

Testimony of Michael Mayo

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Before the Financial Crisis Inquiry Commission

January 13, 2010  
Washington, DC

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Chairman Angelides, Vice Chairman Thomas, and Members of the Commission, thank you for inviting me to testify today about the financial crisis. I currently work for Calyon Securities (USA) Inc. as a Managing Director and Financial Services Analyst. The views and opinions expressed in this document and the oral testimony I will provide to the Financial Crisis Inquiry Commission are solely my own and do not necessarily reflect the views of my employer or any other institution or person I am currently affiliated with or have been in the past. I've submitted almost 200 pages of materials drawn from my research and sector reports to supplement my comments today, and will also be using and submitting slides to help illustrate my main points.<sup>1</sup>

Two decades ago I worked down the street at the Federal Reserve. We were helping banks recover from crisis, and took great meaning from our efforts. I hope that the Commission's efforts lead to a system that does not need to save the banks every decade or two.

This is important. To me, I've been analyzing an "industry on steroids" whose prior achievements were artificially enhanced. Benefits were front-loaded and costs were back-ended. We are now paying the price in what will likely be the biggest taxpayer bailout of US financial firms in history and, given government borrowing, the biggest wealth transfer to the current generation from future generations, that is, my children.

I'm shocked and amazed that more changes to banks have not taken place. There seems to be an unwritten premise that a healthy Wall Street as it is constituted today is necessary for the economy to work. Yet, the economy worked well before inventions of exotic instruments such as CDOs and with risk that was more obvious and easy to see. Wall St. has done an incredible job at pulling the wool over the eyes of government and others. Perhaps this relates to the size of the banks. The four banks that presented this morning have annual revenues of \$300B, or close to the GDP of the 30<sup>th</sup> largest country, Argentina.

My perspective: I've analyzed banks since the late 1980s, worked at 6 of the largest brokerage firms, currently work in affiliation with one of the most independent research platforms<sup>2</sup>, and wrote critical research on the banks – in excess of 10,000 pages over the past decade. The more critical issues that I focused on have been the negative implications of slower economic activity on the growth and quality of bank loans; excessive lending related

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<sup>1</sup> Main summary is in CLSA reports, "The Seven Deadly Sins", April 20, 2009 (first 40 pages). Accounting relaxation is discussed in CLSA reports "Relaxing the Rules: Softer Stance on US Bank Accounting", Nov. 2009 and "Weighing in: NPAs and bank balance sheets", Oct. 2009. Ongoing issues are discussed in the CLSA report "Property Pressure – Exposure to Commercial Real Estate Makes Banks Vulnerable", June 11, 2009.

<sup>2</sup> Asia Money, Nov. 2009; CLSA has a number one ranking in Asia, the home market.

to homes and the potential backlash if and when home prices were to decline; and more lax regulation.

I will cover two areas in my testimony:

- (1) The Problem; and
- (2) The Solution

I. The Problem: banks have been an industry on steroids. I have 10 examples.

- One – enhanced performance with excessive loan growth: Banks and the financial industry in general grew loans twice as fast as the natural rate, approaching 8% or about 10% or more adjusting for securitization (pre-crisis), above nominal GDP of 5%. We – consensus – strongly believed that nominal GDP would slow for the past decade, but banks still pushed for loans that should never have been made. This difference is even greater after adjusting for securitization of loans, or when banks packaged and sold loans, often with little if any “skin in the game” with regard to the loan’s performance.
- Two – pumped up profits with higher yielding assets: Higher yields means higher interest rates and – for banks – higher interest rates mean higher profits. To pick two higher risk loan categories, for the last decade, banks had over 20% average annual loan growth in home equity and over 15% average annual growth in construction loans, areas with higher than typical yields. In securities, banks reduced the percentage of low yielding treasuries from 32% in the early 1990s to under 2% in favor of more risky securities. In the extreme, the ability of a bank to make higher profits in the short-term is as easy as making a phone call. The issue is that higher yields get realized immediately but it comes with higher risk that gets paid later.
- Three – side effects ignored with concentration of assets: The rush in real estate was no secret. Of the 11 loan categories listed by the FDIC, all five of the fastest growing loan categories were real estate related. This is as simple as the old banking adage, “if it grows like a weed, maybe it is a weed” or, perhaps more generally, “don’t put all your eggs in one basket”.
- Four – higher dosage with higher balance sheet leverage at banks and brokers. By 2006 – before the problems hit the industry – U.S. banks had the highest level of leverage in a quarter of a century. There are many ways to look at this, but I took tangible capital and reserves for loan losses (source: FDIC). This data was also not a secret since the data comes directly from bank regulators. Similarly, leverage in the brokerage industry steadily increased from 20x in the 1980s to 30x in the 1990s to almost 40x in the past decade until shortly before the crisis (source: SIFMA).

- Five – investment banks originated more exotic dosages. By this, I mean instruments such as CDOs, CDOs-squared, etc. that amplified leverage in new and untested forms. It is always hard for us analysts to know what type of risk banks have on their balance sheet. These forms were so complex that not even CEOs, directors, and auditors fully understood their risks. As a reminder, some of these products were created by experts with Phd's in mathematics. This type of complexity is often used as a reason to pay people massive salaries. The argument goes that if you don't pay the salaries, good people will go elsewhere in the economy. Isn't that a good thing? The exotic securities are a clear example of several where Wall Street needs to shrink in importance. The protection from monoline insurers also proved much less than met the eye. Innovation often outpaces regulation, but in this case it was more than usual.
- Six – consumers went along for the ride. Consumer debt to GDP has reached a record level of 100%, versus only 50% 25 years ago. This leveraging created a false illusion of prosperity that allowed for the purchase of homes, cars, and other items, many of which should have never been financed and purchased. It is no secret that everyone from kids, pets, and dead people received solicitations for loans.
- Seven – accountants assisted with performance enhancement. In 1998, the SEC required banks to move closer to a pay-as-you-go approach when accounting for losses on their loans. This was wrong. The result was that banks made more risky loans with better profits but set aside even less reserves for future problems. The banking industry saw a steady decline in reserves for problem loans from the time of the decision in 1998. The move by the SEC was well intentioned since it came at a time of concern about "cookie jar reserves" but misguided since it failed to reflect the unique situation related to banks when it comes to conservatism and reserving for future loan problems. This is only one of several accounting examples.
- Eight – regulators facilitated performance enhancement. Banks pay insurance premiums for the coverage that they give on deposits at banks. Banks have paid this fee since the FDIC was established after the Great Depression. Yet, banks paid zero deposit insurance for the decade ending 2006 because the insurance fund was deemed fine. This was a ridiculous insurance model that is analogous to an auto insurance company not charging premiums until somebody has an accident or a life insurance company not charging premiums until somebody dies.
- Nine – the government doled out some of these steroids. GSE's and their role in the mortgage market helped to accelerate the growth in housing related securities via subsidies to banks and consumers whose absence would have meant less of a housing bubble. The government created more of a command

