

LEO TILMAN, PRESIDENT AND FOUNDER OF LM TILMAN & CO., TALKS TO TOM  
KEENE  
AND KEN PREWITT ABOUT U.S. CORPORATIONS

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SPEAKERS:

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TOM KEENE, EDITOR-AT-LARGE, BLOOMBERG NEWS

KEN PREWITT, HOST, BLOOMBERG NEWS

08:07

TOM KEENE, EDITOR-AT-LARGE, BLOOMBERG NEWS: Leo Tilman with us  
Right now, the book was "Financial Darwinism," a real splash last year. Welcome  
back to the program.

LEO TILMAN, PRESIDENT AND FOUNDER, LM TILMAN & CO.: Great to be  
here.

KEENE: Are we still Darwinic? I mean, is there any change. We're getting so many  
interviews where people are going, yes, but nothing's changed. Has anything  
changed in corporate boardrooms?

TILMAN: I think very little has changed, unfortunately, and I think it applies both  
to executive decision-making, but as well as the market dynamics. We're seeing  
equities rallying and credit spreads tightening and it's as if it's smooth sailing from  
here, which is very difficult to imagine.

KEENE: Is it back to 2006?

TILMAN: I think its back to 2004, right before this crisis began to be wound up.  
When you see at the environment itself.

KEENE: Okay.

TILMAN: You see significant headwinds.

KEENE: Simon Johnson and James Kwak this morning at eleven a.m., must listen, Bloomberg on the Economy, chapter five, their book, 13 Bankers. August, I think its 20, 2004 is when they let the floodgates open. They allowed the brokerage firms and the banks to re-lever up. Do we have the systems in control now not to redo your 2004 where we re-lever up?

TILMAN: Well, I think the absolute leverage probably will be would be watched more carefully and the regulators are more attuned to that. But there are other ways in which financial institutions across the board can take on risk, and that cannot be detected by external resource.

KEENE: Leo, its Wednesday. We're PowerPoint-free on Wednesday here. You can't bring in a 40-page PowerPoint to Bloomberg Surveillance. We don't allow that in the middle of the week. It's only like Monday we do that.

TILMAN: There are no PowerPoint's; we're just having a conversation.

KEENE: No, if you look at all the stuff you brought in, look at you should see it over here, Ken. Ken can't see this. He brought in like 44 pages of Leo Tilman consulting here. He's killing me.

KEN PREWITT, HOST, BLOOMBERG NEWS: Leo, haven't we seen banks Become more risk averse then the used to be? I mean harder to get a loan then it used to be.

TILMAN: Yes, in terms of origination they have, but don't forget that they had the luxury of buying treasuries and financing them at zero. And the analog with 2004 to me is as follows; spreads are tight, compensation for all financial services is declining and the only remaining source of income is the yield curve. And what we saw in 2004 is the moment the yield curve started to flatten, leverage skyrocketed, and we can definitely see this coming, it's just not going to be the housing. It could be interest rates. It could be volatility. It could be other dimensions of risk.

PREWITT: Yes, just to clear this up, is this happening now or is this something you foresee for the future?

TILMAN: I think it's starting to happen now already where you start going down in credit quality in corporate bonds and emerging markets and it's only going to intensify as the Fed starts to hike interest rates.

KEENE: And, Ken, I talked to Christine Harper, our Chief Financial Correspondent about this yesterday. You got a great yield curve and, folks, it's not like 2-10 spread that we quote on the show is the industry convention. Leo, its yield curves in tighter, isn't it?

TILMAN: Yes, it's absolutely - it's what you can borrow -

KEENE: Like one-year, you know, three months or one year, yes -

TILMAN: Right and what you can invest in.

KEENE: So what's going to happen when - talk about the punchbowl, what's going to happen when the punch punchbowls taken away? We re-lever up, right?

TILMAN: Absolutely, and that was the feature of 2004 where everybody was bullish on the economy and everybody's margins were under pressure and the moment these margins started to compress, for a variety of reasons, leverage went up.

KEENE: Right, well.

PREWITT: What's your timetable here, Leo?

KEENE: Yes, that's good question.

TILMAN: It's difficult to predict. It will depend on the Fed tightening.

PREWITT: Yes.

TILMAN: It will also depend on how quickly other sources of revenues; bid-ask spreads, underwriting fees and credit spreads come in. And they're coming fairly significantly.

KEENE: Okay, fine, let's say Bernanke doesn't do what we saw in 2003 and keep it accommodative. We go to a - first of all, we got to get the target rate just back to let's call it normal. Let's say they go more restrictive, is that enough to protect ourselves from a re-leverage or are we going to need Barney Frank to be the leverage police?

