

## **ALL THAT GLITTERS IS GOLDMAN SACHS**

### **A primer on Skullduggery in High Finance**

When I told a friend who runs a program in community economic development the subtitle of my talk, A Primer on Skullduggery in High Finance, he replied “Isn’t that redundant?” Of course it is and apparently always has been. It seems that Jesus thought so, and Buddha, not to mention John Adams and Thomas Jefferson whose view of bankers and stockbrokers closely resembled my grandmother’s distrust of clergymen of all faiths and actors of both genders. The common element being that they were all trying to sell you something that was apparently much more for their benefit than for yours.

But perhaps a primer on this subject is redundant in still more ways. After all just about any grade school student will tell you -- now anyway -- that bankers and investment managers are a bunch of thieves if not worse. So perhaps this is a primer for the too sufficiently educated? But, yet another redundancy: here in this room are a sizable number of very well educated people, many with advanced degrees in economics, who have always understood how our economy functions and how it hides those functions behind a wall of mathematized ideological dogma. And we are here to celebrate and sustain the effort they make writing and editing a magazine and list of current books, which are themselves, primers on the skullduggery of the entire economic system, including its financial components.

So do not be surprised if your only satisfaction from these remarks is to confirm what you already know. Now to the business at hand. I am going to follow some advice I read many years ago in a primer on public speaking. First, say what you are going to say. Then say it. Then reprise it. What I am going to say is excellently expressed in a piece called The New-New Gettysburg Address by a Wall Street blogger named Jeff Matthews.

#### ***New-New Gettysburg Address***

*Four or five years ago our Investment Bankers helped bring forth on this continent, and around the world, a new banking system, conceived in Leverage, and dedicated to the proposition that all persons working for Investment Banks can create enormous Wealth for themselves with almost no Risk except to Taxpayers.*

*Now we the Investment Bankers of Goldman Sachs are engaged in a great Scam, testing whether that Nation of Bankers can get paid without Tipping Off the Taxpayers to that Scam.*

*We have come to cash our checks.*

*It is altogether fitting and proper that we should do this, for we have Houses in the Hamptons requiring upkeep.*

*But, in a check-clearing sense, we can not Cash Our Checks so long as  
AIG cannot make good on the credit default swaps we purchased to Hedge  
our Leverage. Thankfully, the brave men of Goldman who struggled to  
Attain Positions of Power in Treasury and the White House have  
consecrated it, far above Barney Frank's poor power to detract from our  
AIG Contracts.*

*The Small Investor will little note, nor long remember, how completely  
screwed He got, but we the Investment Bank of Goldman Sachs can never  
forget what they did to provide us this cash. We thank them for the \$8  
billion Their Government is paying to AIG in order to Make Us Whole.*

*We here highly resolve that The Little Investor shall not have died in  
vain -- that this nation, under Goldman Sachs, shall have a new birth of  
Leverage Without Risk -- and that government of Goldman, by Goldman, and  
for Goldman, shall not perish from the earth.*

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Mr. Matthews, who usually ends his blogs with the expression “No, I am not making this up,” departs unnecessarily from form in this case by saying “Well, Yes, I Am Making This One Up”. While there are a few small errors, notably the idea that Goldman had purchased Credit Default Swaps to hedge its leverage rather than increase it, for the most part this is more accurate than any stories you might find in the NY Times or the Wall Street Journal.

In a recent article in the New York Review of Books, Bob Solow quotes a passage from a book he is reviewing by the ultra-conservative jurist, Richard Posner:

*As far as I know, no one has a clear sense of the social value of our deregulated  
financial industry, with its free-wheeling banks and hedge funds and private  
equity funds and all the rest.*

Solow observes that Posner apparently thinks this social value “is limited.” It is hard not to enthusiastically agree with that conclusion. Starting with my own “industry”, the investment management business whose usefulness is defended in economics text books because it contributes to the rational allocation of capital to the best social uses and attacked by Marx and others as a purely parasitic attachment to the truly productive parts of the economy. I would have to hand the prize to Marx. In my industry the median professional investment adviser, or bank trust department or mutual fund, has consistently, unfailingly done worse than a simple index fund over any ten-year period for as long as records exist. Why? The answer extends to all the rest of the finance sector; the managers consistently put their own interest ahead of the clients. Combined with compensation arrangements that award unusually good short term results far more than they penalize mediocre long term results, this causes managers to take more risks with their clients money than the clients would for themselves. In a market where human nature and professional incentives both lead to excessive risk taking, risk is overpriced and risk taking loses, just as betting on lottery tickets or roulette loses, occasional jackpots notwithstanding.

When I first went to work for a small commercial bank in Boston in the 1970's -- combining my investment management business with theirs -- banking was at an historic turning point. A high point for those who think banks should essentially be regulated public utilities, and a low point for those who think the beneficence of capitalism is necessarily and sufficiently advanced by maximizing the gains to all shareholders, including those who own public utilities and banks. The latter had begun their long march to total victory led by Citibank and its president, John Reed. He invented and immediately began to issue, negotiable certificates of deposit, an early example of securitization (of deposits in this case), which the Fed stared at glumly but declined to ban. Citi and other big banks also initiated the Eurodollar market, which is essentially a banking system with no regulator and no reserve requirements that nonetheless uses the names and regulated status of its participants to increase investor confidence, a now all too familiar model. Again the Fed did not and still has not attempted to regulate this machine for printing dollars off shore.

