

LEO TILMAN TALKS FINANCIAL REGULATION ON BLOOMBERG
RADIO

SEPTEMBER 14, 2009

SPEAKERS: LEO TILMAN, PRESIDENT, L.M. TILMAN & CO.

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TOM KEENE, HOST 'BLOOMBERG SURVEILLANCE': Leo Tilman with us, Leo Tilman and Company, author of 'Financial Darwinism.' Are executives reading your book? Do they just sort of say thank you?

If you go to a board and you hand out 20 copies of your book, do they go thank you, but no thanks? Are they actually reading it?

LEO TILMAN, PRESIDENT, L.M. TILMAN & COMPANY: Good morning. I certainly hope so. I certainly hope that they should, because I think the theme of this hour and the theme in general has been that very few lessons have truly been learned by both the financial institutions themselves and the system as a whole. And therefore when we think about leverage, when we think about future crises, I believe we will see more of this.

KEENE: If the President read 'Financial Darwinism,' what would be the one thing you would hope he would learn, as you look at the new risk model, that corporate officers face?

TILMAN: Well, I think the biggest lesson learned is that the role of risk in the lives of financial institutions has fundamentally changed. And therefore, the way that we look at financial institutions, the way that we regulate them, the way that we assign credit ratings to them, and the way we manage them, should all change. And

that's not happening.

KEN PREWITT, HOST 'BLOOMBERG SURVEILLANCE': Well, Leo, the word Darwinism implies survival of the fittest. Are you suggesting that the government should not have come to the rescue?

TILMAN: Not necessarily. There are different interpretations of this title. And one of them is the ability to adapt. So we're not necessarily talking about winner take all, although we certainly have seen that. But we're talking about the notion that if there are profound evolutionary changes that have taken place in finance, then those financial institutions that are going to survive must adapt. And that was the key differentiating factor between those who succeeded and those who did not.

KEENE: Is the profound evolutionary change that John Mack was thrown out on his butt, because they didn't take up enough risk? He kept that cautious VaR, and it was oops, you didn't make any money, goodbye?

TILMAN: Well, I think that's a quintessential example of the dilemmas that executives face.

KEENE: That's being polite.

TILMAN: So someone gets hurt through proprietary trading or other principal investment activities, decides to shy away from active risk taking and instead take on fee based businesses like wealth management, et cetera. But then the competitive environment creates such pressures to deliver earnings that soon enough financial institutions go back to risk taking.

KEENE: So nothing's changed?

TILMAN: That's the point.

KEENE: So -but we're one year on, in the sense that it's back to basics, right?

TILMAN: I think so. And the microcosm of what happened during this crisis is going to come back very soon, because we saw financial businesses become more profitable over the past two years or so on deriving spreads, bid/ask spreads,

and things of that kind. But soon enough these things will compress enough that financial institutions will go straight back into risk taking.

PREWITT: Well, we do have an Associated Press survey that shows 7 out of 10 Americans lack confidence that the government has taken safeguards to prevent another financial industry collapse. So you're saying they're right.

TILMAN: I believe so too. Certain parts of the regulatory reform were vastly overdue. And they will do some marginal benefits for the system as a whole. But the key problem, the problem that financial institutions respond to pressures through leverage, and that leverage cannot be seen until it's too late, that particular problem has not been solved.

KEENE: Has been solved?

TILMAN: Has not been solved.

KEENE: Yes. Can they still go off balance? They could take the garbage off balance sheet?

TILMAN: Well, there are a million different ways in which you can take on risk. Derivatives, off balance sheet activities, et cetera, et cetera. So that's the problem. The problem that financial markets, and to that point matter regulators, still cannot see the true riskiness of these balance sheets.

The stress tests, when - did a little bit of good in this regard, because they showed the difference between the true economic capital that one needs and regulatory capital. They just did not go far enough.

KEENE: What is the Tilman prescription for 2010? We're one year on, and about what, Ken, in about two weeks we start Christmas focus and all that, holiday focus? That's a joke, but sooner than not its 2010. What is the Tilman prescription to jumpstart what hasn't been jumpstarted yet?

TILMAN: On the regulatory front, or management?

KEENE: Yes, on the regulatory front, or management. I would suggest they're both linked, and that management will

respond to regulatory changes.

TILMAN: Well, we've talked on your shows before that regulation can become a huge catalyst for entirely new thought process on business models. I don't think its going to happen.

So the change is not going to come from regulation. The change is going to come from the strategic vision of executives, of certain firms, that are going to do business differently. And it will come from boards of directors.

KEENE: But I go back to Mr. Mack being essentially shown the door for a set of reasons, is what's been reported. But it sure looked like business as usual to me.

TILMAN: I think so.

PREWITT: Well, when you say regulation is not - when you talk about regulation, is there - when you look back a year ago, was there enough regulation that just wasn't enforced properly, there was too much, or does there need to be more?

TILMAN: Well we needed certain patches to existing regulation. Consumer protection, linking a loan originator to credit risk, origination fraud, things of that kind were absolutely needed. And they certainly would have mitigated the crisis before.

