
The Real Case Against Goldman Sachs: A System Which Should Not Have Been Saved

by John F. Groom

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Total Employee compensation at Goldman Sachs in 2009 was over \$16 billion, or about \$500,000 per employee, including administrative personnel. "In a tense conference call with journalists explaining 2009 compensation, David A. Viniar, Goldman's chief financial officer, repeatedly said that the bank was showing restraint in its pay policies while trying to be fair to employees. 'We are not blind to the economic environment and the pain and suffering still going on around the world,' Mr. Viniar said." Well, yes, in fact, they are.

The CEO of Goldman Sachs, Lloyd Blankfein was paid over \$70 million in 2007 at the height of the bubble, but was awarded "only" a \$9 million bonus in stock in 2009, supposedly as a sop to political criticism. It's quite telling that a payment of \$9 million during a steep worldwide recession can be seen as showing great restraint.

While the employees of Goldman Sachs have always done very well, in good times and bad, the same cannot be said of the actual owners of the firm; the shareholders. The stock price of Goldman (GS) has varied wildly, as stock prices are wont to do, ranging from \$47 to \$250 a share over the last five years. But overall, returns to the real owners of the firm have been very modest; based on the stock price on May 14, 2010, the returns have been about 5% per year for the last ten years, barely outpacing inflation. Investors put actual cash on the line to buy shares, but it is the employees, who have no financial investment, who have reaped the lion's share of financial returns.

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The original purpose of the investment banks was a noble one; to raise money for America's leading corporations and by doing so to enable productive business. Some of the early leading investment bankers, like Sidney Weinberg, were men of high standards. Nicknamed "Mr. Wall Street," Weinberg was the Goldman CEO perhaps best known as the man who orchestrated the Ford Motor Company's first public stock offering in 1956. It's interesting to note that Weinberg dropped out of school after the 8th grade and started at Goldman as a janitor, whereas the current CEO Lloyd Blankfein went to Harvard College and Harvard Law School and started his career as a corporate tax lawyer.

Weinberg refused to do many types of deals that he did not think were "right"; for instance, he would not raise money for gaming companies, as "they were thought to provide no benefit to society." Now Goldman is basically one huge gaming company providing no benefit to society.

According to investment banker, and Goldman alumna, Jonathan Knee, it "was Gus Levy that coined the maxim that what set Goldman apart was that it was long term greedy rather than short term greedy. The simple and honorable notion was that investing in long term relationships at the expense of short term business opportunities was both what distinguished Goldman and made for a superior business model." That may have been so at the time, but those days have long

since passed. It seems that Goldman is incapable of passing up any opportunity, even if it involves blatant conflicts of interest or real risk to the reputation of the firm.

It might be noted that investment banker Michael Milken was vilified as being the king of greed in the 1980s, and he went to jail and paid a \$500 million fine, mostly for technical securities violations. But Milken's firm was actually quite productive in the traditional role of Wall Street in terms of providing financing for new companies such as MCI Communications and Turner Broadcasting, as well as many newspapers, homebuilders, and other productive companies. While Milken was certainly no saint, his primary role was one of providing corporate financing, which is far more than can be said of current investment banks, including Goldman, which make most of their money from trading operations.

As Rick Newman says, "Goldman portrays itself as an important cog in the U.S. economy. There's a picture of a Boeing assembly line on the cover of its 2009 annual report, as if Goldman's activities routinely create jobs for ordinary

Americans. But the firm's financials suggest that Goldman mainly generates money for itself, with any collateral benefit to the broader economy being mere coincidence. In 2008, the first full year after the firm went public, Goldman earned 40 percent of its net revenue from its trading operation, 32 percent from investment banking, and 28 percent from managing assets for clients. In its

Goldman said it earned 80 percent of its revenue from trading, about 11 percent from asset management, and 9 percent from investment banking. So Goldman's trading desk accounts for twice the portion of revenue that it did 10 years ago—and the vast majority of its business."

