The New York Times

April 18, 2010

Senior Executives at Goldman Had a Role in Mortgage Unit

By LOUISE STORY

Tensions were rising inside Goldman Sachs.

It was late 2006, and an argument had broken out inside the Wall Street bank's prized mortgage unit — a dispute that would reach all the way up to the executive suite.

One camp of traders was insisting that the American housing market was safe. Another thought it was poised for collapse.

Among those who saw disaster looming were an effusive young Frenchman, Fabrice P. Tourre, and his quiet colleague, Jonathan M. Egol, the mastermind behind a series of mortgage deals known as the Abacus investments.

Their elite mortgage unit is now at the center of allegations that Goldman and Mr. Tourre, 31, defrauded investors with one of those complex deals.

The Securities and Exchange Commission filed a civil fraud suit on Friday that essentially says that Goldman built the financial equivalent of a time bomb and then sold it to unwitting investors. Mr. Egol, 40, was not named in the S.E.C.'s suit.

Goldman has vowed to fight the S.E.C. But the allegations have left many on Wall Street wondering how far the investigation might spread inside Goldman and perhaps beyond.

Pressure on Goldman mounted on Sunday as two members of Congress and Gordon Brown, Britain's prime minister, called for investigations into the bank's role in the mortgage market. Germany also said it was considering legal action against the bank.

Mr. Tourre was the only person named in the S.E.C. suit. But according to interviews with eight former Goldman employees, senior bank executives played a pivotal role in overseeing the mortgage unit just as the housing market began to go south. These people spoke on the condition that they not be named so as not to jeopardize business relationships or to anger executives at Goldman, viewed as the most powerful bank on Wall Street.

According to these people, executives up to and including Lloyd C. Blankfein, the chairman and chief executive, took an active role in overseeing the mortgage unit as the tremors in the housing market began to reverberate through the nation's economy. It was Goldman's top leadership, these people say, that finally ended the dispute on the mortgage desk by siding with those who, like Mr. Tourre and Mr. Egol, believed home prices would decline.

Lucas van Praag, a Goldman spokesman, said that senior executives were not involved in approving the Abacus deals. He said that the executives had sought to balance Goldman's positive bets on the mortgage market, rather than take an overall negative view.

Mr. Tourre, who now works for Goldman in London, declined to comment, as did Mr. Egol, Mr. van Praag said.

Mortgage specialists like those at Goldman were, in a sense, the mad scientists of the subprime era. They devised investments by bundling together bonds backed by home loans, a process that enabled mortgage lenders to make even more loans.

While this sort of financing helped make loans available, the most exotic creations also spread the growing risks inside the American housing market throughout the financial world. When the boom went bust, the results were disastrous.

By early 2007, Goldman's mortgage unit had become a hive of intense activity. By then, the business had captured the attention of senior management. In addition to Mr. Blankfein, Gary D. Cohn, Goldman's president, and David A. Viniar, the chief financial officer, visited the mortgage unit frequently, often for hours at a time.

Such high-level involvement was unusual elsewhere on Wall Street, where many executives spent little time learning the workings of their mortgage businesses or how those businesses might endanger their companies.

The decision to get rid of positive bets on mortgages turned out to be prescient. Unlike most other Wall Street banks, Goldman profited from its mortgage business as the housing bubble was inflating and then again when the bubble burst.

At the heart of all of this is the mortgage trading unit that, at its peak, employed several hundred people. As recently as 2007, Goldman's mortgage division was split into 11 subgroups, each with a specialty, according to an internal Goldman document that was provided to The New York Times by a former employee.

Together, these groups stood astride the nation's real estate market. One group, for instance, handled actual home loans. Another provided mortgage advice. A third syndicated loans among banks. And still another handled commercial real estate.

During the boom, Goldman's mortgage unit was a leader on Wall Street. In 2006 alone, the bank underwrote $26 billion of collateralized debt obligations, according to Dealogic, a financial data provider. Many C.D.O.'s have since turned out to be bad investments.

