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Chapter 12: Early 2007: Spreading Subprime Worries and Conclusion

United States: Financial Crisis Inquiry Commission (FCIC)

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PART IV

The Unraveling

12

EARLY 2007: SPREADING SUBPRIME WORRIES

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Over the course of 2007, the collapse of the housing bubble and the abrupt shutdown of subprime lending led to losses for many financial institutions, runs on money market funds, tighter credit, and higher interest rates. Unemployment remained relatively steady, hovering just below 4.5% until the end of the year, and oil prices rose dramatically. By the middle of 2007, home prices had declined almost 4% from their peak in 2006. Early evidence of the coming storm was the 1.5% drop in November 2006 of the ABX Index—a Dow Jones–like index for credit default swaps on BBB-tranches of mortgage-backed securities issued in the first half of 2006.[1]

That drop came after Moody's and S&P put on negative watch selected tranches in one deal backed by mortgages from one originator: Fremont Investment & Loan.[2] In December, the same index fell another 3% after the mortgage companies Ownit Mortgage Solutions and Sebring Capital ceased operations. Senior risk officers of the five largest investment banks told the Securities and Exchange Commission that they expected to see further subprime lender failures in 2007. "There is a broad recognition that, with the refinancing and real estate booms over, the business model of many of the smaller subprime originators is no longer viable," SEC analysts told Director Erik Sirri in a January 4, 2007, memorandum.[3]

That became more and more evident. In January, Mortgage Lenders Network announced it had stopped funding mortgages and accepting applications. In February, New Century reported bigger-than-expected mortgage credit losses and HSBC, the largest subprime lender in the United States, announced a $1.8 billion increase in its quarterly provision for losses. In March, Fremont stopped originating subprime loans after receiving a cease and desist order from the Federal Deposit Insurance Corporation. In April, New Century filed for bankruptcy.

These institutions had relied for their operating cash on short-term funding through commercial paper and the repo market. But commercial paper buyers and banks became unwilling to continue funding them, and repo lenders became less and less willing to accept subprime and Alt-A mortgages or mortgage-backed securities as collateral. They also insisted on ever-shorter maturities, eventually of just one day—an inherently destabilizing demand, because it gave them the option of withholding funding on short notice if they lost confidence in the borrower.

Another sign of problems in the market came when financial companies began to report more detail about their assets under the new mark-to-market accounting rule, particularly about mortgage-related securities that were becoming illiquid and hard to value. The sum of more illiquid Level 2 and 3 assets at these firms was "eye-popping in terms of the amount of leverage the banks and investment banks had," according to Jim Chanos, a New York hedge fund manager. Chanos said that the new disclosures also revealed for the first time that many firms retained large exposures from securitizations. "You clearly didn't get the magnitude, and the market didn't grasp the magnitude until spring of '07, when the figures began to be published, and then it was as if someone rang a bell, because almost immediately upon the publication of these numbers, journalists began writing about it, and hedge funds began talking about it, and people began speaking about it in the marketplace."[4]

In late 2006 and early 2007, some banks moved to reduce their subprime exposures by selling assets and buying protection through credit default swaps. Some, such as Citigroup and Merrill Lynch, reduced mortgage exposure in some areas of the firm but increased it in others. Banks that had been busy for nearly four years creating and selling subprime-backed collateralized debt obligations (CDOs) scrambled in about that many months to sell or hedge whatever they could. They now dumped these products into some of the most ill-fated CDOs ever engineered. Citigroup, Merrill Lynch, and UBS, particularly, were forced to retain larger and larger quantities of the "super-senior" tranches of these CDOs. The bankers could always hope—and many apparently even believed—that all would turn out well with these super seniors, which were, in theory, the safest of all.

With such uncertainty about the market value of mortgage assets, trades became scarce and setting prices for these instruments became difficult.