Entrepreneur Mark Cuban makes the same point:

"Wall Street has nothing

to do with creating capital for businesses, its original goal. Wall Street is a platform. It's a platform to be exploited by every technological and intellectual means possible.... The important issue is recognizing that Wall Street is no longer what it was designed to be. Wall Street was designed to be a market to which companies provide securities (stocks/bonds), from which they received capital that would help them start/grow/sell businesses. Investors made their money by recognizing value where others did not, or by simply committing to a company and growing with it as a shareholder, receiving dividends or appreciation in their holdings. What percentage of the market is driven by investors these days?

Investment banks like Goldman Sachs make money by:

- Shifting risk to others; outside investors and, ultimately, taxpayers
- Using huge amounts of borrowed money to accelerate returns

The general business model is pretty simple: When the bets pay off, Goldman takes huge profits, and fees, based on the big returns which are vastly increased by leverage. In 2007, Goldman's leverage ratio was 25, meaning that they borrowed \$25 for every \$1 of their own capital they invested. When the bets are wrong, Goldman still makes money by taking various fees from clients. Losses are absorbed by clients or, in the case of systemic crises, created at least in part by Goldman, taxpayers. Heads, Goldman wins, tails, you lose.

- A large portion of the trading is high frequency trading in which Goldman and other investment banks engage in computer generated micro second trades, causing large possible distortions in the market, and serving no real utility, given that positions are usually held for less than a second. The investment banks say this sort of trading increases liquidity, but given that American capital markets are already the most liquid in the world, the real result is increased volatility and wild

market swings.

As Mark Cuban says:

“The best analogy for traders? They are hackers. Just as hackers search for and exploit operating system and application shortcomings, traders do the same thing. A hacker wants to jump in front of your shopping cart and grab your credit card and then sell it. A high frequency trader wants to jump in front of your trade and then sell that stock to you. A hacker will tell you that they are serving a purpose by identifying the weak links in your system. A trader will tell you they deserve the pennies they are making on the trade because they provide liquidity to the market.”

It's difficult to overestimate the impact of this computer generated high frequency trading on the markets; it is said to currently account for at least half and sometimes over 70% of all stock trades, which means that most trades are generated by computer programs rather than a human decision. This can have far reaching consequences for the market as a whole, as when the market dropped about 1,000 points and regained that in the space of 20 minutes on May 6, 2010, causing market mayhem

with disastrous results for some people who placed orders within that time span. Even after extensive analysis, it was not clear what caused the drop, but high frequency trading probably played a role.

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The greatest bailout to Goldman occurred in the much broader scope of the bailout of the entire financial system; if the system, of which Goldman is a leader and integral part, had failed, Goldman would have failed as well. But trillions of dollars in taxpayer funds were used to bailout the entire financial industry, both in terms of direct subsidies to individual companies like GM, Freddie Mac, and Fannie Mae, subsidized lending programs to entire industries, and, even more broadly, Federal Reserve efforts to drive down interest rates. During this process, Goldman converted to commercial bank status, and it is banks which have been the primary beneficiary of lower interest rates. The bailouts were so huge and took so many different forms, it is impossible to really calculate the total cost, but one way of doing so is by the rise in federal government debt. The federal government debt rose by \$1 trillion in fiscal year 2008 and \$1.9 trillion in fiscal year 2009, meaning that during the financial crisis the total increases in government debt have been well over \$3 trillion, as the costs began in 2007 and continue in 2010. While the cost of this debt is shared broadly among taxpayers and will take many years to pay off, its' benefits have been much more narrowly confined to financial institutions and large corporations such as Goldman. In 2009 the price of Goldman stock doubled, yet most Americans were struggling amidst record foreclosures and very high unemployment. The term "socializing the losses and privatizing the gains" has been coined to describe the effects of government action during this period.

Much more directly, Goldman received \$10 billion in federal government loans from the TARP program (Troubled Asset Relief Program). This basically meant that Goldman could sell the government its bad assets that no one else would buy, and government losses on these assets would be absorbed by the American taxpayer. Since Goldman and other investment banks invented this type of asset, they basically created the problem, made money trading these instruments when times were good, and then, once the market melted down, sold them to the government. Nice work if you can get it.

As the insurance firm AIG melted down during the crisis because it had taken on far too much risk, the government also bailed out Goldman's trades with AIG; in other words, absent the government, Goldman would have lost \$22 billion from AIG's failure.

