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The Conversation

Is It Too Late for Goldman Sachs to Play Offense?

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by Ben W. Heineman, Jr.

What should you do to rehabilitate your general reputation if you are in Goldman Sachs' executive suite at 200 West Street in New York?

Beset by an SEC complaint, a criminal investigation, a Senate grilling, and the resulting loss in two weeks of more than \$20 billion in market capitalization, Goldman has assumed a defensive posture. This is so even though the firm just announced \$3.46 billion in first quarter earnings.

Both in response to the SEC and to Senate questioning, Goldman repeatedly said that what it had done in the past was legal and consistent with industry practice.

But just because something was "legal" in the past, doesn't mean it is "right" in the future. (See [my views from the morning of Goldman's Senate hearing at washingtonpost.com.](#))

Goldman must defend itself against charges when it believes that it acted lawfully with respect both to making a market for [synthetic CDOs](#) (the SEC complaint) and to hedging for balance sheet protection by going short as its long real estate positions started to deteriorate (the subject of much of the Senate hearing). This defense will take place over many months as the investigatory and enforcement processes unfold slowly.

But Goldman should immediately and simultaneously follow a second path: it must argue with equal force and visibility about its vision of what is the "right thing to do" in the financial services industry going forward. It should have the skill to do this by admitting mistakes, but not conceding illegality. (Obviously, if what Goldman did is found illegal in a final court judgment, then this strategy, along with a lot of other Goldman assets, will crater.)

What is "right" has two meanings. In light of the causes of the financial meltdown which nearly took the world economy over the cliff to a second Great Depression (rather than a Great Recession):

- What financial services firms should do differently as a matter of self-governance

- What new, appropriate U.S. and international financial industry regulations should be adopted to ensure the safety and soundness of the financial system and to avoid such catastrophic results in the future

As the U.S. and other nations move from a deregulated financial system to a system with stricter governmental requirements, the general public, opinion-makers, legislators, regulators and all those especially hard-hit by the recession want to understand future solutions, not just define past problems..

Goldman needs to present its vision about what is right because even a powerful financial franchise has to exist in society and cannot be the public whipping boy for Wall Street's failings (especially given the egregious mistakes of so many others). Goldman must also show the way for Wall Street to be integrated back into the real economy and demonstrate value to the nation, not just to the pocket-books of greedy bankers. Of course, given the steepness of the hill Goldman — and its industry — must climb, this could be a Sisyphean task.

One irony of the Goldman's current plight is that it has tried, on a number of occasions and in different forums, to make the case for what is "right" in the future.

Most notably, almost a year ago (on April 7, 2009), Lloyd Blankfein spoke to the Council of Institutional Investors. [His remarks](#) took place against the backdrop of the precipitous credit crisis in the fall of 2008 and the market swoon in the March of 2009.

The issues he addressed were critical. He described the failings of the financial sector: poor risk management, reliance on bad risk models, failure consistently to mark assets to market, insufficient appreciation of hedging and liquidity, overly complex products and poor compensation incentives. He argued that many of these failings needed to be corrected by financial institutions themselves with new systems, processes, management and leadership — and specifically set out compensation principles that were consistent with then-evolving approaches.

But he also frankly acknowledged that "self-regulation has its limits" and "elevating standards or driving the industry to a collective response requires effective central regulation and the convening power of regulators." He described the need for revised capital, liquidity, and underwriting standards, [fair value accounting](#), mechanisms to constrain systemic risk, enhanced transparency, some regulation of all pools of capital, including hedge funds and private equity, and international convergence and cooperation).

Blankfein was one of the first financial service industry leaders to speak with relative candor about what had happened and what needed to be done. His CII speech was viewed as a statesman-like effort that advanced the emotional debate about "whither financial services." It was followed by similar Goldman statements in its Annual Reports (both for 2008 and 2009), in op-ed pieces, in Congressional testimony and in January testimony before the Financial Crisis Inquiry Commission (which restated, in a bit more detail, important elements of financial

regulatory reform). But most of these efforts were couched in highly specialized language and not intended, or capable, of reaching a broader audience.

But perhaps an even greater irony is that, since that forward-looking April 2009 speech, Goldman's "reputational stock" has consistently declined (even as its actual stock sank, then recovered, only to sink again in the past two weeks). No doubt a business school case will be written to examine the sequence of events in depth, and to measure loss of reputation with various audiences. Even Blankfein has recently admitted that the firm had failed to establish a strong relationship with the public. Goldman's problems, prior to the SEC civil complaint and the DoJ criminal investigation, include the following:

— It announced robust revenues after the second quarter in 2009 (\$13.76 billion) but also reserved about 50 percent of that amount for compensation (in line with its historic practice). This reserve set off a firestorm of criticism, even though it was not a pay-out commitment. (Indeed, at the end of the year, Goldman used 36 percent of revenue for compensation, rather than 50 percent — not that anyone was starving.)