economy model that had the effect of allocating an excessive amount of capital to the housing sector.

- Ten – incentives encouraged the behavior. To still further the analogy, the system shunted the “doctors”, that is, those whose job it is to report on the financial health of companies and the industry, in lieu of those with more positive outlooks. Compensation of banks steadily tracked revenues for all of last decade. The problem is that compensation only tracked profits until losses increased later in the decade, highlighting that prior compensation was far above normal after incorporating losses that were attributable to prior year revenues. I saw issues first hand. First, in the past decade (2000-2008), the stocks in the bank index (“BKX”) declined by over 40% but industry compensation failed to decline in a similar amount. Yet, when I wrote about compensation issues a decade ago, the reaction about me was that these issues were none of my business<sup>3</sup>. Second, only 7 months after I testified to Congress in 2002 about the backlash against analysts who provide unflattering research, I faced what I saw as backlash by a large bank against me and my critical views when I had lack of management access similar to others. It reached a point where I put a disclaimer about this lack of access in my research reports. My point is that if I face a backlash even after I testify to Congress on backlashes, how can a loan officer who is under pressure to produce loans realistically say “Maybe we should sell less loans?” and keep their job.

In summary, the banking industry has been on the equivalent of steroids. Performance was enhanced by excessive loan growth, loan risk, securities yields, bank leverage, and consumer leverage, and conducted by bankers, accountants, regulators, government, and consumers. Side effects were ignored and there was little short-term financial incentive to slow down the process despite longer-term risks.

## II. The Solution:

Part of the solution is as easy as ABC – “A” for accounting, “B” for bankruptcy, and “C” for capital. Let me explain.

The “A” for accounting: The first and easiest change is to allow banks to more fully reflect potential loan losses by taking larger reserves for their problems, that is, reverse the impact of the 1998 decision by the SEC. In other words, let the bank regulators take charge again and allow banks to fully reserve for their problem loans – safety and soundness concerns supersede other considerations. That’s always been clear to many of us. Also, more transparency with reserving methodologies would be helpful as well. While all loans are not created equal in terms of risks and rewards, perhaps some baseline level of reserves would be helpful.

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<sup>3</sup> Fortune, 2/5/01, page 132, “The Price of Being Right”

More generally, stop giving so much latitude to bank accounting. In one of my submissions to the Commission, there is a report that gives 24 ways that bank accounting has been relaxed. If it is forbearance that is desired, explicitly do so but do not muddy the financial statements. The purpose of accounting is to capture economic reality in numbers. My job as a financial analyst is to try to recreate this reality the best that I can from these numbers, but the task gets tougher if the numbers are not reported on a similar basis. My analogy is with golf. If some players can take mulligans, and others can kick their ball out of the woods, and still more get gimme's for all putts within 5 feet, the score will not be comparable at the end of the game. For companies, the result can be – and probably should be – a greater risk premium for the higher information risk that would not exist if accounting rules were more consistent.

The “B” for bankruptcy: The worst precedent was the 1998 rescue of Long-Term Capital Management. If a hedge fund of that size was going to get bailed out, what would this mean for other more important firms and the ability to take outsized risks? Bankruptcy is part of our system, whether for banks, borrowers, or others. Why should the prudent subsidize the imprudent? Having said this, some of the exceptions were necessitated by unclear rules. It is time to make the rules clear.

So, of course, this leads to the question of whether banks are or should be too big to fail. I agree with Jamie Dimon's comments before today that bankruptcy needs to be more of a part of the system. Yet, I also feel that it is unrealistic to think that JP Morgan would ever fail. To the extent that there are banks with \$2T balance sheets that are, in reality, too big to fail (as opposed to many other entities), there is a question of what price and how these banks should pay for this special status.

The “C” for capital. There should not be a question of whether banks have enough capital. During the crisis, banks were considered as precious as the most important utility. Imagine turning on the spigot and finding out that the water does not work? Similarly, the capital at banks should help ensure that failure of banks and the system is beyond any doubt - not a reasonable one – but beyond any doubt as to whether banks will easily open for business on any given day, even one of the worst in business history.

In other words, capitalism did not cause the problems as opposed to a lack of capitalism, whether with regard to having good information to make decisions, allowing companies to fail, ensuring that banks pay for external costs (even contingent ones) that they cause, and having markets more than government allocate capital, albeit with limits and effective oversight.

Lastly, one word that is not spoken enough when it comes to our jobs in the financial markets is “meaning”. Goldman Sachs has often said that it is “long-term greedy”, but this too narrowly states its larger role. This year's annual reports could probably give a reminder about the purpose of financial services to an effective economic system and society. For evidence, I look no further than my cousin Andy who is going from Iraq and the Army to business school in the fall.

Andy wrote to me and said that he hoped that “we, as the world leader in capital markets, can make sound investments that help less fortunate people to provide for their family.” In other words, his efforts toward furthering peace and prosperity, regardless of whether they have or will succeed, does not end because he is going into business.

This sums up the larger purpose of what we do in financial services to improve people’s lives by moving scarce resources to where they can best get used. I hope that the Commission’s efforts lead to greater awareness of this purpose and facilitates its execution by preventing future crisis as severe as the current one.

