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Henry Kaufman on Civility in the Financial Sector

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Henry Kaufman


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Introduction

JOANNE MYERS: I'm Joanne Myers, director of Public Affairs Programs, and on behalf of the Carnegie Council and the Dilenschneider Group, I'd like to thank you for joining us.

During the past month, the Carnegie Council in conjunction with the Dilenschneider Group have been hosting a series of programs that address the issue of civility. This afternoon we'll be focusing on the financial sector.

We are very pleased that Mr. Dilenschneider extended an invitation to Dr. Henry Kaufman to be part of this series and to speak to us on this topic. With his long and distinguished career in finance, I believe he will raise many questions that in the end will stimulate a productive dialogue on this topic, especially during these tense financial times of slowing economic growth and regulatory struggles to implement reforms.

For quite a while, many in this country have been dispirited about the state of our economy. Newspapers are filled with articles about financial collapse, deficit, and debt. It has been said that the financial crisis of 2008 and 2009 was the worst in 80 years and was rooted in ethical shortcomings in the financial sector.

It appears that in seeking short-term gains there is a residual of long-term liabilities that continue to affect us. On Wall Street, the fears of losing market share, compensation demands by traders and investment bankers, and other short-term competitive pressures have created tensions and greater risk taking, all which have contributed to our anxiety.

The environment is tense and the atmosphere charged with behavior that is not often respectful. At a time which calls for everyone from Wall Street to Main Street, from Pennsylvania Avenue to Capitol Hill, to brainstorm and work together on the financial state of our country, the question remains whether we can fix what still needs to be repaired and whether we can rebuild the fading confidence of many Americans without the polarization in our society. I think we all want to believe that ours is still a land of financial opportunity.

For an experienced perspective from one who has seen a lot over the years and whose comments continue to impact our world, please join me in giving a very warm welcome to our guest today, the very distinguished Henry Kaufman.

Thank you for joining us.

Remarks

HENRY KAUFMAN: Thank you very much.

Civility, decency, and high ethical standards are essential not only to social and political life, but for economic and financial progress as well. I applaud the Carnegie Council for its long and admirable role in promoting these virtues. I would like to thank you for inviting me this afternoon.

Drawing on my rather long experience in the financial markets, and in view of the recent turmoil, I'd like to focus my remarks today on key aspects of civility and decency; namely, the recurring pattern of irresponsible financial behavior.

Progress in the sciences and technology since the end of World War II has been just astonishing—from moon landings to microcircuits, from modern medicine to the Internet, from bioengineering to nanotechnology.

In contrast, the performance of financial markets has been problematic in many ways. Quantitatively, financial markets have exploded worldwide. The volume and the velocity of securities now traded dwarfs anything that I ever saw in the early career of my life in Wall Street. Yet, we remain subject to regular upheaval, most notably the recent financial crisis, the worst in 80 years.

What is the underlying source of this turmoil? It is not the lack of technological knowledge about how to structure and to trade securities. Rather, it seems to me our financial travail stems mainly from behavioral and ethical shortcomings, from regulatory failures, and from what I would call historical amnesia.

We seem to have learned shockingly little from past financial crises—and there have been many, some dating back many centuries, going back to the 14th century and even earlier.

But that Wall Street has been a problem is, of course, well known. The prevailing culture began to change in the United States.

For a generation or so after World War II, financial behavior was sensible and moderate. The excess of the late 1920s, which many believe led directly to the long collapse that followed, was still fresh in the national consciousness.

More than that, the New Deal regulatory regime had put in place a host of regulatory restraints governing the financial sector and several others. Wall Street managers and traders generally acted conservatively after World War II in lending and investing practices.

But that prevailing culture began to change as the Depression faded in the memories of many and regulatory restraints were gradually relaxed. From the mid-1960s through the last financial debacle, there have been 15 U.S. financial crises of various sorts and many others around the world.

The recent financial crisis is by far the worst in the postwar period. If not for the intervention of the federal government and the Federal Reserve, however belated, many major financial institutions here and abroad would have failed. All were thinly capitalized and interconnected in the markets, and many held huge off-balance-sheet transactions.

