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## **A HEAVY DOSE OF FINANCIAL REALITY AND PRIORITY SHIFTING IS REQUIRED**

I am deeply distressed by the financial disaster being left to my children and to my fellow Americans. The issues and causes that brought us to the brink of a second major depression in less than one hundred years are well publicized and are not the focus of review herein. However, a broken national balance sheet arising from wrong policies and missteps is a disaster. We need to put our people back to work, leave a better world for those that follow us, and make sure that the promises of opportunity to all Americans that are implicit in our social contract as citizens are met. On a grander scale, if the American Dream that so underlies our place in the world and our place in history is weakened or fails, the world would be a far worse place for all of mankind. The economic and financial failures of recent years threaten America's leadership position in the world, threaten the fairness of our system, introduce uncertainties and stimuli that are negative for our people, and increasingly stratify us as a people. So how can we reverse this situation?

To look at the depth of our problem, let's turn to some numbers. According to USDebtClock.org, The total US debt per family is approximately \$669,000, but income per family averages \$62,400. These numbers include all federal, state, local and personal debts including mortgage debt. Add to the total debt of all these sources of some \$54 trillion additional unfunded liabilities of some \$109 trillion and the magnitude of our debt dilemma should become clear. We, and much of the world, have gone crazy on a debt binge of epic proportions. At approximately 4 times GDP, before unfunded liabilities, it is astounding to think that we have the ability to service this debt in any kind of traditional sense (the payment of both interest and principal). Furthermore, as of 2006, the bottom 50% of taxpayers paid about 3.3% of Federal income taxes paid; the top 10% paid 68%. The balance came from other people in other income levels and from other

sources including corporate income taxes. Given that we continue to run huge deficits, do we really believe that the “rich” and companies can sustain the crushing debt burden while still providing the investments necessary to allow us to prosper and grow our way out of this problem? Clearly, to just survive, this debt will be with us ad infinitum and we can only pay the interest on it. But the magnitude of the debt requires that we diminish it in order to have room for other priorities as a government and as citizens. This can only happen if we reduce the burden through economic growth. Don’t forget, our current debt is before the \$109 trillion of unfunded liabilities (equal to about \$353,000 per person)! Some argue that those liabilities are long-term in nature and don’t need to be faced today; they can be dealt with over time. This is partially true. But at the rate that our Government creates these liabilities, the overleveraged position we find ourselves in and given demographic trends within the U.S., these unfunded liabilities are a mega-problem for our economic future. They need to be mitigated through changes in the underlying programs and/or through growing our way out of them. Keep in mind that all these debt numbers referred to are set at very low interest rates, but the burden can further crush us as rates rise to more normal levels.

Let me digress a bit to set the stage for a basic element to dealing with our economic and financial problems. About two weeks after September 11, 2001, I traveled to northern Maine to a small community to take my elderly mother to a dinner to celebrate her birthday. I was deeply moved as nearly every home had an American flag flying and most had signs of support for the New York police and firefighters who gave so much in the World Trade Center terrorist attack. Other signs showed strong patriotic support for bringing the evil-doers to justice. I was awed by the way so much of America---and, indeed, other parts of the world---came together to deal with that tragedy. At many times in our history we have mobilized ourselves to deal with urgent problems and to express our unity as a people when such was required. Given how critical it is to break out of the economic mess in which we find ourselves it is essential to call forth that sense of national unity to cope with the problems and move on. I believe that this is best accomplished through a Financial Restoration Commission with a small, credible,

non-partisan group of Commissioners with no other role in government. They would be charged with developing a financial restructuring plan to be presented to the American people. The President has done something like this through a bi-partisan commission established in the Spring, 2010, and headed by Alan Simpson and Erskine Bowles. The commission is charged with deficit reduction. I would make the mandate even broader to also focus on Government financial restructuring in a broader sense. The critical challenge is to avoid years of economic stagnation and to restore the promise of economic opportunity to our people. The message is simple: (1) we are in a deep financial crisis that can be solved if we set our minds to it; (2) the solutions are predicated upon establishing a national economic policy of growth and financial discipline; (3) to not embark on this path will doom us to years of distress and lost opportunity for all of us; (4) our best days are not behind us but are ahead of us; and (5) promoting financial responsibility is something we all must be involved in. If we were a corporation in distress the Board would select a manager capable of dealing with the crisis, would see to it that a restructuring plan including various options were considered and would then monitor progress to the solutions closely. In the government sector I can think of two parallels worthy of note. In the New York City financial crisis in the 1970's, the Municipal Assistance Corporation was established with the wise and effective guidance of Felix Rohatyn to resolve what the City may not have been able to on its own. Then in the period of high interest rates and recession covering the beginning of the 1980's, Paul Volcker, Chairman of the Federal Reserve and a very strong leader, broke the back of that crisis and helped set us on the path to a strong period of economic expansion. Even the new Prime Minister of Japan has recently proposed establishing a cross-party panel to help deal with fiscal overhaul. Natural political instincts argue against politicians wanting to give up much power to any one person or entity, but politicians can also find cover when others propose and implement fixes. The simple act of developing such a national economic plan would be highly beneficial to financial markets, business confidence, and to the confidence of individuals. Of course, the existing political structure could do the same thing if collaboration and compromise were valued, but they are not and we should not wait. The benefit of speaking clearly to the American people as to what is required is that the

