John Thain: It's 'Unfortunate That the American Dream Has Been Demonized'

Part I: Thain's Remarks

Jeremy Siegel: Let me tell you a little bit about the format of our session this afternoon. I'll give a brief introduction to John. He will speak, and then professor Richard Herring from the finance department, Mukul Pandya, executive editor of Knowledge@Wharton, and I will ask some questions. I am Jeremy Siegel, also from the finance department. Then we will have questions from the audience. So this is a three-part session.

Looking over John Thain's resume, it is truly incredible.... He was born in 1955 in Antioch, Illinois -- 60 miles from Chicago. My hometown is Chicago, too, so we're both Midwesterners. He was valedictorian of his class, captain of the wrestling team and lead debater. He went to MIT and got an engineering degree in 1973. After that he went to Harvard Business School and got his MBA in 1979. He then joined Goldman Sachs and rose up through the ranks to become president and chief operating officer during a very successful time for both him and Goldman Sachs.

In 2004 he joined the New York Stock Exchange. That was after there was a slight controversy about past president Dick Grasso, who took a $140 million bonus, which some thought was excessive for a non-profit quasi government organization. But Thain stilled that controversy and took the New York Stock Exchange even further as it was privatized. The process was started under Dick Grasso and he continued it. He then saw through the very successful merger with Euronext.

In December 2007, he joined Merrill Lynch. And that began the interesting part of his life. Again, there was a little dissatisfaction with the prior CEO, Stan O'Neal, who was being blamed for subprime losses. O'Neal said don't worry about them; the losses will be held to about one half billion dollars. But that, of course, did not prove to be the case. So the situation was just beginning to get serious. John took over at a very, very difficult time both for the firm and for the financial system.

As the subprime crisis worsened, I think John did a very smart thing ... probably the best thing that could have happened to Merrill. He arranged a merger with Bank of America. What was so foresighted about this -- it was not like what Dick Fuld did for Lehman Brothers, which was waiting until the price got to zero and then it was too late to merge it into any company -- was that John negotiated at an early stage. I guess Bank of America had been taking an interest in Merrill for a long time and thought that it would be very good synergies. The merger was announced a year ago.

We had a session last year [at Wharton] to try to explain what was happening. It was the week when Lehman went under. That very day is when the announcement of the merger between Bank of America and Merrill took place. AIG was rescued. On the next day, we were debating that back and forth. Would it go or would it not? I said they would rescue it because there's such chaos in the market. The money fund -- the reserve primary money fund -- broke below a dollar. Panic was in the market. This is probably going to be

enshrined as one of the most notable weeks in history for the financial markets. And that's when the merger was announced. The merger price was $29 a share.

Although that was only about half the price of Merrill when [Thain] took over the company, it was still a 70% premium over the market price that Merrill was trading at, at the time the deal was announced, which valued the brokerage house at just under $50 billion. So I don't know of anyone who could have done better for the shareholders of Merrill....

As I said, the interesting part of John's life probably started when he took over Merrill. I know that John is going to talk about it so I don't want to spend any more time on it.... Of course, losses mounted -- really not due to John's mistakes -- but mistakes that were made early on. Then there came a big controversy -- were these revealed to Bank of America shareholders on time? That's one. Then there was an issue of the bonuses. Big issue.... And then there is, well, the issue of the office. John is now enjoying retirement and is going to talk to us about the pleasures of playing golf and attending charity events. John, welcome.

John Thain: Thank you very much, at least for most of that introduction. This is supposed to be a panel discussion, so I am going to talk only for a few minutes. I'll cover a few things. I really do want to talk a little bit about why, at least in my view, this all happened. What was the cause of this? I want to talk a little about some of the areas that I think need to be changed that aren't being focused on that much. I suppose, because I have to, that I will deal a little bit with the losses and the bonuses. And if I really have to -- my office. And then we'll open up for questions....

I will say that a year ago -- really a couple of days before a year ago -- I was in the Federal Reserve on Friday, Saturday, Sunday and this was truly history in the making. There will be lots of books written about this. This will be studied for years and years and years here and at least some of those other business schools that deal in really important things. It was a pretty amazing time....