Although government officials knew about the deterioration in the subprime markets, they misjudged the risks posed to the financial system. In January 2007, SEC officials noted that investment banks had credit exposure to struggling subprime lenders but argued that "none of these exposures are material."[5] The Treasury and Fed insisted throughout the spring and early summer that the damage would be limited. "The impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained,"[6] Fed Chairman Ben Bernanke testified before the Joint Economic Committee of Congress on March 28. That same day, Treasury Secretary Henry Paulson told a House Appropriations subcommittee: "From the standpoint of the overall economy, my bottom line is we're watching it closely but it appears to be contained."[7]

GOLDMAN: "LET'S BE AGGRESSIVE DISTRIBUTING THINGS"

In December 2006, following the initial decline in ABX BBB indices and after 10 consecutive days of trading losses on its mortgage desk, executives at Goldman Sachs decided to reduce the firm's subprime exposure. Goldman marked down the value of its mortgage-related products to reflect the lower ABX prices, and began posting daily losses for this inventory.[8]

Responding to the volatility in the subprime market, Goldman analysts delivered an internal report on December 13, 2006, regarding "the major risk in the Mortgage business" to Chief Financial Officer David Viniar and Chief Risk Officer Craig Broderick.[9] The next day, executives determined that they would get "closer to home," meaning that they wanted to reduce their mortgage exposure: sell what could be sold as is, repackage and sell everything else.[10] Kevin Gasvoda, the managing director for Goldman's Fixed Income, Currency, and Commodities business line, instructed the sales team to sell asset-backed security and CDO positions, even at a loss: "Pls refocus on retained new issue bond positions and move them out. There will be big opportunities the next several months and we don't want to be hamstrung based on old inventory. Refocus efforts and move stuff out even if you have to take a small loss."[11] In a December 15 email, Viniar described the strategy to Tom Montag, the co-head of global securities: "On ABX, the position is reasonably sensible but is just too big. Might have to spend a little to size it appropriately. On everything else my basic message was let's be aggressive distributing things because there will be very good opportunities as the market goes into what is likely to be even greater distress and we want to be in position to take advantage of them."[12]

Subsequent emails suggest that the "everything else" meant mortgage-related assets. On December 20, in an internal email with broad distribution, Goldman's Stacy Bash-Polley, a partner and the co-head of fixed income sales, noted that the firm, unlike others, had been able to find buyers for the super-senior and equity tranches of CDOs, but the mezzanine tranches remained a challenge. The "best target," she said, would be to put them in other CDOs: "We have been thinking collectively as a group about how to help move some of the risk. While we have made great progress moving the tail risks—[super-senior] and equity—we think it is critical to focus on the mezz risk that has been built up over the past few months. . . . Given some of the feedback we have received so far [from investors,] it seems that cdo's maybe the best target for moving some of this risk but clearly in limited size (and timing right now not ideal)."[13]

It was becoming harder to find buyers for these securities. Back in October, Goldman Sachs traders had complained that they were being asked to "distribute junk that nobody was dumb enough to take first time around."[14] Despite the first of Goldman's business principles—that "our clients' interests always come first"—documents indicate that the firm targeted less-sophisticated customers in its efforts to reduce subprime exposure. In a December 28 email discussing a list of customers to target for the year, Goldman's Fabrice Tourre, then a vice president on the structured product correlation trading desk, said to "focus efforts" on "buy and hold rating-based buyers"

rather than "sophisticated hedge funds" that "will be on the same side of the trade as we will."[15] The "same of side of the trade" as Goldman was the selling or shorting side—those who expected the mortgage market to continue to decline. In January, Daniel Sparks, the head of Goldman's mortgage department, extolled Goldman's success in reducing its subprime inventory, writing that the team had "structured like mad and traveled the world, and worked their tails off to make some lemonade from some big old lemons."[16] Tourre acknowledged that there was "more and more leverage in the system," and—writing of himself in the third person—said he was "standing in middle of all these complex, highly levered, exotic trades he created without necessarily understanding all the implications of those monstrosities."[17]

On February 11, Goldman CEO Lloyd Blankfein questioned Montag about the $20 million in losses on residual positions from old deals, asking, "Could/should we have cleaned up these books before and are we doing enough right now to sell off cats and dogs in other books throughout the division?"[18]

The numbers suggest that the answer was yes, they had cleaned up pretty well, even given a $20 million write-off and billions of dollars of subprime exposure still retained. In the first quarter of 2007, its mortgage business earned a record $266 million, driven primarily by short positions, including a $10 billion short position on the bellwether ABX BBB index, whose drop the previous November had been the red flag that got Goldman's attention.

