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Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

'Recent Innovations in Securitization'

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A. Executive summary:

Chairman Kanjorski, Ranking Member Garrett, and Members of the Subcommittee, we thank you for inviting us to present our thoughts on recent innovations in the securitization market and their impact on the financial crisis. We hope our thoughts prove helpful. I am Head of Global Investment Research at Goldman Sachs (the 'Firm'). I have been involved either directly or indirectly with the securitization market since joining the Firm 15 years ago, as well as during my tenure at the Federal Reserve in the 12 years prior to that. I am pleased to answer your questions on behalf of the Firm regarding the securitization market, and more specifically, the life settlement and life settlement securitization markets.

Before delving into detail on these topics, I would note that Goldman Sachs has never executed in a life settlement securitization. We currently have no client mandates or plans to execute one. In addition, our life settlement business is very small. We estimate that our total investment in the space represents a very small percentage of the total capital investment in the market, and is a fraction of what a number of our institutional competitors have invested. In addition, it is a very small percentage of our overall business.

Given that we have never executed a life settlement securitization, we cannot offer an experience-based view of this market. But, we do not believe that it poses systemic risks and we see significant potential positive benefits from the life settlement market for those who are insured and facing changed circumstances. Yet, we also see the real potential for abuse of consumers. Hence, we would emphasize the need to address potential consumer protection related issues rather than systemic concerns in this market.

We do, however, have significant experience in other securitization markets. Based on that experience, we see a few key areas where securitizations, particularly mortgage related ones, increased systemic risk and contributed to the financial crisis.

Specifically, some financial firms used the relatively favorable rules around securitization to reduce the capital held against poor quality loans. They also made their balance sheets appear healthier than they were by reporting that they were holding 'good' public securities, rather than the high risk loans underlying these securities. This was true even for securities that had never actually been sold in a market, but were instead simply repackaged and relabeled with the help of a ratings agency. In some cases, these rules even allowed firms to make risks disappear entirely from their balance sheets. These abuses lead to wholesale concerns about the balance sheet integrity of all financial firms – regardless of whether they had engaged in such practices – and greatly contributed to the panic at the peak of the crisis. They also drove the need for widespread, massive government assistance for even the most healthy of financial firms.

To address these issues, make the financial system more robust to financial shocks and reduce the future need for government assistance in times of stress, we think that securitizations should only qualify for favorable regulatory treatment after significant parts of all risk tranches have been sold to a true third party. To prevent misreporting of risk exposures, large financial holding companies should consolidate all assets and liabilities onto their balance sheets and mark those assets to market. Further, to prevent the regulatory and accounting arbitrage that allowed massive under- or un-reported risks to build, and inflated profits to be reported, the rules around affiliate transactions should be strengthened. Specifically, assets should not be permitted to be held off balance sheet and firms should not be allowed to cross subsidize business across regulatory or accounting boundaries. We believe these changes in rules would go a long way towards reducing systemic risk.