— It defensively set up a \$500 million facility last fall, to provide credit to small businesses not being served by smaller commercial banks, which received little notice or praise — a result that would have been far different had this action been taken at the time of the 2Q earnings.

— Blankfein made [unfortunate, insensitive, off-hand remarks \("God's work"\)](#) that received outsized attention.

— Goldman's very success in the midst of a great recession, with so much economic suffering all across the nation, made them a target, even though from a purely business perspective they had clearly outperformed their rivals, both in 2009 and during the stresses of 2008 (compare their real estate losses in single digit billions to the losses of other financial companies in the tens of billions). The growing populism on Main Street — reflected through the media and public officials — saw commercial success in 2009 as predatory, not admirable.

So, even as it defends itself, Goldman, as a good corporate citizen, needs to point the way about what is the "right" future for the financial services industry. It has always been considered the gold standard in the financial world. Its alumni go on to public service. It can be true to its traditions by articulating such a vision. But that vision needs to be credible and detailed — and it can only meet those conditions if the vision also involves changes which have an impact on firm results in the service of a greater financial and societal good. For example:

Goldman needs to describe effectively the steps it has taken, inside the firm since the credit melt-down to manage risk, ensure an independent risk function, redesign compensation, mark-to-market. But most importantly, it needs to explain its different activities — advisor, financier, market maker, asset manager and co-investor — and the different kinds of obligations

and responsibilities it has to the parties engaged in such activities as well as to society. It sought, in [this year's annual report](#), to address these issues to some degree, but it is now time to find a forceful way of articulating its different functions and different types of duties to different types of "clients."

In particular, it may need to say that, in its role as market maker, there are some types of markets — e.g., the \$132 billion market in now-worthless synthetic CDOs — which have no relationship to the real economy and have little social utility. (Goldman helped create about 10 percent, \$13.9B, of the synthetic CDO total.) It needs to get out front on what are appropriate and inappropriate instruments in this lucrative market-making activity, especially credit derivatives, which can introduce significant risk into the financial system.

Lloyd Blankfein's [written testimony before the Senate Permanent Subcommittee on Investigations](#) was brief and unilluminating on this fundamental subject (as was the technical, prepared testimony of his colleagues). Operating from its defensive posture, the firm missed an opportunity to deliver a strong and positive message. Moreover, Blankfein's answers to the Senator's questions (admittedly inflammatory for the cameras) were surprisingly fractured and, at times, incoherent (he had a hard time differentiating for Senator Levin the difference between Goldman's role as market-maker for others and its own hedging to protect its financial soundness — and to avoid going the way of failed financial institutions).

Goldman also needs forcefully to restate its support for significant financial services legislation, as the Senate moves to final debate. At the hearing, Blankfein told Senator Coburn that legislation was "absolutely essential," although this remark went unreported. And said he supported reform legislation because it would make financial markets safer, which was good for Goldman and for the nation. On issues where Goldman has a strong and direct interest — too big to fail, systemic risk, capital and liquidity requirements, transparency (especially on off-balance-sheet vehicles), derivatives, consistency in accounting — it needs to stand up, take positions (and explain them in plain English) which support a meaningful bipartisan consensus and which accept the obvious — the bill will necessarily be imperfect in its parts but necessary as a whole to enhance financial safety and soundness.

Even if Goldman were to find a proper forum and a forceful way to express what is right for the future of the financial services industry, it may well be too late to have much immediate effect on its reputation. Given the SEC and DoJ actions against it, any statements now will be viewed cynically as simply self-serving (although its changes and affirmative message may point the way to a civil resolution). It is not clear whether Lloyd Blankfein is still an effective messenger for a positive message, as he was a year ago in his CII speech. It may be impossible to have a fair hearing or enough "space" in the media, given the herd mentality moving against Goldman. The subject matter is complex, and in a fractured political culture, characterized by anger and distemper, communicating positions on difficult subjects may just not be possible.

There are, in sum, reasons why Goldman could decide not to adopt a strategy emphasizing what is "right" for the future and just stay with the approach of "it was legal in the past," given

the hole in which it finds itself. But, even if the chances of short-term impact of the "it is right" strategy are slim among external constituencies, that strategy is still worth pursuing because the damage to date is so great. Such a strategy is also the appropriate course of action in the long run for Goldman Sachs itself: for its own self-image, for its morale and for the firm's tradition as a leader, not a laggard, in the financial services industry.

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