TILMAN: Well, I'm not sure if Barney Frank can be the leverage police. Only the capital markets can be the leverage police when they see these institutions start lever up and start penalizing them. So I honestly believe that regulators cannot possibly do that. And capital markets as of now are not empowered to do that at all.

PREWITT: So are we in for a replay of the fourth quarter of '08, is that what you're saying?

TILMAN: I'm afraid so. I'm afraid so. And again, we have some time. I believe Greece bought us some time because the dollar is not going to be crashing anytime soon. And therefore, we have the environment where the same scenario can be played out.

KEENE: Yes, but you're telling me that the politicians can't produce or, let me rephrase this, the politicians can't enforce existing regulation or make new regulation that will protect us from a re-leverage.

TILMAN: Well, so far, I don't see the measures that would be needed to prevent a crisis like what we just experienced as part of the regulatory reform. We're talking about clearing derivatives. We're talking about some other marginal measures, but the key components of what just happened, which is the property of financial

institutions to lever up the moment they're faced with earnings pressures; that is not being addressed.

KEENE: This is very gloomy. I mean, what do you do here in terms of being a corporate officer if you're worried about a bank and investment re-leverage. You just stay in the mountains of cash that we've got out there?

TILMAN: It's a very complex challenge facing boards of directors and executives. First of all, one of the common themes that is emerging is that folks have shortened their horizons. They're not forecasting for 3 to 5 years and not putting these big strategic plans in place

KEENE: Right.

TILMAN: Because it's virtually impossible to predict what's going to happen to the regulator.

KEENE: Well, Schlosstein was in the other day from Evercore, he said the same thing, Leo.

TILMAN: Is that true?

KEENE: He said, you know forget about synergy, it's going to be little strategic bolt-ons here and there. He didn't have that much optimism about an M&A boom. You share that same caution?

TILMAN: It's part of the same trend. So the trend is shorten your horizon, develop a short-term strategy to capitalize on the short-term trends that we're observing today, but more importantly turn your organization into more of a dynamic organization. The organization can detect change and adapt to it quickly.

KEENE: Leo Tilman, he'll be back with us, very interesting here on leveraging. One of the topics of the moment is certainly the economy and the equity markets improve.

08:13

(BREAK)

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KEENE: Leo Tilman with us, Leo Tilman Consulting. Is compensation going to change on Wall Street? Do you buy the idea where this 3-year delay of equity? Do you see a new compensation structure?

TILMAN: Yes, I think new compensation structures are emerging and there's some [claw backs] there's some longer-term compensation incentives. But I'm not sure how much is going to change behaviors.

KEENE: Right.

TILMAN: Because behaviors are still oriented toward short-term results, short-term accounting earnings and there's the vicious circle of where financial institutions need to deliver these earnings. You just quoted one.

KEENE: Yes, but, Leo, isn't the driving force here seven people in a room, hey, we're number six, we got to be number two within six months or everybody's fired.

TILMAN: Yes

KEENE: On a given category?

TILMAN: Absolutely. One of the most profound conversations that happens in boardrooms and executive offices is is it even reasonable to expect a publicly traded U.S. financial institution to be trailing for a long time their competitors and have the staying power to do so and people are very skeptical about it.

PREWITT: Well, Leo, we did have this report the other day that something like 85 percent, 88 percent of financial executives did not leave their company, even though their pay got cut. You know which may tell us something about the labor market, or it could also tell us that compensation was too high.

TILMAN: And those that left ended up being executives at other financial institutions. So when you look at the industry as a whole, I don't think behavior has changed. I don't think orientation toward short results has changed. I don't believe that risk management got truly linked to executive decision making. So when you look at that and you look at compressing compensation and margins, and ability to leverage to deliver these pressures, you have to be very pessimistic about the repeat of what just happened.

KEENE: We're running out of time. You got to come back for longer time. I mean I want to talk about board behavior. I want to talk about the concentration among the six or eight big banks. Never enough time. Leo Tilman with us, folks, Financial Darwinism, Create Value or Self-Destruct in a World of Risk. You may know Leo Tilman from his first book; it's the Ambient Substitute. It's got more math in it than anything known to mankind. This is not like that. Financial Darwinism is a great read on one theme of how corporate behavior has to change in looking at risk. It used to be, Ken, it was like the risk guy was three floors down and he had a degree from Courant at NYU or Carnegie Mellon taper and you sort of wandered by him every six weeks to be sure the lights were on and Mr. Tilman explaining that he's going to be front and center on the executive floor. Leo Tilman, thanks for coming in.

TILMAN: Thank you.

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\*\*\*END OF TRANSCRIPT\*\*\*