# Financial Crisis Inquiry Commission

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The views and opinions expressed in this document and the oral testimony I will provide to the Financial Crisis Inquiry Commission are solely my own and do not necessarily reflect the views of my employer or any other institution or person I am currently affiliated with or have been in the past.



# Industry on Steroids

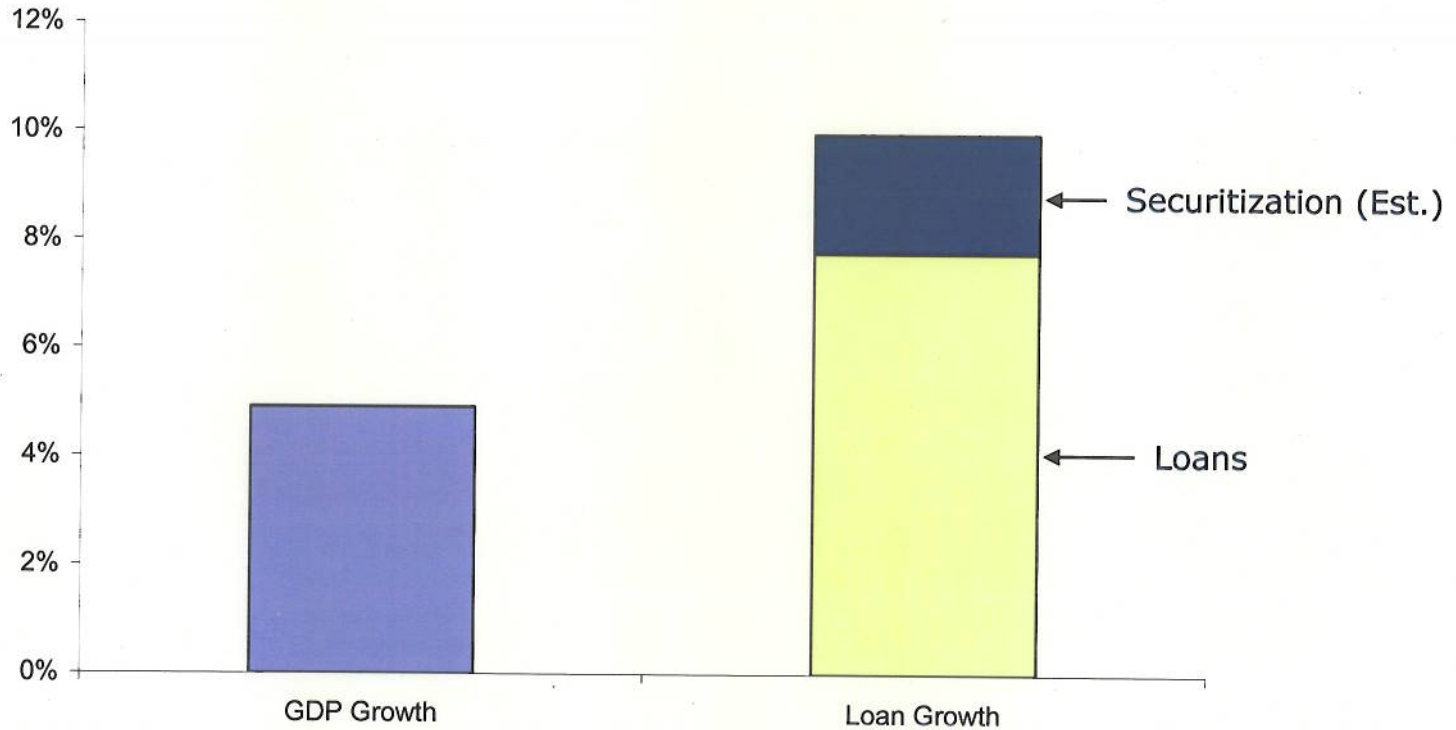
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- 1) Excessive Loan Growth
- 2) Higher Yielding Assets
- 3) Concentration of Assets
- 4) High Bank Balance Sheet Leverage
- 5) More Exotic Securities
- 6) Consumers Went Along
- 7) Accountants Assisted
- 8) Regulators Aided
- 9) Government Facilitated
- 10) Incentives Encouraged Behavior

# 1) Excessive Loan Growth

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## Loan vs GDP growth in the 2000's



Source: FDIC - All banks, Pre-Crisis

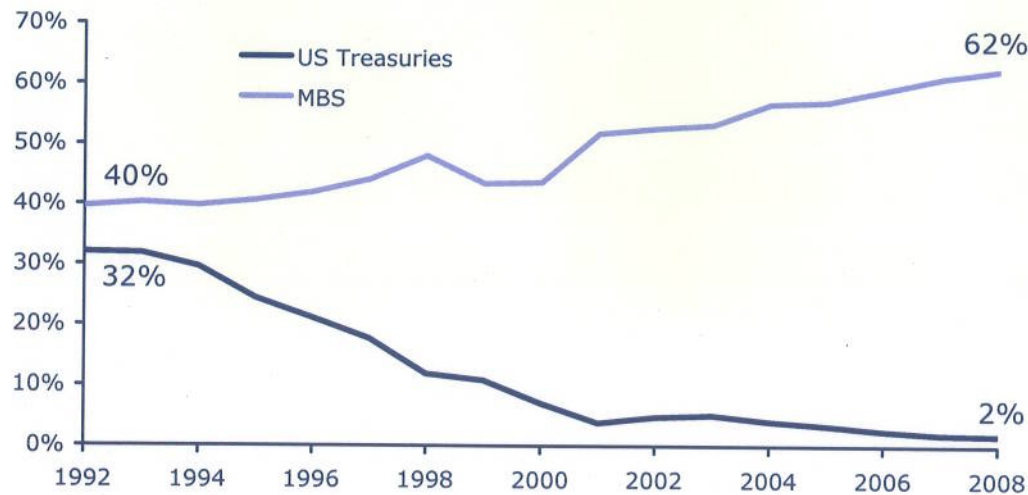
# 2) Higher Yielding Assets

Shift to higher-yielding, higher loss-rate consumer and commercial real estate loans