So let's start out with, how did this happen? I think this was a pretty classic bubble. And because you're at Wharton, you have probably already read [Charles P.] Kindleberger's book [*Manias, Panics, and Crashes: A History of Financial Crises*]. But if you didn't, you should, because if what happened here is a pretty classic bubble, [we should be] trying to figure out whose fault this is and who should be punished and how we make sure this never happens again. Of course we won't make sure this never happens again because bubbles have been happening for hundreds of years. But it was a classic bubble. It just happened to be particularly big.

The beginnings of the bubble really stem from the U.S. Federal Reserve's monetary policy. There was too much money available for too long at too low of a cost. That fueled excessive amounts of leverage in the housing market. It fueled excessive leverage in financial institutions. And it fueled excessive leverage in the private equity firms; ultimately that fed into the stock market. There is plenty of blame to pass around -- including Wall Street. But let's just talk a second about the housing market.

One of the problems in the housing market is that mortgage originators get paid for originating mortgages, and they don't really care what happens to them after they get made. So mortgage originators were originating mortgages with higher and higher loan

devalues, with lower and lower credit checks on the borrower, until ultimately it got to the point where the mortgage originators were totally in the dark.

You had 100% loan devalue mortgages being made to people who had no jobs, no income, no assets. They started calling them NINJA loans -- no income, no job or assets. Those were mortgages that the mortgage originators really didn't care about because they really weren't regulated by much of anyone and they got paid just for volume. So that's one problem that needs to be looked at.

Second, the lenders themselves didn't really care because the lenders were able to push these mortgages -- all of them -- into the marketplace. So they didn't keep any of the pieces of them. One of the proposals that's being talked about now, which I think is a good one, is requiring lenders to keep at least some equity -- some piece of these mortgages -- so they have some responsibility and they do care what actually happens to them after they originate them.

We, of course, had Fannie Mae and Freddie Mac -- you could spend an entire day talking about the problems of having a government-sponsored entity whose actual original purpose was a good one. The idea that Fannie and Freddie should use their government sponsored status to standardize mortgages and to guarantee them, making home ownership more affordable to people -- that's a good thing. But making them a for-profit, public company wasn't such a good thing because they then used their government status to grow a giant portfolio, which really didn't do anything to further the public purpose but did, in fact, allow them to make a lot more money since they could fund their portfolio at slightly over government rates. Their shareholders did better and their executives did better. And, by the way, that's still an issue that has to be dealt with -- what to do with Fannie Mae and Freddie Mac.

We then get, of course, to Wall Street itself. Wall Street was securitizing all these mortgages and, as the credit quality deteriorated, Wall Street decided that we would make more and more complicated structures until we finally got to the point where no one understood them -- certainly not the rating agencies, certainly not most of the buyers of them. And I think, for the most part, not very many people on Wall Street understood them. The best evidence of this was that some of the Wall Street firms -- including Merrill Lynch, which created a lot of these things when it became more and more difficult to sell them -- thought it would be just perfectly okay to pile them up on their balance sheet. That turned out to be a very, very bad idea. But there's no question that, as the securities themselves became much more complicated, the rating agencies completely failed in their jobs [by] rating big chunks of these things triple-A. They had a tremendous amount of leverage built into the structures. The agencies never would have rated a corporation triple-A that had that much leverage.

The prospectuses that these were sold under didn't even explain what the real collateral was inside of them. The buyers didn't understand what they were buying, and Wall Street was packaging these things up and selling them to make money, and then of course also piling on their own balance sheet, which led to the ultimate destruction of several of the firms.

There's also blame to go around on the regulatory side. The regulators -- as the markets went up and as asset prices rose -- allowed financial institutions to get more and more

leverage. So whether it's investment banks or commercial banks, the amount of leverage in those firms grew dramatically. That's a problem. Also, the policies on capital were very pro-cyclical. In a positive environment when banks are earning money, where asset prices are rising, they were allowed to have less capital as a percentage of their total assets.

And then, of course, as the market turned around and went the other way, they need to have more capital, which of course is exactly the wrong thing to do because then they are forced to raise capital at the worst time to try to liquidate assets. And that caused the downturn to be even bigger. We really haven't yet dealt with the regulatory structure that is needed to [handle] these very large financial institutions. I'll come back to that in a minute.