How did this irresponsible behavior become so widespread?

One reason was that the financial markets became increasingly depersonalized. One by one, leading investment banks shifted from partnerships to publicly held corporations, while at the same time their relations with clients became more strict and quantitative in nature.

I know from my own experience as a senior partner of Salomon Brothers that the shift from partnership to corporation had profound impacts over time on the level of our risk-taking and in our relationship with clients. I will give you just a couple of examples.

During one of our executive committee meetings back in the 1970s, a young trader interrupted the meeting that was then being held by Bill Salomon, the managing partner, and he gave him a slip informing him of a very large bond trade we had just completed with one of our institutional clients.

Bill asked, "How much did we take out of the trade?"

The young trader replied, "A point," meaning one percentage point.

Bill then called in the partner in charge of transactions, who reaffirmed that the firm had made one point.

Bill Salomon's admonition was brief and to the point. He said, "Salomon Brothers does not take such a profit." The bonds purchased were highly marketable, of high quality, and they were sold by an institution that was a valued client.

He ordered the trading partner to return part of the profit to the institution. In addition, he told the trading partner that the participation in the profits of the firm for him was going to be reduced.

The question then is: What prompted Bill Salomon to take this action in the 1970s? It was, among other things, to protect the relationship with an important institutional client. But it was also to ensure that this wouldn't happen in other transactions of this kind by the firm.

In that era, the strong competitive zeal within Salomon Brothers was tempered by a strong culture of integrity. When the firm became part of a publicly traded corporation named Phibro, the level of risk-taking in trading and positioning securities gradually increased.

This shift from partnership to corporatized Wall Street encouraged the growth of leverage, borrowings. In the earlier period, the owners of the business, the partners, were on-site, and many were actively involved in day-to-day affairs, and they had the use of the modern parlance "considerable skin in the game," which is to say their liability was unlimited.

I will always remember when Sidney Homer, one of my mentors, told me that I would become a partner. He said, "I'm sure that you will rush to tell your wife." Then he added, "But be sure to tell her that once you sign the partnership papers next week you will be personally liable for $2 billion." [Laughter] That was the firm's total liabilities at the time and, therefore, the amount that each partner was personally exposed to.

Many financial institutions—commercial banks, security firms, and insurance companies—took the additional step beyond corporatization to become financial conglomerates.

As they diversified into multiple businesses and grew enormous, their relationship with clients became even more formalized and depersonalized. Highly elaborative quantitative matrices, rather than personal relationships, became much more the norm.

This, in turn, enabled and reinforced the proliferation of new credit instruments and other forms of securitization, which, in turn, further distanced the firm from their clients. Securitization, as many of you have learned by now, the conversion of non-marketable assets into marketable ones, has been one of the key factors in excess credit creation and market behavior. For many of us, the most vivid illustration has been the mortgages that have been financed in the ten years or so.

Financial derivatives are another credit instrument that expanded rapidly in recent decades and contributed massively to excessive credit creation. They too had a depersonalized influence on markets.

Growing technology interconnected the financial markets but also fostered an easy credit outlook, as markets have been linked globally by information technology and networks, financial information flows nearly instantaneously, and computerized trading had spread to more and more exchanges. Investors can access financial data and participate in markets around the world and around the clock.

These developments have put many economies around the world in the cross-hairs of financial crisis. In other words, they can be triggered by financial laxities outside the boundaries of any individual country.

These two developments, securitization and what is called the seamless interconnectivity of markets, have brought intricate quantitative risk modeling to the forefront of financial practices. Securitization, the pricing of securities on a minute-to-minute basis, generates market prices, while information technology offers the power to quantify pricing and risk relationships. The potency of this combination, its effect on risk-taking, cannot be overstated.

Armed with complicated modeling techniques, increasingly powerful computers, and reams of historical market data, a growing number of investors have become entranced with the dream of scientific rectitude. Few recognize, however, that such modeling assumes constancies in market fundamentals. This is because it doesn't take into account structural changes in markets that will affect prices going forward.

