Testimony of Lloyd C. Blankfein
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House Committee on Financial Services
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Chairman Frank, Ranking Member Bachus, and Members of the Committee:

I appreciate the opportunity to appear before you today to provide information with respect to Goldman Sachs' use of the investment that we received under the TARP Capital Purchase Program.

It is abundantly clear that we are here amidst broad public anger at our industry. In my 26 years at Goldman Sachs, I have never seen a wider gulf between the financial services industry and the public. Many people believe – and, in many cases, justifiably so – that Wall Street lost sight of its larger public obligations and allowed certain trends and practices to undermine the financial system's stability.

The fact is that all of us are contending with the consequences of a deteriorating economy; lost jobs, lost orders, and lost confidence. Our industry simply cannot sustain itself without a healthy, resilient economy. And, Main Street cannot prosper without financial institutions that are strong enough to provide capital to entrepreneurs, businesses and consumers.

We have to regain the public's trust and do everything we can to help mend our financial system to restore stability and vitality. Goldman Sachs is committed to doing so.

The TARP Capital Purchase Program And Our Role in the Capital Markets

We take our responsibility as a recipient of TARP funds very seriously. We view the TARP as important to the overall stability of the financial system and, therefore, important to Goldman Sachs. This capital, combined with the more than $10.75 billion of capital we raised three weeks before receiving the TARP funds, gives us an even stronger balance sheet and increases our ability to inject liquidity across markets and extend capital to our clients.

In that vein, the Committee has asked for our understanding of the purpose of the TARP assistance. We understood that the capital we and other institutions received was designed to promote the safety and soundness of institutions deemed important to the functioning of the financial system. Adequately capitalized, these institutions would have the wherewithal to promote the flow of credit amidst potentially deteriorating economic conditions.

In terms of the planned use for the funds prior to their receipt, we were not anticipating any injection of capital from the Treasury. On September 23rd, Goldman Sachs raised $5 billion from Warren Buffett. The following day, we raised another $5.75 billion in a common stock offering, and could have raised more as the offering was substantially oversubscribed. On October 14th, the Treasury Department announced the Capital Purchase Program (CPP).

We are actively putting our capital to work. Goldman Sachs serves a number of important roles for our clients, including that of advisor, financier, market maker, asset manager and co-investor. Our business is institutionally dominated, with the vast majority of our capital commitments made on behalf of corporations and institutional investors. We are not engaged in traditional commercial banking and are not a significant lender to consumers.

As a financial institution focused on this "wholesale" client base, Goldman Sachs actively provides liquidity to institutions which helps the capital markets function. In short, our businesses require that we commit capital, and our ability to do so has been enhanced since receiving capital under the Capital Purchase Program.

First, through our role as a financier, clients frequently expect our advice to be accompanied by access to the capital necessary to make that advice actionable and practical. For instance, we often provide back-stop or contingent credit, such as a commitment to make a bridge loan until other sources of more permanent capital can be arranged.

Since receiving the $10 billion of capital on October 27th and through January 2009, Goldman Sachs has committed over $13 billion in new financing to support our clients. This compares with $4.5 billion in the three months prior to receiving the government's investment.

For example, we put our capital to work on behalf of Sallie Mae to allow them to provide more than $1.5 billion of student loans. We made a significant investment in the C.J. Peete Apartments Housing Complex, a mixed-income housing project in New Orleans. We also committed capital to Verizon Wireless, Pfizer and a number of other significant corporations.

As a market maker, we provide the necessary liquidity to ensure that buyers and sellers can complete their trades. In dislocated markets, we are often required to deploy capital to hold client positions over a longer term while a transaction is completed.

In recent months, this has been especially true as we have helped our corporate and investing clients manage their exposure to interest rate risk, swings in commodity prices and movements in currencies. More broadly, we have seen widespread de-leveraging. As institutional investors reduce their various risk exposures, they turn to firms like Goldman Sachs, which play the role of intermediary. This ability to help our clients effectively manage their risk requires the active and significant commitment of capital.