In the following months, Goldman reduced its own mortgage risk while continuing to create and sell mortgage-related products to its clients. From December 2006 through August 2007, it created and sold approximately $25.4 billion of CDOs—including $17.6 billion of synthetic CDOs. The firm used the cash CDOs to unload much of its own remaining inventory of other CDO securities and mortgage-backed securities.[19]

Goldman has been criticized—and sued—for selling its subprime mortgage securities to clients while simultaneously betting against those securities. Sylvain Raynes, a structured finance expert at R&R Consulting in New York, reportedly called Goldman's practice "the most cynical use of credit information that I have ever seen," and compared it to "buying fire insurance on someone else's house and then committing arson."[20]

During a FCIC hearing, Goldman CEO Lloyd Blankfein was asked if he believed it was a proper, legal, or ethical practice for Goldman to sell clients mortgage securities that Goldman believed would default, while simultaneously shorting them. Blankfein responded, "I do think that the behavior is improper and we regret the result—the consequence [is] that people have lost money"[21] The next day, Goldman issued a press release declaring Blankfein did not state that Goldman's "practices with respect to the sale of mortgage-related securities were improper. . . . Blankfein was responding to a lengthy series of statements followed by a question that was predicated on the assumption that a firm was selling a product that it thought was going to default. Mr. Blankfein agreed that, if such an assumption was true, the practice would be improper. Mr. Blankfein does not believe, nor did he say, that Goldman Sachs had behaved improperly in any way."[22]

In addition, Goldman President and Chief Operating Officer Gary Cohn testified: "During the two years of the financial crisis, Goldman Sachs lost $1.2 billion in its residential mortgage–related business. . . . We did not bet against our clients, and these numbers underscore that fact."[23]

Indeed, Goldman's short position was not the whole story. The daily mortgage "Value at Risk" measure, or VaR, which tracked potential losses if the market moved unexpectedly, increased in the three months through February. By February, Goldman's company-wide VaR reached an all-time high, according to SEC reports. The dominant driver of the increase was the one-sided bet on the mortgage market's continuing to decline. Preferring to be relatively neutral, between March and May, the mortgage securities desk reduced its short position on the ABX Index;[24] between June and August, it again reversed course, increasing its short position by purchasing protection on mortgage-related assets.

The Basis Yield Alpha Fund, a hedge fund and Goldman client that claims to have invested $11.25 million in Goldman's Timberwolf CDO, sued Goldman for fraud in 2010. The Timberwolf deal was heavily criticized by Senator Carl Levin and other members of the Permanent Subcommittee on Investigations during an April 2010 hearing. The Basis Yield Alpha Fund alleged that Goldman designed Timberwolf to quickly fail so that Goldman could offload low-quality assets and profit from betting against the CDO. Within two weeks of the fund's investment, Goldman began making margin calls on the deal. By the end of July 2007, it had demanded more than $35 million.[25] According to the hedge fund, Goldman's demands forced it into bankruptcy in August 2007—Goldman received about $40 million from the liquidation. Goldman denies Basis Yield Alpha Fund's claims, and CEO Blankfein dismissed the notion that Goldman misled investors. "I will tell you, we only dealt with people who knew what they were buying. And of course when you look after the fact, someone's going to come along and say they really didn't know," he told the FCIC.[26]

In addition to selling its subprime securities to customers, the firm took short positions using credit default swaps; it also took short positions on the ABX indices and on some of the financial firms with which it did business. Like every market participant, Goldman "marked," or valued, its securities after considering both actual market trades and surveys of how other institutions valued the assets. As the crisis unfolded, Goldman marked mortgage-related securities at prices that were significantly lower than those of other companies. Goldman knew that those lower marks might hurt those other companies—including some clients—because they could require marking down those assets and similar assets. In addition, Goldman's marks would get picked up by competitors in dealer surveys. As a result, Goldman's marks could contribute to other companies recording "mark-to-market" losses: that is, the reported value of their assets could fall and their earnings would decline.