But the key problem is that again, financial markets are not equipped to understand the risk of financial institutions. And financial institutions will respond to pressures through leverage because of the way that equity markets are forcing them to deliver earnings day in and day out, to your point, Tom.

So that's the vicious circle that is very difficult to break for financial executives. And it takes true leadership to come out and say I'm not going to play this game, I'm going to create lasting shareholder value.

KEENE: Have you seen one case of that? I don't want to get into your Leo Tilman and Company client relationship. But have you seen even one case of somebody stepping up and saying - come on, Leo, here's the way it works. I'm number six in CMO's, and somebody goes we need to be

number two by September next year. That's the way these meetings go, right? Is there a change?

TILMAN: There are companies that in the words of Bill George, I'm not going to let this crisis go to waste. And they are embracing change, and they're formulating their new strategic vision. And they are becoming more disciplined in the sense of delivering long term value.

It may be at the expense of near term fee ratios and near term earnings. But it's a very, very difficult sale. And the entire management and the board must be on the same page for this to happen.

KEENE: Let me do a data check. We're going to come back. Leo Tilman with us for the whole hour, thoughtful discussion. We're trying to get away, folks, from the - all the stereotypes Ken and I have seen in the last week or so on the one year anniversary of not only Lehman, but many other events wrapped around it.

With us, Leo Tilman, of course formerly with Bear Stearns, now out on his own. And his book, 'Financial Darwinism,' very thoughtful of what corporate officers need to confront, besides a lack of understanding of kurtosis.

(BREAK)

KEENE: With us, Leo Tilman. Leo, before 'Financial Darwinism: Create Value or Self-Destruct in a World of Risk,' there was the page turner, 'Risk Management: Approaches for Fixed Income Markets'. There was a lot of math in earlier Leo Tilman books. Is the math going to be changed forward?

TILMAN: I don't think so, Tom. I don't think we're confronting mathematical challenges today. We understand the limitations of risk management models. We understand when they should and should not be used.

The key problems that occurred were not because risk management models were incapable of forecasting the risk. In certain cases they were. But in the vast majority of cases, it's how they were used by risk takers, by executives, that caused the problems.

KEENE: I enjoyed a dinner last week with John Taylor of Stanford. And he was adamant - and that was my - I slipped their Trump Park Stanford -not Stanford - Stanford University. And he was adamant that this was a collapse of policy, not regulation. Do agree that this was poor policy that got us into this mess?

TILMAN: Well - and you can extend this quote, that its not just policy on the system wide level. It's a policy on company-wide levels, because you can talk about the strategic vision of executives and boards in terms of how much risk they want to take and what kind of value they want to create.

When you start leveraging up, at the moment you're faced with earnings pressures, that's a failure of policy. And the same applies on the macro level.

PREWITT: Well, Leo, is there such a thing as too big to fail?

KEENE: That's a really - thank you, that's a really, really smart question.

PREWITT: We've been hearing - it didn't just come up a year ago. It's come up before.

TILMAN: Yes. And GSE's, government sponsored enterprises, were the favorite subject of that debate, and others.

Yes, I think so, in terms of we saw what a failure of a large financial institution can do to financial markets in the real economy. But it feels that we are fighting the last war, because the next crisis could come from a variety of smaller institutions that are leveraged up, because we learned a great deal about the system and how the system operates. And the system is such that it's not just prone to failures of large institutions. It's prone to deleverage in general.

PREWITT: Well, this is another regulation question. And we're almost out of time here, Leo. But should leverage be regulated? Just put a limit on it. Would that solve a lot of problems?

TILMAN: Yes. But leverage should be defined more comprehensively. It's not regulatory leverage.

KEENE: We're going to come back to this, Ken. This is the key theme I wanted to stay with for the next half hour. Folks, if you're walking to the office right now, we'll be out on Bloomberg Radio and Bloomberg Television in the next half hour with Leo Tilman. Ken, that's got to be our topic of discussion, this idea of helping financial companies help themselves through limitations of some form on leverage.

Leo Tilman with us. The book, it's thoughtful, 'Financial Darwinism,' with a very nice introduction from the laureate Edmund Phelps.

(BREAK)

KEENE: Corporate officers worldwide mouth back to Leo Tilman. What do you hear from the corporate officers you consult? Do they laugh you out of the room? What's the tone you get here on changing risk?

TILMAN: Well, I don't think there's a lot of laughing going on, given what's happened over the past year. But I think companies are taking very different routes out of this crisis. Some are just loading up on near term opportunities, trying to generate as much earnings as possible. And as a result, I don't think they will fundamentally change in the way that they think about risk and operate.

And there are thought leaders who are really trying to make sense of what happened and fundamentally redesign their strategic vision.

KEENE: Can you give us a name like that in the corporate world?

TILMAN: Unfortunately I can't. But let me put it this way. That's what will separate the leaders of tomorrow from those who will get back into the normal swing of things.

PREWITT: Leo, I wanted to get back into this issue of regulation, not whether you should, but whether it will be possible to just regulate leverage. You can only borrow so much.

TILMAN: Well let's think back to our favorite subject a few months ago, called stress tests. Have you heard the term over the past -

PREWITT: Not lately.