Loan Type	2008 % of Total	1992 % of Total	1984 % of Total	1974 % of Total	1942 % of Total
Residential Mortgage	19%	17%	12%	15%	17%
Home Equity	<b>11%</b>	6%	<b>nil</b>	nil	nil
C&I	21%	26%	37%	37%	41%
Core CRE	14%	13%	6%	9%	5%
Construction	<b>8%</b>	<b>4%</b>	5%	3%	nil
Credit Card	<b>6%</b>	7%	4%	2%	<b>nil</b>
Other Consumer	9%	12%	14%	18%	12%
Other	13%	15%	21%	16%	25%

Source: FDIC - All banks

## Growth in securities holdings

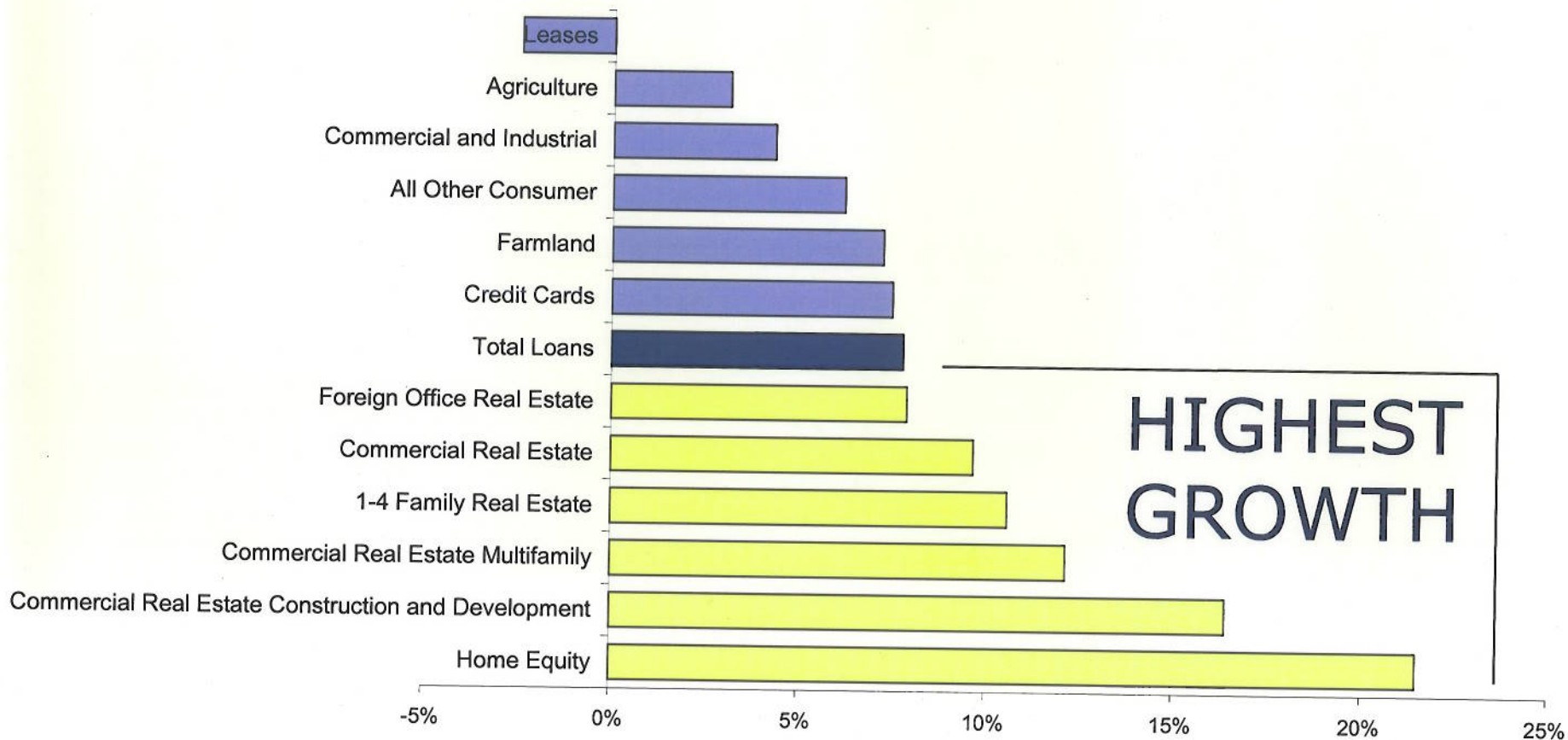


Source: FDIC - All banks

# 3) Concentration of Assets

Real estate was the largest area of growth

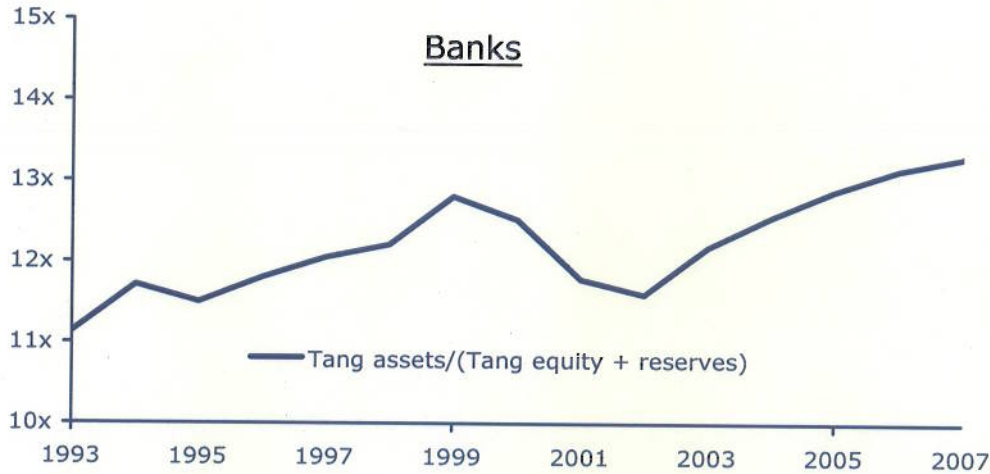
Compound Annual Growth in Loans (2000s)