momentum to see the way through to solutions would be increased. Americans don't like failure.

Following are some specifics and areas of focus:

SPENDING. Federal Budget mandatory spending (Social Security, Medicare, Medicaid, interest on the National Debt and some other expenditures) was budgeted to be \$2.184 trillion for 2010, just about equal to a recent estimate of all Federal tax revenues for the year. Discretionary spending was budgeted at \$1.368 trillion and includes \$663.7 billion for the DoD, and all other costs of the Government. All of these discretionary programs are essentially deficit funded. Do we think that borrowing to meet current expenditures is a path to fiscal soundness? Can we go on by expending all tax revenues on mandatory programs and have to fund the very existence of our government and military by debt? This note takes no position on what government expenditures should be cut or increased other than mandatory expenditures which are primarily entitlement programs. It is the normal function of Government to debate budgets and spending programs and they should do so, but there is no room for spending when our debt burden is so onerous and when our growth prospects are so modest. To continue spending is reckless, and to debate new programs or modifications to existing programs that result in higher outlays is similarly irresponsible.

Medicare and Medicaid account for about \$776 billion of current budget expenditures and Social Security accounts for about \$687.7 billion. For unfunded liabilities Social Security accounts for about \$14.4 trillion, Prescription Drug benefits account for about \$19 trillion and Medicare accounts for some \$75.6 trillion. The U.S. Government spending problem is largely an entitlement program problem, and this is where the fixes need to be focused. Some of the problem is due to diminished tax revenues during the economic downturn, but, given our financial problems, under existing conditions don't expect these revenues to rise soon or by enough to make a meaningful difference. Social Security was principally a retirement program when established in 1935 with payments to people who had shorter life expectancies than is the case today.

Today people live longer and can usually work longer. Changing benefit start dates and payments can go a long way to solve the financial burden of this program. However, demographics simply mean that as our population ages there are fewer active workers supporting each retiree even further mandating that we seek fundamental fixes. Medicare, when enacted in 1965, was a modest program that has grown to the largest single budget item today. Despite the recently enacted Healthcare legislation that purports to, among other things, help deal with the costs of health care, the long-term trend politically seems that healthcare is an entitlement program with claims increasingly paid for by the Government. Healthcare as a percent of GDP is rapidly growing and is somewhere near 16%, or approximately \$2.25 trillion per year. Few believe that the new healthcare legislation will reduce governmental expenditures on healthcare, and the Medicare trend in expenditures is highly concerning. The direction of healthcare burden on the Government is probably past the sustainable level. We need to define what the Government's role should be in healthcare; it certainly can't do it all. Clearly, there are areas where the Government can help such as in promoting medical outcomes management, developing good information programs for healthcare consumers, developing outlines for healthcare plan design, fostering litigation control, continuing to run drug review and approval, increasing competition by enabling plan buying across state lines, and a few others. But moving in the direction of being the principal payor in healthcare just doesn't work financially, especially in our weakened financial state. The sooner we deal with this reality the sooner we head back to fiscal responsibility.

As part of a restructuring review a thorough review of expenditures at all levels needs to be made to bring budgets in line. What services need to be provided by government? What services can be outsourced? What assets do not need to be under government ownership? What is the proper level of staffing in different parts of Government? Restructurings are required at all levels of government to bring services in line with economic reality, not just for the current level of tax receipts but to cut back to levels that allocate only as many resources to governments as is economically realistic. Governments cannot keep increasing

the percentage of GDP allocated to them. Some states simply can't get their budget and financial management process under control. In these instances a process of government reorganization is required. If we are getting the Federal house in order financially, we must avoid the risks of contagion from state governments that are out of control.