Of course, the most famous example of conflict is a result of the fraud charges which the SEC filed against Goldman in April of 2010. Goldman was paid \$15 million to construct a security but did not disclose that the person paying them, John Paulson, was actually betting against the securities. Goldman not only created and sold these subprime securities to other clients, but also made bets against similar securities for their own account. Investors in the CDO lost about one billion, while billionaire hedge fund investor John Paulson made about \$1 billion.

This is the quote from the Goldman trader, Fabrice Tourre, who was charged in the case:

"The whole building is about to collapse anytime now." He described himself in the email as the "Only potential survivor, the fabulous Fab... standing in the middle of all these complex, highly leveraged, exotic trades he created without necessarily understanding all of the implications of those monstrosities!!!"

"Maybe it was legal. But it was wholly unethical," one hedge fund manager said of Goldman's Abacus CDO deal.

But that is hardly the only deal on which Goldman had blatant conflicts of interest and profited while clients lost. Goldman raised \$4 billion for its Whitehall real estate investment fund. The fund is now worth less than \$800 million, so investors have taken an 80% loss. But Goldman paid itself \$200 million in management and other fees from the fund. Why should

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Goldman be paid a huge fee to orchestrate a massive failure?

Goldman can fail, and yet still make money in a wide variety of investments. Another huge loser was the leveraged buyout of TXU for \$48 billion in February of 2007, the largest leveraged buyout deal in history. The buyers were leading leveraged buyout firms KKR and TPG, advised by Goldman Sachs. As of May 2010 the value of the investment had fallen 70% due to falling natural gas prices and the weak economy. The deal was essentially a huge and hugely leveraged bet on natural gas prices that went wrong. Like many companies bought during the leveraged buyout boom, there was nothing fundamentally wrong with the company until the buyout firms loaded it with billions in debt, which became difficult to service when times got tough. In fact, the company has to make \$3.6 billion in interest payments every year, just to stay current on its debt,

and it has a balloon payment of \$20 billion coming due in 2014. But no matter, the group has already received more than \$370 million in fees, so even if the firm goes bankrupt, and has to fire thousands of employees, Goldman will make money. The vast majority of the purchase price was borrowed from outside investors. The company may lose, and employees may lose, and lenders may lose, but Goldman will win from failure.

Goldman and its clients spent \$17 million lobbying Texas and legislators to gain approval for the deal. According to the New York Times:

“The buyout group also sought friends in high places. It signed on several powerful Texas politicians as lobbyists, directors or advisers, including Ronald Kirk, the former mayor of Dallas who is now the Obama administration’s trade representative; _____, the former secretary of state and Bush

family confidant, who was given a million shares as part of the buyout;

, the former secretary of commerce; and Lyndon L. Olson Jr., a former Texas state representative."

"They were hiring Democrats and Republicans alike," says Tom Smith, director of the Texas division of

, a consumer advocacy group. "They would have hired a socialist if we had any in Texas."

When the deal started to go sour, and the lenders tried to renegotiate the terms, "Goldman Sachs had representatives sitting on both sides of the table: the firm was one of the large private equity investors but had also acted as investment banker and lender and would, ultimately, nab a big piece of TXU's huge commodity hedging business. Goldman was on so many sides of the TXU deal that its representatives made other lenders nervous, according to participants, because it was hard to ascertain whose interests the bank was serving."

Goldman also routinely makes bets that increase in value if the value of their client's companies falls. For instance,

Goldman bet against Washington Mutual and Bear Stearns, both clients with which the bank did a significant amount of business. Goldman says these bets are part of a normal hedging strategy, to offset the risks of doing certain deals. But if that is the case, why did they not hedge the risk they had with AIG, requiring that taxpayers bail them out from derivatives contracts with which AIG was the counterparty? More fundamentally, the idea of making bets against clients makes one wonder where Goldman's true loyalty lies. If Goldman makes money regardless of how well a client does, why should they care if their clients are successful?

When even the hedge funds start to attack you, your days are limited.

Hedge funds are the world's most sophisticated investors, and are in the best position to accurately judge Goldman's actions. But even they are

starting to turn against the firm. This is what a few of them say:

"They've lost their way, fallen for the trap of short term profits, and abandoning clients," one hedge fund manager told John Carney, a CNBC editor.