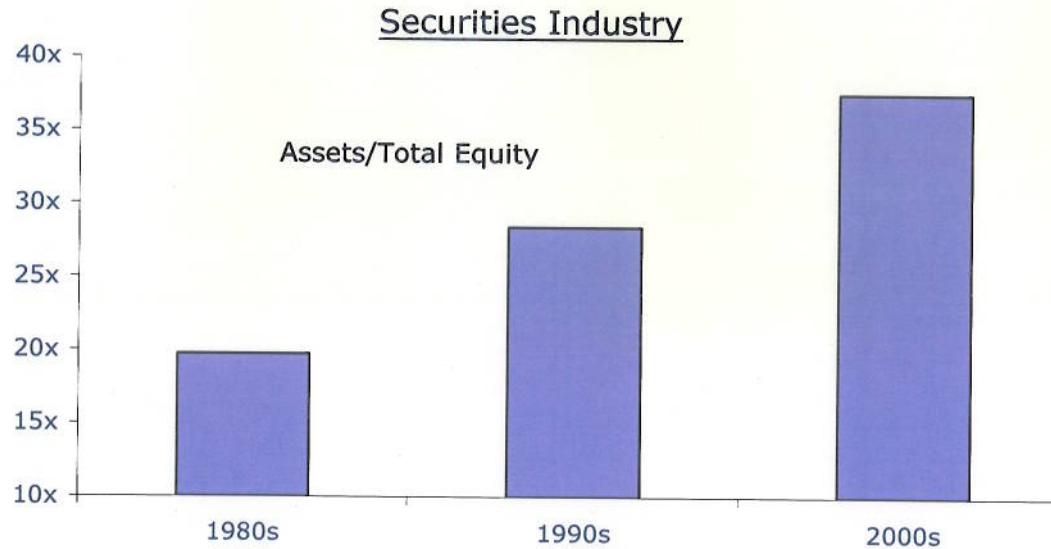
Source: FDIC - All Banks

# 4) Balance Sheet Leverage

Leverage increased



Source: FDIC - All Banks

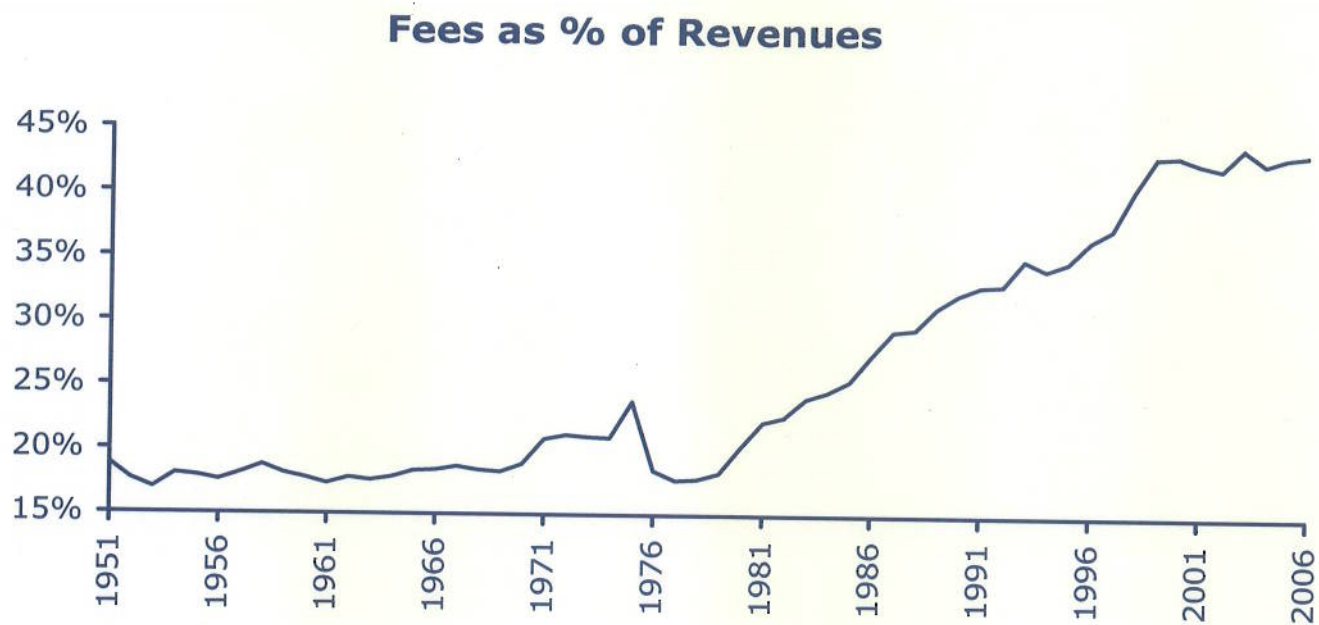


Source: SIFMA Balance Sheet

# 5) More Exotic Securities

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Fees are a larger percentage of revenues