For many years I've questioned the wisdom of relying heavily on quantitative risk analysis. The modern quantitative econometric techniques developed since the 1970s have given investors and portfolio managers a new sense of confidence in their ability to forecast future trends and behavior.

The fact is that these relationships don't hold. The vast majority of models rest on assumptions about normal and rational behavior. But during market manias logic doesn't prevail. Such markets are driven more by hubris, elation, fears, pessimism, and the like, which are all emotions that the current models do not, and perhaps cannot, really compute.

So the question is, where does the responsibility lie for the behavior of our financial institutions?

Who is the guardian of credit? The managers of financial institutions, presumably, should be in the front line. But they are as subject to the impact of structural changes in financial markets as any market participant, perhaps even more so.

My first doubt that financial managers would serve as the leading guardian of responsible behavior emerged sometime way back in the 1970s, when securitization, globalization, and new information technology began to filter into the landscape.

I sensed that the conventional wisdom was coming into question when Walter Wriston, the CEO of Citicorp, asked me to come to lunch to discuss a *Financial Times*-sponsored talk I had given about "will the bankers face a harsher climate?" I had concluded that the banks required more equity capital because, among other reasons, the size of their balance sheet was increasing very rapidly.

He disagreed. His conclusion was based on the following premise: first, banks charge floating interest rates on their loans (interest rates go up and down); second, with the gradual deregulation of deposit rates, the cost of bank funds could be managed as a spread below the rate of return on bank assets; and third, because banks could now monitor a constant favorable interest rate spread over the cost of their borrowings, interest rates themselves didn't matter as much as bank managers once feared. For all these reasons, Walter concluded banks did not need to hold as much capital.

Although this argument sounded reasonable, I disagreed and told Walter that for his reasoning to be correct the credit quality of the bank borrower would have to remain constant. Walter was adamant in replying, "Henry, we are bankers and know how to make correct credit judgments." He was of course wrong, which was all the more significant because Walter Wriston was the dominant commercial banker of his era. He was very articulate in writing and in speaking and carried great influence in the financial community.

But his comment left an indelible imprint on my thinking, and it helped me to conclude that leaders of financial institutions could not be counted on to be guardians of credit. In fact, the structural changes I've been discussing narrowed the decision-making latitude of senior managers by shifting attention and power to those driven by day-to-day performance pressures—traders, investment bankers, and managers of proprietary trading.

At the same time as financial institutions diversified into new business and new product lines, their senior managers found it increasingly difficult to keep abreast of the vast number of risks in which their firms were investing and trading. It became virtually impossible for them to resist the impulse to grow and compete for profits and market share against rivals who were also taking on a higher risk level. Allow me to give you two examples of how such pressures compromised the judgment of senior financial managers.

The first dates way back into the early 1980s when I was still at Salomon. John Meriwether, who later founded Long-Term Capital Management, came to one of our executive committee meetings and proposed that the firm should become a broker in interest rate swaps. As brokers, we wouldn't be taking any risk because we weren't positioning them.

But several of our competitors soon entered the business. John returned and proposed that we become a dealer. We would take interest swaps into inventory, he explained, but the obligations were of relatively short maturity.

The executive committee again agreed. Within months, we were asked to position much larger and much larger amounts and longer maturities. So the executive committee acquiesced at each step along the way. Trading in interest rate swaps became very a profitable business, and Salomon's risk positioning on these and many other types of derivatives was not very clear. So it wasn't long before the firm's huge level of activity in derivatives began to constrain at times its position in other markets, reflecting a subtle, but quite a significant, shift in Salomon's strategy priorities that grew more and more pronounced over time.

The other illustration is of a more recent vintage. It is a well-known comment in 2007 by Charles Prince, who was the CEO of Citigroup. Referring to his bank's participation in the financial markets, he admitted that "as long as the music is playing, you have to get up on the dance floor and dance."

Now, this insightful comment was quite revealing of how the decision-making process among senior managers of large institutions had become imprisoned. Fear of losing market share, compensation demands by traders and investment bankers, and other short-term competitive pressures made it virtually impossible for top managers to pull their firms off the dance floor. Because their managers' compensation often was linked to their firm's profitability, there was another incentive to stay in the game and lean in favor of greater risk taking.

