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Subject: Banks Bundled Bad Debt, Bet Against It and Won

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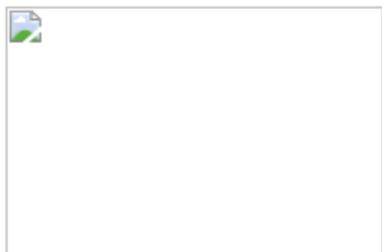
Banks Bundled Bad Debt, Bet Against It and Won

By [GRETCHEN MORGENSON](#) and [LOUISE STORY](#)

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In late October 2007, as the financial markets were starting to come unglued, a [Goldman Sachs](#) trader, Jonathan M. Egol, received very good news. At 37, he was named a managing director at the firm.

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Right, William P. O'Donnell/The New York Times

One former Goldman salesman wrote a novel about the crisis. A Deutsche Bank trader passed out T-shirts for investors hoping to profit on a housing bust.

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Mr. Egol, a Princeton graduate, had risen to prominence inside the bank by creating mortgage-related securities, named Abacus, that were at first intended to protect Goldman from investment losses if the housing market collapsed. As the market soured, Goldman created even more of these securities, enabling it to pocket huge profits.

Goldman's own clients who bought them, however, were less fortunate.

Pension funds and insurance companies lost billions of dollars on securities that they believed were solid investments, according to former Goldman employees with direct knowledge of the deals who asked not to be identified because they have confidentiality agreements with the firm.

Goldman was not the only firm that peddled these complex securities — known as synthetic [collateralized debt obligations](#), or C.D.O.'s — and then made financial bets against them, called selling short in Wall Street parlance. Others that created similar securities and then bet they would fail, according to Wall Street traders, include [Deutsche Bank](#) and [Morgan Stanley](#), as well as smaller firms like Tricadia Inc., an investment company whose parent firm was overseen by Lewis A. Sachs, who

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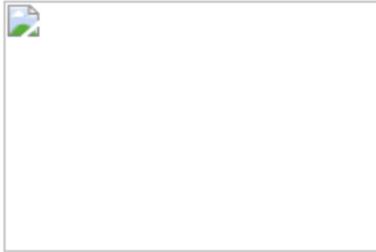
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Left, Treasury Department; Kevin Wolf/Associated Press

Lewis Sachs, left, who oversaw [redacted]'s before becoming a Treasury adviser, and John Paulson, whose company profited as the housing market collapsed.

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this year became a special counselor to [Treasury Secretary Timothy F. Geithner](#).

How these disastrously performing securities were devised is now the subject of scrutiny by investigators in Congress, at the [Securities and Exchange Commission](#) and at the Financial Industry Regulatory Authority, Wall Street's self-regulatory organization, according to people briefed on the investigations. Those involved with the inquiries declined to comment.

While the investigations are in the early phases, authorities appear to be looking at whether securities laws or rules of fair dealing were violated by firms that created and sold these mortgage-linked debt instruments and then bet against the clients who purchased them, people briefed on the matter say.

One focus of the inquiry is whether the firms creating the securities purposely helped to select especially risky mortgage-linked assets that would be most likely to crater, setting their clients up to lose billions of dollars if the housing market imploded.

Some securities packaged by Goldman and Tricadia ended up being so vulnerable that they soured within months of being created.

Goldman and other Wall Street firms maintain there is nothing improper about synthetic C.D.O.'s, saying that they typically employ many trading techniques to hedge investments and protect against losses. They add that many prudent investors often do the same. Goldman used these securities initially to offset any potential losses stemming from its positive bets on mortgage securities.

But Goldman and other firms eventually used the C.D.O.'s to place unusually large negative bets that were not mainly for hedging purposes, and investors and industry experts say that put the firms at odds with their own clients' interests.

"The simultaneous selling of securities to customers and shorting them because they believed they were going to default is the most cynical use of credit information that I have ever seen," said Sylvain R. Raynes, an expert in structured finance at R & R Consulting in New York. "When you buy protection against an event that you have a hand in causing, you are buying fire insurance on someone else's house and then committing arson."

Investment banks were not alone in reaping rich rewards by placing trades against synthetic C.D.O.'s. Some hedge funds also benefited, including Paulson & Company, according to former Goldman workers and people at other banks familiar with that firm's trading.

Michael DuVally, [a Goldman Sachs spokesman](#), declined to make Mr. Egol available for comment. But Mr. DuVally said many of the C.D.O.'s created by Wall Street were made to satisfy client demand for such products, which the clients thought would produce profits because they had an optimistic view of the housing market. In addition, he said that clients knew Goldman might be betting against mortgages linked to the securities, and that the buyers of synthetic mortgage C.D.O.'s were large, sophisticated investors, he said.

The creation and sale of synthetic C.D.O.'s helped make the [financial crisis](#) worse than it might otherwise have been, effectively multiplying losses by providing more securities to bet against. Some \$8 billion in these securities remain on the books at [American International Group](#), the giant insurer rescued by the government in September 2008.

From 2005 through 2007, at least \$108 billion in these securities was issued, according to Dealogic, a financial data firm. And the actual volume was much higher because synthetic C.D.O.'s and other customized trades are unregulated and often not reported to any financial exchange or market.

Goldman Saw It Coming

Before the financial crisis, many investors — large American and European banks, pension funds, insurance companies and even some hedge funds — failed to recognize that overextended borrowers would default on their mortgages, and they kept increasing their investments in mortgage-related securities. As the mortgage market collapsed, they suffered steep losses.

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