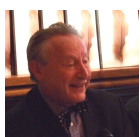


Disappointing Congressional Hearings on the Financial Crisis

By Paul GOLDSCHMIDT



Former director at Goldman Sachs International, former director at the European Commission (1993-2002), member of the Advisory Board of the Thomas More Institute.

A lot has been written on the financial crisis. There is a broad consensus that its causes were multiple involving, over a considerable period of time, the responsibility of a broad spectrum of actors. They include political appointees in both the executive and legislative branch, regulatory authorities in their "supervisory" and "policy making" roles as well as public and private economic actors.

The (sometimes) heated exchanges between the Chairman of the American bipartisan Commission investigating the causes of the financial crisis and Lloyd Blankfein, Chairman of Goldman Sachs, were not the best example of "democracy in action".

The opening statement of the Chairman demanding the "truth" on behalf of the "American people", followed by a clearly biased line of questioning seemed more aimed at throwing red meat at a hungry and angry beast (main street America) than conducting an impartial investigation.

The tone set by the Chairman put the panel of witnesses clearly on the defensive to the point where one wondered whether recourse to the First Amendment would not be invoked to avoid self incrimination. The publicity surrounding the hearings severely limited the ability of witnesses to put their unanimously accepted "shared responsibility" within the proper context. In particular "decency" imposed only the most discreet references to the failures of political and regulatory authorities.

These constraints did not permit, for instance, to distinguish between the degree of risk managed by the four institutions and their exposure to a global meltdown. Such an event would clearly have affected them, through the domino effects of "counterparty risk" spreading through the system. If this was avoided through the timely intervention of the authorities, it remains indisputable that there was a severe failure of the regulatory framework (abetted by inappropriate legislative underpinning, inadequate financial resources and, in some instances, political ideology) that brought the whole system to the brink of collapse. This applies to the American and International financial markets which are inextricably interconnected.

Bankers should assume full responsibility in such areas as the lack of competencies at senior management and board levels, inadequate risk management, inappropriate compensation policies, faulty product design, etc. without attempting to incriminate third parties for these failures. On the other hand, one should bear in mind that the panel of witnesses represented four institutions where these weaknesses were least exacerbated and which have since implemented corrective measures, most of which follow closely or exceed the recommendations of the G20.

Mr Blankfein gave a spirited defence of Goldman's business practices during the crisis. He was particularly convincing in explaining how Goldman had adequately hedged its exposure to AIG

(USD7.5 billion in cash/2.5billion in CDS protection against AIG failure) and was therefore in no way tributary to a "government backed" bail out of AIG to protect itself. He also explained clearly the justification for "selling short" securities in the "subprime" mortgage market in order to offset the risk of large amounts of new securities held temporarily for distribution. This was meant to diffuse the accusation of taking positions "against" the interests of the clients to whom the primary securities were sold.

Less convincing, however, was the justification for being in the business of underwriting "subprime" mortgage backed securities in the first place. Having spent myself 23 years with Goldman Sachs until 1985, I remember that it is there that I learned the highest standards of ethical behaviour and in particular to put the interest of clients first.

There seems to be little doubt that the growing complexity of financial markets and products has tended to blur the distinction between "proprietary" and "agency" trading, of transactions relating to risk management (hedging) and outright open "speculative" positions. These ambiguities became apparent during the hearings through the questioning of Commission members. The line of argumentation consisting in invoking the "professionalism" of the purchaser of these securities (caveat emptor) and the purported "service" rendered to customers by providing them with the risk assets they were "demanding" does not really stand up to scrutiny. These arguments may protect the firm from legal challenges but not necessarily from questioning its ethics.

Mr Blankfein admits that as early as 2006, Goldman's research was raising questions as to the soundness of the American real estate market. In this light, was the firm carrying out the appropriate due diligence on the assets underlying the securities it was underwriting? Was it making independent judgements on the "ratings" assigned by the agencies or was the firm involved, like other originators, in obtaining the ratings through dubious practices involving clear conflicts of interest revealed in the investigations concerning the Rating Agencies?

I believe that there was a fairly clear case for abstaining in the distribution of these securities (and therefore to sell them short as a hedge) but that, unfortunately, like it was the case with many competitors, the "greed factor" prevailed as, for as long as it lasted, this segment of the market provided enormous revenues to the intermediaries.

It is most unfortunate that these latest hearings will contribute very little to clarifying the causes of the financial crisis and, on the contrary, maintain an atmosphere of distrust. Re-establishing confidence of the public in financial markets and in the highest standards of ethics of its main actors is a sine qua non precondition for entering the slow process of economic recovery.

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