Transcript of Interview with Ruth Porat

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Interviewed by
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Note: This is a verbatim transcript but with minor editing for clarification.

Yale SCHOOL OF MANAGEMENT

Garten: Ruth thanks very much for doing this. I'd like to start by getting a sense of the role that you played at Morgan Stanley during the financial crisis. I know you did a lot of different things so I was hoping you might summarize them.

Porat: First, great to be with you.

Until December of 2009 I was the global head of financial institutions investment banking and at that point I became the CFO of Morgan Stanley. So I really played three different roles. First on the banking side, I worked with banks on both sides of the Atlantic as they went through the financial crisis, and then more productively as we re-equitized, helped them raise equity capital, coming out of the financial crisis.

Second, I was an advisor to Secretary Hank Paulson and to the U.S. Treasury. I led a team there looking at Fannie Mae and Freddie Mac, which led to the conservatorship of Fannie and Freddie, and then working with the New York Fed as it relates to AIG. Then finally, my third role was working with Morgan Stanley, again through the financial crisis, and then more to the point as CFO as we've come out over the last five years and repositioned our business.

Garten: So you really saw it from lots of different angles, right? Certainly internally in the firm with regard to other banks in the industry and then also with the government.

Porat: Correct.

Garten: I've heard you say that every crisis spawns its lessons and I wonder if you could identify a few of the lessons that you think are worth underlining from a crisis like this and hopefully lessons that would inform people if they ever got involved in something remotely similar.

Porat: There are a number of lessons. I think first is the importance of liquidity for banks and for a financial system more generally. The expression we used a lot in that period is that “liquidity is oxygen for a financial system” and it very much is. There's no question that capital is the first line of defense but if you don't have ample liquidity and it's not durable, in times of stress as you're looking for liquidity you're forced to sell assets at declining prices which then eat into your capital position, so it becomes this very, very negative cycle. There's no question that liquidity is sacrosanct.

That's the way I think about managing Morgan Stanley from a liquidity risk management perspective.

I think the other lessons are broader. First is the importance of leadership that has courage based on experience and instinct. Events move far too quickly during a crisis and what you're dealing with is typically, as we called it back then, the least-worst option. There are no good options in the midst of a crisis. And so having experience in capital markets, having a team with experience in capital markets enables you to be nimble, creative, try different approaches and try and optimize within this bucket of the least-worst.

The other important lesson is time is your enemy in a crisis; and Hank Paulson once said to me, "You have to have the will and the means and too often by the time you have the will you no longer have the means." I think he was thinking of the U.S. when he said that but probably the best example is what happened with Greece, where what should have been a small, containable problem -- because there wasn't the will to deal with it up front -- spread to the periphery and then we were talking about “What about Italy, Spain, Portugal?” - a much broader problem. So recognizing that time is your enemy is very important.

And then I think the last point I would make is about communication. If you think that you're dealing with least-worst choices and that there are some tough decisions that need to be made, trying to provide clarity to all core constituents who need to make some of those choices is key, clearly not over-selling because these situations unravel quickly and credibility is binary. You can't lose it because you can't regain it. And so, again, communicating where you're going so that you have enough confidence conveyed that there are tools that you can use and that choices are being made.

Garten: So on the last point, when you talk about the variety of constituencies: from where you were, let's say from the position of CFO, in a crisis of huge magnitude, enumerate the constituencies that you feel are yours.

Porat: I'll actually answer that in two ways because having had the opportunity to work with the U.S. Treasury, one of the key challenges in that period was working with both Congress as well as trying to convey more broadly how the situation was unraveling. Inside Morgan Stanley the question was how do we manage our team internally, our broad employee base, but also the constituents who are trying to understand the viability of the firm, the choices that can be made and the implications for them. So it's again both internal and external as well as regulators. They're trying to assess where you are. So it's a broad set of different constituents.

Garten: But the message has to be quite consistent right? In other words, you may have to adapt the message but the core message to all the constituencies must be quite similar.

Porat: As situations unravel it's hard to know where they're going to go. So, yes, you can only deal with a set of facts that you have at a time and I think one of the very important elements again that Secretary Paulson laid out is some core principles that you are adhering to. So as it related to Fannie Mae and Freddie Mac, the focus was on market stability, mortgage availability and taxpayer protection. Everything we did came back to some very important core principles. And you may not know exactly how you're going to execute but as long as it's very clear that you're solving for some core principles at Morgan Stanley, our view was, given the strength of our franchise, yes, there were tough choices that need to be made, but we had, and have, an extraordinary global franchise so we would make it through this crisis and that confidence was key because we had many tools at our disposal as we've evidenced since then. But again: core principles.

