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The People versus Goldman Sachs

The US investment bank Goldman Sachs is earning a reputation as public enemy no. 1 in the financial world. At the same time the firm is one of the Commission's favourites when it comes to asking for advice on regulating financial markets. It is high time for the Commission to close the door on Goldman Sachs.

Goldman Sachs is in the dock. On the 16th April, the US financial authorities, the Securities and Exchange Commission (SEC), accused the renowned investment bank of outright fraud in connection with billion dollar deals made on American house owners' misery by tricking European financial corporations. It's not every day you see the US authorities file charges against a major financial institution, and the stock market reacted swiftly. There was a 16 per cent plunge in Goldman shares, a plunge in the price of gold, and even a depreciation of the dollar to the yen as capital fled to a safer haven. But whereas criminal charges against the bank are rare, Goldman Sachs has provoked public opinion on numerous occasions in the past decade. The pending case will at its root be about making a profit from accelerating the financial crisis. In 2007, the very year the crisis broke, Goldman Sachs reaped a record Wall Street profit of US$ 11.6 billion. The following year was disastrous for the banking sector, but Goldman fared comparatively well with a profit of US$ 2.3 billion. In 2009 the firm was close to setting another record making US$ 11.4 billion in profits[1].

Crisis profiteer as advisor

Since other major financial firms have either ceased to exist, have been bailed out or nationalised, or have suffered major losses, Goldman Sachs is in a class of its own. The skilful staff have managed to reap benefits from major crises that have caused enormous harm to millions of people. The SEC case is the most prominent example, but there are others. The renowned investment bank and Wall Street power house has also done its bit to slow down action on Greek debt, and has profited from pushing millions into hunger by way of commodity speculation[2]. These examples are presented in this article to make the case to decision makers in the European Union to cut close ties to the bank.

For despite all this, the European Commission very often chooses advisors from Goldman Sachs to help shape the rules for the financial markets in the European Union. The Commission has ignored the negative side of Goldman Sachs and has regularly allowed it to take a seat among the privileged few who get to influence proposals for EU legislation long before they are presented to the public and the open political process starts.

The question is whether the case in the US should be taken as the opportunity to stop this access, and expel Goldman Sachs from these "Expert Groups". If the new Commissioner for the Single Market Michel Barnier is serious about curbing speculation in sovereign debts and commodities, and if he is serious about transparency in financial markets, it's hard to think of a more intransigent and uncooperative partner than Goldman Sachs.

Sniffing out a profit

The issue that the Securities and Exchange Commission (SEC) has looked into has caused deep resentment towards Goldman Sachs since late 2007[3]. After the peak of the financial crisis, Goldman Sachs was more like the last man standing on Wall Street, mainly due to its speculation in the downfall of the market in the infamous subprime loans in US real estate. This is the case that has now led to an indictment. Some facts are still disputed, so let's be conservative and stick to the basic undisputed events.

In early 2007, experts within Goldman Sachs started making very negative predictions about the market in real estate in general and the collateralised debt obligations (CDOs) containing junk subprime loans in particular. In February Fabrice Tourre, Vice President at Goldman Sachs had meetings with an insurance company ACA, which was looking for assistance on further investments into the real estate market. Tourre also met with hedge fund manager John A. Paulson who had the opposite agenda: He wanted to bet against the very same CDO's.

"This is surreal," Fabrice Tourre wrote.

Slightly more than a week later, Tourre received an email from a colleague with a clear verdict on CDO's: "The CDO biz is dead. We don't have a lot of time left.[4]"

Beggar thy neighbour

In the months that followed, Tourre set up a project called Abacus 2007-AC1. The project was two-pronged. On the one hand, Goldman Sachs allowed Paulson to pick CDOs to be sold to customers like ACA which put 951 million dollars on the table[5]. Among other prominent customers were European financial corporations like the German bank IKB Deustche Industriebank AG and Dutch bank ABN Amro. At the same time, Goldman Sachs helped hedge fund manager Paulson betting against the very same investments, he had picked out. Since Paulson's fund was and is quite big, a major bet was possible. And as it turned out, it was quite profitable. It made US$ 3.7 billion and the fund jumped in value by 590 per cent.

