

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

Part III: Questions from the Audience

Siegel: Thank you. We're going to have questions from the audience now.

Speaker: My question is simple. Over the next 12 months, or in the near term, what do you see as the biggest risk to a recovery in the financial system?

Thain: I think the biggest risk right now is in the commercial real estate market.... Asset prices there have fallen even if a lot of the equity holders don't want to recognize it. As debt comes due, it's going to be very hard to refinance it. So as I look out into the next 12 months, I think the commercial real estate market and the people who lent into that market -- that's probably going to be the biggest source of problems.

I still am pretty pessimistic about the U.S. economy. I know that the stock market has rallied and Bernanke has claimed that the recession is over, but there are still a lot of people who don't have jobs. And there are still a lot of people who are getting kicked out of their houses. The people who don't have jobs and houses don't buy things. So I think that the U.S. economy is going to be pretty weak, but the single biggest kind of concentration of risk that hasn't yet been recognized is in commercial real estate.

Speaker: Do you think the Fed should have a financial stability mandate? And, if so, how do they manage attention between that and their other two mandates?

Thain: I think the Fed already has a financial stability mandate and they just need to structure it and embed it into a regulatory and legal structure. But they already do that, and they were doing that.

Thain: [In response to the next question]: It's a very interesting question about whether the Fed should use monetary policy to try to burst or reduce bubbles. Greenspan argued very strongly that the Fed shouldn't do that. But what they should do is they should use the regulatory structure and in particular, the regulatory capital requirements.... They could use that to mitigate the impact of bubbles. Actually, that's one of the things I think they probably will do.

Siegel: You talked about spreading some of the blame. I do think there was a major failure of the Federal Reserve.

Greenspan and Bernanke -- but particularly Greenspan -- didn't see the build up of these leveraged risky assets in key financial institutions. He never really talked about the housing bubble. He talked about a stock market bubble -- 1996. He made a lot of noise about that but did not really mention anything about housing. I think the Fed definitely has to take a big part of the blame here.

Speaker: I just wanted to ask your opinion on executive compensation because that's a very emotional issue. It seems to me that when executive compensation is calculated and the contracts are signed -- even if the company doesn't do well -- a lot of people have golden parachutes and they just leave. You mentioned about linking it to long-term performance. Could you elaborate on that?

Thain: I have actually never believed in either executive contracts or golden parachutes. I don't think people should have golden parachutes. I don't think CEOs should have contracts. My attitude about that might have changed a little bit after last year, since I didn't have a contract either. But, honestly, I think, CEOs should not have contracts that guarantee them compensation. They should get paid based upon the performance of the company. Obviously, you have to take into account how the company did in the environment that they're in. But I don't think CEOs should have contracts or golden parachutes. By the way, I think golden parachutes are pretty much done with. I don't think any board is going to award golden parachutes in the future.

But I don't think they should have contracts either. And, by the way, I also don't believe in multi-year contracts, even to employees. Investment banks should not be giving out multi-year guarantees to people to get them to change jobs, which is still happening to some extent. That is a very bad practice. People should get paid based upon how they do, how their firm does and, to some extent, how the industry does.

Siegel: John, it sounds like you would be against tenure, too. That's okay.

Thain: Unfortunately, the answer is yes. I would be against it.

Speaker: Professor Schiller of Yale University has suggested a system of channeling risk away from people and towards international well-diversified investors who would hold onto mortgage risk. Do you see such a development taking place in the near future?

Thain: I don't know enough about how that would work to answer that and I haven't seen what he wrote. [To comment on] whether or not that's practical, I would have to understand it better.

Siegel: Do you think that there could have been new risk sharing instruments that might have alleviated the crisis?

Thain: I think we did a pretty good job sharing risk. We blew up Iceland. We blew up towns.

Herring: One has to remember that 60% of the subprime debt was sold to Europeans. We did a lot of that.

Thain: There was risk shared pretty much around the world -- at least among financial institutions. But I don't know the answer about the specifics of that proposal.