The markdowns of these assets could also require that companies reduce their repo borrowings or post additional collateral to counterparties to whom they had sold credit default swap protection. In a May 11 email, Craig Broderick, who as Goldman's chief risk officer was responsible for tracking how much of the company's money was at risk,[27] noted to colleagues that the mortgage group was "in the process

of considering making significant downward adjustments to the marks on their mortgage portfolio [especially] CDOs and CDO squared. This will potentially have a big [profit and loss] impact on us, but also to our clients due to the marks and associated margin calls on repos, derivatives, and other products. We need to survey our clients and take a shot at determining the most vulnerable clients, knock on implications, etc. This is getting lots of 30th floor attention right now."[28]

Broderick was right about the impact of Goldman's marks on clients and counterparties. The first significant dispute about these marks began in May 2007: it concerned the two high-flying, mortgage-focused hedge funds run by Bear Stearns Asset Management (BSAM).

BEAR STEARNS'S HEDGE FUNDS: "LOOKS PRETTY DAMN UGLY"

In 2003, Ralph Cioffi and Matthew Tannin, who had structured CDOs at Bear Stearns, were busy managing BSAM's High-Grade Structured Credit Strategies Fund. When they added the higher-leveraged, higher-risk Enhanced Fund in 2006 they became even busier.

By April 2007, internal BSAM risk exposure reports showed about 60% of the High-Grade fund's collateral to be subprime mortgage–backed CDOs, assets that were beginning to lose market value.[29] In a diary kept in his personal email account because he "didn't want to use [his] work email anymore," Tannin recounted that in 2006 "a wave of fear set over [him]" when he realized that the Enhanced Fund "was going to subject investors to 'blow up risk'" and "we could not run the leverage as high as I had thought we could."[30]

This "blow up risk," coupled with bad timing, proved fatal for the Enhanced Fund. Shortly after the fund opened, the ABX BBB- index started to falter, falling 4% in the last three months of 2006; then another 8% in January and 25% in February. The market's confidence fell with the ABX. Investors began to bail out of both Enhanced and High-Grade. Cioffi and Tannin stepped up their marketing. On March 7, 2007, Tannin said in an email to investors, "we see an opportunity here—not crazy opportunity—but prudent opportunity—I am putting in additional capital—I think you should as well."[31] On a March 12 conference call, Tannin and Cioffi assured investors that both funds "have plenty of liquidity," and they continued to use the investment of their own money as evidence of their confidence.[32] Tannin even said he was increasing his personal investment, although, according to the SEC, he never did.[33]

Despite their avowals of confidence, Cioffi and Tannin were in full red-alert mode. In April, Cioffi redeemed $2 million of his own $6.1 million investment in Enhanced Leverage and transferred the funds to a third hedge fund he managed.[34] They tried to sell the toxic CDO securities held by the hedge funds. They had little success selling them directly on the market,[35] but there was another way.

In late May, BSAM put together a CDO-squared deal that would take $4 billion of CDO assets off the hedge funds' books. The senior-most tranches, worth $3.2 billion,

were sold as commercial paper to short-term investors such as money market mutual funds.[36]

Critically, Bank of America guaranteed those deals with a liquidity put—for a fee. Later, commercial paper investors would refuse to roll over this particular paper; Bank of America ultimately lost more than $4 billion on this arrangement.[37]

"19% is doomsday"

Nearly all hedge funds provide their investors with market value reports, at least monthly, based on computed mark-to-market prices for the fund's various investments. Industry standards generally called for valuing readily traded assets, such as stocks, at the current trading price, while assets in very slow markets were marked by surveying price quotes from other dealers, factoring in other pricing information, and then arriving at a final net asset value. For mortgage-backed investments, marking assets was an extremely important exercise, because the market values were used to inform investors and to calculate the hedge fund's total fund value for internal risk management purposes, and because these assets were held as collateral for repo and other lenders. Crucially, if the value of a hedge fund's portfolio declined, repo and other lenders might require more collateral. In April, JP Morgan told Alan Schwartz, Bear Stearns's co-president, that the bank would be asking the BSAM hedge funds to post additional collateral to support its repo borrowing.[38]