Damage from financial excesses in recent decades would not have been as severe if not for the aggressive growth in giant financial conglomerates. These institutions played the central role in credit creation through derivatives, mortgage securities, credit default swaps, and other exotic instruments. These firms, which sprawled across commercial banking, investment banking, insurance, credit cards, mutual funds, and many other domains, also embraced quantitative risk analysis, which as I've suggested, tended to increase rather than diminish risk and fostered a debt overload.

Liquidity itself has taken on a new meaning in recent decades. Again, the leading financial conglomerates were at the forefront of the change. Liquidity has shifted from an asset-based concept to one on the liability side of the balance sheet.

Before this shift, corporations measured their liquidity in terms of the inventory turnover, the maturity of accounts receivable, the size of their liquid assets, and of course the relationship of assets to liabilities.

In a couple of decades, a new mindset has emerged in which liquidity is understood to have been access to credit, access to borrowing. Before the recent financial crunch, business began borrowing almost seamlessly and painlessly, and households literally stopped saving when access to credit became super-abundant. The major conglomerates played a heavy and leading role in promoting new mortgage-lending products, flooding the economy with credit cards, and offloading riskier assets into subsidiaries or by securitizing them.

Government officials did not respond promptly to this array of problems created by large financial conglomerates. Even in the wake of the crisis, the reactive Dodd-Frank Act is a rear-guard action designed to build firewalls around large institutions in order to limit the size and scope of their activities.

But these measures, I am convinced, will fail over time. The leading conglomerates already are attempting to chip away at the legislation by lobbying to modify some of the various key elements of the legislation.

In the broadest sense it seems to me that financial consolidation, the concentration of financial assets, affects the foundation of our political economy by pushing us farther away from an ideal economic democracy. As the recent crisis demonstrated vividly, when the financial sector is highly concentrated, the government must continue to play a large role in allocating credit.

Now, just as frailties in economic behavior underlie the drift towards financial concentration, frailties in political behavior help to explain the failure of policymakers to effectively address the "too big to fail" conundrum.

Neither major party was eager to support measures that would genuinely support financial competition and ensure the dominance of market mechanisms in credit allocation.

Of course, identifying which firms are "too big to fail" is a tricky business. Still, if the largest diversified financial institutions were required to divest assets, competition, by definition, would increase in the universe of our credit markets. But lack of political will on both sides of the aisle ensured that the Dodd-Frank Act did not address the "too big to fail" issue decisively. It effectively kicked the can down the road, leaving it to others to deal with it and the ultimate negative consequences of heavy concentration.

Foundationally, the responsibility of guarding our financial system resides for the most part with the Federal Reserve System. Charged with encouraging economic growth and price stability, the Fed has the power to raise and to lower interest rates.

Its performance records has been checkered. In responding to the recent crisis, the Fed response was late, but nevertheless massive, dramatic, and I thought innovative. That intervention stopped the economy and the financial markets from falling into an abyss. Even the much-debated quantitative easing you've been reading about was from my perspective correct, because it reversed the decline in the value of financial assets, an important prerequisite for reversing the weakness in the economy.

Although the central bank response to the crisis was generally admirable, its role leading up to the crisis was much more problematic. Up until the crisis was in full bloom, the Federal Reserve took a hands-off approach in managing the credit structure of the United States. It followed a kind of a clinical and antiseptic tactic of focusing on the growth of the monetary variables and, thus, failed to adequately restrain the growth of credit, the growth of debt. It allowed credit and debt to grow much faster than the growth of the economy's nominal GDP.

As I have suggested, the rapid growth of credit in recent decades was propelled, of course, by several structural changes in the financial markets and a lot of innovation. Officials at the Federal Reserve failed to appreciate the impact of these changes—securitization, derivative growth, and so on—and to understand what the impact would be on the economy and the system.

The Fed failed also to recognize that abandoning the Glass-Steagall Act would accelerate financial concentration and thereby create even more of a "too big to fail" problem. It took the near-collapse of our financial system for the Fed to officially admit in public that some giant institutions were too big to fail.

