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

Part II: Questions from the Panel

Siegel: I have a few questions. First let me say that I had the honor of having Professor Kindleberger in my graduate work at MIT. In *Manias, Panics and Crises,* he talked about the cycles. There's also something called the Hyman Minsky Cycle, which is similar where a period of stability gives rise to excess leverage and then a bump causes a tremendous reaction. So it's in the spirit there. Professor Kindleberger lived all the way into his 90s. He just passed away a few years ago.

You mentioned a critical subject -- too big to fail. I don't know if you've had time to look over the Treasury's proposals. They recommend that they look at the financial institutions and those that reach a certain size -- called Tier 1 financial holding companies -- would have to have more regulation, much more risk capital, maybe even subordinated debt. Do you think this is a realistic way to pursue regulation? Admit that there are going to be firms that are too big to fail, and if they are, we just have to have them with enough equity so that they don't take excess risk and throw the cost on to the taxpayer?

After all we've done that with banks. The same argument used to be held against the banking system -- don't let the banks get too big or that will happen. And we've had a few occasions where it has happened. But on the whole -- Dick might want to comment on that -- I think it's working very well. But the question is, do you think that is the new reality out there, that we will identify such firms and have them under more regulation? The good part is the government may step in and guarantee your senior bonds. The bad part is you're going to have to have more regulation being that big and the firm will have to worry about the trade-off between those two.

Thain: First of all, I think we have to accept the fact that these institutions -- at least as they exist today -- are, in fact, too big to fail. Of all the things that happened over the last year, the single biggest mistake was allowing Lehman Brothers to fail. For what would have been at the time somewhere between $20 billion and $30 billion, if the government had done a program that was similar to what they did with Bear Stearns -- where they took a chunk of their commercial real estate assets and pulled them out and protected them and put them on the Fed's balance sheet -- for $20 billion or $30 billion of exposure, either Bank of America or Barclays would have bought Lehman and, at least in my view, the trillions of dollars of destruction that followed Lehman's bankruptcy is much less likely to have happened.

Yes, there may have been another one down the road. And AIG certainly would have been a problem, but there's no question in my mind that allowing Lehman to actually go bankrupt was a huge mistake. So with too-big-to-fail institutions, you can deal with them a number of different ways.

You could, in fact, say you can't be that big -- you can break them up. I don't think that's very likely to happen. And it's not necessarily good for U.S. competitiveness because remember, these financial institutions compete around the world.

You could have a regulatory capital regime that really does force them to have enough capital to deal with the risks that they take. I think that's possible. I'm pretty skeptical the government will be very good at that. I'm also skeptical that [the government] will actually have the ability to make them have enough capital to take into account the risks that they're really taking. But that certainly seems to be the direction that we're going.

And the third thing you could do -- and maybe you do this in combination with the capital requirements -- you could actually charge them for being that big. So just like the FDIC charges insurance for deposits, you could charge them. And the bigger they get and the riskier they get, you could charge them more. So they could have both more capital and pay for at least some of that implicit guarantee.

You could, on the other hand, go down a different path that says that if a financial institution is going to go under, I'll wipe out the shareholders, I'll wipe out the stock holders, I'll wipe out the preferred holders -- maybe I have to wipe out the subordinated debt holders -- and maybe if the loss is big enough, I get all the way and I haircut the senior debt. But it doesn't mean you simply default on all the contracts. And so even in the case of Lehman Brothers, it would have been much better if they said, 'Okay, we'll wipe out the common, we'll wipe out the preferred, we'll wipe out the sub debt, but then keep the contractual arrangements in place' so that you didn't have the complete shut down of the capital markets. The other alternative is to take that approach.

Richard Herring: Could I follow-up on your notion that we've done a good job with banks? I think one could have argued that if you have only a bank and not a bank holding company, the sorts of things that John just described do actually happen. The FDIC can step in. They'll do it always on a weekend very carefully. They'll open the next Monday. They'll apply haircuts to the stockholders, the preferred shareholders and usually the subordinated debt holders and maybe even the uninsured depositors. But it would only be credit risk; it wouldn't be liquidity risk. They actually make an attempt to give them the expected value right up front so you don't add liquidity to a credit-risk problem.