Dealer marks were slow to keep up with movements in the ABX indices. Even as the ABX BBB- index recovered some in March, rebounding 6%, marks by broker-dealers finally started to reflect the lower values. On April 2, 2007, Goldman sent BSAM marks ranging from 65 cents to 100 cents on the dollar—meaning that some securities were worth as little as 65% of their initial value.[39] On Thursday, April 19, in preparation for an investor call the following week, BSAM analysts informed Cioffi and Tannin that in their view, the value of the funds' portfolios had declined sharply.[40] On Sunday, Tannin sent an email from his personal account to Cioffi's personal account arguing that both hedge funds should be closed and liquidated: "Looks pretty damn ugly. . . . If we believe the runs [the analyst] has been doing are ANYWHERE CLOSE to accurate, I think we should close the Funds now. . . . If [the runs] are correct then the entire sub-prime market is toast."[41] But by the following Wednesday, Cioffi and Tannin were back on the same upbeat page. At the beginning of the conference call, Tannin told investors, "The key sort of big picture point for us at this point is our confidence that the structured credit market and the sub-prime market in particular, has not systemically broken down; . . . we're very comfortable with exactly where we are." Cioffi also assured investors that the funds would likely finish the year with positive returns.[42] On May 1, 2007, the two hedge funds had attracted more than $60 million in new funds, but more than $28 million was redeemed by investors.[43]

That same day, Goldman sent BSAM marks ranging from 55 cents to 100 cents on the dollar.[44] Cioffi disputed Goldman's marks as well as marks from Lehman, Citigroup,

and JP Morgan.[45] On May 16, in a preliminary estimate, Cioffi told investors that the net asset value of the Enhanced Leverage Fund was down 6.6% in April.[46] In computing the final numbers later that month, he requested that BSAM's Pricing Committee instead use fair value marks based on his team's modeling, which implied losses that were $25 to $50 million less than losses using Goldman's marks.[47] On June 4, although Goldman's marks were considered low, the Pricing Committee decided to continue to average dealer marks rather than to use fair value. The committee also noted that the decline in net asset value would be greater than the 6.6% estimate, because "many of the positions that were marked down received dealer marks after release of the estimate."[48] The decline was revised from 6.6% to 19%. According to Cioffi, a number of factors contributed to the April revision, and Goldman's marks were one factor.[49] After these meetings, Cioffi emailed one committee member: "There is no market . . . its [*sic*] all academic anyway—19% [value] is doomsday."[50] On June 7, BSAM announced the 19% drop and froze redemptions.

"Canary in the mine shaft"

When JP Morgan contacted Bear's co-president Alan Schwartz in April about its upcoming margin call, Schwartz convened an executive committee meeting to discuss how repo lenders were marking down positions and making margin calls on the basis of those new marks.[51] In early June, Bear met with BSAM's repo lenders to explain that BSAM lacked cash to meet margin calls and to negotiate a 60-day reprieve. Some of these very same firms had sold Enhanced and High-Grade some of the same CDOs and other securities that were turning out to be such bad assets.[52] Now all 10 refused Schwartz's appeal; instead, they made margin calls.[53] As a direct result, the two funds had to sell collateral at distressed prices to raise cash.[54] Selling the bonds led to a complete loss of confidence by the investors, whose requests for redemptions accelerated.

