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Carl Levin, Chairman

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Opening Statement of Senator Carl Levin
U. S. Senate Permanent Subcommittee on Investigations Hearing

Wall Street and the Financial Crisis:
The Role of Investment Banks

Today the Subcommittee holds the fourth in our series of hearings to explore some of the causes and consequences of the financial crisis. These hearings are the culmination of nearly a year and a half of investigation.

The freezing of financial markets and collapse of financial institutions that sparked our investigation are not just a matter of numbers on a balance sheet. Millions of Americans have lost their jobs, their homes and their businesses in the recession that the crisis sparked, the worst economic decline since the Great Depression. Behind every number we cite are American families who are still suffering the effects of a man-made economic catastrophe.

Our Subcommittee's goal is to construct a record of the facts in order to deepen public understanding of what went wrong; to inform the ongoing legislative debate about the need for financial reform; and to provide a foundation for building better defenses to protect Main Street from the excesses of Wall Street.

Our first hearing dealt with the impact of high-risk mortgage lending, and focused on a case study of Washington Mutual Bank, known as WaMu, a thrift whose leaders embarked on a reckless strategy to pursue higher profits by emphasizing high-risk exotic loans. WaMu didn't just make loans that were likely to fail, creating hardship for borrowers and risk for the bank. It also built a conveyor belt that fed those toxic loans into the financial system like a polluter dumping poison into a river. The poison came packaged in mortgage-backed securities that WaMu sold to get the enormous risk of these loans and their growing default rates off its own books, dumping that risk into the financial system.

Our second hearing examined how federal regulators saw what was going on, but failed to rein in WaMu's reckless behavior. Regulation by the Office of Thrift Supervision that should have been conducted at arm's length was instead done arm in arm with WaMu. OTS failed to act on major shortcomings it observed, and it thwarted other agencies from stepping in.

Our third hearing dealt with credit rating agencies, specifically case studies of Standard & Poor's and Moody's, the nation's two largest credit raters. While WaMu and other lenders dumped their

bad loans into the river of commerce and regulators failed to stop their behavior, the credit rating agencies assured everyone that the poisoned water was safe to drink, slapping AAA ratings on bottles of high risk financial products. The credit rating agencies operate with an inherent conflict of interest – their revenue comes from the same firms whose products they are supposed to critically analyze, and those firms exert pressure on rating agencies who too often put market share ahead of analytical rigor.

Today we will explore the role of investment banks in the development of the crisis. We focus on the activities during 2007 of Goldman Sachs, one of the oldest and most successful firms on Wall Street. Those activities contributed to the economic collapse that came full-blown the following year.

Goldman Sachs and other investment banks, when acting properly, play an important role in our economy. They help channel the nation's wealth into productive activities that create jobs and make economic growth possible, bringing together investors and businesses and helping Americans save for retirement or a child's education.

That's when investment banks act properly. But in looking at this crisis, it's hard not to echo the conclusion of another congressional committee, which found, "The results of the unregulated activities of the investment bankers … were disastrous." That conclusion came in 1934, as the Senate looked into the reasons for the Great Depression. The parallels today are unmistakable.

Goldman Sachs proclaims "a responsibility to our clients, our shareholders, our employees and our communities to support and fund ideas and facilitate growth." Yet the evidence shows that Goldman repeatedly put its own interests and profits ahead of the interests of its clients and our communities. Its misuse of exotic and complex financial structures helped spread toxic mortgages throughout the financial system. And when the system finally collapsed under the weight of those toxic mortgages, Goldman profited from the collapse. The evidence also shows that repeated public statements by the firm and its executives provide an inaccurate portrayal of Goldman's actions during 2007, the critical year when the housing bubble burst and the financial crisis took hold. The firm's own documents show that while it was marketing risky mortgage-related securities, it was placing large bets against the U.S. mortgage market. The firm has repeatedly denied making those large bets, despite overwhelming evidence.