We also had too much leverage in the private equity world. Private equity firms were able to borrow more and more money. That also helped to drive stock prices up. So what basically happened was a fundamental bubble that was driven by, first, monetary policy, but then ultimately all these other factors. And that bubble burst.

We're now in the mode of trying to deal with the damage of the bubble bursting and what to do to at least try to make sure that -- I don't think you can prevent bubbles from happening -- they don't do as much damage as this particular one has done.

So let me talk about a couple of things that I think we need to focus on. One is the regulatory framework in the United States. I think it's unfortunate because one of the great things about crises -- if there is anything good about them -- is you can use them to make change. At least at the moment, it doesn't seem to me we're going to make what are the fundamental changes in the regulatory structure in the U.S. financial system. Why do we have the SEC and the CFTC [Commodity Futures Trading Commission]? Why do we have the FDIC [Federal Deposit Insurance Corporation], the Fed, and the OCC [Office of the Comptroller of the Currency]? There is no real attempt to consolidate and to eliminate the duplication in that regulatory structure.

We certainly don't have a mechanism to capture the gaps in those structures. When you have multiple regulators that are duplicative, you also create gaps. That's one of the reasons AIG financial products was able to do what it did, which was basically write massive insurance contracts without any regulatory requirements whatsoever. I think it's unfortunate but I'm not very optimistic that we're really going to do something to create a more logical, less duplicative, less expensive, but also better regulatory structure for financial institutions. But I think that's an area that needs focus on it.

The second area I think we need to focus on is the whole bonus structure on Wall Street. I'll talk specifically just for a minute about Merrill, but I think it's more the concept. I don't think there's anything inherently evil about bonuses. Having compensation that's variable is better than having compensation that's fixed. So if you just pay people X millions of dollars no matter what they do -- whether they perform well or not and whether or not the company has performed well or not -- that's not a good alternative.

But I do think bonuses have to be tied much better to longer-term performance. They have to be tied better to the shareholders. And they also have to be tied to real results.... If I'm trading foreign exchange, and at the end of every day my positions are completely liquid and you can see what they're really worth, that's one thing to pay me based upon that. But

if I'm creating triple A ABS [asset-backed securities] and CDOs [collaterized debt obligations], and I'm marking them to market but I'm building up a huge pile of them on my balance sheet, which ultimately leads to losses in the future, that's a totally different and much less high quality of earnings. You want to pay people much differently for that kind of thing.

So you first have to take into account what exactly is generating earnings. And second of all I think you have to make compensation -- and bonuses, in particular -- longer-term and more equity-based and then require that the stock be held for a long period of time.

I think you'll see some of this happen. You will see some of the firms use much more stock or stock-like things, make people hold them for very long periods of time. But that's not the only answer and I think there's too much focus on the bonuses, because actually Lehman, as well as Bear Stearns, had components of equity in their compensation structure and made their employees hold them for long periods of time. And that didn't do them the slightest bit of good. So I also think there has to be much better focus on risk management. Because even if you have a compensation structure, if you don't have good risk controls -- if you don't understand the risks that you're taking, if you allow traders or businesses to wipe out the earnings of all the other employees of the firm -- that undermines the entire compensation structure no matter what you have. That was one of the problems at Merrill Lynch.

The losses that were generating Merrill Lynch's P&L -- almost all of them were mortgage and mortgage-related. All of the people who created those losses either got fired before I got there or I fired them. So I then have 60,000 people who are working in wealth management, working in investment banking, working in equity trading -- basically all of whom are doing a good job. They come to work every day. They're actually earning money in their businesses. And all of their efforts get wiped out by these legacy assets that were put on this balance sheet through a complete breakdown of the risk controls. None of the people are even there. So you have to tie compensation as well to good risk management because otherwise you still have the problem of one group or one business blowing up the entire firm, which is what risk management is supposed to prevent.

The other topic we're going to cover is "too big to fail." We have a problem in this country right now, which is that the concept of moral hazard has been thrown away. We have the very large financial institutions right now that are too big to fail -- Lehman has proven that they are, in fact, too big to fail. And so they have an implicit government guarantee. But we haven't done anything to change how they do business. We haven't done anything to change their regulatory requirements. We certainly don't have any intention of breaking them up so that they're smaller. And there isn't any formula right now to actually make them pay for that implicit government protection. The FDIC charges for deposit insurance. Right now we have implicit government insurance of these big financial institutions that they don't pay for, and at least so far, they haven't changed their behavior. I think that is a potential problem in the future.