The reason it hasn't worked -- and you've seen very little of it in the last two years -- is that our largest banks have chosen to hold 20% to 40% of their assets in their holding companies. And their holding companies are subject to bankruptcy laws. It would be just like Lehman Brothers all over again. So the Fed at this point -- in fact the whole government, as we saw after Bear Stearns -- simply doesn't have the tools to deal with this sort of problem.

I'm wondering about another kind of issue, because it is true the Obama plan tends to dwell on size as the feature of systemic risk. But there are other aspects as well -- interconnectedness is something that came up with Bear. In fact, Bear didn't even make the list of the large complex financial institutions, although of course Merrill did. Part of that stems from their corporate structure. Part of it indeed stems from the international structure that you spoke about. A bank like Citibank has something like 2,400 majority owned subsidiaries -- more than half in foreign countries. Every single one of those foreign countries has a different resolution process.

If you even thought that the countries had the goodwill to try to work together, the coordination costs of doing it are almost unimaginable. So one tack that could be taken is to do what the British have done and suggest that each of these firms figure out a plausible winding down scheme that would make it possible for them to gracefully leave the scene without causing horrendous side affects for the rest of the market. In fact, investment banks used to be like that because investment banks used to have this wonderfully liquid balance sheet that allowed them to expand and contract like an accordion, depending on the funding base. It was really only within the last seven or eight years that the asset side of their balance sheet got to be so illiquid -- in terms of having bridge loans and complicated instruments that were not very easy to sell -- that they began to look like banks, but without the safety net.

Now that they've got the safety net ... do you see investment banks coming back? Do you think it's really stable to put them together with large bureaucratic banks? Or do you see them spinning off at some future time?

Thain: I think what will happen is actually a reversal of what has been happening over the last 30 years. Over the last 30 years, there has been a continual consolidation in both banks and investment banks where the number of firms shrinks and the ones that remain are bigger and bigger. I think we're probably at the point now where you're going to start to see a whole lot of new, smaller, private -- to some extent -- boutique types of firms start. I think that will probably mean there will be a greater number of smaller firms. Some of them will grow and be successful.

And you have to remember -- I made this comment earlier today -- 30 years ago, Goldman Sachs was not one of the top tier firms. Thirty years ago, the top three firms were Morgan Stanley, White Weld and Dillon Reed. Goldman Sachs was actually in the second tier with Kidder Peabody and a bunch of others. Salomon Brothers was actually there, too.

Herring: And probably no one of them was too big to fail.

Thain: I agree with that. I totally agree that probably none of them were too big to fail. So what's happened is there's been this consolidation. Now you've got these huge, huge firms that are completely interconnected around the world and do, in fact, have operations all over the world. They operate through, as you said, thousands of subsidiaries and under all different regulatory regimes, all different tax regimes and all different bankruptcy regimes, which makes dealing with them in bankruptcy really, really difficult.

I'm pretty skeptical about the idea that you're going to be able to have this living will and make it really work. So just think about that. Okay, if you told Citi to create a living will, more likely they'd be dead before they come up with it. There's just no mechanism to resolve having subsidiaries -- thousands of subsidiaries -- because you have to have regulatory regimes. You have to comply with the local regulatory regimes. You have to comply with the local tax regimes. And if you have problems, you have to deal with the bankruptcy laws in all of the different countries. I think it would be quite optimistic and naïve to think that the world is going to come up with some global regime that will actually be practical.

Herring: But that actually takes us back to one of your earlier themes, which is this has been a regulatory failure. Indeed, to give institutions incentives to have such complicated structures has also been a regulatory failure. The main reason that Citicorp has most of those subsidiaries is to evade regulations of various sorts and to comply with the tax code, which gives them benefits to structure certain products in certain ways in certain offshore centers.