"It's not the same firm it was a decade ago," said another hedge fund manager.

"They've now got a 'rip your eyes' out culture," another agreed.

Many people think that investment bankers are brilliant but evil. They're generally only right about the latter. According to Bloomberg News, as of mid May 2010, clients who followed Goldman's recommended top trades for 2010 had lost money on seven of the nine recommended strategies. And that does not include the cost of the advice. Goldman clients would have done far better to pick trades by flipping coins. Of course, Goldman generally does much better when it trades on its own account, which must mean it is not following the advice that it sells to clients.

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A part of Goldman's business is creating complex instruments to enable deception, such as the instruments which were set up for Greece to help them hide the extent of their fiscal decline. By postponing the realization of reality, this kind of transaction has played a major role in Eurozone problems, the decline of the Euro, and civil unrest in Greece and elsewhere.

In order to protect the value of their common currency, the Euro zone members have rules specifying certain fiscal levels that member countries must maintain; two of the most important are that the annual budget deficit must not exceed 3% of Gross National Product in any given year, and that the total cumulative public debt must not exceed 60% of GDP. These rules are contained within the Maastricht Treaty. Of course, adherence with the rules depends on member states accurately conveying the relevant figures to the Eurostat offices which track such matters. But with the help of Goldman, Greece found a technically legal way of circumventing the rules, using currency swaps and derivatives contracts.

“Goldman devised a special kind of swap with fictional exchange rates. That enabled Greece to receive a far higher sum than the actual euro market value of 10 billion dollars or yen. In that way Goldman Sachs secretly arranged additional credit of up to \$1 billion for the Greeks. This credit disguised as a swap didn't show up in the Greek debt statistics. Eurostat's reporting

rules don't comprehensively record transactions involving financial derivatives. 'The Maastricht rules can be circumvented quite legally through swaps,' says a German derivatives dealer."

Goldman made an estimated £192 million pounds on the deal, or over \$300 million depending on the exchange rate.

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In May, Goldman was leading the effort to save ShoreBank, a small community bank with which Goldman would normally have nothing to do with, but Shorebank happens to be the most politically connected bank in the United States. It has been involved with lending to a project in Kenya to which then Senator Obama was involved; a couple of Obama's neighbors were executives at the bank. What this really shows is not just that Goldman thinks it can buy political favors for its \$20 million investment, but how nakedly it is seeking to buy power.

Goldman has made other efforts along these lines, such as a program to supply small businesses with credit. Here's an excerpt from a Bloomberg article:

Goldman Sachs Group Inc., under fire in Washington for setting aside billions of dollars for bonuses a year after getting a taxpayer bailout, is joining Warren Buffett to provide assistance to 10,000 U.S. small businesses.

The \$500 million charitable effort coincides with one of the Obama administration's top economic priorities: spurring hiring at smaller companies. The initiative aims to provide assistance -- ranging from counseling to obtaining funding -- to 10,000 businesses. Buffett's Berkshire Hathaway Inc. is the largest shareholder in New York-based Goldman Sachs.

Goldman Sachs, the securities firm in Wall Street history, is trying to dispel criticism from lawmakers and pundits who portray the company as the greedy face of a whose excessive risk-taking fuelled the credit crisis. Unlike competitors that make home loans and provide small-business credit lines, more than 90 percent of Goldman Sachs's pretax earnings this year came from trading and principal investments.

If Goldman was doing what it should be doing; providing capital to large businesses, it would not have to divert attention by these sorts of noblesse oblige efforts outside its core markets. While small business lending may not seem to be a harmful activity, when it is engaged in for political purposes rather than business purposes, it tends to reward politically connected businesses, not ones with a legitimate business mission. This is not an area in which Goldman or Buffett have any real interest or experience, so the money is bound to be wasted

and generally misallocated, distorting the markets and wasting resources.

In return for this sort of thing, Goldman buys favors at very high levels. Very few firms can have the political pull that Goldman does; even former President Clinton has come out to defend them regarding the SEC's civil fraud charges; an area very far outside of Clinton's expertise.