TILMAN: Exactly.

(BREAK)

KEENE: Leo, we've been talking about leverage. Is leverage part of the debate, or is it a separate debate where Barney Frank and other regulators can come in, limit leverage to control risk in the future? Can regulators limit the growth of leverage?

TILMAN: Absolutely, and they should. However, leverage must be defined in a different way.

Remember when we spoke about stress tests? They were designed to reveal a very important point. That by looking at regulatory capital and regulatory leverage, and other numbers that are publicly available, you could not judge the health of a financial institution. So you needed something else. And that essentially highlighted the notion that we need economic leverage as a way of judging the -

KEENE: Okay, fine. But if we went from fifteen to one, to twenty two to one, to a mix of say twenty three to twenty seven to one leverage, whatever those numbers were, can't we just have a law that says effective immediately you can only leverage up? Or do we risk losing that financial system abroad?

PREWITT: Yes, Leo.

(CROSSTALK)

PREWITT: After all, at least for an individual, there's a limit on margin.

TILMAN: Absolutely. And again, you absolutely must limit the leverage. But the leverage must be defined comprehensively. It's not just traditional measures. It's also how many toxic assets you have on your balance sheet and so on.

So as long as the leverage is properly defined, you absolutely must limit it.

KEENE: Who does that? BIS and Basel? Or is it done by the Fed? Is it done by Congress?

TILMAN: I think it should be done by Federal regulators. And it has to be consistent policy. And that's probably where international cooperation would be beneficial, so you don't create competitive advantages for certain kinds of countries and certain institutions.

PREWITT: So in part we're back to the discussion we were having a year ago, which is there are a lot of these assets that are fairly exotic, and you can't mark to market because there's basically no market.

TILMAN: Yes. And the ability to clear derivatives, for instance, on exchanges, is not going to get you there. You need to look inside of institutions to figure it out.

KEENE: For our TV viewers, I want to go back to what we were talking about at the beginning of the interview. John Mack was shown the door. Many will say one of those reasons was he took on too little risk, his VaR was low versus Mr. Blankfein with a higher VaR. What does that signal does that send you? Essentially if you don't have risk, you don't get to play.

TILMAN: Or worse yet, if you don't have the same power to formulate your vision of what the value proposition of your company is to your stakeholders, you're going to be at the mercy of market pressures.

So if you don't have a vision that your company is going to be a less risky company that is going to deliver stable and growing earnings, then the moment your competitors load up on risk and outperform, you're going to be forced right back in.

PREWITT: Well there's another issue. We had Dick Bove in here the other day, well known bank analyst, who said basically nobody except Goldman Sachs gets it. Everybody else takes on risk, but they don't really understand, they don't really know what they're doing. Is that a valid criticism?

TILMAN: Well, without commenting on specific companies, I highlighted Goldman Sachs in 'Financial Darwinism' for exactly that reason. If you explicitly acknowledge that risk plays the central role in your business model, then the entire enterprise is managed in a very different way. You manage it as a - for lack of a better word - a macro hedge fund that takes on a lot of risks. And you need to dynamically rebalance them.

KEENE: Do they have the knowledge of math to do this? Can corporate officers talk the risk management architecture that you talk fluently? Do they have the ability to do that?

TILMAN: I believe that all the math is there, and all the professionals who can help financial executives are also there. The disconnect is again between how executives make decisions, and how the pressures on earnings and returns influence it, rather than on math.

KEENE: Well, Leo Tilman stay with us. Betty Liu, back to you. That's of course Leo Tilman with 'Financial Darwinism.' I talk here, Leo, about this idea of risk. What is the big change now versus when you began to write 'Financial Darwinism?'

TILMAN: Well, we were trying to answer very different kinds of questions. When 'Financial Darwinism' emerged, we were in this low return, low volatility environment where everybody believed that the world would not have a single big crisis ever again because of skillful monetary policies and risk management and all of that.

And only very few thought leaders in finance were telling me how nervous they were, and how they realized that you cannot have compressing margins and record earnings at the same time. And they wanted to reveal what was going on and do something about it. Today it's an entirely different discussion.

PREWITT: Well, also one reason to be nervous is that if nobody else is, then you should be, right?

TILMAN: Absolutely.

KEENE: But bring this around - and thank you so much for coming on this important day. The President of the

United States, who's a little bit busy with, as Ken mentioned earlier, this healthcare reform, he's traveling up to Wall Street to deliver a message. You just suggested it could be a constraint of leverage. What is the message he needs to convey today?

TILMAN: Well, I think the message is as follows. The financial industry plays a critical role in this economy, as we have all learned. It can fuel this economy, and it can demolish this economy.

So we need to pay great attention to how this industry is managed, how it's regulated, and who are the people who are leaders of this industry, what kind of moral fabric they have. What are they driven by? How can this industry benefit the society at large?

KEENE: Well some of the tone there, folks, I think of Benjamin Friedman up at Harvard, and his 'The Moral Consequences of Economic Growth'. Leo Tilman with us. Of course the book is 'Financial Darwinism'.

8:44

END OF TRANSCRIPT