At the Federal level the presentation of the financials of the Government other than just on a cash basis, would be helpful. Identifying assets, liabilities, revenue and expenditure levels, matching period expenditures with period benefits, and showing what future obligations are with their funding levels would be useful. Having these financials signed off by a credible entity would be necessary.

GROWTH. The importance of getting growth back into our economy as a fundamental tenet of our financial recovery cannot be overstated. Policy makers must understand that entrepreneurial drive gives rise to new and expanded businesses that hire people and develop new products. In addition, corporations of all sizes---small to large---are our engines of financial growth and strength. Policies that inhibit entrepreneurialism and detract from the strength of companies will necessarily weaken us economically. Recognition must also be given to the fact that the world is increasingly competitive and interconnected. No longer can we rest on the fact that our economy is so large that success can be achieved just domestically. Most businesses, other than those that are distinctly local, will find competitors from Asia, Europe, and emerging economies, and the competition in the market is usually fierce. To meet these challenges our education and training must yield those with the skill sets to be competitive and who recognize the necessity to change and develop additional skills as circumstances demand. Greater rapidity of change is probably a hallmark of the modern world. This change may be destabilizing but, on the other hand, change can bring learning, new challenges and the prosperity and security of being world-class competitive. All levels of government must orient their services and policies to this world reality. Unions need to contribute to this effort as well. What good came from all the wage and benefit gains for unions and workers in the auto industry only to find that membership rolls have collapsed as the companies

shrunk and as financial pressures required the renegotiation of previously won benefits? This is not to single out unions for blame; rather, it is to suggest that a critical contributor to our economic success is for labor to work with managements to help assure the viability of the companies and industries in which they operate.

Crippling our business establishments is foolishness. Despite copious rhetoric to the contrary, much of the leveraging of corporations by LBO shops has been disastrous for the country. The pattern of overpaying, firing large numbers of workers, draining cash to pay excessive debt, and weakening an enterprise, especially at a time when we need our economic engines to be strong and we need people at work, makes no sense. This is especially ridiculous when we see that the sponsors of these deals get huge deal fees, yearly maintenance fees from the leveraged companies, special dividends paid periodically, and then fees to arrange for the exit from the company. The returns from a large number of these deals in recent years don't justify the arguments that wise private equity sponsors can add value by helping the companies restructure and be better managed. On top of that, we let sponsors create tax shelter by allowing the interest on the vastly increased debt burden to be a tax deductible expense. Someone else (you and me) pay to make up for the yearly tax shortfall. This is not a criticism of all buyouts or of private equity providers; rather, it is a negative commentary on recent performance by so many in this business. Many early buyouts helped equity owners realize the value of their holdings which were not recognized by the equity market, and many helped rationalize business that needed to be restructured. Private equity has an important role to play in finance, especially when the holding period of many public equity investors can be measured in weeks or months, not over the longer-term necessary to appropriately manage companies. But let's get back to financial prudence.

Corporate boards can and must do better jobs in helping managements develop value and competing in the business world. While a full discussion of this topic is beyond the scope of this piece, areas where focus is needed are in the areas of strategic planning and competitive assessment, management development and succession, and in developing compensation systems that

promote long-term corporate success. Well before any leveraged transactions occurs, management and the board should be analyzing business mix to assess the outlook and best direction for the company with the goal of making the enterprise as successful as possible.

To promote growth, government tax policies should reduce or eliminate taxes on capital gains, incent capital investment and worker training, facilitate (at least for the near-term) the repatriation of foreign earnings for investment or deleveraging here, and set a corporate tax rate to recognize that the long-term value of companies as investments typically capitalizes an after-tax earnings stream. The more the Government takes, the greater the incentive to use debt for the interest tax shelter benefit and the less attractive these entities are to equity capital providers to facilitate new investment. By having a corporate income tax, the Government has made itself effectively a partner with these companies. As such, I argue that being “long-term greedy” by having companies as successful as possible is more attractive than maximizing the upfront take through taxes if that reduces the financial strength of the entity and new, productive investment. Obviously, the Federal debt burden right now is such that we must all be deeply concerned. To the extent that taxes have to stay higher over the near-term to deal with this burden, policy should be to sunset some taxes and scale in declines in other taxes and communicate these decisions to the markets. But remember, our debt problem is most rapidly solved by fixing our excessive entitlement programs.