The Fed's role as a guardian of our financial system is analogous to the relationship between the parent and a child. As a guardian, the parent's role is to set out standards of behavior and hold the child to those standards. A parent should not play the role of a friend in his or her relationship with the child. Similarly, the central bank should define and enforce standards of behavior. It should never become a folk hero of the marketplace.

I would take it even a step further. No senior government official dealing with supervision of financial markets should be permitted to be employed by financial institutions within several years after leaving the government of the United States.

Now, I'd be a little bit remiss in my comments today on the current irresponsible financial behavior if I failed to comment on the role of the economics profession. On the whole, this role has been less than distinguished.

As noted academic economists became entranced with trying to mathematically move ahead by modeling economic behavior, the theory of rational expectations became extremely popular in the halls of academia.

Two recent critics of this describe it as follows: "An economic theory of the world that starts from the premise that nothing genuinely new ever happens has a particularly simple—and thus attractive—mathematical structure: Its models are made up of fully specified mechanical rules that are supposed to capture individual decisionmaking and market outcomes at all times: past, present, and future." [Roman Frydman and Michael D. Goldberg, *Beyond Mechanical Markets: Asset Price Swings, Risk, and the Role of the State* (Princeton University Press 2011)].

The popularity of the theory of rational expectation and the concomitant quantification of economic and financial behavior encouraged the academic community to downplay the importance of structural changes and the impact on the economy and financial markets. There were precious few academic economists who called attention to the instability of our financial system.

Academicians and private-sector economists alike are heavily influenced by behavioral biases that are very difficult to escape. On the whole, these biases discourage analysts and market participants from accepting the likelihood of panics, crises, and other financial mishaps.

Consider for example the all-too-human propensity to minimize risk and to avoid isolation. It is comforting to run in the crowd, and doing so minimizes the likelihood of being singled out or being wrong.

When it comes to looking ahead, we inescapably look to the past for guidance. But it is important to keep in mind that history never repeats itself, but rather, as Mark Twain said, it rhymes. This makes the real challenge to identify what differs from the past in the current situation, quite a difficult challenge. Mathematical equations that are based on historical data are unable to make such judgments.

Another important cognitive bias is that most of us find it very difficult to actually change our minds. Consider the economist who gained prominence through years of writing and developing an economic and financial theory. This economist is unlikely to change his conclusions promptly in light of contrary evidence. And this is probably true for anyone working beyond the confines of a test-tube.

There is also a clear bias against negative predictions. As far as I know, no American president, no chairman of the Council of Economic Advisers, no secretary of the U.S. Treasury or chairman or the Federal Reserve has ever forecast a business recession.

For that matter, large business and financial institutions avoid talk of near-term difficulties. The latest financial turmoil was, of course, no exception to this bias. Just months before the recent crisis reached its depth in 2008, officials noted publicly that the problem in the housing market was "well contained."

There are many reasons for this bias, not least the fact that negative economic and financial projections make for bad politics. They can cut short the career of political leaders, interfere with the aspirations of leaders in business and in finance, and imperil the performance record of financial managers, even when they are on the mark.

How many times have we heard prominent individuals say in response to some negative development: "Of course I am a long-term optimist. This too will pass."

Of course most of us here and everywhere are optimists. How else would we cope with the many harsh realities of life?

I have personally encountered the fallout that comes to those who make negative predictions. Decades ago, I was labeled "Doctor Doom." Indeed, the economist Albert Wojnilower, a friend of mine of many years, was called "Doctor Death."

What did I warn about that earned me this title of Doctor Doom? My major concern included the dangerous rise in the rate of inflation in the 1970s, the excessive speculation and speculative zeal of markets and market financial participants, the overleveraging by financial institutions and business corporations, and the periodic ineptness of official policymakers.

Economists and business analysts, especially those employed by "sell-side institutions"—that is, organizations involved in such activities as trading and investment banking—are confronted with the difficult task of maintaining objectivity. Just the designation of "sell-side" suggests that their analysis should help further a trade or the distribution of new securities. Wall Street has been riddled with this conflict, which has become more and more exposed, as all of you know, in recent decades.