Whether the big bets against the CDO market, organised by Goldman Sachs, actually exacerbated and speeded up the collapse of the market – for which millions all over the world have paid dearly – is not clear. But the consequences for the clients on the other side of the deal were tangible. Losers included IKB Deutsche Industriebank (US$150 million)[6] and ABN Amro (US$ 840 million)[7].

Later the same year, IKB nearly collapsed, but was saved by an injection of 10 billion euros from the German government. At the time, the German state owned 40 per cent of IKB. By 2008 it owned 90 per cent when IKB was sold to US private equity fund Lone Star. How much this cost German tax payers in the end, remains to be disclosed, but billions, no doubt. In Germany the struggle over the guilt of key players, such as Goldman Sachs, is still ongoing.

As for ABN Amro, it is now owned by Royal Bank of Scotland, which again is 84 per cent owned by UK taxpayers who picked up the bill for more than US$ 841 billion[8]. Whether RBS will succeed in transferring the losses to a second party is not clear.

With manoeuvres like this, Goldman Sachs was able to steer relatively smoothly through a time of tempest on Wall Street. It managed to bring down the huge bundle of “toxic securities” in their possession from US$ 81 billion worth to US$ 14.5 billion. This move earned Goldman Sachs some admiration, including from Robert Lenzner in Forbes Magazine who in a comment on the firm’s 2008 annual report wrote:

“Survival of the fittest required it. The firm dumped real estate in the Americas and in Europe… Goldman sold its worrisome garbage to others as a way to remove risk of it going to zero. Pragmatic, tough minded”[9].

Speculating on hunger

The collapse of the subprime market was and is not the only crisis that Goldman Sachs has intelligently bent to its own advantage. Before “the CDO biz” was officially dead in late 2007, Goldman Sachs, as well as other major investors, had turned their attention to other profitable investment objects, including food. In 2007 and 2008 the world saw a major food crisis that added approximately 100 million people to the world's “under-nourished and food insecure”, that is; to the world's hungry or starving[10]. The reason was straightforward; food commodity prices had started going up steeply from 2006, and were to continue to rise well into 2008. Compared to prices in 2006, the price of wheat for instance, more than tripled in mid 2008, according to US Senate investigators[11]. In no small measure, this was the result of a massive influx of footloose financial capital. Take Goldman Sachs’ word for it: “Without question increased fund flow into commodities has boosted prices”[12].

How does this work? Put briefly, speculation works through betting on commodity prices, including grains and other kinds of food. Years ago, some financial instruments were standard tools for producers to guarantee a tolerable price, but for the past 10 years or so, major speculators, called Index Speculators, have stormed into the market and started speculating on price movements. Their massive presence in the market tends to detach prices from supply and demand[13].

Goldman: a major price mover

So, what is Goldman Sachs’ part in this silent disaster?

Goldman Sachs is one of the four largest dealers in the most important financial instrument used by Index Speculators; “commodity swaps”[14], a swap where payments are dependent on the price of an underlying commodity, be that oil, rice or something else. The others are Morgan Stanley, J.P. Morgan and Barclays Bank. Among them, they control 70 per cent of “commodity index swaps positions”[15].

“One out of every four contracts on the commodities futures exchanges is controlled by these four Wall Street Banks. This represents tremendous power over markets and pricing,” according to a report on food speculation written by two financial experts[16].

In fact, trading in commodities helped Goldman Sachs escape the destiny of other major investment banks in 2008. The interest in commodity speculation in 2008 played to the advantage of Morgan Stanley and Goldman Sachs, accounting for half of the US$ 15 billion revenue generated from commodities the year before[17]. Commodity trading, said analyst Frank Feenstra to Bloomberg "is very large for them, and that is even more important now given what's happening with the rest of the business"[18].