So there's a sense in which the regulators have the tools -- if they have the will -- to set up an entirely different incentive system. What do you see as the main benefits for being a very, very large financial institution? Because the academic literature really doesn't find much evidence that there's benefit to society or to shareholders.

Thain: There's a question of, how big is big? There's certainly a point at which financial institutions get too big. They get too big to manage. Whatever efficiencies are created by consolidating in size and getting bigger at some point become inefficiencies.

I don't know the answer about where -- that's probably a good academic study. There is probably some efficient frontier about what's the real optimum size of a financial institution.

Herring: The academic studies say it's somewhere in the range of $100 billion of assets, which is way, way short of where we are now.

Thain: I don't know the answer to that.

Siegel: In other countries, the tendency is bigger and bigger. What is the average size?

Herring: The tendency is bigger and bigger. There are lots of reasons [for this]. People get paid a lot more at big institutions.

Siegel: Firms like Lehman, Bear Stearns and many others formulated either in the 19th century or in the early part of the 20th century survived the shock of the Great Depression, which is many, many times what we've experienced in this crisis. Why did they fail here? In particular, I would like you to address -- and I think you were at Goldman when it went from being a partnership into a stockholding company -- whether when they went public there was a different sense of risk. Was there maybe an abdication by CEOs or others about taking into account the big picture of what the risk was? Do you think that this was better controlled under a partnership system, or that this was not a factor in what had happened?

Thain: I absolutely agree with you that a partnership structure, where you're betting your own money, is a much better one at focusing you on risk management. I think one of the reasons why Goldman has always been better at risk management and one of the reasons why Goldman, even in this environment, continues to do better on the risk control side is because, as a partnership, it really mattered to have good risk management because it was your money you were risking.

So having your own money at risk is a very, very powerful motivator to make sure that the risk and reward tradeoff is being made correctly. That develops a culture in a company where the risk managers have equal power to the risk takers.

That doesn't exist in very many other companies. So even though Goldman changed into a publicly traded company, still that culture of "it's your money" stayed there to a fair extent. Of course Goldman's employees collectively continue to own a significant portion of the stock. But you still have to [acknowledge that] well, Lehman's employees and Bear Stearns' employees also owned a significant portion of their stock.

Herring: In fact, even greater.

Thain: Nobody lost more money than Dick Fuld. No individual, anyway, has lost more money than Dick Fuld in the collapse of Lehman. So why was that economic incentive still not enough to make them be more careful? I think it has to do with the cultures of the firms and the focus on making sure there's a much better balance between risk takers and risk managers.

Herring: Could I suggest another hypothesis that I think fits something you said earlier? We have a real problem with pro-cyclical capital requirements and pro-cyclical supervision. Part of it is very easy to understand. In fact, you were, I guess, one of the first firms to adopt the new Basel II rules because of the agreement with the Europeans, which is really rigorously pro-cyclical in a way that the former regime wasn't. But the problem, of course, is in the way we count profits. Because what does a $100,000 a year supervisor really have to say to a Wall Street manager who is making hundreds of millions when [that manager] is doing very well? The same thing, I think, happens internally within firms.

Risk managers don't get a lot of attention when things are going very well. People don't want to hear bad news in general. But they get a lot of attention when things go badly. So there's this pro-cyclical affect in risk management, too, that I think is equally damaging.

Thain: I agree with what you said, but I think that this is highlighting one of the problems. A trader who makes $100 million versus a risk manager who saves the company from losing the $100 million -- why is one worth millions in compensation and the other is worth $100,000 in compensation? As a matter of fact, I would argue that the risk managers should be paid much more comparable to the traders. The other thing that, for instance, Goldman did and still does is it takes people who are traders and puts them on the risk management side. I think that any company that takes the attitude that risk management is a low-level function and that the traders are kings are setting themselves up for a problem.

Herring: But isn't it very difficult to compensate a risk manager for essentially the dog that didn't bark? Because when they're good, you scarcely ever know it because things go well. But when there's a lapse, then you know you've had a real problem. It may be because you didn't listen to them or it may be because ...