To minimize this conflict, I feel strongly that the head of research should be a member of the senior management and not report to the head of an operating function, such as trading, sales, or investment banking. That is still not the process.

At Salomon Brothers, the role I eventually attained on the executive committee afforded me independence from sell-side and other pressures and did give me the opportunity to shelter the research effort of the firm. When in the 1980s I came to disagree with Salomon's new strategy decisions that I feared would get it into trouble, I didn't take any pleasure in severing the longtime relationship or in the fact that the firm got into difficulties later on.

My point is that very few members of the investment community enjoy the kind of independence from conflict of interest that I enjoyed, and we should do all that we can to minimize such pressure and biases.

For all the advanced econometric modeling and other new techniques at the disposal of today's economists, they are not observing a world as reliably predictable as experts in the physical sciences and cannot run the same kind of controlled experiments. Theirs is a human science.

I wish I could assure you that irresponsible behavior in financial markets will abate in the future. But I can't.

As we struggle to emerge in the aftermath of the recent upheavals, we continue to face some headwinds. Far too many financial assets are still not shown on the books at realistic prices. Oversight in both the United States and in Europe remains under par and still has to be agreed upon. Occasionally, near-term speculative impulses in financial markets continue to flare, but they will be constrained for a while by the massive debt overhang in the credit structure.

We need fundamentally new ways of thinking about market behavior from our economic thinkers and political leaders. It is so difficult for those who have dominated economic thought and dominated political life in recent decades—and still do—to think in fundamentally new ways.

The new paradigms almost certainly will emerge not from the minds of the incumbents, but rather from the ranks of tomorrow's leaders.

Thank you very much.

Questions and Answers

JOANNE MYERS: Thank you.

Since we are talking about finances, I would have to say that credit goes to Mr. Dilenschneider for inviting you, but we are indebted to you for your remarks.

I'd like to open the floor to discussion.

QUESTION: Thank you. Matthew Olson.

I have, as always, enjoyed your tour d'horizon. I am biased because about the time you were designated "Doctor Doom," I was beginning as a trader in the financial markets in anticipation of the demise of the Glass-Steagall Act, which as you know didn't happen right away.

When I hear people criticize the demise of the Glass-Steagall Act, I think of the period 2008-2009, when so many very large investment firms looked like they were going the way of Lehman Brothers. It was the giant banks that were induced or jumped of their own accord to take over those institutions and, thus prevented subsequent

Lehman events.

I hesitate to bring up something so practical, but could you talk about that when you criticize the Glass-Steagall Act's demise?

HENRY KAUFMAN: It was only when we got to 2008 or so that the Federal Reserve and the U.S. Treasury admitted that large, integrated financial institutions should be deemed to be "too big to fail."

Heretofore there was always that kind of aura that "the market will clear the transaction." That was the spirit of the former head of the Fed, Alan Greenspan, who, unfortunately, allowed a monetary expansion and a credit expansion but didn't induce the discipline to make that work.

Then, by the time we got to 2008, the financial structure became so intertwined, the amount of debt on-balance sheet and off-balance sheet was so large, domestically and globally interconnected, that the central bank and the U.S. Treasury had really no choice. If it allowed more failures, then there would have been no institution of big size that would have failed.

Apropos of this, I should remind you I wrote an article for *The Wall Street Journal* about a year and a half ago in which I said the very same thing, and I said specifically that no institution, from Citigroup to JPMorgan Chase, would have survived.

Jamie Dimon called me the next day and said, "You can't say that."

I said, "Why not?"

He said, "We would have survived."

I said, "Well, you'll have to prove that, because you are the largest writer of derivatives in the United States. You have enormous international linkages. You have a big repo book, as we would call it. There's no way."

Well, he never proved it to me, and I can understand why. [Laughter]

QUESTION: John Brademas. Thank you, Henry, for a fascinating analysis.

My late father was born in Greece and I am the first Greek-American elected to the Congress of the United States. It is with that observation that I ask if you have any comments on the current problems facing Greece.

HENRY KAUFMAN: John is also the former president of New York University, I should say one of the distinguished former presidents of that university, from which I have two degrees.

QUESTIONER: And former chairman of the New York Fed.