Hiding the debt: the Greek Crisis

There doesn't seem to be a major crisis situation in financial markets where the name Goldman Sachs doesn't pop up, and quite often in a way that is to say the least controversial. The Greek debt crisis is no exception.

There were some doubts before the launch of the euro as to whether the Greek economy met the criteria to join the euro in the first place. A major problem was that the country's debt was at odds with the criteria for joining. Goldman Sachs came up with a shrewd idea: from the beginning of 2002 Greece was given big loans from the bank in such a way as to allow the money to disappear from the radar of the EU office for statistics, Eurostat, and the EU financial authorities, including the European Central Bank. The financial product used is called a currency-swap. Basically the money came to Greece through currency trades based on phoney exchange rates and was not recorded as loans. In the documented case, Goldman Sachs was able to raise an extra 1 billion dollars for Greece "off-balance-sheet". There are more cases like this involving not just Goldman Sachs. According to a document commissioned by the Greek Ministry of Finance, the swaps were used to defer interest payments that in the end caused "long-term damage" to the Greek state. And – one might add – long term damage to the plight of Greek citizens. Goldman Sachs was handsomely rewarded, earning US$ 300 million according to bankers familiar with the deal[19].

Lobbying for a lax response

Finally, after the SEC case, food speculation and the hiding of Greek debt, there's a fourth story which is slightly more complicated. It has to do with the speculative attacks that made Greece suffer even more this year. These attacks were made via so called "naked CDS", an instrument that allows speculators to make a profit from a worsening economic situation in Greece, and even make loan conditions worse for the Greek government. From the beginning of 2010 to early May the interest the Greek Government had to pay for loans went up steeply. The yield on 10-year Greek bonds stood at slightly less than six per cent in early January. In May it reached a record 14 per cent[20] Greek bonds were finally classified as junk bonds, and can now only be bought by speculative funds or the European Central Bank.

Did Goldman Sachs itself speculate against its client?

This is a question on which there is a lot of speculation in the financial press[21]. No evidence seems to be in the public domain. But Goldman Sachs was active on another level. In October 2008 it was invited by Single Market Commissioner Charlie McCreevy to discuss proposals for reform of the markets in derivatives. According to statements from McCreevy it was to be a debate that would look at the fundamentals, but as time passed it became obvious that the Commissioner had opted for light-handed regulation. One of the measures completely ignored by the Commissioner after months of intense dialogue with the financial industry, including Goldman Sachs, was the possibility of outlawing particularly toxic financial instruments, including the very kind of instruments used to speculate against the Greek economy; naked credit default swaps or "naked CDS". So, while naked CDS was part of the debate on reform in the US starting late 2008, it was practically off the EU agenda, until McCreevy was replaced and speculation against Greece took off. The new Commissioner has now announced a proposal in October to curb the use of naked CDS. Much too late for Greece[22].

The clout of Goldman Sachs

This leads us to the political influence of Goldman Sachs. Obviously, Goldman Sachs is so big that it moves markets. A further intriguing thing about Goldman Sachs is that its clout in the market place is mirrored on the political scene. In 2004, for instance, it managed to win over the US government for a self-regulation regime of investment banks[23], thanks to its then Chairman, Henry Paulson, who two years later became Treasury Secretary. From 1998-2008, Goldman Sachs spent US$ 46 million on "political influence buying" in the US[24]. According to a report by Wall Street Watch[25] the lobbying effort of Goldman Sachs and the other major financial firms, led directly to the kind of lax regulations that paved the way for the crisis.