Thain: If you have good leadership at the top of your firms, you will recognize the value of good risk management and you will compensate them appropriately. So I would argue it's just good management, good leadership. It's not that it's structurally difficult to do.

Siegel: I just want to follow-up on something John said. You talked about Dick Fuld losing a lot of money. I want your judgment on it, that a lot of these CEOs had taken a lot of money out. They may still have a lot of stock, but one of the things about a corporation versus a partnership is that you get to diversify out. You get to cash out. And so, yes, he may have lost a billion there, but he may have had a billion somewhere else. It's not like the CEOs, when it was a partnership, [putting] all of their wealth there. Warren Buffett always says, "I put everything in Berkshire Hathaway. 100%. I'm not taking part of it out. That's where I'm going to keep it. That's my wealth. I'm going to act as if the risk for my shareholders is the same as the risk to me." I'm just wondering whether the cash out business means yes, I still have a lot of stock, but I'm independently wealthy if something goes down.

Thain: I don't know their personal circumstances, but I think your basic point that a partnership -- because it focuses the mind when you have got all your wealth at risk every day -- is a better structure for risk management. You can't return all these firms to partnerships, but any form of compensation that has that affect [would be positive]. So for instance, paying the senior executives only in stock, that they have to hold for 10 years and can't sell until after they retire, which is not that dissimilar from a partnership because basically under the old Goldman partnership, you couldn't take your money out until you actually retired, and even then you had to take it out over time. You could set up that structure. You could basically say okay, CEOs of big financial institutions take 100% of their compensation in stock. The stock vests over 10 years. And you can't sell any of it until after you retire. And then you sell it out over five years after you retire. A structure like that actually mirrors to a fair extent the partnership structure.

Siegel: Okay. One more question and then we're going to give Mukul a chance also to ask questions before turning it over to the audience.

The whole question of who is responsible -- you could, as you say, spread the blame. But do you believe ultimately that it's the CEO? The buck stops here. The person at the top had to take the big view and failed to take the big view -- abdicated a responsibility to say hey, listen, I know [what] my technicians say, but I'm putting this firm and its thousands of workers at risk. They failed to make some very critical judgments that could have saved their firms.

Thain: Yes. I absolutely agree with that. My dilemma on that weekend a year ago was if Lehman's going to go bankrupt, the risk to Merrill Lynch is going to be enormous. I'd been the CEO for nine months. The last thing in the world I want to do is sell Merrill Lynch. Merrill Lynch was a great company. I liked being the CEO. No matter what happens, I'm not going to be the CEO going forward if I sell the company. So my job is to protect the Merrill Lynch shareholders. My job is to protect the Merrill Lynch employees. That's what I'm going to do. And, you know, if I lose my job over it, that's what -- although I didn't get paid -- that's what I should have gotten paid for. And that was my job. It is the CEO's job to do the right thing for its shareholders and to protect the shareholders. Where the CEOs didn't do that -- whatever the reason -- they failed in their jobs.

Mukul Pandya: During the past year, I wonder how your view of Wall Street has changed. How is Wall Street different today than it used be? Is investment banking, for example, still going to be a viable career option for our friends here from Wharton and other business schools?

Thain: The easy answer is yes, there will still be a viable career option. As a matter of fact, you're already seeing Wall Street coming back. I think the one very unfortunate thing that has happened -- and this is, again if you read Kindleberger's book, it's not unusual -- after there's a bubble that bursts, basically it has to be somebody's fault. Politicians have to blame someone. It certainly isn't the politicians' fault because it's never their fault. So to some extent, Wall Street has been blamed for this. That is unfortunate because I think Wall Street continues to be a great place for people to come and work and be successful and have great careers.

