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HANG SENG	22,303.10	+187.83	0.85%
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Goldman Secret Greece Loan Shows Two Sinners as Client Unravels

By Nicholas Dunbar & Elisa Martinuzzi - 2012-03-06T00:01:00Z

Simon Dawson/Bloomberg

The Greek national flag above the parliament building in Athens on Feb. 16, 2012.

Greece's secret loan from Goldman Sachs Group Inc. (GS) was a costly mistake from the start.

On the day the 2001 deal was struck, the government owed the bank about 600 million euros ($793 million) more than the 2.8 billion euros it borrowed, said Spyros Papanicolaou, who took over the country's debt-management agency in 2005. By then, the price of the transaction, a derivative that disguised the loan and that Goldman Sachs persuaded Greece not to test with competitors, had almost doubled to 5.1 billion euros, he said.

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Papanicolaou and his predecessor, Christoforos Sardelis, revealing details for the first time of a contract that helped Greece mask its growing sovereign debt to meet European Union requirements, said the country didn't understand what it was buying and was ill-equipped to judge the risks or costs.

"The Goldman Sachs deal is a very sexy story between two sinners," Sardelis, who oversaw the swap as head of Greece's Public Debt Management Agency from 1999 through 2004, said in an interview.

Goldman Sachs's instant gain on the transaction illustrates the dangers to clients who engage in complex, tailored trades that lack comparable market prices and whose fees aren't disclosed. Harvard University, Alabama's Jefferson County and the German city of Pforzheim all have found themselves on the losing end of the one-of-a-kind private deals typically pitched to them by securities firms as means to improve their finances.

Goldman Sachs DNA

"Like the municipalities, Greece is just another example of a poorly governed client that got taken apart," Satyajit Das, a risk consultant and author of "Extreme Money: Masters of the Universe and the Cult of Risk," said in a phone interview. "These trades are structured not to be unwound, and Goldman is ruthless about ensuring that its interests aren't compromised -- it's part of the DNA of that organization."

A gain of 600 million euros represents about 12 percent of the $6.35 billion in revenue Goldman Sachs reported for trading and principal investments in 2001, a business segment that includes the bank's fixed-income, currencies and commodities division, which arranged the trade and posted record sales that year. The unit, then run by Lloyd C. Blankfein, 57, now the New York-based bank's chairman and chief executive officer, also went on to post record quarterly revenue the following year.

'Extremely Profitable'

The Goldman Sachs transaction swapped debt issued by Greece in dollars and yen for euros using an historical exchange rate, a mechanism that implied a reduction in debt, Sardelis said. It also used an off-market interest-rate swap to repay the loan. Those swaps allow counterparties to exchange two forms of interest payment, such as fixed or floating rates, referenced to a notional amount of debt.

The trading costs on the swap rose because the deal had a notional value of more than 15 billion euros, more than the amount of the loan itself, said a former Greek official with knowledge of the transaction who asked not to be identified because the pricing was private. The size and complexity of the deal meant that Goldman Sachs charged proportionately higher trading fees than for deals of a more standard size and structure, he said.

"It looks like an extremely profitable transaction for Goldman," said Saul Haydon Rowe, a partner in Devon Capital LLP, a London-based firm that advises global investors on derivatives disputes.

Disappearing Debt

Goldman Sachs declined to comment about how much it made on the swaps. Fiona Laffan, a

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See today's average mortgage rates across the country.
Source: Bankrate.com

Type	Today	1 M
30-Year Fixed	3.73%	3.
15-Year Fixed	2.83%	2.
5/1-Year ARM	2.96%	2.
3/1 Year ARM	3.04%	3.
1-Year ARM	4.76%	4.
30 Year Jumbo	4.07%	4.
15-Year Fixed Jumbo	3.41%	3.
5/1-Year ARM Jumbo	2.91%	2.