Garten: Okay. Let me ask you about the government response now. I wonder if you could evaluate it in a few different ways. Let's divide it into two phases. Let's divide it into crisis management and then the longer-term regulatory response. When it comes to crisis management, what kind of evaluation do you give the government for the gigantic intervention in a horrendous crisis?

Porat: I think we were fortunate to have had the leadership that we had between Secretary Paulson, Ben Bernanke, Tim Geithner. I would give them high marks because they kept trying to find the key sources of stress and build in time to respond in a way that was the least destructive for markets, the economy, for Main Street. And so again -- if you go back to my first point that liquidity is oxygen -- one of the key elements was really a host of liquidity tools to again provide some time to address some of the core problems. And that, plus the speed with which they responded, and the willingness to continue to evolve different approaches, I think was key. As much as there's been a lot of criticism about many elements of it, I think without that attempt to have a circuit breaker in the market it would have been much worse. So on that element, the crisis management, I would give them high marks.

Then moving to since then, I think a lot has been accomplished. The financial system has been fundamentally transformed when you look across the dimensions. We have substantially higher capital, more liquidity. It's substantially more durable. Back in '08 there was too much funding that was overnight. Today that funding is substantially more durable. Dodd-Frank captures a number of elements with respect to the scope of activities, so again what's important is de-risking institutions by limiting the scope of activities. That's very key as well.

And the simple visual way I think about it is that you needed to strengthen institutions in a business as usual sense, which we did with capital, liquidity, reducing leverage, changing the scope of activities. But what you really also needed was to create a long runway, a long period of time, where these institutions could survive in periods of stress and could assess how to weather through it. And by really increasing the durability of funding, firms had the ability to continue to move on. And by creating what are recovery plans, we now have playbooks that banks can follow which they didn't have back in '08. The crisis hit, funding was short term and the collapses were rapid.

Now the institutions are more durable and there's a substantially longer runway with codified playbooks to deal with how to downsize an institution or adjust under stress. So I would say there's been substantial change -- much pushed by the regulators and firms recognizing the imperative to change and many of us dealing strategically with how to evolve our businesses. So whether it was firms, banks kicking and screaming, getting to a different position or because in their gut, as I think we did here at Morgan Stanley, recognizing the need to evolve, we're in a much stronger position collectively than we certainly were in '07.

Garten: I'll come back to that point but let me just ask you: in evaluating the regulatory response obviously it was a massive response and very, very difficult to thread the needle given the multiplicity of interests. Do you think that it's possible that the government overshot or undershot just in terms of the calibration? This is not a critique. It’s just from where you sit, in a big, global institution, you and your colleagues, key to economic growth and all of that, in this overshoot/undershoot expression, where do you think the government response falls?

Porat: I think it's an important question and I think it's hard to answer completely today because pendulums swing and clearly the pendulum had swung far too far in the direction of lax, and now it's gone in the other direction. And really only time will tell the extent to which the rules really work well one with the other. I think there are concerns that in fact there may be too much liquidity that's been pulled out of the system more broadly. But again only time will tell whether the rules will work well with one another. I think there are two areas that are concerning. One is on the undershoot. When Fannie Mae and Freddie Mac were put into conservatorship, Secretary Paulson called it a "time out." And the notion was that we needed to arrest the potential of a collapse but there would be a period during which all the core constituents could assess what did we want for U.S. housing more broadly. And that time out still hasn't been addressed. So in terms of an undershot we still need to deal with the ultimate shape of housing and the GSE's (Government-Sponsored Enterprises).

In terms of overshot I think one of the concerns is for the smaller banks in this country. The multiplicity of rules and the administrative requirements are very expensive. And are we in fact choking institutions that weren't really at the heart of the crisis last time and making it tough for them to serve their very important role of lending to smaller companies, middle market companies and individuals. So I think those would be the two. And then in the middle is where we should all remain vigilant. I think it was important to complete as much as possible as soon as possible, but it's not a once and done process and so continuing to see the extent to which rules work together is the next leg of it.