HENRY KAUFMAN: Former chairman. So you were partly responsible. [Laughter]

I'm not an expert on Greece, number one.

Number two, the Greek problem is a problem that started way back in the 1990s when the euro market was organized and the euro currency came into being.

It's interesting. I looked up a talk which I gave at that time, in the 1990s, and I said there was going to be trouble because you had a central bank that conducted monetary policy but you didn't have a centralized fiscal policy where you would raise and lower taxes throughout the Eurozone. So you had an opportunity whereby countries like Greece, Spain, and Portugal could be in the market and borrow huge sums of money, very close to the best credit in Europe, which is Germany and France and so on. That created a lack of discipline.

So today here we are with Greece heavily indebted. Its banks have huge balance sheets and they are heavily indebted, particularly to European financial institutions. The government of Greece issued a huge amount of debt, which is also domiciled in the banks. Also, there's about $40-$50 billion of Greek debt in American institutions.

There is no easy way out. If you are a conservative investor, you could buy today two-year Greek obligations issued by the government at a yield of 28 percent per annum. The market is open tomorrow and you can buy as much as you'd like. It was up to 30 percent two days ago. So in that sense, eventually Greece will have to lower its debt burden.

The dilemma is that those obligations of the Greek banks and of the government are sitting heavily in European institutions—German and French institutions—and in the European Central Bank. So if there is a kind of failure in the restructuring, those institutions will have to write down those assets on their books. That's not an easy thing to do.

So there is great desire to delay that event. There is a political desire to delay it. There is an economic desire to delay it. Hopefully, the European institutions will get enough earnings and improve their balance sheets enough so that the loss that they will have taken will not impair their liquidity.

So my suspicion is that the can will be kicked down the road for another year or so until the inevitable will happen, that Greece will have to go into a quasi-bankruptcy.

QUESTION: Ron Berenbeim.

The subject here is civility. When I think about civility, I think about a couple of things that seem to have changed a lot, at least since I started in the working world and—I hesitate to say this—since you did. That is the education and the rigor of training and the internal incentives and the promotional and decision-making processes within banks and financial institutions. I would be interested in your thoughts on that.

HENRY KAUFMAN: That's a very interesting observation. As I tried to indicate, the market process developed a series of credit instruments that were highly tradable, and you could therefore gain quick profits very quickly. But that's not the only issue involved.

I didn't mention it in my talk, but I've mentioned it earlier. I have to be careful. John Brademas is sitting here from the university with which I'm affiliated. But the academic world did not do its job. The business schools did not do their job.

Very few business schools that I've come across made it mandatory for a student to take a course in financial history or economic history or business history. It became an elective course out in left field.

What the business schools developed generally were major finance departments that service large institutions. It produced MBAs that were highly skilled analytically and quantitatively that then moved into the financial markets. That's one of the great failures of our system, because we wanted to quantify everything analytically.

Gradually, now business schools are beginning to change. But that's not easy. When you have a structure in place, you just don't abandon that structure. All the major business schools—and NYU is no exception—have huge finance departments, very strong people, well-qualified in what they specifically teach as such. To change that structure can't be done quickly.

QUESTION: Edith Everett.

I was in the investment business for 40 years. Everything that you said was visible for anybody who wanted to see it. But they closed their eyes, and that's where the problem is.

I think that the government is highly complicit in all of this. Members of Congress can be bought. The White House can be bought. And now we see even the august Supreme Court hanging out with the Koch brothers before a very important decision-making. What is happening to this country? Give me something to hope for, because I feel very depressed.

HENRY KAUFMAN: Change moves in an irregular path. Usually, before you get significant change, you have to have significant problems.

I think what you're talking about ultimately is there have to be rules of the game, rules of behavior. That diminished for a lot of reasons, particularly in economy and finance, where the assumption was that the market will clear the transaction; if you do well, you will prosper; if you do poorly, you will fail. But those rules weren't adhered to as such.

Just imagine if you had a football game without rules of behavior, where they lined up on both sides and the referee could hardly blow the whistle. Can you imagine what would happen? It's the same thing with economic and financial life and personal life—rules of behavior.