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Goldman's roots with the government go pretty far back; Henry Fowler was secretary of the Treasury from 1965-1968 and then became a partner at Goldman. But most make their fortunes before seeking power:

Robert Rubin left Goldman to become Bill Clinton's Treasury Secretary. Rubin is also ex-chairman of Citigroup, where he received \$126 million in cash and stock compensation during a period in which Citigroup was basically run into the ground, requiring a vast government bailout engineered by none other than Hank Paulson, the former Goldman CEO and treasury secretary under George Bush who engineered the early stages of the bailout. Paulson was recruited to the Bush White House by Joshua Bolten, George W. Bush's Chief of Staff from 2006 to 2008; Before that, Bolten was deputy chief of staff, before which time he, of course, worked for Goldman, in their London office (94-99). Paulson is a former CEO of Goldman, but at one time he worked at Goldman as Jon Corzine's deputy. Corzine was the head of fixed income trading who many blamed for Goldman's trading losses. In 1994, Corzine and Paulson announced layoffs at the firm for the first time in modern memory, but swore it would never happen again. They announced layoffs again in January of 1995. None of this stopped Corzine from becoming co-CEO of Goldman, before being kicked out in an internal putsch. He then used his vast Goldman

fortune to buy a senate seat, but not enjoying that he decided to run for governor of New Jersey, where he was just as ineffective as he had been in the senate.

Corzine lost his reelection bid in 2009, and shortly thereafter returned to Wall Street, where he probably ran into William Dudley, who holds one of the most powerful positions in public finance; the presidency of the New York Fed. He is also, of course, a former Goldman partner. The New York Fed directly supervises Goldman and other New York based investment banks, but no one seems to consider the conflicts issue. According to the Wall Street Journal, the New York Fed is "widely viewed as having failed in its job as one of Wall Street's top cops"; that did not stop the previous head of the New York Fed, Tim Geithner, from being promoted to Treasury Secretary in the Obama administration.

In the insider world of Goldman and the federal government, connections trump merit, and failure often leads to promotion. In May 2009, it was reported that the Chairman of the New York Fed, _____, was a former director at, and shareholder of, Goldman Sachs, having retired from the firm in

1994 and retained substantial stock. The controversy and criticism caused by what was seen as a conflict of interest between Friedman's new role as supervisor and regulator to Goldman Sachs forced him to resign on May 7, 2009.

George Herbert Walker the 4th is a second cousin of former president George W. Bush, and a former partner and managing director at Goldman.

Mark Carney worked for Goldman Sachs for 13 years in their offices in London, Tokyo, New York, and Toronto before becoming head of the central bank of Canada.

Neel T. Kashkari was a Vice President of Goldman Sachs before joining the treasury and becoming Assistant Secretary of the Treasury for Financial Stability, where he led the program to buy troubled financial assets under the TARP program; \$10

billion of this was allocated to his former employer.

Robert Zoellick is the current president of the World Bank. He was the

and _____ . He has previously served as Senior International Advisor to Goldman Sachs.

Malcolm Turnbull worked for Goldman as chairman and managing director for Australia from 1997 to 2001. He was leader of the opposition and parliamentary leader of the Australian Liberal Party in 2009, and has served in the Australian House of Representatives since 2004.

John Thain is one of the most notorious Goldman alumni, he was president of the firm from 1999 to 2004. In 2008, he was president of Merrill Lynch before engineering the sale of the firm to Bank of America. The deal later came under fire as

Thain authorized \$700 million in bonuses to Merrill Lynch executives just days before the bank of America takeover; it was later alleged that these bonus payments were fraudulent. In 2008, Thain was paid almost \$84 million by Merrill Lynch as the financial world melted down. He also spent over \$1.2 to remodel his office, among many other extravagances.

Other Goldman alumni include:

- - Under Secretary of State for Economic, Business, and Agricultural Affairs (2007-)
- - Prime Minister of Italy twice (1996-1998 and 2006-2008) and President of the European Commission (1999-2004)
- - Governor of the Bank of Italy (2006-)
- Massimo Tononi
 - Italian deputy treasury chief (2006-2008)

“Rajat Gupta, a director of Goldman Sachs, announced that he will not seek reelection to the Goldman board after being named as part of a wide ranging investigation into insider trading.” The investigation has already resulted in charges against the founder of a major hedge fund, Galleon’s Raj Rajaratnam. “The government says Gupta told Rajaratnam in advance about the investment Buffett made in Goldman in the depths of the financial crisis, . He also allegedly told Rajaratnam about Goldman’s earnings results ahead of their release in June and September 2008.”