Siegel: Related to that, I think you really hit on this when you said there was a lot of money creating these bundled securities and commissions in selling them. I think the problem was they were also being held. Maybe for two reasons -- maybe they couldn't sell

them at the end, and maybe they just thought they were good investments. It was very different than the tech bubble where the brokerage firms basically ... got them all out into the system and didn't hold them. The actual loss of stock market wealth in that bear market was really very much similar to this, but it didn't have the impact on the financial firms because the financial firms didn't hold these Internet stocks that tanked the way this did. Should they have just gotten rid of them instead of having them concentrated in their own portfolios?

Thain: Well, whoever owned them still is going to lose money.

Siegel: But it wouldn't have tanked the firms. I think the tanking of the firms is really a major source of the recession.

Thain: I agree with that. But these instruments were still bad. These instruments were so complicated. One of these -- I'm talking now about ABS CDOs, and actually the CDOs-squared are even worse. Merrill created one. I picked one particular one. To actually model out the things that are inside an ABS CDO [is difficult] because derivatives are already inside the CDOs. They're already derivatives created out of derivatives. So you have to go way underneath to get to the actual pools of mortgages. To model correctly one tranch of one CDO took about three hours on one of the fastest computers in the United States. There is no chance that pretty much anybody understood what they were doing with these securities.

Creating things that you don't understand -- that the buyer doesn't understand, that the rating agency doesn't understand, that the regulator doesn't understand -- is really not a good idea no matter who owns it. I think that the degree of complexity that was created in the securities, and the lack of anybody's ability to really understand how they were going to perform, was simply an error and a bad thing. The fact that the firms that created them were stupid enough to own them doesn't make me feel any better.

Siegel: Just the plain vanilla 80% mortgage when you've had prices go down 50% in areas like Phoenix, Miami, California, sometimes more -- those are going to be under water with no complexity at all. A lot of them blew up that were just the regular mortgages. We never had a decline in home prices of more than 3% or 4% before this crisis. So people thought that if I take the top 80%, it is going to be safe because we've never had a national decline.

Herring: Just look around the world. They happen every 20 years. We have thousands of them.

Siegel: They didn't happen in the United States. Of course, we didn't have the bubble. We never had increases of 25% year after year after year. You mentioned Bob Schiller, my good friend at Yale, who wrote about the bubble in real estate. There were people who were saying this is just unsustainable and it's going to cause trouble in the future. And indeed it did.

Speaker: You alluded earlier to the incentive structures being completely misaligned. I agree. Have we done really enough? For example, the mortgage originators are paid on how many loans they close every day. Rating agencies are incentivized by the same investment banks that are asking them to rate the securities that they have to rate. So have we done

enough to take these incentive schemes out of there and fix them? Because I think unless we do, there's no long-term solution to this.

Thain: The answer is no, we have not. The two places you mentioned: We have not fixed the mortgage origination process. We haven't fixed the rating agencies yet. I highlighted them because I think they need to be fixed. But, at least as of now, there hasn't really been a change as to how rating agencies get paid. And I don't know of any proposals to change how mortgage originators get paid. So I think those are both areas that need to be focused on.

Speaker: That was actually my question related to the rating agencies. So to me, it seems like there was a big disconnect in actually identifying the risk and actually rating the securities properly. But to kind of piggyback on that question, do you have any specific recommendations or thoughts on what can be done to actually address that issue with the rating agencies?

Thain: Well, there are a lot of different things that potentially can be done. For one thing, we should probably open up competition. Right now, the rating agencies basically have a duopoly because you can't get recognized as one of the statutorily approved rating agencies very easily. Second of all, I think we should change how they get paid. There are a lot of different schemes to do that. One would be to have the users pay for them rather than have the people who create the securities pay for them. There are different things. But right now there's clearly a problem with the compensation structure.

