DID THE FINANCIAL REGULATORS APPRECIATE THE MEANING OF THE DATA IN THE SEC V. GOLDMAN SACHS CASE?

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On April 16, 2010 the Securities and Exchange Commission (SEC) formally charged Goldman Sachs & Co. with making materially misleading statements and omissions in connection with the Abacus synthetic collateralized debt obligation (CDO). The SEC's probe of the firm began in August 2008 and in the summer of 2009 sent Goldman Sachs a formal Wells notice that the staff of the SEC planned to recommend that the Commission commence an enforcement action against the firm to the Wells notice contained a statistical summary (Table 1) comparing the quality and performance of the loans in the disputed portfolio and two related portfolios of similar deals. The response implied that the data supported the claim that like other transactions with similar lower-rated subprime portfolios, the market performance of the portfolio (Abacus) was a result of the general collapse of the subprime market.

Table 1: Comparative Performance of the Reference Portfolio

Characteristic	Reference- 90	Initial-86	Subprime Deals
Number of Bonds	90	86	293
Avg. % 60 days Delinquent	46.2	45.9	44.4
Avg. Cum. Loss	13.1	12.5	12.2
Avg. Borrower FICO score	629	627	624
Avg. Loan-to-Value Ratio	80	80	81
Avg. % Limited Documentation	37	40	33
Avg. Original Credit Enhancement	4.5	4.6	4.6
Avg. Weighted Avg. Loan Age	37	38	38
Avg. % Write-down	85	80	72
Avg. Time to Write-down	0.8	1.4	1.7

The data in the Table 1 reproduces the statistics summarized in the responses submitted by Goldman Sachs. It compares the performance of the Reference portfolio of 90 with the Initial 86 proposed by ACA (before the firm and a hedge fund manager suggested changes) and the universe of 293 Baa2 securities, which include the 90 in the Abacus portfolio. First, one notes that while the averages of various characteristics, e.g., average percentage written down or over 60 days delinquent are given in the Table, no measure of variability is presented. This makes it difficult to apply formal statistical testing to the data.

By comparing the Reference portfolio in question to the other 203 similar securities, i.e. removing the Abacus-90 from the 293, Gastwirth (2011) showed that that their percentage of loans written down was nearly 20% greater than the appropriate comparison group. Assuming the time to write-down follows an exponential distribution the reanalysis shows that loans in the Reference 90 portfolio were written down statistically significantly faster than the other 203. Similar analyses indicate that the new securities added to the initial-86 to replace those dropped at the request of Goldman and the hedge fund manager during the negotiations performed worse than the ones they replaced.

As the Abacus deal was also scrutinized by the U.K. financial authorities and is a template for the SEC's examination of other questionable CDO's organized by major investment houses and banks during the recent financial crisis, the analysis presented indicates that the financial authorities need to carefully examine statistical summaries offered by the securities industry and require them to submit the underlying data so the SEC and other financial authorities can conduct an independent re-analysis.

REFERENCES

Gastwirth, J.L. (2011) The Need for Careful Analysis of the Statistical Summary in the Response to the Complaint in the *SEC v. Goldman Sachs* case. *Law, Probability and Risk* (to appear).

SEC complaint (2010). www.scribd.com/doc/30031334/Sec-Goldman (last visited on May 3. 2010). Goldman-Sachs' response is available from the same website.