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Remarks by

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MODERN FINANCE AND ITS LEADERSHIP CHALLENGES

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It is great to be back in Melbourne. I was here last year on the 27th of December-- to watch Day 2 of the fourth Ashes test. Andrew Symonds and Matthew Hayden put together a great partnership, which proved to be the "tipping point" in that match and led the following week in Sydney to a comprehensive 5-nil whitewash of England.

Among the people I greeted at the MCG were Mervyn King, Governor of the Bank of England and your inaugural lecturer last year; and the then Prime Minister John Howard. While Australia still dominate world cricket (no change there!), much has changed this past year in the world of finance and politics. Ten months ago when your organizers invited me to be your second distinguished lecturer, and we agreed the topic "modern finance and its leadership challenges"—little did I realize how much new material would become available. These past months of 2007 have presented what must seem a lifetime of challenges for leaders of the world's financial institutions.

MODERN FINANCE

Let me start by highlighting some features of our modern financial industry. Remember, financial services is a very old industry. People have needed and been provided lending, savings, payment, trading, and insurance services for several thousand years. It is perhaps ironic that such an old industry finds itself larger, more vital, more competitive, and more change-filled than at any time in its history. We know that as an economy grows and modernizes, its financial services sector usually becomes an even larger share of GDP, of equity market capitalization, and of corporate earnings. This is because financial markets and services enable even greater efficiency gains in the real economy. Global financial assets today exceed $US 150 trillion—more than three times world GDP—and no one financial institution has more than about one percent market share. It is an enormous, global, fragmented, dynamic, super-competitive industry—meeting the same basic financial needs of people and businesses as always, but in new and very different ways.

Especially over the last 30 years, the combination of new financial theory and financial technology, together with dramatic changes in information technology and global economic integration, have introduced breath-taking transformation in how things are done. Just look at one major financial service—lending. This is the age-old business of providing affordable loans to creditworthy borrowers.

In the "old days," one institution—typically a regulated bank—found these borrowing customers, priced and committed to make the loan, funded the loan from its own resources, held the loan on its balance sheet in its loan portfolio, serviced, and collected the loan. The bank was a financial intermediary—operating between a borrower who needed an affordable rate loan and savers who wanted a reasonable return. It was a vertically integrated intermediary. Everything was done under one roof, and the one firm had strong incentives to get everything right from beginning to end of the loan transaction.

In our modern finance world, intermediation still exists, but has been substantially restructured and sub-divided--perhaps as many as ten or more separate entities (many of them unregulated) might get involved in making a loan today:

(1) a commissioned sales person—perhaps an independent contractor affiliated with a loan broker—who finds the borrowing customer;

(2) a loan broker who prices the loan, and commits to deliver the loan proceeds to the customer;

(3) a bank or mortgage company, who agrees to buy the loan from the broker, with the intention to package it up with other loans into a collateral pool;

(4) an investment banking firm who underwrites and manages the distribution of various securities whose proceeds will fund the acquisition of the loan from the bank, along with other loans from this and other banks; the loan pool so assembled will serve as collateral for the securities; and the securities often come in tranches, with different risk grades and preferences over access to collateral;

(5) perhaps a loan guaranty insurer, who agrees to repay some portion if a loan defaults, thereby enhancing the creditworthiness of the original borrowers and the credit rating of the securities;

(6) a rating agency who rates the various classes of securities created by the investment bank, thereby helping investors assess the default risk of each security class;

(7) <u>another commissioned sales person</u>—who may work for the underwriting investment bank or for some other securities firm—finds investors who will buy the securities;

(8) <u>investors</u> who buy the securities, thereby becoming the ultimate source of loan proceeds for the borrower;

(9) <u>a credit default swap holder</u> who agrees to assume some or all of the risk taken on by some of the investors;

(10) <u>a loan servicer,</u> who collects the principal and interest payments from the borrower and sees that they get passed along to the investors and other service providers;

(11) <u>a loan collection agency</u> who may get involved if the borrower defaults on the loan and has payment difficulties beyond those manageable by the servicer.

And of course, each of these 11 players has its own lawyers and insurers to add even more parties to the transaction. Compared to the old model, this "modern finance" is a very different world for savers and borrowers, and for the financial service companies who facilitate this intermediation.

THE ADVANTAGES AND CHALLENGES OF MODERN FINANCE

As a consequence of all these changes, there is both "good news" and "bad news." On the positive side, it has been possible in recent years for more people and businesses to access credit on better terms than they could under the earlier single institution loan-making regime.   It is also possible for savers with different preferences--for liquidity, credit, volatility, maturity, and return--to find better investment alternatives, accepting only that portion of the risk/return spectrum they prefer.   The allocation of financial resources is more efficient, and the allocation of real economic resources is more efficient, as the “right” people bear the “right” risks at the “right” time with the “right” counterparties.