For little banks like mine, John Reed had these messages: create a bank holding company which can own your bank, buy other banks that your bank couldn't buy -- at the time most states and federal law restricted the scope of banks to one state, one county in Massachusetts, even one branch in Illinois. And, by the way, the holding company, not being a regulated depository institution itself, but only an owner of such banks, could sell debt, implicitly guaranteed by the banks it owned, without Fed approval. In sum, grow by acquisition, lend all of your deposits at the highest possible rates, increase leverage every way possible. The consolation prize, if you couldn't pull this off? Some other acquisitive bank would buy you out at a big premium to your stock market price. The number of banks in the United States went from over 22,000 at the start of the 1970's to about 8,000 today and still falling fast. Needless to say the size of Citi, Bank America and the other largest banks has increased dramatically faster than the size of the entire bank system, the five largest now accounting for about 40% of the total.

The evidence is quite clear, and has been all along, that big banks with exposure to many cities, states and countries are not safer not more efficient and not more profitable than smaller banks. They are the opposite. They do have some monopoly pricing power; but approximately all of it is expropriated by the mafia size tributes extracted by management, directors and other insiders. Returns on equity are higher only because of the debt leverage. And, of course, they are too big to fail. (In addition as Tom Ferguson and Robert Johnson argue in two recent papers, they may also be too big to bail.) In any case the final triumph in all of this was the merger eleven years ago of Citibank with Travelers' insurance, one of the largest in the nation and the owner of Salomon Smith Barney a recently merged large brokerage house. At the time, the Glass Steagall Act, which was passed in 1933 for the explicit purpose of keeping regulated and deposit-insured banks out of other financial businesses like insurance and the stock market, had been substantially mutilated but not repealed. The merger was clearly in violation of the act. But the Best Congress That Money Can Buy responded to this problem obligingly the next year, 1999, by simply repealing the entire Act. The repeal received overwhelming bi-partisan approval, including our own Barney Frank, who had been riding the bank-deregulation horse since he sat in the legislature in the 1970's, and also I believe by the entire Massachusetts delegation and the likes of Christopher Dodd and Charles Schumer, true friends all of the working banker. The Clinton White House had strongly backed the measure and issued a

celebratory statement claiming that it had calculated the annual savings to consumers from this legislation at eighteen billion dollars a year! ... a number no doubt certified by then Secretary of the Treasury, Chief Mathematical Wizard and self-proclaimed Infallible Authority on Everything, Larry Summers, who had recently replaced Robert Rubin, former head of Goldman Sachs. Rubin had become one of the three ruling executives of the illegally combined Citigroup just a month before the repeal of the now offending sixty-six year old legislation.

But, now that we have again touched a thread of Goldman we must hurry on to make sure we arrive in time at the Sachs at the end of the rainbow (Sorry Dan). So here is a condensed review of another of the casually dismissed items on Richard Posner's list of dubious financial innovations, Private Equity Funds. When Steve Schwartzman, the head of Blackstone Group, took his company public in the middle of 2007, near the peak of the stock market and the economy, he was said to be worth five billion dollars, nearly all of it accumulated over the previous ten years or so. Since then, investors in his company have lost about \$4.5 billion, while his own losses have been considerably less. So how did he accumulate so much money in such a short time, the answers are not pretty and are general throughout the Private Equity business. Companies were bought for less than they were worth. This was accomplished by essentially bribing existing management to support Blackstone's offer by promising rich employment contracts after the takeover.

Money was effectively stolen from existing bondholders by debasing their bonds with the issue of many more bonds from the acquired company -- honestly called Junk bonds in a rare departure for Wall Street -- making it likely that the company would default on all its bonds. Earnings were increased by moving activities from unionized or high wage locations to less costly locations or simply eliminating them altogether. Money was "saved" by eliminating expenses that were subtracted from current earnings but only contributed to future earnings like research and development, maintenance, labor training and education, community relations and advertising.

The junk bonds having been sold at the beginning to state pension plans, university endowments and all the usual suspects, so that Blackstone could complete the purchase with very little money, stock in the refurbished company would then be sold after two to four years with miraculously improved earnings to the blessed Small Investors, by the ever devious investment banks including Goldman Sachs. We are still in the early phase of the wave of bankruptcies and defaults that this approach creates in its aftermath; but this is already the third time we have been through this process in recent years, so we know that many of the bond and stock holders will be left with nothing.

Onward and upward to Hedge Funds. The first thing to know about them is that, with rare exceptions, they are not and they have no intention to hedge anything, in the sense of offsetting a potential loss or gain one place with the opposite someplace else. Their raison d'être is to magnify results with borrowed money and with inherently leveraged instruments like derivatives. Also, the principals get rich even if the investors lose everything because of the very generous fixed fees they are paid and because their so called "carry" or percent of gains, is not offset by any percent of losses, ever. This fee structure is illegal in our business; but hedge funds are not regulated because they claim to be private placements to sophisticated, wealthy investors and

therefore exempt from regulation. The allegedly sophisticated investors end up earning about what they could have made in a stock market index fund, in spite of the exorbitant fees and risks comparable to investing in lottery tickets. In fact they are not regulated because they are incredible contributors to political campaigns. Because they are not regulated, hedge funds do whatever they want as we shall see.