Last month, for instance, we provided short-term liquidity to a portion of the mortgage market through a large agency mortgage transaction. This significant extension of our capital helped keep mortgage rates from increasing by allowing billions of dollars of mortgage securities to be financed.

Additionally, the role we play as a specialist and market maker in NYSE listed stocks has grown increasingly significant, particularly in volatile markets when liquidity demands are higher. For instance, in certain shares, our specialist business may account for nearly one-quarter of total trading in a particular stock.

We also recognize the importance of being an active co-investor with our clients. Over the summer, we established a $10.5 billion senior loan fund which makes loans to companies in need of capital. The fund invests both our own capital and that of our clients. This is significant because, in many cases, the normal market mechanisms to facilitate the extension of credit in many areas have broken down. Investors are wary of credit ratings and are reluctant to invest their own money directly. They are looking for some assurance of quality before they are willing to commit capital.

Through this fund, each dollar that Goldman Sachs commits is multiplied many times over as we attract capital from our clients. Already, the fund has made approximately $5 billion in loan commitments.

In the next year, Goldman Sachs intends to launch additional funds to inject capital across the corporate capital structure. These funds will extend needed capital to a variety of companies whose growth opportunities would otherwise be limited in this extremely tight credit environment.

In addition to how we are using the TARP funds, the Committee asked if we are tracking the investment, and if so, how.

We have been tracking the level of capital we commit on behalf of our clients since we received the funds under the CPP. As I indicated earlier, we have made over $13 billion of capital commitments since October 27th, and this amount doesn't include the capital we extend as a market intermediary and co-investor. That compares with $4.5 billion in the same period before we received the investment.

First, we have a Capital Committee which reviews and approves all transactions involving commitments of the Firm's capital. The committee is comprised of our most senior people.

The Committee prepares a weekly report, tracking capital commitments made and those pending. It looks at previous week, monthly and quarterly levels to gauge the level of commitments we have made. Each week, a senior leadership group, including me, reviews the level of capital commitments. Of course, the goal is not to blindly lend or commit to lend money, but if volumes change significantly, senior management gets directly involved with the relevant businesses to understand the reasons.

In terms of the expectations and conditions communicated on receipt of TARP investment, they are laid out in the Securities Purchase Agreement and encompass provisions with respect to dividend restrictions, redemptions, repurchases and executive compensation.

Lastly, the Committee has asked us to address our compensation policies and practices. Since we became a public company, we have had a clear and consistent compensation policy. We pay our people based on three factors (1) the performance of the firm; (2) the performance of the business unit; and (3) the performance of the individual.

We believe this approach has incentivized our people to act in a way that supports the firm as a whole and not be parochial or narrow minded about their specific division or business unit. More broadly, it has produced a strong relationship between compensation and performance.

Since going public in 1999, Goldman Sachs has exhibited a near perfect correlation between changes in net revenues and compensation. From 2000 to 2007, Goldman Sachs has produced a compounded annual growth rate of over 20 percent in earnings per share and 16 percent in book value per share. Adjusted for increased head count over the period, aggregate compensation expense has increased less than 10 percent per year.

For our nine full years as a public company, which includes an exceptionally difficult 2008, Goldman Sachs generated an average return on equity of approximately 21 percent for our shareholders.

While the firm produced a profit of $2.2 billion in 2008, our revenues were down considerably. Compensation across the firm, dictated by our policies and practices, reflected that. End of year bonuses were down on average 65 percent. Our most senior people -- the firm's approximately 417 partners -- were down approximately 75 percent.

The bulk of compensation for our senior people is in the form of stock, which vests over time. I would also note that Goldman Sachs has never had golden parachutes, employment contracts or severance arrangements for its executive officers.

Although we believe our policies and practices have proven to be effective in setting compensation, we also recognize that having TARP money creates an important context for compensation. That is why, in part, our executive management team requested not to receive a bonus in 2008, even though the firm produced a profit.