On the down side, this modern world also brings some new and difficult challenges—real leadership challenges—to every firm now involved in credit markets. Just a few of the obvious difficulties include:

1. the products, relationships, and institutional structures are <u>much more complex</u>—this is no longer the “simple” loan business of years past;#
2. there is great <u>potential for misalignment</u> in the incentives of the various participants, with players working against each others’ interests and perhaps losing sight of the borrowing and investing customers and their needs;#
3. there are <u>new risks being created</u> on top of the old ones, and risks being split-up, shared, and re-distributed—making it hard to track who is actually bearing what risk;#
4. there is <u>intense competition</u> in all market segments, with ideas generated and copied and made into products as fast as they become possible, and perhaps even faster than they are understood by all parties;#

5. market pressure is relentless—there is pressure on all parties to perform financially, which is often then amplified by the pressure that comes from marking everything to market everyday.#

How does one make sense of all these challenges? The best way to start is by focusing on some basic "truths" that remain just as important in the new environment as in the old. Because the more things change, the more the basics stay the same.
Let's call them "leadership lessons" that today's market turmoil only serves to reinforce.
I have a list of nine.

LEADERSHIP LESSONS

1. Borrowers need to repay their loans, and no lender does a borrower a favor by putting the borrower into a loan that can't be repaid. Every generation of lender seems to re-learn this lesson! It is easy to make loans, but hard to make good loans. You only discover the difference with time. The current sub-prime lending problem is the latest in a series of excessive credit extension cycles which in the past 35 years have included commercial real estate (twice), agriculture, shipping, oil and gas, developing countries, and leveraged buyouts (twice). With 10 or more parties operating between the original borrowers and the ultimate lenders, it can be easy to lose sight of the underlying credit risk of the real borrower if you are not careful. Keeping your eye on the ball of underlying credit risk is the most basic of all lessons.

2. Savers and investors need their money back with a return, and no one does savers any favor by selling them investments whose risk they either don't understand or can't bear. Every excessive credit extension cycle invariably includes debt winding up with lenders or investors who should not be holding it. In this latest episode, we find German savings banks, local governments in Norway and Florida, Taiwanese commercial banks, Japanese agricultural banks, and many others holding CDOs containing sub-prime mortgage-backed securities, when they should have been invested in other assets.#
3. If it looks too good to be true, it probably is. As one market participant observed after the latest problems surfaced: "this risk turns out to be really risky!" Risk comes with a cost. There is no alchemy in finance, and there is no way to turn junk into gold. AAA rated securities with higher than AAA returns signal a problem in the making. So do ever-narrowing credit spreads. Investors who can't understand or bear the risk inherent in a particular transaction or security, should not buy it; nor should they have it sold to them—if the selling institution is really looking out for its customers.#
4. "Not all sales are final!" (or, not all assets and liabilities are on the balance sheet). The situation with structured investment vehicles (SIVs) and conduits, where originating banks didn't really have the underlying assets completely sold, brought this truth out in the open. Many thought that after Enron, and the problems which arose with the misuse of "special purpose" and "variable interest" entities, that this lesson might have been learned for a while—but history has repeated itself in short order.#

5. "Not all funding is created equal." In particular, borrowers keep learning the difference between dealing with markets and wholesale funding sources (which can be, and typically are, very impersonal, unstable, and uncompromising) versus dealing with institutions and retail funding sources (where at least the borrower can find someone to talk with and possibly work things out with, and the investor tends to be more stable).

6. If it is too difficult to understand, don't buy it, trade it, or underwrite it. Certainly in some cases of CDOs, CPDOs, sub-prime mortgage-backeds, other asset-backeds, CDXs, and CDSs, it is not entirely clear that investors, underwriters, or traders fully understood what they were dealing with in terms of risk, return, and valuation. Just ask the former CEOs of Citibank and Merrill Lynch.#

7. "Normal" distributions exist only in probability and statistics textbooks, not in financial markets. "Fat tails" are a fact of life in finance, and the "100 year flood" is prone to occur every 10 years, not every 100! One continually reads of events this year being described as "unprecedented, unexpected, totally unpredictable, unforeseeable"—which is just not the case. The behavior of prices and investors has been within the bounds of past credit cycle experience and reason, and behaviors based on models using normal distribution assumptions have cost people dearly. Another statistical mistake has been to use a data history that was far too short and unrepresentative when constructing price, risk, and loss models.#

8. The short run and long run are not the same! This seems too obvious to mention, yet time and again, once you strip away the complexity and the multiple parties involved, we find people engaged in that age-old recipe for disaster of borrowing

short and lending long, and then expressing surprise that "their liquidity has dried up." Look at Northern Rock. Look at the SIVs and conduits. The so-called "profits" that come from riding the yield curve when it slopes upward steeply can be both illusory and reversible.