Speaker: If you're a sales person and your job is to sell securities, how would you differentiate the ethics of selling these securitized mortgages and selling, say, Merrill Lynch stock in Q4 of 2007 to Bank of America?

Thain: Whenever you sell anything to somebody, there are a few things that you have to do. One is you have to make sure that the person who is buying it has the financial capacity -- the sophistication -- to understand what they're buying. Second of all, I think you have some responsibility to make sure it's appropriate for them, which goes along with sophistication. So what you sell to PIMCO is different than what you sell to a grandmother in Iowa who doesn't know anything about financial securities. And then you have to make sure you fully explain to them what it is they're buying.

As they get more and more sophisticated and they become much more institutional, then they bear more of the responsibility for understanding what they're buying. But I think you have to make sure that they understand, and that it's appropriate and that you're open with them about what the risks of the securities are. Securities have risk. If you want to have a riskless security, buy a Treasury bill. Given our deficit, even that might not be riskless. I guess if it's short enough, it is. So securities all have risk. It's just a question of making sure the person can understand the risks -- that the risk is appropriate for them -- and that you explain it correctly. By the way, that's true whether you're selling CDOs or common stock. It's true whether you're individuals or institutions. You just have to make sure you're following those guidelines for the person you're selling to.

You shouldn't sell stuff to people that they either can't understand or don't understand. And, by the way, as a sales person, you should make sure you understand them as well.

Speaker: Jeremy mentioned that you've been playing a lot of golf and attending charity functions. But you're a relatively young man and you probably have two or three careers left ahead of you. I'm wondering if you've thought what you might do over the next few decades and what kind of imprint you'd like to leave on society?

Thain: Well, you can't believe everything people say. I haven't been playing golf because I don't play golf. And I haven't been going to charity events because I hate charity events. As a matter of fact, my normal line is I'll give you twice as much money if I don't have to go.

But I do a lot of charitable things. And, by the way, I did that before. These are not really new things. I'm on MIT's board. I am on the board of Columbia Presbyterian Hospital. I'm on the board of the New York Botanical Garden. I'm on the board of the French-American Foundation. One of the best things that I've done: Columbia Presbyterian was building a new hospital for children. I don't know if any of you have ever seen it. But they were building a new children's hospital. Columbia has always had a problem because where the babies are actually born is not where the children's hospital is. So if a baby is born with some problems, they then have to move [the baby] from where the babies are born to where the children's hospital is. So my wife and I actually gave them the money to build a new birthing unit on top of the children's hospital.

Every day, hundreds of babies are born in a brand new facility that is right on top of the children's hospital so that children, if they have a problem, can instantly go to the intensive care unit or the heart unit or whatever they need. The number of people who have their children there, who have had babies there, who say that was such a great thing to do -- that makes me feel very proud of the fact that at least I can give something back to society. And there's lots of ways you can do that, whether it's a little thing or a big thing.... Bette Midler plants trees in Manhattan. And, you know, every tree she plants makes Manhattan a little bit better. Whether it's planting trees or building babies units or giving time -- for a long time I always worked on a house for Habitat for Humanity. It doesn't matter what it is. All of you -- not just me -- you all should do those kind of things.

And you should view that as part of what you should do going forward, because in many ways work is work, but making the world a better place is something special. I would encourage you all to do stuff like that.

Speaker: Thanks for your talk Mr. Thain. What do you think of Ken Lewis?

Thain: You know, it's tempting to answer that. But I'm not going to.

Herring: Could I ask a more subtle version of it? What do you think of Judge Rakoff's decision to throw out the agreement between the SEC and Bank of America to keep it all sort of quiet for a fine?

Thain: Anything that relates to the litigation I am not going to get into. Because this is too public a forum and I have kind of been out of it and have no reason to want to get into it.

Speaker: First of all, I want to thank you for coming to speak with us. I know for many of us, we really appreciate the example of leadership you have shown and the way you have

been able to balance taking care of shareholders, taking care of your employees and making personal decisions that the public views in a good light. So we want to thank you for coming here and being a good example.