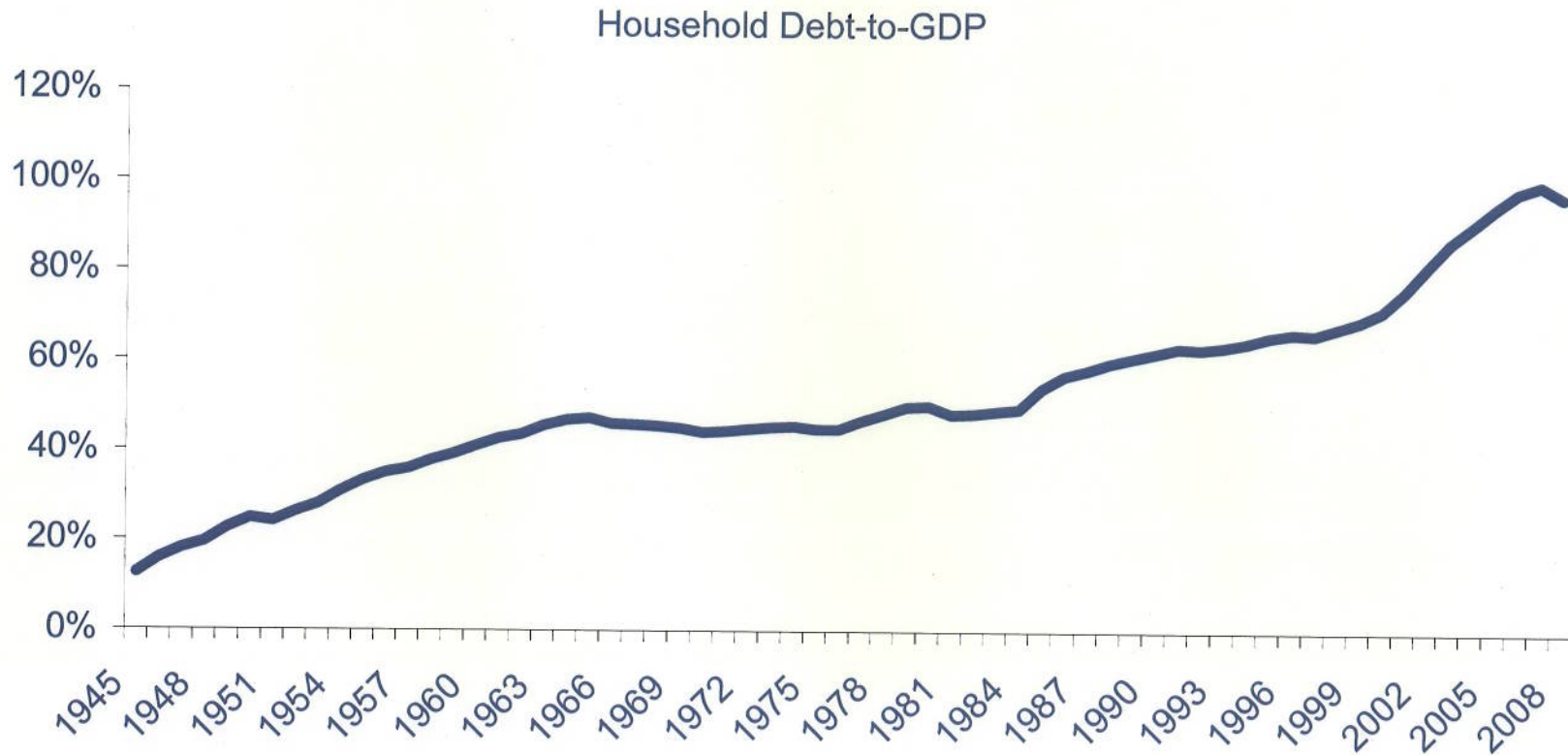


Source: FDIC -All Banks

# 6) Consumer Debt - Highest in History

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## Household debt at record levels