9. <u>Borrowing in one currency and lending (unhedged) in another can get you in trouble</u>. This also seems too obvious to mention, yet huge sums have been borrowed (such as in Yen) and invested (such as in New Zealand, Australian, or U.S. dollars) this way over this past cycle. It is another classic "mismatch" that might work for a while, but never works for the long run. It is remarkable this ever came to be called the "carry trade," which I guess is because of the momentary "positive carry" between low rate yen and higher rate NZD, AUD, or USD. But the only thing being carried here is currency risk, which ultimately will extract a price. This trade is very much part of the "borrow-short-lend-long" family of risk bets that everyone is tempted to try ("easy" money is always tempting!) and is sure they can unwind before markets adjust. How soon people forget some of history's great "carry trade" fiascos, like the yen and Swiss franc loans made to borrowers in Australia in the 1980s.#

LEADERSHIP OF MODERN FINANCIAL INSTITUTIONS

With all these "lessons" being taught and learned in this modern financial world, what can we say about the leadership of the many important institutions that make up this world? Here I want to emphasize enterprise leadership—responsibility for the results and ongoing viability of the financial institution, and not just the transactional leadership that most of the forgoing lessons cover. The test of enterprise leadership is whether the firm is stronger 5 and 10 years after the leader departs than while he or she was in charge. In particular, it is a test best measured along five key dimensions:

First, strategy and strategic choices. Is the firm following some logical framework which guides the choices that determine its nature and direction, and is it following this with a sense of discipline and vision? The first test of leadership is what the firm does and, perhaps just as importantly, does not undertake to do. In a market like financial services where no one has more than one percent global share, it is very easy to get distracted with opportunistic transactions that do not build strategic competence or advantage. Figuring out and sticking with what in the world your firm will be best at, is a big and important leadership challenge. Manage what you know and understand, and what creates lasting value—and don't do anything you don't understand or can't do well. Strategy is all about being better than your competitors by being different—by "doing the right things"—for your firm.

Second, attracting and retaining the right people. It is a reality of today's modern finance that the talented people who perform this activity are both valuable and mobile—and it is often the case that the institution which employs them needs the talented people more than the talented people need any particular institution. Thus, a key leadership challenge is attracting and retaining good people who will take responsibility for leading and executing the strategic vision of the firm, and who want to be part of building the enterprise for the longer run, not just for this year's bonus. People who believe in your strategy and who want to do things right. The easy mobility of people means that, if you are not careful, you can easily attract the wrong people.

Third, culture and values. Modern financial firms operate in fast moving markets, in very competitive conditions, with huge volumes of transactions. Getting the right people taking responsibility for performing the hundreds and often thousands of leadership roles within the firm is critical, but equally important is building the right culture within which they operate. It has to be a culture that is honest about the reality of the firm's situation, where people are encouraged and rewarded for raising issues and surfacing potential problems early, where doing the right thing for customers is highly valued, and where everyone is encouraged to use their brains to generate the best ideas. Culture has to do with how things are done, what gets valued within the firm, how people get ahead, and what people do as well as what they say. Certainly we know that Enron had a terrible culture—one which did not confront reality and which rewarded destructive behaviors. Cultures take a long time to build, and require constant effort at the top to sustain and strengthen. I don't know what life is like within Citigroup or Merrill Lynch today, but the media report a climate under the two departed CEOs that sounds problematic—where allegedly people were removed for speaking-up and open discussion was not encouraged. If strategy is about doing the right things, culture is about everyone in the firm "doing things right."

Fourth, risk management. Finance involves many types of risk—market, interest rate, credit, liquidity, financial, and operational. Many financial firms operate in a highly geared fashion to start with, so a strong risk management culture is absolutely critical. People have to start first and foremost with an understanding and an "ownership" of the risks inherent in any product, relationship, or transaction, and how they will respond to competitive pressures that push the return-for-risk envelope too far and price risk too cheaply. If concern for risk is not championed at the top, and then rewarded and encouraged throughout the firm, there is too much temptation for the pressures of short-term sales and growth to damage the risk management culture and economic viability of the firm. We have seen evidence of this almost every week since the late June announcement by Bear Stearns that its funds were in trouble.

Fifth, long run value and the need for change. Contrary to popular perception, leadership is not about power, or fortune, or fame. It is fundamentally about responsibility--responsibility for the sustained health and performance of the organization. In fulfilling this responsibility, it is about a role one plays in changing an organization for the better. Organizations need to change because the world around them is changing, and competitors and customers are changing. Those firms which successfully navigate the kinds of adaptive change required of leading organizations are the ones who win in the marketplace. It is often said that leaders face too much short-term performance pressure—the real performance pressure they face is to build long run sustainable value for the firm. Enron built no long run value. The firms in credit or liquidity difficulty today are suffering extreme value mark-downs. The biggest leadership challenge of them all is to stay focused on the firm's sustainable advantage and on the disciplined, risk-controlled, culturally-strong execution of sound plans. This is the only sure path to a successful future for the financial institution and all its constituents—customers, staff, shareholders, and the broader community.

These constituents all need the firm to perform well. This is the real leadership challenge of modern finance—institutions that perform in everyone's best interest. Let's hope our leaders will meet that challenge in the years ahead.