Yale SCHOOL OF MANAGEMENT
Program on Financial Stability

EliScholar – A Digital Platform for Scholarly Publishing at Yale

YPFS Resource Library

7-1-2010

Testimony by David A. Viniar Before the FCIC

David Viniar

https://elischolar.library.yale.edu/ypfs-documents/6450

This resource is brought to you for free and open access by the Yale Program on Financial Stability and EliScholar, a digital platform for scholarly publishing provided by Yale University Library.
For more information, please contact ypfs@yale.edu.

Testimony from David A. Viniar
Chief Financial Officer
The Goldman Sachs Group, Inc.
Before The Financial Crisis Inquiry Commission
July 1, 2010

Chairman Angelides, Vice Chairman Thomas and Members of the Commission:

I appreciate the opportunity to appear before you and contribute to the Commission's work on understanding some of the causes of the financial crisis. I will focus my comments on our risk management practices, including the use of derivatives, and how we managed our exposure to AIG.

As a global investment bank and financial intermediary, Goldman Sachs integrates advice, financing, market-making, co-investing and asset management with its risk management capabilities to serve a broad range of largely institutional clients.

When we commit capital to buy or sell financial instruments or extend credit, we accumulate both long and short positions – in the form of assets and liabilities and contingent exposures – that have implications for our liquidity, credit and market risks.

We deploy a range of risk management capabilities to keep the firm's overall exposures within carefully prescribed risk limits and establish off-setting positions (hedges) or sell and buy positions as necessary to control overall exposure to adverse developments.

Derivatives are a very important part of any risk management strategy. Non-financial companies in many different sectors use them to manage a wide range of financial and business risks. Financial institutions use derivatives to manage their own funding, help clients manage a range of risk exposures and help manage their own risks.

With respect to Goldman Sachs's own funding, we enter into derivatives contracts to manage the interest rate and currency exposures on our long-term borrowings and certain short-term borrowings, and to manage currency exposure on our net investment in non-U.S. operations. As a core service to our clients, we enter into derivatives contracts to help them manage interest rate, currency, equity, commodity or credit exposures. We then use derivatives to manage our own positions as we take the other side of contracts on our clients' behalf.

With regard to revenues and profits from derivatives, it is important to underscore that we, generally, do not have a "derivatives business." Rather, derivatives are risk management instruments integrated into many businesses. As a result, we do not divide revenues or profits between derivative and non-derivative products or track or report our financial results that way. And we manage the risk exposures we take on through derivatives as part of an integrated set of trading businesses. We carry all derivatives positions at fair market value, net of collateral paid or received.

I know the Commission is interested in the role of derivatives, including synthetic derivatives, in causing or amplifying the effects of the financial crisis. We believe the vast majority of the losses that financial institutions sustained over the course of the financial crisis can be traced to bad credit decisions in general, and most of those can be traced back to bad real estate loans. Securities, like CDOs and associated derivatives, including synthetics, embedded what were essentially concentrated credit risks emanating from bad lending decisions. More broadly, whether in derivatives or the most basic of activities, such as bank loans or mortgages, there also appear to have been failures of risk management across the industry.

With respect to AIG, our relationship was governed by the same client service and risk management focus described above. To put our relationship with AIG in context, our clients first came to us to help them manage credit exposure to Super Senior CDO positions on their books. We entered into credit derivative swap contracts (sold protection) to help them hedge against a fall in the value of their Super Senior CDOs. We then entered into offsetting contracts (bought protection) with AIG to manage the resulting exposure in our books.

Our net risk was consistent with our role as a market intermediary rather than a proprietary market participant.

We established credit terms with AIG consistent with those extended to other major counterparts, including collateral arrangements that we tightly managed. As we do with many other counterparty relationships, we limited our exposure to AIG through a combination of collateral and market hedges in order to protect ourselves against the potential inability of AIG to make good on its commitments.

We established a pre-determined hedging program which provided that if aggregate exposures moved above a certain threshold, CDS and other credit hedges would be obtained.

In July 2007, as the housing market deteriorated, we began to significantly mark down our Super Senior CDO risk. Our rigorous commitment to fair value accounting prompted us to mark our positions down on a real-time basis. This resulted in collateral disputes with AIG. We believe our marks were accurate and reflected the realistic value markets were placing on these securities. We also believe that events later in the housing market proved our marks to be correct.

Over subsequent weeks and months, we continued to make collateral calls consistent with deterioration in the housing market. We made those collateral calls based on prices that were consistent with the prices we had on similar securities held in our inventory and on which we posted collateral to clients on the other side of the AIG transactions. We also offered to buy from and sell to AIG at our marks.

While we collected significant amount of collateral, there still remained material gaps between what we were paid and what we believed we were owed. These gaps were hedged primarily by the purchase of collateralized CDS, such that we had no material residual risk.

In mid-September, prior to the government's action to save AIG, our total exposure was roughly $10 billion, which included AIGFP predominantly, but also a number of other AIG legal entities. Against this, we held roughly $7.5 billion in collateral. The remainder was fully covered through hedges.

I believe the way we managed our exposure to AIG demonstrates the importance of systematically marking positions to market, paying attention to what the markets tell us, and maintaining a disciplined approach to risk management.

During the course of the financial crisis, we made our fair share of mistakes. We lost a considerable amount of money through our exposure to leveraged loans and mortgages.

We learned once again that financial institutions that focus on the fundamentals of measuring, monitoring and dynamically managing their risks make themselves much more resilient to uncertain and unpredictable market behavior.

Thank you very much and I am happy to answer your questions.