QUESTION: Thank you so much for that presentation. It was fascinating. Anne Phillips is my name.

I wanted to mention Brooksley Born to you, whom I'm sure you know of. She was appointed by Clinton to be the head of the Commodity Futures Trading Commission.

She came out strongly and strenuously criticizing the trading of derivatives. She said that most people trading didn't even know what they were, had no understanding of them.

And talk about civility or lack of civility. Robert Rubin, Arthur Levitt, Geithner, and Greenspan attacked her publicly, said that she should be quiet, that she would have a harmful effect on the market. They tried to shut her up. They wanted to get her fired, but they couldn't, because she was accountable only to the White House.

They called congressional hearings, as you know, and publicly she was condemned by senators, mostly Republican senators, and by the financial people, and she was forced to resign.

A year and a half later, everything she predicted—she said that there would be a ferocious recession—everything that she predicted came true. I heard her the other night.

She said because, as you said, they kicked the can down the road, it's starting in again, with the derivatives and so forth. She is very fearful that we will have a repetition of the same kind of recession. I wonder if you could comment on that.

HENRY KAUFMAN: I won't comment on her comment. You made the comment.

I would certainly not disagree with what her conclusions were about the events leading up to the current crisis. Both sides of the aisle contributed to that problem—both sides, both Republicans and Democrats. There's no doubt about that.

As to the repetition of this event, it's going to take a little bit of time because the credit-creation process has slowed. If you look at the growth of debt—credit and debt are the same—if you look at the growth of debt, household debt is not growing, consumer debt is not growing, and mortgage debt is not growing, state and local government debt is not growing. Business debt is growing a little bit.

The private sector for the time being is somewhat incapacitated. When you see the private sector come back to life and really become a big borrower, that's when you should begin to worry.

QUESTION: Susan Gitelson.

Now that we've had this incredible analysis, there's the question about punishment, because there are a number of exposés of the people who created the problems and made huge fortunes in the process and have been able to retain their earnings; for example, Fannie Mae, Freddie Mac, many of those who were in the derivatives business.

What is the government going to do, what can we as citizens do, in order to right the balance and give people what they deserve?

HENRY KAUFMAN: You raise a difficult question to which there is only a very difficult answer, because it's very complex to ask yourself: Where do you begin and where do you end in this process of what you call holding people accountable?

You can go back, not just for the last couple of years, but going back. If you talk about Fannie and Freddie and so on, it was the political body that encouraged the liberalization of lending to homeowners. Those agencies were held accountable to minimum standards of lending, minimum lending to subprime borrowers.

Do you want to go into government and hold those people accountable too who voted for all of this? I would say there is no complete answer to this.

The only thing that you can do is try to put into the system standards of behavior, standards of accountability, so that we don't get back to this—unfortunately, that is the dilemma—and we're not doing that that well yet.

QUESTION: Henry, thank you for a great set of comments.

The New York Times this morning carried a story about profits overseas that have the possibility of a tax holiday, bringing those profits back to the United States. They were talking about as much as $1 trillion being brought back into the United States if a tax holiday could be created.

First of all, do you think that's possible? Secondly, if it's not possible, what happens to the money? Third, if it is possible, what impact will it have on the economy?

HENRY KAUFMAN: It will have a near-term favorable impact. I thought we did this once before and had a tax holiday and money was brought back.

But money is fungible, in the sense you can have it off-site and borrow against it and bring some money back in here on a borrowed basis. This is the interesting aspect about money and credit. It isn't locked up anywhere.

Not to get too personal here and to mention anyone, but it was written up in the same paper that GE paid very little in taxes because it kept most of its earnings through legal accounting means off-site. Isn't that interesting? And the president of the United States appointed the head of GE to his new productivity council. I'm not sure he was fully aware of this. But it's not illegal.

So you have to pass legislation that requires the bringing back of this money, which is not easy, because there is this fungibility. That's the interesting thing about financial markets. Financial markets have a very interesting way of seeping credit and debt all over the place.

Rules of behavior are very important in financial markets as well as in personal life. So let me end there.

JOANNE MYERS: Thank you very, very much.