Garten: Can you explain how all this has impacted Morgan Stanley? Let me just throw out an expression and you could develop it. When you think about risk management, in the broadest sense, how has all of this actually impinged on risk management as you think about it at Morgan Stanley?

Porat: We have fundamentally strategically repositioned our business mix, our balance sheet and our governance. So we think about it in the broadest of sense. Sitting here today when you look at our business mix it's very different relative to 2008. One of the few positive things to come out of the financial crisis was the opportunity to acquire the wealth management business from Citi. We now have the largest wealth management business in the U.S., coming close to $2 Trillion in assets under management. It is the most stable portion within financial services so it adds a really elegant, stable, consistent business to our overall business mix and one that is symbiotic with what we do on the institutional securities side.

As part of that acquisition we acquired the deposits associated with our retail client base so we now have embedded within Morgan Stanley the tenth largest depository in the U.S. and, again, that gives us the opportunity to support loan growth for both our wealth management clients and our institutional clients, and again a very attractive business to be in. And then we've really reshaped what we're doing in institutional securities. We've always had a leading investment banking and institutional equities business and therefore those are quite annuity-like. So as we sit here today we describe our business as approximately 85 percent annuity-like. And we've repositioned fixed income so it's consistent with our strengths in supporting both what our wealth management and institutional securities clients want.

The balance sheet we've similarly repositioned. It's a much stronger balance sheet, more capital, the funding substantially more durable. And then to the heart of the word you used at the outset with respect to governance and risk management, we have invested meaningfully in analytics, in people and substantially built out what we're doing there. So, fundamentally there has been change across all elements.

Garten: Regarding the job of CFO, it's always been a crucial job and I'm just wondering if in the span of the career that you've had as a CFO, how the responsibilities of that job may have changed and if you could, maybe just speculate, if you were to have the job for another ten years -- although nobody should be under that pressure for so long -- but, if you were to have it for another ten years, how do you see this position evolving? What is the dynamic view of the role and the responsibility of a CFO in a big global financial institution?

Porat: Well I think if I actually take it back in time, the role of a CFO was much more about the controllership function. It was your CPA. It was much more of the accounting focus and what the crisis really required was a big broadening of that role. So today for me, obviously the controllership element, the guardianship element is central to what we're responsible for but understanding regulatory requirements and ensuring that we're positioning for them, relationships with regulators globally is key. I've already talked a lot about the importance of balance sheet and managing the balance sheet whether that's capital, capital optimization or how you fund the firm.

All of our core constituents are substantially more engaged and you know we've been trying to push as much as possible on transparency so they understand the elements of the business. And I think that breadth of the role – I'm hard pressed to think that that changes. So much of what we do is intertwined with strategically where should the institution go and so it's a broader role in thinking forward ten years. I'm again hard pressed to think it goes back to the former because I think that these elements of depth in the capital markets and depth with regulators and regulatory change should remain central to what we do.

Garten: So when you look ahead, are there any big issues that you worry about? I'm not asking you to predict the next crisis but you're obviously your antennae are up and part of what you do is really to think about where something can come, a crisis can come from at the earliest possible stages. We've had this big wave of regulation and we've had changes of the kind you talked about within some of the best firms but nobody would say that we're going to live in a world without crisis. So are there some areas that you worry about? Areas you'd like to see shored up because they look weak to you at this point?

Porat: Well when I think of that question I think of three levels. So within the regulated world is one set. The next is moving outside the regulated world and I think the third is more broadly. I think the regulated world has been well addressed by regulatory change. At the next level out -- the unregulated, shadow finance, market based finance or generally less regulated -- I would say one of the biggest areas of concern is the potential risk within central clearing and central clearinghouses. One of the most important elements of Dodd-Frank was derivatives reform and the move to central clearing because it results in driving standardization of product and transparency, but we're moving literally trillions of derivatives, notional value, to clearing houses so we need to ensure that we have proper risk management.

The area that concerns me at least as much if not more is actually one step even further removed and that is to ask the question where is risk being mis-priced. Where are there rules that are driving change and growth in asset classes?

One of the most apparent, I think, areas today is in the student lending area. In the government student lending program, we now have over $1 Trillion dollars funded by the U.S. government associated with student lending. That's up fourfold since 2004 and one of the prime assumptions for the Congressional Budget Office in assessing the program is that there's no default risk because the government can garnish Social Security and wages.