Since financial markets are heavily integrated across the Atlantic, it's logical to ask if Goldman Sachs has a role in EU legislation. The company is absent from the European Commission's lobby transparency register, so it's impossible estimate how much Goldman Sachs spends on lobbying in Brussels. But Goldman Sachs does play a major role in EU decision-making on financial markets. In the EU access to decision makers even comes for free when you're a major Wall Street firm. For years now, Goldman Sachs has been a frequent guest in key advisory groups – a gift for any firm with a lobbying ambition.

Everywhere That Counts

In the European Union the key institution responsible for tabling proposals for reform of the financial system – the Commission – is in the habit of consulting intimately with the major financial corporations long before presenting a proposal for political debate in the Council or in Parliament, or to the public for that matter. Invitations to participate in the Commission's expert groups have long been a key instrument for the financial lobby in Brussels – worth far more than any army of lobby foot soldiers paying regular visits to MEPs before a vote. Participation in expert groups is an invitation to set the agenda for the discussion in the Council and the Parliament in a complicated decision process that almost never concludes with a decision fundamentally different from the Commissions' proposal.

And as in the US where top executives from Goldman Sachs often take important seats in government and vice-versa, in the European Union there are strong links between the Commission and the bank. No less than three former Commissioners have taken up positions with Goldman Sachs after the end of their term; Peter Sutherland (Ireland), Karel van Miert (Belgium) and Mario Monti (Italy).

As for the legislative process, Goldman Sachs seems to be everywhere that counts.

- When the Commission set out to review its strategy on financial services in 2004, expert groups were formed to help and Goldman Sachs was represented.
- When the Commission started considering regulation on hedge funds, an expert group was formed. Goldman Sachs was represented.

- When Commissioner McCreevy set up a group to advice on reforms of the derivatives markets in October 2008, Goldman Sachs was represented[26].

- Of the existing 10 expert groups on financial services with business participation, three of them include employees of Goldman Sachs[27].

- Last, but not least, when the Commission formed a High Level Group to advise the EU on the response to the financial crisis, one of the seven members was an advisor to Goldman Sachs, Otmar Issing[28].

All in all, Goldman Sachs is one of the most privileged firms in the EU in terms of representation in these powerful groups.

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Should a guilty verdict change our attitude to these privileges? Not really. Whichever way it goes, the Commission should stop consulting Goldman Sachs on how to regulate financial markets.

Whether Goldman Sachs will actually be convicted in the suit filed by the SEC in the US remains to be seen. In any case, most analysts do not see this as a prelude to a dramatic clash between the authorities and a major financial corporation. Even if convicted, Goldman Sachs might be able to brush off much of the scandal quite quickly, since it’s “only” about not providing customers with full information. At least this is what some experts say.

At this point in time, it would be a mistake to judge Goldman Sachs only by their respect for law and regulations. The financial crisis has revealed an amazing disrespect of the public interest among financial corporations, and the rules guiding their operations are undergoing change. In that process, the trust the public should or shouldn’t have in a given financial institution, becomes important. And who, outside the inner circles of the financial world, would trust Goldman Sachs?

Time to go

Besides the misdeeds to the public interest outlined in the above snapshots from the past decade, Goldman Sachs is resisting any kind of meaningful reform to financial regulation in, for instance, derivatives. And it would come as a big surprise if the firm were ever to mutter a word on a solution to speculation in food. Since the new Single Market Commissioner has promised effective reforms to stop food speculation, and to stop speculation on sovereign debt, he should be asked if he’s picking the right advisors. It would be ironic, to say the least, if Goldman Sachs is among them. In fact it's timely to ask what on earth they're doing in any of the Commissions’ expert groups. Considering the actions of the bank in the past decade, it’s certainly time to expel them, if not for their possible crimes under US law, then for their crimes against the well being of millions of citizens in Europe and elsewhere.

[1] "Taxpayers Help Goldman Reach Height of Profit in New Skyscraper", Bloomberg, 20. December 2009. 2008 number from Goldman Sachs' letter to shareholders, included in the 2008 Annual Report; http://www.asiaing.com/goldman-sachs-2008-annual-report.html

[2] This claim will be substantiated below.