Shortly after BSAM froze redemptions, Merrill Lynch seized more than $850 million of its collateral posted by Bear for its outstanding repo loans. Merrill was able to sell just $181 million of the seized collateral at auction by July 5—and at discounts to its face value.[55] Other repo lenders were increasing their collateral requirements or refusing to roll over their loans.[56] This run on both hedge funds left both BSAM and Bear Stearns with limited options. Although it owned the asset management business, Bear's equity positions in the two BSAM hedge funds were relatively small. On April 26, Bear's co-president Warren Spector approved a $25 million investment into the Enhanced Leverage Fund.[57] Bear Stearns had no legal obligation to rescue either the funds or their repo lenders. However, those lenders were the same large investment banks that Bear Stearns dealt with every day.[58] Moreover, any failure of entities related to Bear Stearns could raise investors' concerns about the firm itself.

Thomas Marano, the head of the mortgage trading desk, told FCIC staff that the constant barrage of margin calls had created chaos at Bear. In late June, Bear Stearns dispatched him to engineer a solution with Richard Marin, BSAM's CEO. Marano now worked to understand the portfolio, including what it might be worth in a worst-

case scenario in which significant amounts of assets had to be sold.[59] Bear Stearns's conclusion: High-Grade still had positive value, but Enhanced Leverage did not.

On the basis of that analysis, Bear Stearns committed up to $3.2 billion—and ultimately loaned $1.6 billion—to take out the High-Grade Fund repo lenders and become the sole repo lender to the fund; Enhanced Leverage was on its own.

During a June Federal Open Market Committee (FOMC) meeting, members were informed about the subprime market and the BSAM hedge funds. The staff reported that the subprime market was "very unsettled and reflected deteriorating fundamentals in the housing market." The liquidation of subprime securities at the two BSAM hedge funds was compared to the troubles faced by Long-Term Capital Management in 1998. Chairman Bernanke noted that the problems the hedge funds experienced were a good example of how leverage can increase liquidity risk, especially in situations in which counterparties were not willing to give them time to liquidate and possibly realize whatever value might be in the positions. But it was also noted that the BSAM hedge funds appeared to be "relatively unique" among sponsored funds in their concentration in subprime mortgages.[60]

Some members were concerned about the lack of transparency around hedge funds, the consequent lack of market discipline on valuations of hedge fund holdings, and the fact that the Federal Reserve could not systematically collect information from hedge funds because they were outside its jurisdiction. These facts caused members to be concerned about whether they understood the scope of the problem.

During the same meeting, FOMC members noted that the size of the credit derivatives market, its lack of transparency and activities related to subprime debt could be a gathering cloud in the background of policy.

Meanwhile, Bear Stearns executives who supported the High-Grade bailout did not expect to lose money. However, that support was not universal—CEO James Cayne and Earl Hedin, the former senior managing director of Bear Stearns and BSAM, were opposed, because they did not want to increase shareholders' potential losses.[61] Their fears proved accurate. By July, the two hedge funds had shrunk to almost nothing: High-Grade Fund was down 91%; Enhanced Leverage Fund, 100%.[62] On July 31, both filed for bankruptcy. Cioffi and Tannin would be criminally charged with fraud in their communications with investors, but they were acquitted of all charges in November 2009. Civil charges brought by the SEC were still pending as of the date of this report.

Looking back, Marano told the FCIC, "We caught a lot of flak for allowing the funds to fail, but we had no option."[63] In an internal email in June, Bill Jamison of Federated Investors, one of the largest of all mutual fund companies, referred to the Bear Stearns hedge funds as the "canary in the mine shaft" and predicted more market turmoil.[64] As the two funds were collapsing, repo lending tightened across the board. Many repo lenders sharpened their focus on the valuation of any collateral with potential subprime exposure, and on the relative exposures of different financial institutions. They required increased margins on loans to institutions that appeared to be exposed to the mortgage market; they often required Treasury securities as collateral; in many cases, they demanded shorter lending terms.[65] Clearly, the triple-A-rated

mortgage-backed securities and CDOs were not considered the "super-safe" investments in which investors—and some dealers—had only recently believed.

Cayne called Spector into the office and asked him to resign. On Sunday, August 5, Spector submitted his resignation to the board.

RATING AGENCIES: "IT CAN'T BE . . . ALL OF A SUDDEN"

While BSAM was wrestling with its two ailing flagship hedge funds, the major credit rating agencies finally admitted that subprime mortgage–backed securities would not perform as advertised. On July 10, 2007, they issued comprehensive rating downgrades and credit watch warnings on an array of residential mortgage–backed securities. These announcements foreshadowed the actual losses to come.