But in 2006, some inside Goldman began to worry about the fragile state of housing. Daniel L. Sparks, the Texan who ran the mortgage unit, sided with those who believed the market was safe. Two of his traders, Joshua S. Birnbaum and Michael J. Swenson, had placed a big bet that mortgage bonds would rise in value.

But this camp clashed with Goldman sales staff who were working with hedge funds that wanted to bet against subprime mortgages. Mr. Birnbaum told the team to stop promoting bets against some mortgage investments since such trades were hurting the market and Goldman's own position, according to two former Goldman employees.

But a few desks away, Mr. Tourre and Mr. Egol were quietly working on the Abacus deals.

They were, former colleagues say, something of an odd couple. A slight man with a flair for salesmanship, Mr. Tourre joined Goldman in 2001, after coming to the United States to study business operations at Stanford. At Goldman, he courted investors like European banks and big hedge funds.

The taller Mr. Egol, a specialist in analytical finance with a quiet but sometimes intimidating demeanor, devised the Abacus investments. He came to Goldman after studying aerospace engineering at Princeton and finance at the Booth School of the University of Chicago.

What united them was an unusually negative view on the mortgage market. As far back as 2005, they clashed with Goldman traders who worked with big mortgage lenders like Countrywide to buy and package loans. Their Abacus deals included insurancelike protection that would pay out if certain mortgage bonds soured. Such credit-default swaps were not worth much in 2005, when housing was flying high, but became highly valuable once the market sputtered.

"Egol and Fabrice were way ahead of their time," said a former Goldman worker. "They saw the writing on the wall in this market as early as 2005."

Unlike many of their colleagues at Goldman and other banks, they argued that the nation's mortgage market was far more interconnected than believed, former Goldman employees said. Their view was that if one group of mortgages or mortgage bonds ran into trouble, the entire market might falter.

Mr. Tourre and Mr. Egol created a way for a prominent hedge fund manager, John A. Paulson, to bet against risky mortgages.

With Mr. Paulson's help, Goldman created an Abacus investment that, the S.E.C. now says, was devised to fall apart. By betting against that Abacus investment, Mr. Paulson reaped $1 billion in profit, according to the S.E.C. Mr. Paulson was not named in the S.E.C. complaint.

Goldman’s top ranks changed its stance on housing in December 2006. In a meeting in a windowless conference room on the executive floor, Mr. Viniar, the chief financial officer, and Mr. Cohn, the president, gathered about 10 executives for a briefing. Mr. Sparks, the head of the mortgage unit, walked them through the numbers. The group was unanimous: Goldman had to reduce its exposure to the increasingly troubled mortgage market.

A few months later, in February 2007, senior executives began turning up on the trading floor. The message, one former employee said, was clear: management was watching.

“They basically said, ‘What does this department do? Tell us everything about mortgages,’ ” this person said.

The executives told Mr. Sparks to tell his traders to sell Goldman’s positive bets on housing. The traders’ short positions — that is, negative bets, mostly used to hedge other investments — were placed in a central trading account.

Not everyone was happy about it. One trader leaving the firm wrote the mortgage unit a one-word e-mail message: “goodbye.”

Goldman turned over all these negative positions to Mr. Swenson and Mr. Birnbaum, the traders who had previously been positive on the market. Along with Mr. Sparks, they have been credited for managing the short position that yielded a $4 billion profit for Goldman in 2007. Mr. Sparks retired in 2008. Mr. Birnbaum also left in 2008, to start his own hedge fund.

But former Goldman employees said those traders benefited from the short positions that were given to them. And their trading was tightly overseen by senior executives.

At one point in the summer of 2007, for instance, Mr. Birnbaum made a case to Mr. Cohn that some mortgage assets were cheap and that Goldman should let him add $10 billion in positive bets. Mr. Cohn said no.

Meantime, Goldman managers instructed Mr. Egol in early 2007 to add insurance against mortgage bonds.

By the third quarter of 2007, the mortgage unit was minting money, while Goldman’s rivals were losing big.

Mr. Viniar, the chief financial officer, told analysts that the mortgage unit was posting record profits because of its short bets that mortgage investments would lose value.

“Our risk bias in that market was to be short, and that net short position was profitable,” Mr. Viniar said.