Why does this matter? Surely there is no law, ethical guideline or moral injunction against profit. But Goldman Sachs didn't just make money. It profited by taking advantage of its clients' reasonable expectation that it would not sell products that it didn't want to succeed, and that there was no conflict of economic interest between the firm and the customers it had pledged to serve. Goldman's actions demonstrate that it often saw its clients not as valuable customers, but as objects for its own profit. This matters because instead of doing well when its clients did well, Goldman Sachs did well when its clients lost money. Its conduct brings into question the whole function of Wall Street, which traditionally has been seen as an engine of growth, betting on America's successes and not its failures.

To understand how the change in investment banks helped bring on the financial crisis, we need to understand first how Wall Street turned bad mortgage loans into economy-wrecking financial instruments.

Our previous hearings have covered some of this ground. The story begins with mortgage lenders such as WaMu, which loaned money to home buyers and then sought to move those loans off its books. That activity spawned an ever more-complex market in mortgage-backed securities, a market that for a while worked pretty well. But then things turned upside down. The fees that banks and Wall Street firms made from their securitization activities were so large that they ceased to be a means to keep capital flowing to housing markets and became ends in themselves. Mortgages and mortgage-backed securities began to be produced for Wall Street instead of Main Street. Wall Street bond traders sought more and more mortgages from lenders in order to create new securities that generated fees for their firms and large bonuses for themselves.

Demand for securities prompted lenders to make more and riskier mortgage loans. Making and packaging new loans became so profitable that credit standards plummeted and mortgage lenders began making risky, exotic loans to people with little chance of making the payments. Wall Street designed increasingly complex financial products that produced AAA ratings for high-risk products that flooded the financial system.

As long as home prices kept rising, the high risk mortgages posed few problems. Those who couldn't pay off their loans could refinance or sell their homes, and the market for mortgage-related financial products flourished.

But the party couldn't last, and we all know what happened. Housing prices stopped rising, and the bubble burst. Investors started having second thoughts about the mortgage backed securities Wall Street was churning out. In July 2007, two Bear Stearns offshore hedge funds specializing in mortgage related securities suddenly collapsed. That same month, the credit rating agencies downgraded hundreds of subprime mortgage backed securities, and the subprime market went cold. Banks, securities firms, hedge funds, mutual funds, and other investors were left holding suddenly unmarketable mortgage backed securities whose value was plummeting. America began feeling the consequences of the economic assault.

Goldman Sachs was an active player in building this mortgage machinery. During the period leading up to 2008, Goldman made a lot of money packaging mortgages, getting AAA ratings, and selling securities backed by loans from notoriously poor-quality lenders such as WaMu, Fremont and New Century.

Of special concern was Goldman's marketing of what are known as "synthetic" financial instruments. Ordinarily, the financial risk in a market, and hence the risk to the economy at large, is limited because the assets traded are finite. There are only so many houses, mortgages, shares of stock, bushels of corn or barrels of oil in which to invest. But a synthetic instrument has no real assets. It is simply a bet on the performance of the assets it references. That means the number of synthetic instruments is limitless, and so is the risk they present to the economy. Synthetic structures referencing high-risk mortgages garnered hefty fees for Goldman Sachs and other investment banks. They assumed an ever-larger share of the financial markets, and contributed greatly to the severity of the crisis by magnifying the amount of risk in the system.

Increasingly, synthetics became bets made by people who had no interest in the referenced assets. Synthetics became the chips in a giant casino, one that created no economic growth even when it thrived, and then helped throttle the economy when the casino collapsed.

But Goldman Sachs did more than earn fees from the synthetic instruments it created. Goldman also bet against the mortgage market, and earned billions when that market crashed. In December 2006, Goldman decided to move away from its "long" positions in the mortgage market in what began as prudent hedging against the firm's large exposure to that market, exposure that sparked concern on the part of the firm's senior executives. The edict from top management after a Dec. 14, 2006 meeting was "get closer to home," meaning get to a more neutral risk position. But by early 2007, the company blew right past a neutral position on the mortgage market and began betting heavily on its decline, often using complex financial instruments, including synthetic collateralized debt obligations, or CDOs.

