harvest, the Government's stock of forest offset credits will reduce and its net liability increase.

Diplock: Regulation too weak for funds hub

Regulation in New Zealand is not good enough for the country to become a super-hub for the fund management industry, says Securities Commission chairman Jane Diplock.

The Government is investigating the potential of establishing New Zealand as a base for international fund managers, but Diplock told TVNZ's *Q+A* programme yesterday the country's regulations weren't up to the task.

"They're not good enough for it at the moment.

"Investors in Hong Kong and in Singapore have a better regulatory framework of managed funds than we do, and they won't recognise our managed funds framework."

However she said this would be reformed in a review of the Securites Act.


Jane Diplock

"Part of the Securities Act review which is coming up this year is going to address that particular point."

Diplock told *Q+A* that inadequate regulation was a factor in finance company collapses which have put more than $6 billion of investors' money at risk.

"There are many, many factors that led to the finance company collapses, and the regulatory desert was one of them. I think we certainly, looking back, could say we needed a better regulatory framework at the time."

She cited a lack of resources as a reason why it has taken so long to take action against finance companies and their directors.

"It's clear that the commission is under-resourced, there's no doubt about that.

"Each time we've gone to the ministry and they go to the Treasury to ask for funding, we've received about half or a third of what we felt we required."

She said she was motivated by the New Zealanders who had lost money in failed investments. "If you asked me what keeps me awake at night, it is precisely that people have lost this money, and that people's hopes and dreams have been destroyed."

The Government estimates that creating a managed fund hub could generate as many as 5000 jobs.