[3] An article in the New York Times was important in shedding light on Goldman Sachs' deals; "Goldman Sachs Rakes in Profit in Credit Crisis", 19. November 2007.

[4] Quotes from "SEC Accuses Goldman of Fraud in Housing Deal", New York Times, 16. April 2010.

[5] Bloomberg, 17. April 2010.

[6] "Abacus Casualty no. 2", New York Times, http://dealbook.blogs.nytimes.com/2010/04/20/abacus-casualty-no-2-ikb-of-duesseldorf/

[7] "ABN Amro laat in handel kredietderivaten", Het Financieele Dagblad, 20. April 2010.

[8] See for instance, "Goldman Sachs investigation could put Wall Street under microscope", The Guardian, 19. April 2010.

[9] Robert Lenzner; "Goldman Sachs' Diary of Survival", Forbes Magazine, 21. May 2009.

[10] FAO Media Centre; "Number of hungry people rises to 963 million", 9. December 2008.

FAO; "Hunger on the rise: Soaring Prices Add 75 Million people to global hunger", 17. September 2008.

[11] Steve Suppan; "Commodity Market Deregulation and Food Prices", IATP, Spring 2010.

[12] Murthi & Singer; "Has the super-spike end game begun?", Goldman Sachs Global Investment Research. 5. May 2008, page 12.

[13] Michael W. Masters & Adam K. White; "How Institutional Investors Are Driving Up Food and Energy Prices", Accidental Hunt Brothers, Special report, July 2008, page i ff.

[14] Michael W. Masters & Adam K. White; "How Institutional Investors Are Driving Up Food and Energy Prices", Accidental Hunt Brothers, Special report, July 2008, page 23.

[15] Ibid., page ii.

[16] Ibid. page 23.

[17] The other half includes eg. earnings on oil and other energy sources.

[18] "Goldman, Morgan Stanley Profits Conceal Reliance on Commodities", Bloomberg, 15. June 2008.

[19] "Fed Reviewing Goldman's Moves on Greek Debt", The New York Times, 25. February 2010.

[20] http://www.guardian.co.uk/business/2010/apr/27/greece-credit-rating-downgraded

[21] An interesting but rather speculative piece from Financial Times; "Funds' role in Greek Drama Examined", 5 March 2010. According to the correspondent, Goldman Sachs hosted a meeting with hedge funds in Athens in January, including the now infamous Paulson fund. Following the meeting, several of the funds present made a fortune on Greek misery, according to the writer, who hints that Goldman Sachs was a key organiser and provided the brains of the operation.

[22] This process is analysed in more detail in Corporate Europe Observatory; "Financial Warmongers Set EU Agenda", April 2010. http://www.corporateeurope.org/lobbycracy/content/2010/04/financial-warmongers-set-eu-agenda

[23] Robert Weisman; "Sold Out - How Wall Street Betrayed America", Wall Street Watch, March 2009 page 17. http://wallstreetwatch.org/reports/sold_out.pdf

[24] Ibid. Page 99.

[25] See footnote 13.

[26] Corporate Europe Observatory; "Financial Warmongers Set EU Agenda", April 2010, page 2, footnote 8. http://www.corporateeurope.org/system/files/files/article/Financial_Warmongers_April2010.pdf

[27] Clearing and Settlement Advisory and Monitoring Expert Group 2 - http://ec.europa.eu/transparency/regexpert/detail.cfm?ref=2194, Clearing and Settlement Code of Conduct Monitoring Group - http://ec.europa.eu/transparency/regexpert/detail.cfm?ref=1926,

Derivatives - http://ec.europa.eu/transparency/regexpert/detail.cfm?ref=2299

[28] Corporate Europe Observatory, SpinWatch, LobbyControl & FoEE; "Would You Bank on Them? Why We Shouldn't Trust the EU's Financial Wise Men", February 2009, page 7-8.