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### Goldman Sachs email from Daniel Sparks Re dinner

Daniel Sparks

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**From:** Sparks, Daniel L  
**Sent:** Thursday, March 01, 2007 9:05 AM  
**To:** Sparks, Daniel L  
**Subject:** dinner

Quick review of subprime mkt - what it is, what has happened, and what is happening, & potential meanings for mkts

All credit markets generally - credit environment with little risk premium

2004-2006 - strong economies, good fundamental, great liquidity, desire for increased earnings and returns, new technology to disseminate risk

Subprime market - caught in this, and demonstrate what can happen when capital markets overshoot

More volume for originators meant more profits - capital markets accepted most everything, you could refinance clever guys, you could come up with new products that required less down-payments and monthly payments so people could buy homes, home price appreciation bailed out any mistakes

Business generally is that originators make loans, those loans are warehoused, they are then sold to the street, securitized or help on the balance sheet often in levered form.

Originators cost to make a loan has been around 2% and for a while they could sell loans for 104, then 103, then 102. The street was taking out 1 point, then half a point, then a quarter, then just the carry and the chance to create a resid.

In securitization, pools of specific loans are pooled together, tranches into different rating categories AAA, AA to residuals, a servicer is selected, and unique securities are issued.

Demand grew from all types of investors all over the world, including investors in structured vehicles.

The general view was that it was all about the economy and employment, and people generally pay their mortgage. Margins continued to decrease, participants became vertically integrated to be more competitive, participants at more risk, and structured more ways to make money.

The trading business was generally long to flat.

In last 2 years - derivatives market created that allowed a very physical unique CUSIP market became a market people could get dramatically more exposure on the long side, and now people could play it from the short side.

Early on in synthetics, people wanted more risk because the loss assumption was viewed as out of the money.

Most of the synthetic flows were hedge funds getting short and CDO vehicles getting long.

What happened next.

Home prices stopped going up.

Loan performance information declined.

Lending mistakes started to be a problem - EPDs which are early payment defaults became a real issue leading losses.

The synthetic market started forecasting significantly higher risk premium and losses.

Loans had been bought assuming a 4% cumulative loss projection, derivatives were subjecting 8-10%.

Very levered originators had to deal with putbacks, write downs, concerned lenders and inability to operate business profit as loan resale prices went to par.

Put backs can also include reps & warranties including fraud - any type of fraud.

Disarray.

And it became clear that many people should not have been given loans.

Questions about who owns the risk - it's spread out all over the world in various formats including repackaging v Not that obvious to find who is feeling the pain.

What is ABX

Each index is 20 names by rating category - AAA,AA,A,BBB,BBB-

Contracts are pay as you go.

The most sensitive and levered contract is a 2006 originated paper for attachment points from 4 to 5.25% - there excess spread.

An index that included \$300mm of underliers had over a hundred billion of trading volume.

Very sensitive to losses.

Loss assumptions doubled.

The index was an out of the money option on cumulative losses became closer to an at-the-money option.

Many loss models - HPA, unemployment, economy, interest rates, borrower behavior.

As this is now close to in-the-money, I don't think anyone is good enough to model this within 20 points.

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You want to be long vol if you can.  
There became a very volatile trading market.  
Dramatic dislocations between loan trading values, cash RMBS levels, single name CDS and indexes.  
Great trading opportunities.  
Major stress, pain and volatility.

Who is feeling the pain  
Alt A and prime  
CDOs  
Commercial real estate - Blackstone, EOP, cap rates, fundamentals, demand for space, limited supply, liquidity  
but asset repricing and no risk premium.  
But I am a lender - so tough to call as fundamentals are good.

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