Rates may inclu

See today's average home equity rates across the countr
Source: Bankrate.com

Type	Today	1 M
30000 USD	6.28%	6.2
Home Equity Loan	7.01%	7.4
HELOC 30000 USD	5.44%	5.5
HELOC Loan	3.95%	3.6
Credit Union HELOC	4.30%	4.3

See today's average savings rates across the country.
Source: Bankrate.com

Type	Today	1 Mo
5-Year	1.31%	1.37
2-Year	0.85%	0.86
6-Month	0.47%	0.47
1-Month	0.11%	0.11
5-Year Jumbo	1.37%	1.45
2-Year Jumbo	0.96%	0.93
1-Year Jumbo	0.83%	0.81
6-Month Jumbo	0.53%	0.53
1-Month Jumbo	0.11%	0.11

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Source: Bankrate.com

Type	Today	1 Mo

spokeswoman for the firm in London, said the agreements were executed in accordance with guidelines provided by Eurostat, the EU's statistical agency.

"Greece actually executed the swap transactions to reduce its debt-to-gross-domestic-product ratio because all member states were required by the Maastricht Treaty to show an improvement in their public finances," Laffan said in an e- mail. "The swaps were one of several techniques that many European governments used to meet the terms of the treaty."

Cross-currency swaps are contracts borrowers use to convert foreign currency debt into a domestic-currency obligation using the market exchange rate. As first reported in 2003, Goldman Sachs used a fictitious, historical exchange rate in the swaps to make about 2 percent of Greece's debt disappear from its national accounts. To repay the 2.8 billion euros it borrowed from the bank, Greece entered into a separate swap contract tied to interest-rate swings.

Falling bond yields caused that bet to sour, and tweaks to the deal failed to prevent the debt from almost doubling in size by the time the swap was restructured in August 2005.

Greece, which last month secured a second, 130 billion-euro bailout, is sitting on debt equal to about 160 percent of its GDP as of last year.

Eurostat Rules

Under Eurostat accounting rules, nations were permitted until 2008 to use so-called off-market rates in swaps to manage their debt. Greek officials, including Sardelis, say they learned that other EU countries such as Italy had employed similar methods to shrink their debts, taking advantage of the secrecy of over-the-counter derivatives compared with swaps traded on exchanges.

Eurostat said Greece didn't report the Goldman Sachs transactions in 2008 when the agency told countries to restate their accounts.

"The Greek authorities had never informed Eurostat about this complex issue and no opinion on the accounting treatment had been requested," the Luxembourg-based agency said in a statement last month.

Eurostat said it had only "general" discussions with financial institutions on its debt and deficit guidelines when the swap was executed in 2001. "It is possible that Goldman Sachs asked us for general clarifications," Eurostat said, declining to elaborate.

Loudiadis Role

Bloomberg News filed a lawsuit at the EU's General Court seeking disclosure of European Central Bank documents on Greece's use of derivatives to hide loans. Releasing such information could damage the commercial interests of the ECB's counterparties, hurt banks and markets, and undermine the economic policy of Greece and the EU, the central bank said last May in a response to the suit. A judgment is pending.

Sardelis, 61, and Papanicolaou, 72, said several banks, including Goldman Sachs, made proposals to manage Greece's debt. The bank was represented by its top European sales executive at the time, Addy Loudiadis. She was trusted, said Papanicolaou, because she had

Type	Today	1 Mo
New 36 Month	3.05%	3.14'
New 48 Month	3.10%	3.72'
New 60 Month	2.89%	3.82'
Used	3.55%	4.29'

See today's average credit card rates across the country
Source: Bankrate.com

Type	Today	1 Mo
Standard Variable	14.12%	14.1
Standard Fixed	14.43%	14.4
Gold Variable	12.70%	12.7
Gold Fixed	11.99%	11.9
Platinum Variable	14.82%	14.8
Platinum Fixed	14.08%	13.7

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helped price competitors' derivatives and in 1999 warned the Greeks against buying a complex swap.

Sardelis, a former bank economist, described Loudiadis, who's based in London, as "very professional -- a little bit aggressive as is everyone at Goldman Sachs."