Much has been said about the decline in manufacturing in America. While there is “noise” in some of the data, it seems clear that the number of factories and manufacturing jobs have declined. Increasingly we buy products manufactured overseas which makes sense as lower wage countries industrialize and as the economic laws of competitive advantage work. Much of this helps consumers here and helps economies develop that then become consumers of our exports. This process is inexorable. But we need to figure out what we are giving up when we export so many jobs offshore and trade these versus the benefits we get. Trained workers who take less skilled and lower income jobs are a loss for us. Supplier networks are disrupted. Skills involved in managing and

developing business systems may be lost. Communities may be devastated. Rarely is the transition to competitive advantage smooth or without those who lose. That cost is not to be ignored just as is the long-term benefit of moving to areas of competitive advantage. I suspect that if fewer of our best and brightest became lawyers or derivative traders and if more capital and management skills were focused upon making products here, with the appropriate rewards to incent this development, we would lose fewer jobs to overseas manufacturers. We have to value manufacturing and want to support it to not wake up one day and find that we have gutted our ability to make things.

FINANCIAL SYSTEM. Our financial system has been shaken by the near-depression experience of the past few years, and it has let us down. However, it is important to remember that there were contributors throughout every walk of life in our country to the devastation we experienced. While many of those in banking failed so did investors, many home buyers, those in mortgage origination, legislators, regulators, and everyday consumers who lived off the equity in their homes and off credit cards. The fixes we need to avoid these problems in the future are less complex than some of the reforms or new regulations being discussed would suggest.

The first and overriding problem is just too much debt. Whether that debt was on banks or industrial companies, at investment banks, through margin debt, in credit cards, in home or commercial real estate mortgages, built into investment products, or at various levels of government it was just excessive and will take time to work down. The second is a breakdown of basic financial standards and how business being done is reviewed before being brought to the markets. Bank loans are not designed to be toothless in covenants. Banks invest depositors' funds and are supposed to do so in ways that give a high degree of assurance that they will get their money back. Gutting loans of basic provisions does not help this process; rather it simply benefits borrowers and helps the banks get more lending business that they should not have or want. Where were the bank regulators when they looked at the business of these institutions? Where were the security industry regulators when leverage went to insane levels and when even a cursory examination would have revealed that commitment

committee processes had failed. A standard of “we can sell it” is not consistent with the better question of “should we sell it”. In some cases it appears that if a deal’s ratings were high enough that no review was needed prior to the creation of hundreds of millions or billions of dollars of product. This is a basic failing of process. The rule of “know your customer” clearly failed when so many credit default swaps were sourced from one principal institution. Where was common sense? Why were banks apparently evaluated on whether their mortgage lending to low and moderate income borrowers was at some quota the government felt was desirable? Why wasn’t the standard whether or not the loans were well underwritten? How much focus is there upon government pressure on the GSE’s to accept substandard mortgages? Is our national debate sufficient to look at the increasing government involvement in our economy? I don’t think so.

We are now the proud owners of a new 2000+ page financial regulation bill. There must be some useful ideas in the bill, but it appears that more than 200 separate studies will be required before we know how our system will work. Of course, new bureaucracies will be created and greater expenses will be incurred, but did we have to go that far for most of the supposed benefit in the Bill? There has certainly been a failure of regulators to supervise the behavior of our key financial institutions. But I don’t believe that there has ever been a time in my career when a senior regulator couldn’t sit down with the senior management of a banking institution and suggest that their practices were lacking and that changes were in order. Pity the management who didn’t take such advice! There has also been a dismal failure by boards of directors to review practices at so many of the problem financial institutions. Wouldn’t fixes where regulators regulated and Boards of Directors directed have been more in order with greater flexibility and greater simplicity?

Derivatives have been an area of deep focus, as they should be. At the end of 2007 and early in 2008 there was shock as it came to the fore just how big the credit default swap market had become. And of course, many of the mortgage and other packaged structures sold into the fixed income market were heavily derivatized by their nature as investors woke up to find themselves wiped out by even modest credit problems within the structure. I believe that in looking at the

derivative market that there needs to be a separation of products for analysis purposes. Interest rate caps to hedge interest expense is a product that makes sense and is probably not a problem area. Interest rate swaps also do not appear to be an area of profound problems. Financial products sold on stupid ratings and stupid---or judgmentally foolish--- assumptions are best dealt with by analytical discipline. Credit committees and commitment committees are appropriate points of review to originate such products, and regulators and boards should all focus reviews on practices in this area. For structured products, detailed disclosure at the time of issuance and subsequently during the life of the product can go a long way to make any problems diminish or disappear. Credit default swaps appear to have been an insurance-type product with none of the insurance industry safeguards or standards applied. If they were created as most insurance products they would be subject to varying capital ratios based upon the credits protected, concentrations of risk, other business risk aspects, pretty detailed actuarial studies as to the adequacy of the writing entity to meet its obligations under a wide variety of scenarios, the terms of the products written, and different measures of market price to book price performance, among other factors. Writing CDS's without such basic protections should be limited business at best, but writing them with appropriate protections should hugely reduce problems in this area.