S&P announced that it had placed 612 tranches backed by U.S. subprime collateral, or some $7.35 billion in securities, on negative watch. S&P promised to review every deal in its ratings database for adverse effects. In the afternoon, Moody's downgraded 399 mortgage-backed securities issued in 2006 backed by U.S. subprime collateral and put an additional 32 tranches on watch. These Moody's downgrades affected about $5.2 billion in securities. The following day, Moody's placed 184 tranches of CDOs, with original face value of about $5 billion, on watch for possible downgrade. Two days after its original announcement, S&P downgraded 498 of the 612 tranches it had placed on negative watch. Fitch Ratings, the smallest of the three major credit rating agencies, announced similar downgrades.[66]

These actions were meaningful for all who understood their implications. While the specific securities downgraded were only a small fraction of the universe (less than 2% of mortgage-backed securities issued in 2006), investors knew that more downgrades might come. Many investors were critical of the rating agencies, lambasting them for their belated reactions. By July 2007, by one measure, housing prices had already fallen about 4% nationally from their peak at the spring of 2006.[67]

On a July 10 conference call with S&P, the hedge fund manager Steve Eisman questioned Tom Warrack, the managing director of S&P's residential mortgage–backed securities group. Eisman asked, "I'd like to know why now. I mean, the news has been out on subprime now for many, many months. The delinquencies have been a disaster now for many, many months. (Your) ratings have been called into question now for many, many months. I'd like to understand why you're making this move today when you—and why didn't you do this many, many months ago. . . . I mean, it can't be that all of a sudden, the performance has reached a level where you've woken up." Warrack responded that S&P "took action as soon as possible given the information at hand."[68]

The ratings agencies' downgrades, in tandem with the problems at Bear Stearns's hedge funds, had a further chilling effect on the markets. The ABX BBB- index fell another 33% in July, confirming and guaranteeing even more problems for holders of mortgage securities. Enacting the same inexorable dynamic that had taken down the Bear Stearns funds, repo lenders increasingly required other borrowers that had put up mortgage-backed securities as collateral to put up more, because their value was unclear or depressed. Many of these borrowers sold assets to meet these margin calls,

and each sale had the potential to further depress prices. If at all possible, the borrowers sold other assets in more liquid markets, for which prices were readily available, pushing prices downward in those markets, too.

AIG: "WELL BIGGER THAN WE EVER PLANNED FOR"

Of all the possible losers in the looming rout, AIG should have been among the most concerned. After several years of aggressive growth, AIG's Financial Products subsidiary had written $79 billion in over-the-counter credit default swap (CDS) protection on super-senior tranches of multisector CDOs backed mostly by subprime mortgages.

In a phone call made July 11, the day after the downgrades, Andrew Forster, the head of credit trading at AIG Financial Products, told Alan Frost, the executive vice president of Financial Product's Marketing Group, that he had to analyze exposures because "every f***ing . . . rating agency we've spoken to . . . [came] out with more downgrades" and that he was increasingly concerned: "About a month ago I was like, you know, suicidal. . . . The problem that we're going to face is that we're going to have just enormous downgrades on the stuff that we've got. . . . Everyone tells me that it's trading and it's two points lower and all the rest of it and how come you can't mark your book. So it's definitely going to give it renewed focus. I mean we can't . . . we have to mark it. It's, it's, uh, we're [unintelligible] f***ed basically."[69]

Forster was likely worried that most of AIG's credit default swap contracts required that collateral be posted to the purchasers, should the market value of the referenced securities decline by a certain amount, or should rating agencies downgrade AIG's long-term debt. That is, collateral calls could be triggered even if there were no actual cash losses in, for example, the super-senior tranches of CDOs upon which the protection had been written. Remarkably, top AIG executives—including CEO Martin Sullivan, CFO Steven Bensinger, Chief Risk Officer Robert Lewis, Chief Credit Officer Kevin McGinn, and Financial Services Division CFO Elias Habayeb—told FCIC investigators that they did not even know about these terms of the swaps until the collateral calls started rolling in during July.[70] Office of Thrift Supervision regulators who supervised AIG on a consolidated basis didn't know either.[71] Frost, who was the chief credit default swap salesman at AIG Financial Products, did know about the terms, and he said he believed they were standard for the industry.[72] Joseph Cassano, the division's CEO, also knew about the terms.[73]