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We've focused on the firms' trading activities because that is where it makes most of its money, but Goldman also of course does a brisk business in mergers and acquisitions, as do most investment banks. In fact, before the rise of trading, this was where investment banks like Goldman generated most of their fees. As former Goldman banker, and author, Jonathan Knee points out: "In a world where economists can be found on as many sides of an issue as politicians, it is a relief to find a topic on which there is effective unanimity: Mergers and acquisitions do not create value." More importantly to Goldman however, they do create huge advisory fees, and with very little or no capital investment. For example, in late 2009, it was revealed that Tech firm 3Com had paid Goldman \$41 million for advising it on its recent \$2.7 billion sale to Hewlett-Packard. If the deal ends up going sour, as most of these deals do, Goldman will keep the fee of course, while HP shareholders will suffer. By catering to the ego of CEOs investment banks can often persuade them to do deals that end up destroying value.

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In early May of 2010, it was revealed that the New York Stock Exchange had fined Goldman \$450,000 for various rules violations having to do with the technical requirements of processing transactions. Goldman's response:

"This was the result of an inadvertent, manual processing error following the change in Rule 204T close-out requirements in October 2008. There was no financial impact on clients. We now have improved, automated processes in place to avoid future errors."

While certainly not a major problem or fine by their standards, it shows that while Goldman can make big mistakes, like getting the direction for the market wrong and giving terrible client advice, they can also make costly small mistakes as well. Which would be no big deal, except they pay themselves as if they didn't make mistakes, not as if they were ordinary mortals.

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Charles Ferguson is a very bright, well educated guy who made his fortune developing an internet company which he sold to Microsoft for \$133 million. He has written several books and made films, one of which was a documentary about the Iraq War which was nominated for an Oscar. His latest film, Inside Job, is about the investment banking industry. Here are some excerpts from an interview:

“American finance has become a criminal industry, particularly investment banking. That’s true in two senses: the extremely literal way in which these people have broken the law. In the film, we go through a list of large-scale criminal activities, in which major financial institutions have already been convicted. The second sense is that there has evolved a culture in American investment banking where there’s no restraint on what people do.

The secondary thesis of the film is that as this industry has grown more powerful and wealthy, it has corrupted the institutions and people who should have restrained it — obviously the political system, the regulatory system and, less obviously but equally important, the academic and research discipline of economics.”

In a technical sense, Ferguson is probably wrong; while Goldman occasionally breaks the law, the great majority of its transactions are

probably, technically, legal. And some things they do are, no doubt, beneficial to others outside the firm.

But the real question is, if Goldman were to shut down tomorrow and cease all operations, would the world be a better or worse place? An investment bank can be a force for great good in the world, if it enable productive business deals and financing for companies that create value. But between the times that Goldman knowingly engages in deception, the times it is just wrong, the times it bets against its clients and takes both sides of a trade, the times it corrupts the system through political pull; all these things, in toto, create an institution that does more harm than good. But the greatest harm they may do is by steering public opinion away from business and markets in general.

Institutions like Goldman do far more to corrupt markets than to facilitate them, and, if, through its greed and short term self-interest, Goldman taints the perception of business and markets in the public's eye, it will have done far more evil than any bad trade. There are people like Michael Moore who stupidly attack any institution they perceive as part of the "capitalist"

system, and of course Goldman supplies plenty of ammunition to thoughtless leftist critics. But the real damage from Goldman is that they turn the best and the brightest against the market system. What Goldman really does on a day to day basis has little to do with the best sort of capitalism, and everything to do with the unethical manipulation of the system.

Goldman, and the other over leveraged and excessively complex financial institutions, should have been allowed to fail in 2008. The pain would have been sharp and have resulted in a severe recession. But in the long run, we could have, and would have, built a better sort of capitalism from the ashes.