Banks have a critical role to play in our economy, and they need a market in which to function that gives them the ability to fulfill their role with an acceptable level of risk. As mentioned earlier, they are supposed to invest depositors funds safely. Traditionally, they made loans to companies and in the interbank market, against home and commercial real estate, and invested in government securities. Loans made were well documented and secured, and, while some part of the loans could be sold down, a large exposure was retained by each bank. The bank market has been an important source of working capital financing, term financing for longer-term needs, and acquisition funding. Not only is an important part of the credit needs of our economy met by the banks, but they are also important vehicles through which the Fed exercises monetary policy. These roles are important. As other institutions have gotten into the loan market to securitize

the product, competition has not always promoted good banking practices. Standards of origination move towards “what can be sold” and not to “what is prudent to continue to hold”. The power of fees for origination is great, but the end result may leave us with a banking system that is not what is in our best interest. Without getting into the discussion of whether or not Glass Steagall should have been repealed or what businesses should banks not be in, I believe that it is in our interest to carve out for banks the kinds of loan and investment areas that are traditional, that incent them to exercise discipline, and that help the Fed exercise its monetary policy actions through them.

The structure of our markets has changed hugely over the past couple decades. I do not see the logic to having some investment funds report holdings but others be exempt from doing so. Every fund of any consequence should have similar disclosure requirements. Disclosure is one of the keys to market integrity and the avoidance of manipulation. In trading equities, some market participants are attempting to gain market advantage on timing through faster computer systems and software. This is not right. The exchanges should set a technology standard to be met by all and all investors should have equal access to the markets. To not do so promotes front running and brings into question the integrity of markets.

Auditors have got to be reviewed for some of their practices. Changing partners on a company’s account every five years may offer benefits. However, it should not be open season to review everything the previous partner supervised and to change policies accepted for years. After all, if an audit firm reviewed a company’s financials, presumably audit standards were good and policies were appropriately reviewed and signed off. Where there is no evidence of fraud or misstatement by a company, this partner change should not be a subterfuge for a massive increase in audit fees. This happens too often. However, if an issue of concern rises, of course the auditors should conduct such review as they deem appropriate in the pursuit of fair disclosure and professional standards.

The Fed’s mission is to achieve full employment and stable prices. The objectives are desirable but the execution has been poor. The attempt to remove

risk from the market by communication of direction and other efforts paradoxically results in greater risk, the promotion of one bubble after another, and less than full employment and very possibly not stable prices. Markets cannot, and should not, operate without having appropriate risk premiums charged. For some time Fed policies have supported bubble mania through essentially “free” money. Of course, as events of 2008 and 2009 unfolded the Fed had gargantuan and unprecedented tasks facing it. It is important to give them credit for the heroic efforts that kept us out of depression and to understand that they were only one of several key players in dealing with the financial crisis. However, creating what have come to be called Fed “puts” so that investors can facilitate bubble investment through massive carry trades is unacceptable. Let’s have more Volckerism instead as conditions permit and get back to pricing risk appropriately. Also, the printing of money to deal with the crisis is debasing our fiat currency and simply creating more bubbles. A dollar is a bit like a share of stock in America. Debasing it may offer some short-term political gain, but it is anathema to long-term sound economic management and fairness.

CONCLUSION. We have come through one of the most dangerous periods in American history and we have probably escaped a depression. However, we need a number of reforms and a review of policies necessary to move us back to prosperity if we are to avoid a prolonged period of stagnation and diminished opportunity for our people. There is urgency to effecting changes. The stronger our economy the greater is the ability we have to pay for entitlement programs, should we so choose, or the less the burden the Government can be on our economy. Those are political choices. But not dealing decisively with our financial crisis means our adverse choices have largely been made for us. If this is the case, we have been poor trustees of the legacy of opportunity, strength and freedom bequeathed to us.