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'Teaser Rate'

The derivative Loudiadis offered Sardelis in 2001 was also complex. Designed to provide a cheap way to repay 2.8 billion euros, the swap had a "teaser rate," or a three-year grace period, after which Greece would have 15 years to repay Goldman Sachs, Sardelis said. All in, the deal appeared cheap to officials at the time, he said.

"We calculated that this had an extra cost above our normal funding cost on the yield curve of 15 basis points," Sardelis said. A basis point is 0.01 percentage point.

Loudiadis, now CEO of Rothesay Life, a Goldman Sachs unit that insures longevity risk for U.K. corporate pension plans, declined to comment, a company spokeswoman said.

'Very Bad Bet'

Sardelis said he realized three months after the deal was signed that it was more complex than he appreciated. After the Sept. 11, 2001, attacks on the U.S., bond yields plunged as stock markets sold off worldwide. That caused a mark-to-market loss on the swap for Greece because of the formula used by Goldman Sachs to compute Greece's repayments over time.

"If you calculated that when we did it, it looked very nice because the yield curve had a certain shape," Sardelis said. "But after Sept. 11, we realized this would be the wrong formula. So after we discussed it with Goldman Sachs, we decided to change to a simpler formula."

The revised deal proposed by the bank and executed in 2002, was to base repayments on what was then a new kind of derivative -- an inflation swap linked to the euro-area harmonized index of consumer prices. An inflation swap is a financial bet that pays off according to the degree to which a consumer-price index exceeds or falls short of a pre-specified level at maturity.

That didn't work out well for Greece either. Bond yields fell, pushing the government's losses to 5.1 billion euros, according to an analysis commissioned by Papanicolaou. It was "a very bad bet," he said in an interview.

"This is even more reprehensible," Papanicolaou said of the revised deal. "Goldman asked them to make a change that actually made things even worse because they went into an inflation swap."

Confidentiality Requirement

Greece was handicapped, in part, by the terms Goldman Sachs imposed, he said.

"Sardelis couldn't actually do what every debt manager should do when offered something, which is go to the market to check the price," said Papanicolaou, who retired in 2010. "He didn't do that because he was told by Goldman that if he did that, the deal is off."

Sardelis declined to comment about the analysis, as did Petros Christodoulou, director general of the debt-management agency since February 2010.

It isn't unusual for dealers to impose confidentiality requirements on clients in complex transactions to prevent traders from using the information to front-run or trade against the bank arranging and hedging the deal, said a former official who analyzed the swap and asked not to be named because the details are private.

'Large Number'

Goldman Sachs's initial 600 million-euro gross profit "sounds like a large number, but you have to take into account what the bank will be setting aside as a credit reserve, the cost to Goldman to fund the loan and the cost of hedging the currency component," said Peter Shapiro, managing director of Swap Financial Group LLC in South Orange, New Jersey, an independent swaps adviser. "It's hard to tell what the profit margin would have been."

The report Papanicolaou commissioned after taking over the agency showed the repayment formula meant that Greece would have to pay Goldman Sachs 400 million euros a year, he said. The coupon and the mark-to-market swings on the swap prompted George Alogoskoufis, then finance minister, to decide to restructure the deal again to limit losses, Papanicolaou said.

Loudiadis and a team of Goldman Sachs advisers returned to Athens in August 2005, according to former Greek officials. The agreement they reached to transfer the swap to National Bank of Greece SA and extend the maturity to 2037 from 2019, gave the Greeks what they wanted, Papanicolaou said.

'Squeeze Taxpayers'

The 5.1 billion-euro mark-to-market value of the swap was "locked in," Papanicolaou said. It was that politically motivated decision to restructure and fix the increased market value that did as much damage as the original swap, said Sardelis, now a board member of Ethniki General Insurance Co., a subsidiary of National Bank of Greece.

"You can't have prudent debt management if you change all the assumptions all the time," he said.

Gustavo Piga, a professor of economics at University of Rome Tor Vergata and author of "Derivatives and Public Debt Management," sees a different lesson.

"In secret deals, intermediaries have the upper hand and use it to squeeze taxpayers," Piga said in an interview. "The bargaining power is in investment banks' hands."

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