The Washington Post

With SEC charges, Goldman Sachs's reputation is tarnished

By Felix Salmon
Sunday, April 25, 2010; B05

On May 4, 1999, Henry Paulson rang the opening bell at the New York Stock Exchange, and Goldman Sachs became a public company for the first time in its 130-year history. Paulson, chief executive and chairman of the board, was suddenly worth more than $260 million. But going public wasn't just about giving Goldman's partners 50 percent ownership of a very valuable public company. It was also about removing from them the unlimited liability for which they had been on the hook up until that point, in the event that Goldman ever lost money.

The 11 years since that day have been long ones for Goldman Sachs. There was the dot-com crash, and the housing bubble, and then the global financial meltdown, which saw Goldman forced to accept $25 billion in bailout funds. In September 2008, Goldman gave up its coveted investment bank status to become a bank holding company, submitting to the oversight of New York state's banking regulator as well as that of the Federal Reserve. At the time, there was much talk of "the end of Wall Street" -- but at Goldman, the record profits continued to roll in, thanks to diminished competition and the Fed's extremely bank-friendly monetary policy.

Goldman Sachs is now worth $83 billion, $50 billion more than 11 years ago. By this yardstick -- the only one Wall Street seems to care about -- Paulson's decision to go public was a great success. But now, with the firm under attack from the Securities and Exchange Commission, which has accused it of fraudulently misleading investors in a 2007 deal, it is finally clear how far Goldman truly has fallen since 1999.

No longer does the company inhabit an exalted place in the financial-services firmament. With a single filing, the SEC has revealed that underneath its impassively urbane exterior, Goldman Sachs is no better than the rest of Wall Street. Bear Stearns, the scrappy bank that had always seemed to be Goldman's polar opposite, actually turned down the deal that the SEC is focusing on, saying it just wasn't right. The complaint paints a picture of sleazy, untrustworthy bankers -- and it's that picture, more than the legal charges themselves, that has toppled Goldman from its pedestal.

For some time, many close observers have realized that this kind of thing was probably going on. After Paulson became George W. Bush's last and most powerful Treasury secretary in 2006, he was replaced at the firm by Lloyd Blankfein, who took home a record $68 million paycheck in 2007. That's not the kind of money that can be made by giving valuable and impartial advice to clients with whom you have a long and storied relationship. Instead, it's the kind of money that comes from leverage and aggression and trillions of dollars' worth of simple and complex trades in hundreds of markets and dozens of countries around the world.

Blankfein is by no means the first trader to run Goldman Sachs, although he might be the purest: He started in the company's J. Aron commodity-trading arm, a business that doesn't have clients so much as counterparties and where rectitude gets you nowhere. The thing that matters most when you're trading commodities is what your prices are and whether you're making money. You rarely even know the identities of the people you're trading with.

When Blankfein took over Goldman, he married a born trader's natural pugnacity to the firm's venerable name; the combination was fearsome and unbeatable. Goldman was the IBM of investment banks, the firm that no one ever got fired for hiring. It was the firm, often nicknamed "Government Sachs," where the walls between commerce and politics were so porous as to be almost nonexistent, where key technocrats moved effortlessly between Washington and company headquarters. It was never flashy -- to this day, it has refused even to put its name on the outside of its headquarters -- and it generally lived up to its mantra of "long-term greed": Do right by your clients, the idea went, and ultimately you will do very well by yourself.

Without its clients' trust, the Goldman franchise crumbles, and the bank becomes just an ordinary trading shop. No longer can it charge a premium for its mergers and acquisitions advisory services, or its stock and bond underwriting, or its customized structured products. To put it in baseball terms, it has lost what another storied franchise, the Yankees, so closely guards -- its mystique and aura.

The seeds of all this were sewn on that fateful day in 1999 when Goldman changed from a tight-knit partnership to a public company with quarterly earnings reports and a new appetite for record profits and growth. There was nothing beautiful about small anymore: Goldman's balance sheet, which grew from $100 billion in 1995 to $250 billion in 1999, was more than $1.1 trillion by 2007 -- it had more than $36 million in assets for every employee.

A partnership would never, could never, have $1 trillion in assets. The risk is too great: A 10 percent drop in the value of your assets would mean a $100 billion loss, or about $450 million per partner. Individuals are risk-averse and much prefer to build their wealth slowly, by charging high fees for high-quality service, rather than to risk all.

But when Goldman went public, that changed. The senior executives were now at risk only to the extent that they were also shareholders. What's more, by growing so enormous, Goldman became "too big to fail" and could therefore take on massive risk, safe in the knowledge that if things went spectacularly wrong, the government would step in.

And that's exactly what Goldman did. The traditional investment bankers, and anybody else who earned income off client fees, became marginalized; the traders, who leveraged the bank's own funds as aggressively as they could and who made multibillion-dollar bets with other people's money, ended up running the shop. That was what made money, and what drove Goldman's quarterly earnings ever higher. But something important was lost: client focus, and the natural caution and restraint that come with owning your company rather than simply working for it, and from measuring the time horizon in decades rather than in quarters.

The SEC, in making its complaint public instead of trying to quietly settle with Goldman, has used its subpoena power to put an end to the firm's reputation once and for all. Among other things, the agency uncovered a series of damningly glib e-mails from a trader who referred to himself as "the fabulous Fab."

And so far, Goldman's desperate response has only made matters worse. It tried to paint a veteran saleswoman as someone who couldn't understand simple e-mails about corporate structure. It used the word "sophisticated" 18 times in a single document, trying to shift the blame onto the victims of its scheme, because, well, they were sophisticated. And when its general counsel came onto its quarterly earnings call last Tuesday, he refused to answer most questions. The overriding impression Goldman is creating is one of a panicked company caught with its pants down -- not of a professional banking organization rising effortlessly above the fray.

Goldman's clients have known for years that the long-term-greedy investment bankers of the past were being marginalized by the short-term-greedy traders who have taken over the company's upper echelons. But the company's mystique overwhelmed this knowledge. Clients flocked to Goldman anyway, sometimes against their better judgment.

They won't be doing that anymore: Goldman's competitors will make sure of it. On the Friday that the SEC charges were announced, and again on the following Sunday, Blankfein left voicemail messages for all the firm's employees, saying, in his characteristically combative way, that Goldman would fight the charges.

But those weren't the calls that really mattered. The truly important conversations were taking place in the boardrooms of Goldman's clients, and between those clients and bankers at rival shops. Have you read the complaint? they asked -- and the answer was always yes. And do you still trust Goldman Sachs? The answer to that was no.

Felix Salmon is the finance blogger at Reuters.

From the archives: For recent Outlook coverage of the financial crisis, see "How to reduce risk on Wall Street? Make the banks pay." (April 11) by Matthew Richardson and Nouriel Roubini, and "To battle Wall Street, Obama should channel Teddy Roosevelt" (April 4) by Simon Johnson and James Kwak.