B. Securitizations and their contribution to systemic risk:

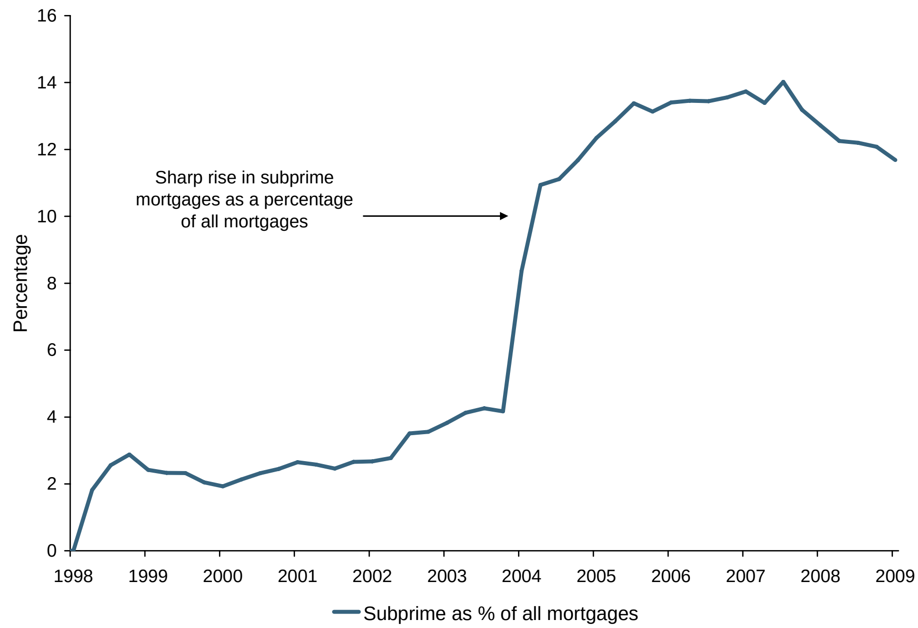
The direct and dominant cause of the financial crisis was substantial lending that did not meet prudent lending standards. In our view, it is unclear whether securitizations worsened or moderated the decline in lending standards. When considered in terms of market discipline, they clearly acted as a moderating force. In fact, low quality assets reached a point where they were largely unable to be sold in the open market. Instead, they were mostly held at originating firms. However, the accounting and regulatory gaps around securitizations made some firms willing to make and hold these substandard loans even after the market had shut down entirely.

As we show in Exhibit 1, lending standards eroded sharply in the build-up to the financial crisis. When lending standards reached their lows in 2006, the securitization market began to shut down and was nearly completely closed 6 months later. What is disturbing is that subprime loans continued to be made even after the securitization market shut down (see Exhibit 2). This was possible in large part because these loans were labeled and held on the balance sheets of many financial firms not as sub-prime loans, but as highly rated public securities, even though most of these securities were still in the hands of the originating bank and had never actually been sold in a market.

Exhibit 1: Lending standards eroded sharply

Source: Federal Reserve Board, Goldman Sachs Global Investment Research.

Exhibit 2: The percentage of subprime mortgages soared to record levels, even after securitization markets shut down in 2006



Source: Mortgage Bankers Association, Goldman Sachs Global Investment Research.

Securitization benefited from lower capital standards than the underlying loans because the packaging of loans into securities that were then re-sold was supposed to reduce risk at the individual bank level by spreading it more broadly across the financial system. Yet, when banks became unable to sell low quality securitized assets, they continued to securitize and hold them anyway.

Financial firms were willing and able to continue to make these 'bad' loans for a few reasons. First, they were able to reduce their capital requirements by securitizing them. Second, some banks used hold-to-maturity accounting or aggressive marks on these assets, justified by the high ratings these securities enjoyed. As such, they felt comfortable not marking these loans to market and therefore did not report the losses that were accumulating from poor lending standards. And third, some banks moved securitized assets off balance sheet into captive Structured Investment Vehicles, using overly flexible rules around affiliate transactions. By doing so, in some cases they made risks disappear from regulatory and investor oversight entirely.

The combination of these actions taken by some financial firms left the system under-capitalized and brought the balance sheets of all financial firms into question – regardless of whether a specific firm had engaged in these questionable strategies. It is precisely this loss of faith in the balance sheets of all financial firms that moved this problem from an institution specific crisis into a general one, and caused all firms (healthy or not) to require government assistance.

The simplest demonstration of the importance of this lack of faith was the market response to the U.S. Stress Test. The Stress Test forced banks to reassess the value of their assets based on a series of consistent and challenging parameters. In the process, it made bank balance sheets considerably more transparent and gave investors greater confidence in the prices assigned to bank assets. As a result, within days of the release of the stress test results, U.S. banks raised $140bn – nearly twice as much as the Treasury required them to raise over six months. And, even the worst-positioned banks were able to raise capital.

