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Goldman Sachs Fiasco: What it Means to You

By Bert Whitehead M.B.A, J.D. © 2012

It is about time we called it like it is....The ethical standards of financiers across the board are notorious for being somewhere between lax and non-existent. This is so ingrained that most firms dealing don't even think that their behavior is errant.

Goldman Sachs is now the pimple getting squeezed by the feds. Their firm is notable in the acne scarred financial landscape only because their greed duped even their peers beyond prior boundaries. Their financial practices are held up as the cause of the current economic meltdown, but in fact Goldman's executives are not feigning surprise.

Looking back at who caused the current bubble is a charade of shady practices instilled in virtually all the players in the money game. The bubble was kicked off by the politicians in 1999 with the repeal of the Glass-Steagall act. This was pushed by Clinton and endorsed by the then-Republican congress to free banks to participate in the full smorgasbord of financial offerings. Instead of just providing savings accounts and direct lending, now they could offer brokerage services, securitize debts on the secondary market, act like venture capitalists, etc., just like the big wirehouses. It was expected that this would create more competition.

So our current tragedy was birthed by the best of political intentions which seemed like a good idea at the time. Instead, as often happens when the government tries to effectuate public policy, they accomplished the exact opposite of what was intended.

There was a strong social policy, backed by both parties (as well as Acorn), to make housing affordable to all Americans. The percentage of homeownership during the 90's expanded to almost 70%, up from 62% in the 1980's. Congress pressured Fannie May and Freddie Mac to loosen lending standards to accommodate the increased demand for families to own their own homes. These private mortgage companies had nothing to lose by taking more risk because they were essentially indemnified by the federal government.

Key to this was the bundling of mortgages to be sold on the secondary market. One problem, however, was there was no experience rating to judge the future performance of such an influx of sub-prime borrowers. Rating agencies over-rated these offerings using the inadequate information available, because they are paid by the folks selling these securities rather than the investors ultimately taking the risk.

This egregious conflict-of-interest has been an accepted practice for decades. Even when underwriters issuing stocks for companies were exposed, no meaningful changes were made. Instead, the brokerage companies (including not only Goldman Sachs, but Merrill Lynch, Smith Barney, etc.) simply started a new department within their firms

for their ratings business. This was justified because these new departments would be insulated by a ‘Chinese Wall’ so that investors could rely on their ratings. This was not only proposed with straight faces, I’m convinced the financial executives really believed that it was ‘business as usual’ and it would still enable them to sell new offerings.

With their mortgage bundles now over-rated, it was a good time to become a mortgage broker serving sub-prime borrowers. To put it gently, most sub-prime customers are not very financially savvy. A predatory mortgage broker would befriend the customer and offer to turn their dreams into reality. The commissions earned on these mortgages typically ranged from 6% to 12% of the full amount of the mortgage. They were constructed so that they were affordable at first, and buyers were assured that they would be able to re-finance in a few years, and the home values would continue to skyrocket.

These over-valued securities started getting wobbly when investors realized that more than the expected 4-5% of sub-prime borrowers were defaulting; the actual default rate even at the beginning was 10-15%. Like a game of ‘hot potato’ financial firms rushed to offload their failing mortgage bundles, and sold them to one another, and any one else. It’s not that they actively mislead other firms, but they didn’t provide full disclosure as to the risks which were becoming evident.

But why should they have to disclose risks, or conflicts of interest? When you listen to a Goldman Sachs executive explain their innocence, it’s like listening to a life insurance or annuity salesperson explain their commissions:

“How much in commissions do you earn on this sale?”
“Why do you need to know that? It has no relevance as to whether this is a great investment for you. Letting me put your money to work will more than cover my commission!”

The real problem here is that the financial industry does not believe they owe a fiduciary duty to their clients. A fiduciary duty means they have to make full disclosure of their fees and compensation, any conflicts of interest involved, as well as all the risks involved.

Yes, I am very biased on this issue because I think financial professionals should be held to the same fiduciary standards as doctors and even lawyers. This has been proposed in recent financial reforms, but the lobbies of the institution as is see no need to change because ‘this is the way business is done!”

Good grief.

N.B. This blog was originally written two years ago. My colleagues cautioned that it was too vicious to send out, so I put it away. With Goldman Sachs back in the news in this context, I brushed it off and had some of my family, friends and clients review it

again. They suggested I tone it down, but urged that it be published. So I am going ahead now.

Posted by Bert Whitehead at 9:19 AM 2 comments