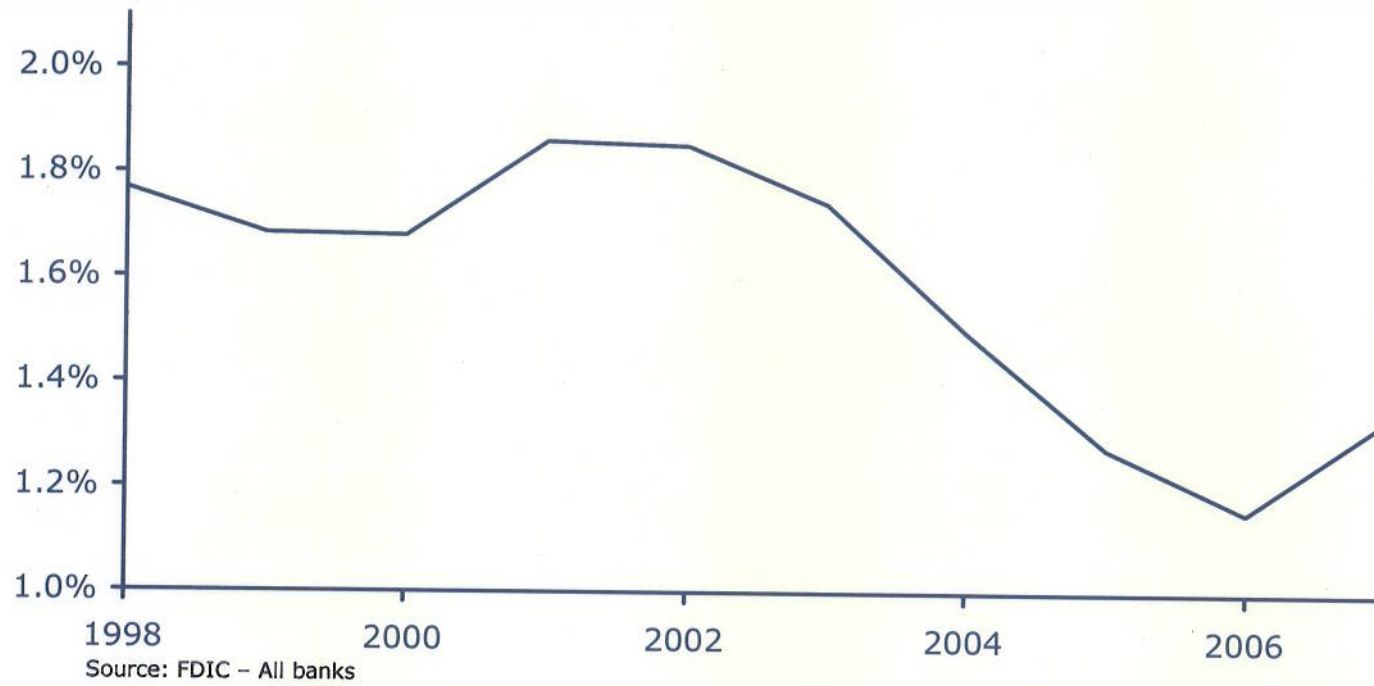


Source: Federal Reserve, Bureau of Economic Analysis

# 7) Accountants Aided

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**Reserves to Loans**

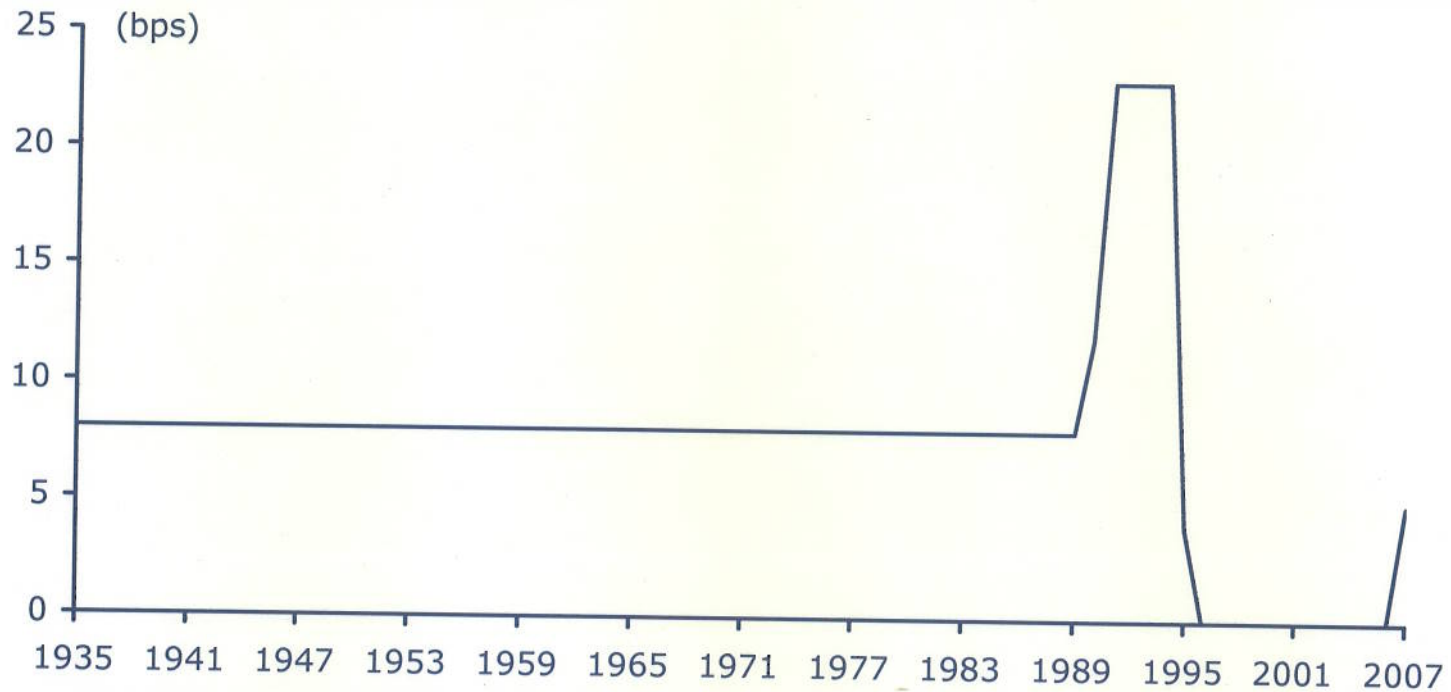




# 8) Regulators Aided

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**Annual FDIC Insurance Fee**