And the counterparties knew, of course. On the evening of July 26, Goldman Sachs, which held $21 billion of AIG's super-senior credit default swaps,[74] sent news of the first collateral call in the form of an email from Goldman's salesman Andrew Davilman to Frost:

DAVILMAN: Sorry to bother you on vacation. Margin call coming your way. Want to give you a heads up.

FROST, *18 minutes later*: On what?

DAVILMAN, *one minute later*: 20bb [$20 billion] of supersenior.[75]

The next day, Goldman made the collateral call official by forwarding an invoice requesting $1.8 billion.[76] On the same day, Goldman purchased $100 million of five-year protection—in the form of credit default swaps—against the possibility that AIG might default on its obligations.[77]

Frost never responded to Davilman's email. And when he returned from vacation, he was instructed to not have any involvement in the issue, because Cassano wanted Forster to take the lead on resolving the dispute.[78] AIG's models showed there would be no defaults on any of the bond payments that AIG's swaps insured. The Goldman executives considered those models irrelevant, because the contracts required collateral to be posted if market value declined, irrespective of any long-term cash losses.[79] Goldman estimated that the average decline in the market value of the bonds was 15%.[80]

So, first Bear Stearns's hedge funds and now AIG was getting hit by Goldman's marks on mortgage-backed securities. Like Cioffi and his colleagues at Bear Stearns, Frost and his colleagues at AIG disputed Goldman's marks. On July 30, Forster was told by another AIG trader that "[AIG] would be in fine shape if Goldman wasn't hanging its head out there." The margin call was "something that hit out of the blue and it's a f***ing number that's well bigger than we ever planned for." He acknowledged that dealers might say the marks "could be anything from 80 to sort of, you know, 95" because of the lack of trading but said Goldman's marks were "ridiculous."[81]

In testimony to the FCIC, Viniar said Goldman had stood ready to sell mortgage-backed securities to AIG at Goldman's own marks.[82] AIG's Forster stated that he would not buy the bonds at even 90 cents on the dollar, because values might drop further. Additionally, AIG would be required to value its own portfolio of similar assets at the same price. Forster said, "In the current environment I still wouldn't buy them . . . because they could probably go low . . . we can't mark any of our positions, and obviously that's what saves us having this enormous mark to market. If we start buying the physical bonds back then any accountant is going to turn around and say, well, John, you know you traded at 90, you must be able to mark your bonds then."[83]

Tough, lengthy negotiations followed. Goldman "was not budging" on its collateral demands, according to Tom Athan, a managing director at AIG Financial Products, describing a conference call with Goldman executives on August 1. "I played almost every card I had, legal wording, market practice, intent of the language, meaning of the [contract], and also stressed the potential damage to the relationship and GS said that this has gone to the 'highest levels' at GS and they feel that . . . this is a 'test case.'"[84]

Goldman Sachs and AIG would continue to argue about Goldman's marks, even as AIG would continue to post collateral that would fall short of Goldman's demands and Goldman would continue to purchase CDS contracts against the possibility of AIG's default. Over the next 14 months, more such disputes would cost AIG tens of billions of dollars and help lead to one of the biggest government bailouts in American history.

COMMISSION CONCLUSIONS ON CHAPTER 12

The Commission concludes that entities such as Bear Stearns's hedge funds and AIG Financial Products that had significant subprime exposure were affected by the collapse of the housing bubble first, creating financial pressures on their parent companies. The commercial paper and repo markets—two key components of the shadow banking lending markets—quickly reflected the impact of the housing bubble collapse because of the decline in collateral asset values and concern about financial firms' subprime exposure.