And so on again to Credit Default Swaps. First thing once again, they are definitely not “swaps” in the sense that something was exchanged for something else in any way that you would recognize. In fact this is never the case when Wall Street calls something a swap. This I tell you with certainty, although I confess that I am often not sure what some swap really is. When an article in the Wall Street Journal attempts to explain what it is by saying what gets swapped for what, you can be pretty certain that the author doesn’t know what it is either.

In short, a Credit Default Swap is an insurance policy against a particular bond defaulting. You can buy a default swap to insure a bond you own. But you can also buy a swap as a speculation even if you don’t own the bond. Likewise, anyone can sell a default swap if they want to and if the buyer believes they will be able to make good. This explains why the nominal value of credit default swaps outstanding has often been as large or larger than the nominal value of bonds outstanding.

Perhaps by now everybody knows that AIG, one of the two or three largest insurance companies in the world, followed the bank trick and got itself owned by a holding company that was not a regulated insurance company but used the same AAA rated AIG name and made itself very busy with numerous complex transactions for various purposes including the active sale of credit default swaps to others, effectively as an unregulated and unreserved insurance product, and that Goldman Sachs was the major owner of these swaps or insurance policies when AIG went down in the wake of Bear Stearns. Perhaps you know also that Hank Paulsen, then Secretary of the Treasury, previously head of Goldman Sachs met with Timothy Geithner, then president of the New York regional federal reserve bank and Ben Bernanke in a series of meetings to decide what to do about AIG and all of the default swaps it had sold and bought. Perhaps you didn’t know that according to the New York Times, the only non-government official who attended any of their meetings was Lloyd Blankfein, then and now the head of Goldman Sachs. Or that Edward Liddy, who was selected by the government troika to run AIG for the taxpayers, went there directly from the board of Goldman Sachs. Of course everybody now knows that the chairman of the board of the NY Fed to whom Geithner was then reporting, was Stephen Friedman (you can all join in) a former head of Goldman Sachs.

Mr. Friedman was also still a major stockholder in Goldman. In the crisis last September the Fed agreed with unprecedented speed to let Goldman become a commercial bank with insured deposits and access to the Fed’s discount facilities, old and new, while Paulsen injected \$10 billion of temporary capital. Mr. Friedman claims to have had no knowledge of or influence over these decisions, which is plausible. Indeed he claims to have had no influence over any important policy decisions. When Goldman Sachs became a real bank however, his stock holdings became illegal. Geithner, Bernanke, Paulsen and sometimes Blankfein proceeded to plot the rescue of AIG which turns out to have been the rescue of Goldman and others who had bought default swaps from AIG. Friedman did not resign and the NY Fed applied to Washington

for a waiver of the rules, claiming that Friedman, who had hired Geithner, was an indispensable leader to keep on board in the search for Geithner's replacement should Obama win and Geithner go to Treasury. All of which sounds a little inconsistent with Friedman's stance that he and the board made no important decisions. While waiting for the waiver of the rules, Friedman, still claiming innocence of any knowledge of where the AIG bailout billions were going, went ahead and bought some more Goldman stock. After the waiver came through he bought still more again. In January, he announced his choice for the new head of the New York Fed, William Dudley (careful this time) a former Chief Economist of Goldman Sachs for about fifteen years, including the time Friedman was boss.

An obviously frustrated Wall Street Journal reporter summarized his convoluted conversation with the legal department of the NY Fed about Friedman's stock ownership as follows:

*Because he wasn't allowed to own the stock he had, the Fed doesn't consider his additional December purchase to be at odds with its rules at the time. The Fed had no policy requiring directors to inform if of new stock purchases, and Mr. Friedman didn't. The Federal Reserve Board is now in the process of rewriting its rules for handling situations like Mr. Friedman's.*

When the Journal's story was printed Mr. Friedman's profits on his new purchases only, were above \$2 million. Now they are greater still.

So here is my reprise. One cannot put too fine a gloss on this no matter how hard one tries. The Bush administration and the Obama administration have simply abandoned the principles that worked for Roosevelt through the Reconstruction Finance Corporation in the first days of his administration, that worked in the Savings and Loan Crisis in the early 90's, that worked in Sweden as well at the same time and that have been understood by capitalist central bankers for 150 years. Save the depositors not the bank owners or bondholders.

As Simon Johnson, a former chief economist of the IMF pointed out in a recent Atlantic article, the banks now effectively own the government. Two other former chief economists of the IMF, Nobel prize winners Paul Krugman and Joe Stiglitz have made the same point. All of which proves that in addition to reading Dollars and Sense, or studying at U.Mass Boston or U. Mass Amherst, there is now another way to become a radical economist, spend two years at the IMF. Alas it doesn't work for everybody.