C. Life settlement and life settlement securitization markets:

Before we discuss our view on the potential risks posed by the life settlement securitization market, we provide a brief background of the life settlement and life settlement securitization markets, as well as our role in them:

The life settlement market began in the mid 1990's. Its purpose is to provide owners of life insurance with alternatives to lapsing or surrendering their policies, for a small fraction of the premiums they pay. Policyholders whose circumstances change – who no longer want or need coverage or who cannot afford it – can choose to sell their policy for more than they would receive by surrendering it to the issuing insurer for its cash value.

In a report published in March 2005, Bernstein estimated that $13bn of insurance policy face value had been sold into the life settlement market[1]. We estimate that those purchases represented an investment of approximately $3bn of capital[2]. Current estimates of capital invested in life settlements range from $10bn - $12bn [3]. Consider, for the purpose of comparison, that the mortgage market in the U.S. reached more than $11trn at the end of 2008.

We entered the life settlement market in 2006. Our primary focus has been as a principal investor. Our business is small – both in terms of the life settlement market itself and relative to our overall revenues as a firm. As we noted earlier, our total investment in this space represents a very small percentage of the total capital invested in the market to date, and we are small relative to our competitors. In addition, it is a very small percentage of our overall business.

We buy life settlements through a wholly-owned, state licensed life settlement provider. We also have a minority stake in a second provider. We operate the business with very conservative investment standards and business practices and procedures. We also launched a longevity index called QxX in December 2007. The index has allowed market participants to observe longevity and mortality trends, and if needed, to hedge those risks in their portfolios. At present, there is no commercial activity occurring in connection with this index, and it is used as a statistical / actuarial tool. Several other longevity indices have been launched in recent years by other institutional participants in this market.

The handful of life settlement securitizations that have occurred to date, appear to have had little or no impact on the life settlement or life insurance markets. We estimate that just over $1bn of life settlements have been securitized since 2000 This remains one of the smallest and most sporadic of the securitization sectors, and while we have never been involved in a life settlement securitization, we see little investor interest in such a market given its size as well as numerous structuring challenges.

D. Life settlement securitization market not likely to pose systemic risks but should be monitored:

We do not see the life settlement securitization market as a cause for concern for the financial system as a whole. First, as we noted earlier, it is a very small market and we see limited prospects for growth. As such, it is unlikely to become large enough to pose risks that could be systemic in nature. And second, quite unlike the mortgage securitization market, it is unlikely to drive concerns around issues like lending standards, which can have more far reaching implications for the economy.

That said, we agree that there may be the potential for abuse in this market. The primary effect of securitization is that it can raise the potential amount the insured may be able to receive. This would, in our view, be a positive outcome. But, questions must be raised about how much of this incremental income will be passed down to the insured and how such transactions will be represented to the insured. Therefore, it is our view that the rules around

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1 BernsteinResearch – Life Settlements Update, March 4, 2005.

2 GS estimate assumes purchase price of 20-25% of policy face value.

3 Life Insurance Settlement Association (LISA), FINRA.

direct or indirect sales of life settlements that may end up in securitization pools need to be carefully scrutinized.

E. Our suggestions for improved regulation of all securitizations:

As we have noted, life settlement securitizations do not appear to pose any special securitization related risk, and can be treated like any other securitization. However, there does appear to be special issues in terms of consumer protection in life settlement in general that may be appropriate for Congress or a regulator appointed by Congress to address.

We have several suggested changes that can be made to regulatory and accounting rules to reduce the systemic risks posed by other securitization markets. We believe that our suggestions would help to make the financial system more robust to financial shocks, improve transparency and reduce the need for future government interventions in times of stress:

First, securitizations should only qualify for favorable regulatory treatment after significant parts of all risk tranches have been sold to a true third party. Second, to prevent misreporting of risk exposures, large financial holding companies should consolidate all assets and liabilities onto their balance sheets and mark those assets to market. Third, to prevent the regulatory and accounting arbitrage that allowed massive under- or un-reported risks to build and inflated profits to be reported, the rules around affiliate transactions should be strengthened. Specifically, assets should not be permitted to be held off balance sheet and firms should not be allowed to cross subsidize business across regulatory or accounting boundaries.