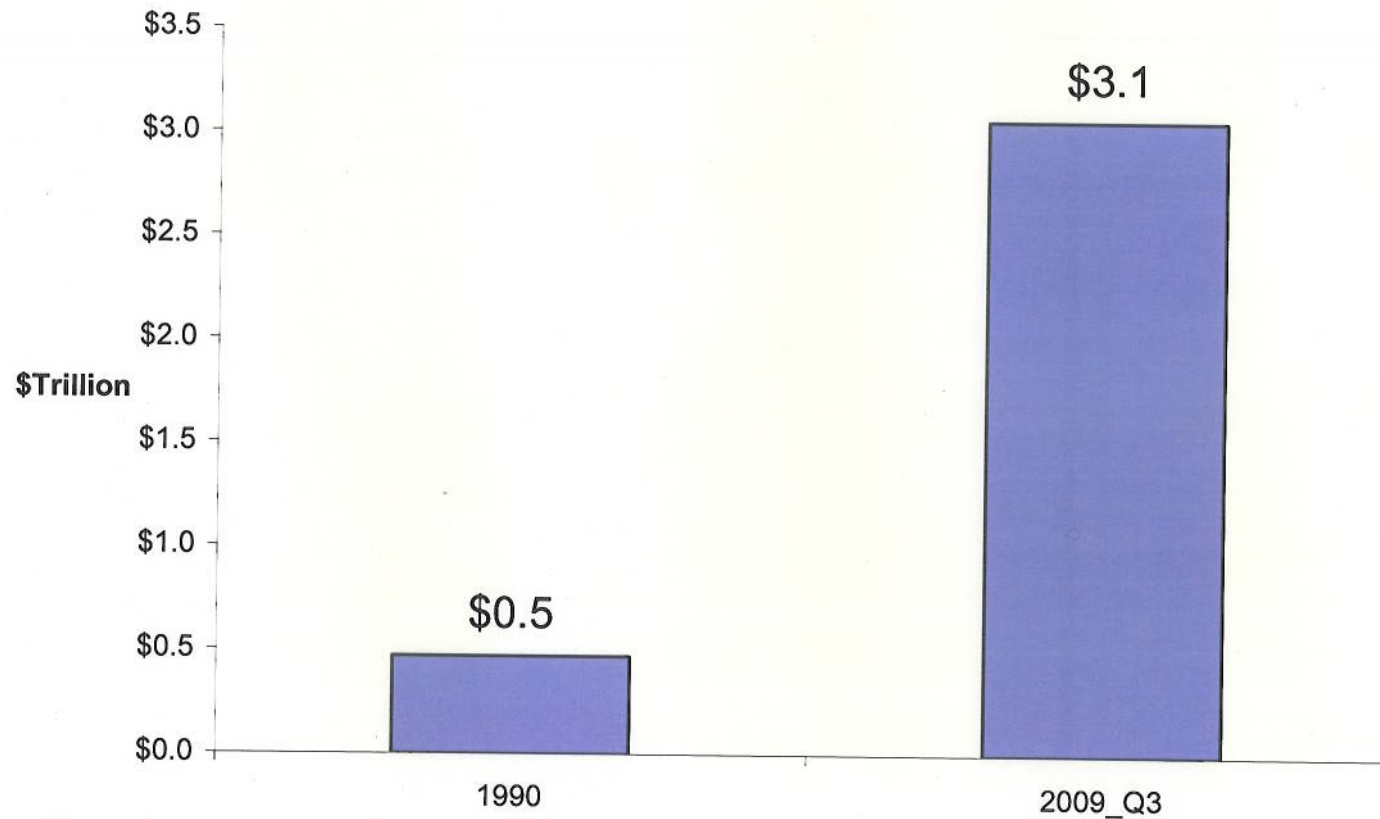
Note: Per \$100 of deposits

Source: FDIC

# 9) Government Facilitated

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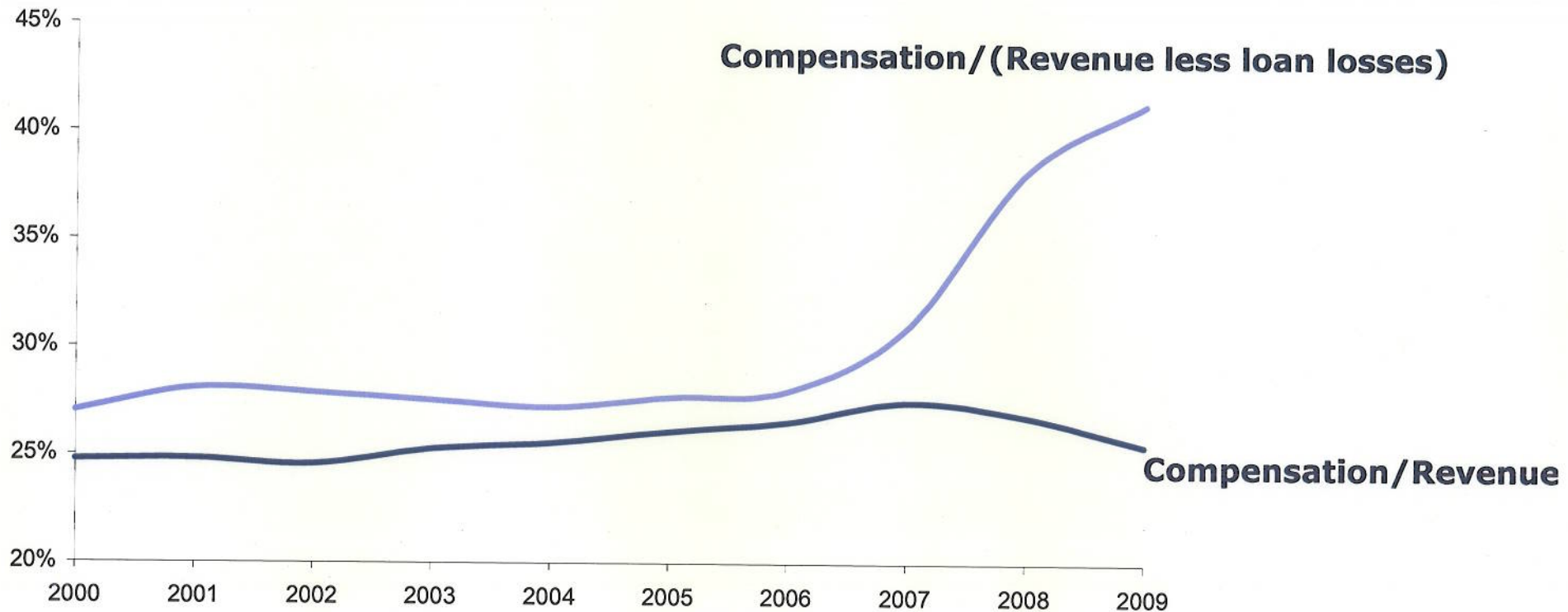
**GSE debt increased over 6 times in 2 decades**



Source: Federal Reserve, Flow of Funds

# 10) Incentives Misaligned

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Note: Loan Losses = Provision for Loan Losses

Source: FDIC All Banks

# Industry on Steroids

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- Performance enhanced by excessive...
  - Loan growth
  - Loan risk
  - Securities yields
  - Bank leverage
  - Consumer leverage
- Excesses conducted by...
  - Bankers
  - Accountants
  - Regulators
  - Government
  - Consumers
- Side effects ignored...
  - Little financial incentive to slow down
  - Ignored long-term risks

# The Solution – Partly a function of “ABC”

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- “A” for Accounting
- “B” for Bankruptcy
- “C” for Capital

# "A" for Accounting

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- Reverse impact of 1998 SEC move
- Achieve purpose of accounting
- Lack of consistency (24+ ways, tough to compare)

# "B" for Bankruptcy

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- Mistake: 1998 rescue of Long-Term Capital
- Do we want prudent to subsidize imprudent?
  - Banks, borrowers, others
- Too big to fail? Ongoing question

# "C" is for Capital

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- Banks are one the most precious utilities
  - Should have no question about safety
- "C" is also for Capitalism
  - Need more good, objective information for decisions
  - Allow companies to fail
  - Ensure financial firms pay for external costs (even contingent ones)
  - Let markets over governments allocate capital (with limits)
  - Crisis caused by lack of capitalism



# Meaning

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- Banks/Financial services key to effective economic system and society
- A personal reminder
- Larger purpose: Help move scarce resources to where they can best get used