Thain: Thank you.

Speaker: My question is regarding private equity firms buying failed banks. Do you think that doing that takes some pressure off the FDIC? Are there other regulatory issues that are challenging? And then, operationally, do you think they can actually run them better and unlock value?

Thain: First of all, I think that private equity firms should be able to buy banks. The FDIC, at least so far, has been making it sort of difficult for them to do that. But I think they should be able to do that. Many times the private equity firms run companies better. Not always, but many times they do. Where you have a banking system that is short of capital and needs capital, there's no reason why you wouldn't embrace what are generally very smart people coming into an industry and wanting to put capital in it. Because you're dealing with government guaranteed deposits, you have to make sure you're safe guarding those. You don't want those financial institutions to take excessive risks. But there's absolutely no reason why they can't do that in the normal regulatory structure. So I think they should be much more open than they are to allowing private equity firms to buy banks.

Speaker: How do you think your MBA degree has helped you to lead -- especially in challenging times?

Thain: It's a little bit specific to me because I went straight from undergrad to business school. At that time you could do that -- at least about 20% of Harvard's class did that. So one of the things that was very good for me -- but I think it's generally true -- is you really pick up a much broader way of looking at the world. Whenever you have a case, [it's a] different way of approaching [things], the different views, the diversity of thought about how you should deal with the particular problem that's in the case -- really respecting other people's views and listening to what other people have to say and thinking about how does what they say fit into what you think. I believe in leaders and CEOs. I believe in much more of a consensus driven style. So I believe that one of the jobs of a good CEO is to listen to those who work for you, to listen to your employees, to basically solicit input before you decide what you think the right thing to do is. I don't believe in the very authoritative -- "God has given me the view. I know the right path. And we're marching the way I said" approach, because nobody is that smart. One of the things that you pick up in business school is you realize that there are lots and lots of other very smart people who have different opinions and different ways of looking at things, and you need to pay attention to that.

Speaker: My question centers on the economy. You mentioned that there are no jobs and no housing and problems in real estate are looming. So what do you think it's going to take and how long are we going to go through this painful period?

Thain: Unfortunately, I think the thing that it's going to take is time. I just don't think that the economy is going to recover quickly. The U.S. historically is a consumer driven economy, and I don't think the consumer is going to spend like [he/she] did in the past.

Longer-term, that's probably better because, as a country, we weren't saving anywhere near as much as we needed to save. So five or 10 years from now it'll probably be better if we have a more balanced economy and our savings rate is positive and we actually have built up a pool of savings.

But I think it's going to be painful the next couple of years. I just think the U.S. economy is going to grow slowly. That means that for all the people who have lost their jobs and lost their houses, it is going to be a difficult time. Things that we can do to try to mitigate that I think are good things include extending unemployment benefits. Trying to keep people from being kicked out of their houses by extending the mortgage terms is also a good thing. But I think it is going to be difficult for the next couple of years. Let's take one more question so that we don't end on that negative note.

Thain: The question was, what do I want my legacy to be? How do I want to be remembered in light of my tenure at Merrill. My tenure at Merrill was only nine months. I've always taken pride in the fact that I've always tried to do the right thing. I've always tried to be honest and tried to think about the consequences of my actions. I also like to try to fix things. I went to the New York Stock Exchange because it was broken and it's an important part of the U.S. financial system and I was successful in fixing it. I think I could have fixed Merrill if I had had more time. You can't fix the problems that they had built up over five years in nine months. I think if Lehman hadn't gone bankrupt and if I had had two or three years, I could have fixed Merrill as well.

But I think the most important thing was to protect my shareholders and to protect my employees, and I did the right thing for what my job was. The fact that this came at the expense of my own job and then, even beyond that, to some extent my reputation was certainly damaged by the aftermath of that -- I still believe in being honest and telling the truth and doing the right thing. And I would like to be remembered for that. Thank you very much.