I don't want to personalize this, but I grew up in a small town in the Midwest. I had never been to the East coast. My friends in high school pump gas, sell insurance or are in jail. I went to school. I went to a good undergraduate school ...went to an okay business school. I went to Wall Street. I knew nobody. I had no contacts. I knew not one person. I had no money. Purely based on the fact that Wall Street is a pretty good meritocracy -- you have to have the right skill set -- basically you can start from zero there. You can become the president of Goldman Sachs. You can become the CEO of the New York Stock Exchange. You can become the CEO of Merrill Lynch. You can make a lot of money.

That's the American dream. That's a good thing. And the fact that this has been kind of demonized now, I think, is very unfortunate. But it will change. It will come back. I think Wall Street still is a great place for people to be successful. It's just not true that it has no socially redeeming value. It funds business and companies and economies, and you can see what happens when it doesn't work. It causes huge problems with the economy. That doesn't mean that it's not a great thing to be a doctor or -- I don't know -- lawyers are in a different category. But it doesn't mean it's not a great thing to be a doctor or a scientist or go work for an NGO. By the way, it's also a great thing on Wall Street, and it's a particular tradition coming out of Goldman, to do a lot of other not-for-profit or other community service things. That's also a great thing.

So I believe Wall Street and financial institutions will still be an attractive place for young people to go to be successful. I do think that they should do other things than just make money. Actually it is a great place to do a lot of really good things beyond just your day job. So I still think it will be a great place to go.

Siegel: I want to say that when you look at the crisis, it isn't because the demand for financial services collapsed -- wealth management service, everything else, financing new companies. Yes, subprime mortgages will not be popular for a while. But that is a small part. The demand for finance is there. The problem is the firms got over leveraged in that position, tanked themselves, but it's not like horse and buggies are going out because the automobile is coming. We're training people for jobs that don't have any demand any more.

The demand for those jobs -- especially with internationalization and the globalization of finances -- I think is going to be as big as ever. I'd like to go to the audience unless you have one more question.

Pandya: Just one last follow-up to what you just said. I read all those articles about the office and the commode and all that. I think that hearing you speak today you come across as a really honest and a really decent man. And a courageous man because you addressed those issues head on even though Jeremy Siegel let a pregnant pause stand after his comment about the office. So I just want to ask you this question from my heart. And the question is very simple. If you heard President Obama's speech on Monday, he said that apart from the sort of individual personal mistakes that people like you corrected, this country has lost $5 trillion in wealth. And I wonder in the privacy of your own thoughts if you have ever felt responsibility, regret or remorse at anything?

Thain: It is -- besides being a difficult question -- it's a very good question. Yes, there have been trillions of dollars of wealth destroyed. And that is a very bad thing. Millions of people have lost their jobs. Millions of people have lost their houses. Millions of people's lives have been disrupted by all this.

So do I -- does Wall Street -- collectively bear some responsibility for that? Yes, absolutely. Is it just Wall Street's fault? No, it's not. Has there been a failure here that we should try to make sure doesn't happen again? Yes, there has been a failure here. There was way too much risk. There was way too much leverage. People didn't think about the consequences of just assuming house prices were going to go up forever.

By the way, I was going to say this at the end, but I'll say this now. One thing that you really always have to think about: Relying on the world continuing to look like it used to look is a really bad idea. There's something called HPA -- Home Price Appreciation. All these mortgages -- all these securities -- all this was always based on the premise -- the belief -- that housing prices would only go up. Well, now that looks like a pretty stupid assumption. But if you said three years ago that you thought housing prices in the United States were going to fall 25% over the next couple of years, people would have thought you were crazy. So not relying on these assumptions that everybody takes for granted is a really important thing in terms of thinking out of the box.

But going back to your point. Yes, I think that we collectively -- I as a representative of Wall Street -- bear a cost and a responsibility for the financial destruction that has been caused. I don't think -- like some senator or Congressman suggested -- that we should kill ourselves over that. I think what we should do is say, how do we fix it? What can we do to get the economy started again so people have jobs? What can we do to minimize the damage of the housing price declines and people getting kicked out of their houses? How can we make it better? And what can we do to at least reduce the chances that it happens again to such an extent? Because okay, yes, it's very bad. But piling up investment bankers and burning them is not going to do any good.