Goldman took large net short positions throughout 2007. This chart, which is based upon data supplied to the Subcommittee by Goldman Sachs, tracks the firm's ongoing huge net short positions throughout the year. These short positions at one point represented approximately 53% of the firm's risk as measured by the most relied upon risk measure, "Value at Risk" or "VaR." And these short positions did more than just avoid big losses for Goldman. They generated a large profit for the firm in 2007.

Goldman says these bets were just a reasonable hedge. But internal documents show it was more than a reasonable hedge – it was what one top executive described as "the big short."

Listen to a top Goldman mortgage trader, Michael Swenson, who touted his success in 2007, what he called his "proudest year" because of what he called "extraordinary profits" – $3 billion as of September 2007 – that came from bets he recommended the firm take against the housing market. Mr. Swenson told his superiors, "I was able to identify key market dislocations that led to tremendous profits."

Another Goldman mortgage trader, Joshua Birnbaum, wrote in his performance evaluation about the billions of dollars in profits earned in 2007 betting against the mortgage market. "The prevailing opinion within the department was that we should just 'get close to home' and pare down our long," he wrote. He then touted the fact that he had urged Goldman Sachs "not only to get flat, but get VERY short." He wrote that after convincing his superiors to do just that, "we implemented the plan by hitting on almost every single name CDO protection buying opportunity in a 2-month period. Much of the plan began working by February as the market dropped 25 points and our very profitable year was under way." When the mortgage market collapsed in July, he said: "We had a blow-out [profit and loss] month, making over $1Bln that month."

These facts end the pretense that Goldman's actions were part of its efforts to operate as a mere "market-maker," bringing buyers and sellers together. These short positions didn't represent customer service or necessary hedges against risks that Goldman incurred as it made a market for customers. They represented major bets that the mortgage securities market – a market Goldman helped create – was in for a major decline.

Goldman continues to deny that it shorted the mortgage market for profit, despite the evidence. Why the denial? My best estimate is that it's because the firm cannot successfully continue to portray itself as working on behalf of its clients if it was selling mortgage related products to those clients while it was betting its own money against those same products or the mortgage market as a whole. The scope of this conflict is reflected in an internal company email sent on

May 17, 2007, discussing the collapse of two mortgage-related instruments, tied to WaMu-issued mortgages, that Goldman helped assemble and sell. The "bad news," a Goldman employee says, is that the firm lost $2.5 million on the collapse. But the "good news," he reports, is that the company had bet that the securities would collapse, and made $5 million on that bet. They lost money on the mortgage related products they still held, and of course the clients they sold these products to lost big time. But Goldman Sachs also made out big time in its bet against its own products and its own clients. Goldman CEO Lloyd Blankfein summed it up this way: "Of course we didn't dodge the mortgage mess. We lost money, then made more than we lost because of shorts." The conflict of interest that lies behind that statement is striking.

The Securities & Exchange Commission has filed a civil complaint alleging that in another transaction, involving a product called Abacus 2007-AC1, Goldman violated securities law by misleading investors about a mortgage-related financial instrument.

The SEC's complaint alleges that Goldman Sachs in effect helped stack the deck against the buyers of the instrument it sold. The hedge fund that bought the short position in the transaction – in other words, that bet that the product would not perform well – helped select the mortgages that were to be referenced in the product that Goldman sold to investors. The SEC alleges that Goldman Sachs knew of the hedge fund's selection role and failed to disclose it to the other Abacus investors, who thought the package had been designed to succeed, not fail. We learned in last week's hearing that Goldman also failed to disclose the hedge fund's role to the credit rating agency that rated the Abacus deal. Eric Kolchinsky, who oversaw the ratings process at Moody, testified before the Subcommittee, "It just changes the whole dynamic on the structure, where the person who is putting it together, choosing it, wants it to blow up."