Going forward, we should apply basic standards to how we compensate people in our industry. The percentage of the discretionary bonus awarded in equity should increase significantly as an employee's total compensation increases. An individual's performance should be evaluated over time so as to avoid excessive risk taking. To ensure this, all equity awards need to be subject to future delivery and/or deferred exercise. And, senior executive officers should be required to retain most of the equity they receive until at least they retire, and equity delivery schedules should continue to apply after the individual has left the firm.

Conclusion:

Mr. Chairman, our firm recognizes the extraordinary support the government has provided to the financial markets and to our industry. We will live up to the spirit and letter of the responsibilities our regulators, the Congress and the public expect of us. And we will do so whether we still have TARP funds or not.

While mindful of the fragility of market conditions, Goldman Sachs' financial position is sound. Given the reduction in our risk exposures in 2008, immaterial direct consumer exposure, and strong capital and liquidity levels, we believe we are well-positioned to continue to commit capital as a financier, market maker and co-investor to and with our clients.

We appreciate that the TARP funds were never intended to be permanent capital. When conditions allow and with the support of our regulators and the Treasury, we look forward to paying back the government's investment so that money can be used elsewhere to support our economy.

Do not destroy the essential catalyst of risk

By Lloyd Blankfein

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Since the spring, and most acutely this autumn, a global contagion of fear and panic has choked off the arteries of finance, compounding a broader deterioration in the global economy.

Much of the past year has been deeply humbling for our industry. People are understandably angry and our industry has to account for its role in what has transpired.

Financial institutions have an obligation to the broader financial system. We depend on a healthy, well-functioning system but we failed to raise enough questions about whether some of the trends and practices that had become commonplace really served the public’s long-term interests.

As policymakers and regulators begin to consider the regulatory actions to be taken to address the failings, I believe it is useful to reflect on some of the lessons from this crisis.

The first is that risk management should not be entirely predicated on historical data. In the past several months, we have heard the phrase “multiple standard deviation events” more than a few times. If events that were calculated to occur once in 20 years in fact occurred much more regularly, it does not take a mathematician to figure out that risk management assumptions did not reflect the distribution of the actual outcomes. Our industry must do more to enhance and improve scenario analysis and stress testing.

Second, too many financial institutions and investors simply outsourced their risk management. Rather than undertake their own analysis, they relied on the rating agencies to do the essential work of risk analysis for them. This was true at the inception and over the period of the investment, during which time they did not heed other indicators of financial deterioration.

This over-dependence on credit ratings coincided with the dilution of the coveted triple A rating. In January 2008, there were 12 triple A-rated companies in the world. At the same time, there were 64,000 structured finance instruments, such as collateralised debt obligations, rated triple A. It is easy and appropriate to blame the rating agencies for lapses in their credit judgments. But the blame for the result is not theirs alone. Every financial institution that participated in the process has to accept its share of the responsibility.

Third, size matters. For example, whether you owned $5bn or $50bn of (supposedly) low-risk super senior debt in a CDO, the likelihood of losses was, proportionally, the same. But the consequences of a miscalculation were obviously much bigger if you had a $50bn exposure.

Fourth, many risk models incorrectly assumed that positions could be fully hedged. After the collapse of Long-Term Capital Management and the crisis in emerging markets in 1998, new products such as various basket indices and credit default swaps were created to help offset a number of risks. However, we did not, as an industry, consider carefully enough the possibility that liquidity would dry up, making it difficult to apply effective hedges.

Fifth, risk models failed to capture the risk inherent in off-balance sheet activities, such as structured investment vehicles. It seems clear now that managers of companies with large off-balance sheet exposure did not appreciate the full magnitude of the economic risks they were exposed to; equally worrying, their counterparties were unaware of the full extent of these vehicles and, therefore, could not accurately assess the risk of doing business.

Sixth, complexity got the better of us. The industry let the growth in new instruments outstrip the operational capacity to manage them. As a result, operational risk increased dramatically and this had a direct effect on the overall stability of the financial system.