We have a rapidly growing market that is not part of the deficit discussion because it's viewed as no default risk. In fact the more loans extended the lower the deficit because we're making money on those loans. And yet the facts are different. This past year the default rate on loans has been about 15 percent and so my concern is that this is an example of a very well-intentioned social program, one predicated on the assumption that education creates greater opportunity. And yet for many kids going to school and taking out the loans, they're not graduating, they're taking on substantial expense and it's not clear they're actually getting value for their money and that's being reflected in a growing default rate.

So as a country we have $1 Trillion dollars and growing with an assumption that is already proven to be inaccurate and I'm concerned both what we're doing to the kids and what the financial impact is. More discussion has been on the interest rate charged and that is a problem. There's no question too many students are really choking on the cost of the debt but I think the bigger issue for all of us is the rate of origination, the new loans that are being created. And the concern is that this again as I said, is a very well-intentioned social program but it needs to be addressed just as it was a very well-intentioned social program to look at increasing house ownership, home ownership in this country in the 1960's.

Garten: So my final question is a little hypothetical but what I want to try to get at is from where you sit, and from the wide range of activities that you oversee, when you think about the global financial system, what really matters to you? There are a lot of different issues, there's exchange rates and then there's regulation and there's monetary policy and there's access to foreign markets -- so a huge number of issues. But for the sake of argument I'm going to hypothesize that there's a big global financial conference five years from now and you have been nominated as one of the American delegates to go there, and you're nominated because of when you sit right now, a CFO in a major global firm.

What kind of issues would you be thinking about now to bring up? In other words, you want a financial system that is both stable but conducive to growth and obviously conducive to the profitability of firms like yours. So what matters? What, if you had to pick two or three things that are really important to you and the firm, what would they be?

Porat: I would come back to that framework I somewhat touched on a minute ago which is at the highest level in five years, I think, and over those five years, not just in five years, within the regulated world have we overshot or undershot? At the core we've so fundamentally transformed the regulated world, let's make sure the rules work well together and let's make sure there's no opportunity for financial regulatory arbitrage on a global basis. So as much harmonization of rules as possible. And we'll have the opportunity to see whether rules do work well together as rules are digested over the next several years. I think the next very important one is what's moving outside of the regulated world because merely moving risk around the ecosystem is not mitigating risk, it's just moving it potentially to areas where it's not as clear how it's being managed.

There's quite a bit of lending product that's moving out of the regulated world and I've already commented on the really big risk, the trillions moving into clearinghouses and the imperative that we start early to look at risk management protocol within clearinghouses and make sure we have high standards. Because again, we're at the early stage of derivatives moving through clearinghouses. That number will just continue to grow. And then I think the third is what are some of those bigger emerging risk areas.

I've already commented on student lending and I think that's a major concern but what are areas that are, or will affect the financial system, will affect markets, will affect economies that are even broader in scope and so in addition to student lending I would say continue to stretch one's self and look for what could be those threats and the other obvious one is for example cyber security.

For cyber security what's imperative within the financial system is this -- we can't operate in a silo. The financial markets are not just about the financial players themselves but we're reliant on the energy grid, we're reliant on the communications grid. So there's again an entire ecosystem upon which we rest and when you think about cyber security the threat to any institution can come from anyplace where there's a touch point. So whether that's payment systems, exchanges, clearinghouses, smaller institutions. So again thinking as broadly as possible about what could be that next source of risk and next source of threat.

So I would come back to three levels from the most regulated; next, quite contiguous; and then broader. And this may not fit into your list of three narrowly within the regulated world but I think the other very important element for your conference in five years is continuing to reinforce the lessons learned from the crisis. I think for any of us who've lived through it, it was a searing experience. That's one way to learn those lessons. It's obviously substantially more productive to learn them any other way one can.

But there's no question for those of us that lived through it, some of these key elements like: liquidity is sacrosanct; liquidity risk management is paramount; how do you build a durable institution; how do you ensure you have a long runway --- are lessons we will never forget. So continuing to reinforce those because it is about tone from the top. Regulation can provide structure and constraints but it's not nearly as flexible or dynamic as leadership tone from the top and having it embedded in culture.

Garten: Well that's a wonderful place to stop. Ruth, thank you very much. It was very, very informative.

Porat: Thank you. Great to be with you. Thanks very much.

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