The SEC and the courts will resolve the legal question of whether Goldman's actions broke the law. The question for us is one of ethics and policy: Were Goldman's actions in 2007 appropriate, and if not, should we act to bar similar actions in the future?

Abacus may be the best-known example of conflicts of interest revealed in the Goldman documents, but it is far from the only example. Anderson Mezzanine Funding 2007-1 was a synthetic product assembled by Goldman. According to company documents, a Goldman client had expressed interest in taking a short position in the transaction, but an executive noted that Dan Sparks, the head of Goldman's mortgage department, might "[want] to preserve that ability for Goldman." This suggests that not only was Goldman going to bet against the instrument that it was selling, but it wanted to make that bet badly enough that it took the bet for itself instead of letting an interested client have it. It then sold Anderson securities to its clients, without disclosing that it would profit if those securities suffered losses.

Client loyalty fell so far that one Goldman employee cited his refusal to assist Goldman clients facing losses from a Goldman financial product as performance that should be rewarded. Mr. Swenson wrote to his superiors in his performance review: "I said 'no' to clients who demanded that GS should 'support the GSAMP program," Goldman Sachs' subprime mortgage-backed security program. Mr. Swenson wrote that saying "no" to clients who asked Goldman to support a security it had sold them were "unpopular positions but they saved the firm hundreds of millions of dollars."

Most investors make the assumption that people selling them securities want those securities to succeed. That's how our markets ought to work, but they don't always. The Senators who in the 1930s investigated the causes of the Great Depression stated the principle clearly:

> "[Investors] must believe that their investment banker would not offer them the bonds unless the banker believed them to be safe. This throws a heavy responsibility upon the banker. He may and does make mistakes. There is no way that he can avoid making mistakes because he is human and because in this world, things are only relatively secure. There is no such thing as absolute security. But while the banker may make mistakes, he must never make the mistake of offering investments to his clients which he does not believe to be good."

Goldman documents make clear that in 2007 it was betting heavily against the housing market while it was selling investments in that market to its clients. It sold those clients high-risk mortgage-backed securities and CDOs that it wanted to get off its books in transactions that created a conflict of interest between Goldman's bottom line and its clients' interests.

These findings are deeply troubling. They show a Wall Street culture that, while it may once have focused on serving clients and promoting commerce, is now all too often simply self-serving. The ultimate harm here is not just to clients poorly served by their investment bank. It's to all of us. The toxic mortgages and related instruments that these firms injected into our financial system have done incalculable harm to people who had never heard of a mortgage-backed security or a CDO, and who have no defenses against the harm such exotic Wall Street creations can cause.

Running through our findings and these hearings is a thread that connects the reckless actions of mortgage brokers at WaMu with market-driven credit rating agencies and the Wall Street executives designing the next synthetic. That thread is unbridled greed, and the absence of a cop on the beat to control it.

As we speak, lobbyists fill the halls of Congress, hoping to weaken or kill legislation aimed at reforming these abuses. Wall Street is on the wrong side of this fight. It insists that reining in its excesses would unduly restrict a free market that is the engine of American progress. But this market isn't free of self-dealing or conflict of interest. It is not free of gambling debts that taxpayers end up paying.

I hope the executives before us today, and their colleagues on Wall Street, will recognize the harm that their actions have caused to so many of their fellow citizens. But whether or not they take responsibility for their role, I hope this Congress will follow the example of another Congress, eight decades ago, and enact the reforms that will put a cop back on the Wall Street beat.

I would like to thank my ranking member, Sen. Coburn, who is carrying out a very important responsibility at the White House this morning and who will join us later, for his support and that of his staff, and I recognize the acting ranking member, Sen. Collins, and welcome her remarks.