Last, and perhaps most important, financial institutions did not account for asset values accurately enough. I have heard some argue that fair value accounting – which assigns current values to financial assets and liabilities – is one of the main factors exacerbating the credit crisis. I see it differently. If more institutions had properly valued their positions and commitments at the outset, they would have been in a much better position to reduce their exposures.

For Goldman Sachs, the daily marking of positions to current market prices was a key contributor to our decision to reduce risk relatively early in markets and in instruments that were deteriorating. This process can be difficult, and sometimes painful, but I believe it is a discipline that should define financial institutions.

As a result of these lessons and others that will emerge from this financial crisis, we should consider important principles for our industry, for policymakers and for regulators. For the industry, we cannot let our ability to innovate exceed our capacity to manage. Given the size and interconnected nature of markets, the growth in volumes, the global nature of trades and their cross-asset characteristics, managing operational risk will only become more important.

Risk and control functions need to be completely independent from the business units. And clarity as to whom risk and control managers report to is crucial to maintaining that independence. Equally important, risk managers need to have at least equal stature with their counterparts on the trading desks: if there is a question about the value of a position or a disagreement about a risk limit, the risk manager's view should always prevail.

Understandably, compensation continues to generate a lot of anger and controversy. We recognise that having troubled asset relief programme money creates an important context for compensation. That is why, in part, our executive management team elected **not to receive a bonus in 2008**, even though the firm produced a profit.

More generally, we should apply basic standards to how we compensate people in our industry. The percentage of the discretionary bonus awarded in equity should increase significantly as an employee's total compensation increases. An individual's performance should be evaluated over time so as to avoid excessive risk-taking. To ensure this, all equity awards need to be subject to future delivery and/or deferred exercise. Senior executive officers should be required to retain most of the equity they receive at least until they retire, while equity delivery schedules should continue to apply after the individual has left the firm.

For policymakers and regulators, it should be clear that self-regulation has its limits. We rationalised and justified the downward pricing of risk on the grounds that it was different. We did so because our self-interest in preserving and expanding our market share, as competitors, sometimes blinds us – especially when exuberance is at its peak. At the very least, fixing a system-wide problem, elevating standards or driving the industry to a collective response requires effective central regulation and the convening power of regulators.

Capital, credit and underwriting standards should be subject to more "dynamic regulation". Regulators should consider the regulatory inputs and outputs needed to ensure a regime that is nimble and strong enough to identify and appropriately constrain market excesses, particularly in a sustained period of economic growth. Just as the Federal Reserve adjusts interest rates up to curb economic frenzy, various benchmarks and ratios could be appropriately calibrated. To increase overall transparency and help ensure that book value really means book value, regulators should require that all assets across financial institutions be similarly valued. Fair value accounting gives investors more clarity with respect to balance sheet risk.

The level of global supervisory co-ordination and communication should reflect the global inter-connectedness of markets. Regulators should implement more robust information sharing and harmonised disclosure, coupled with a more systemic, effective reporting regime for institutions and main market participants. Without this, regulators will lack essential tools to help them understand levels of systemic vulnerability in the banking sector and in financial markets more broadly.

In this vein, all pools of capital that depend on the smooth functioning of the financial system and are large enough to be a burden on it in a crisis should be subject to some degree of regulation.

After the shocks of recent months and the associated economic pain, there is a natural and appropriate desire for wholesale reform of our regulatory regime. We should resist a response, however, that is solely designed around protecting us from the 100-year storm. Taking risk completely out of the system will be at the cost of economic growth. Similarly, if we abandon, as opposed to regulate, market mechanisms created decades ago, such as securitisation and derivatives, we may end up constraining access to capital and the efficient hedging and distribution of risk, when we ultimately do come through this crisis.

Most of the past century was defined by markets and instruments that fund innovation, reward entrepreneurial risk-taking and act as an important catalyst for economic growth. History has shown that a vibrant, dynamic financial system is at the heart of a vibrant, dynamic economy.

We collectively have a lot to do to regain the public's trust and help mend our financial system to restore stability and vitality. Goldman Sachs is committed to doing so.

The writer is chief executive of Goldman Sachs