I will cover a couple of Merrill things since you brought them up at the beginning. It will save you all from asking. Easiest one is the bonuses.

When we negotiated the deal in September, there was no TARP money. There was no government injection of capital into any of the financial institutions. We negotiated really four main things. We negotiated the price. We negotiated the bonuses. The third thing we negotiated was the materially adverse change clause. The fourth one doesn't really matter.

So as part of the deal on that September weekend, Bank of America agreed then that we could pay -- they agreed to pay up to $5.8 billion of bonuses. They did that for what they now say is the obvious reason -- that if you have 60,000 people, if you don't pay them anything, they have alternatives and they'll leave. Since the company basically is a people business, you can't just not pay 60,000 people anything, or they will go find alternative places to work where they *will* pay them.

So they agreed in September that we could pay up to $5.8 billion of bonuses. They were totally involved in the process to do that. I'll give you some of the details just for fun. When we agreed in September, it was supposed to be 60% cash, 40% stock. They asked us to change it to 70% cash, 30% stock, which we did. We ultimately changed $5.8 billion to $3.6 billion because we were trying to at least reflect somewhat what was happening both in the market as well as at Merrill. They asked us to use their stock instead of Merrill stock. So it's a little interesting in January when they claim they didn't know anything about these bonuses since we used their stock to pay them. And basically when I got fired in January -- when they said John Thain secretly accelerated these bonuses -- they were lying.

That has now trapped them into a lot of trouble because there's a piece of paper -- there's a document -- that says yes, they in fact agreed to this in September. So one take away for all of you is it's really always better just to tell the truth.

When I thought Lehman was going to go bankrupt, I believed at the time that this was going to be catastrophic in the marketplace, which unfortunately turned out to be true. But I also thought it would be catastrophic to Merrill Lynch because of the amount of bad assets we had on our balance sheet. So the idea that we were going to lose money in the fourth quarter after Lehman went bankrupt is why we sold the company. If we were going to make money, we wouldn't have sold the company.

So I don't think there was any question that -- given the complete shutdown in the credit markets and given the amount of bad assets that were on our balance -- we were going to lose money. Did we lose more than maybe Bank of America thought we were going to lose? Well, probably. But the market was really, really bad. And a lot of those losses actually were just mark-to-market losses and actually a lot of them have come back. Merrill Lynch contributed the vast majority of Bank of America's earnings in the first quarter. Part of that was these losses being reversed.

So I don't think there is anything particularly surprising other than perhaps the overall size. But the idea that we were going to lose money in the fourth quarter was pretty obvious, I think.

And the last thing, since you brought it up, I'll talk about my office. So you all learn lessons from people who make mistakes. I joined Merrill Lynch in December 2007. That was before Bear Stearns, before the world imploded, before there was any government money, and I used my office to receive clients, to receive guests.

I used it as a meeting space. The way the office was set up, it had a big desk right in the middle. So it didn't have seating space. You couldn't really receive clients. And also one of the conference rooms had been converted into a private gym. If I want to work out, I don't need to work out at the office. I can work out at my home or in a real gym. So we tore out the private gym. We reconfigured the office so that it was like a normal office where you could have guests and have meetings. And we decorated it in kind of the style that Merrill Lynch offices, which were very, very nice.

Now, in hindsight that was a mistake. All right? I admit that was a mistake. I didn't know the world was going to explode, but it did. And that was a mistake and I'm sorry that I did that. If I had that to do over again, I'd furnish it in IKEA.

But I also did as much as I could do to correct that mistake. There was no government money that went to pay for any of that stuff ever -- no matter what certain politicians say. Given what happened and given that it clearly was a mistake, I reimbursed the company for the full cost of all those renovations. So I believe in doing the right thing. That renovation was a mistake and so I corrected it to the extent that I could and so that it didn't cost the shareholders any money either. And, by the way, just for all of you who watch TV or whatever -- a commode is not a toilet. A commode is a chest of drawers.

So I still recommend -- if you're going to go to a financial institution in difficulties -- just go to IKEA or keep the furniture that's there. So that's it. I'm happy to answer whatever questions you have. Thank you.