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Viewpoint

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Restoring Trust in the New Normal

Remarks to SIFMA Annual Meeting

Douglas Hodge

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Thank you and good afternoon. I'd like to start by thanking SIFMA (the Securities Industry and Financial Markets Association) for inviting me to speak today. It's an honor and a pleasure to be here with so many leaders of the financial services industry.

We are meeting at a consequential time. In two and a half weeks Americans will go to the polls to elect a president and new Congress.

The outcome will impact whether we go over the "fiscal cliff" – and if so, how far we fall; the evolution of Dodd-Frank, the most far-reaching financial reform since the Great Depression; and, of course, the longer-term policies that will help, or hinder, our economic growth in this country.

This moment is also consequential because of the structural realignments that are reshaping the global economy as well as the financial services industry. And that's what brings us here today.

As to how this all plays out, well, there are many unknowns. In the immortal words of Yogi Berra, "It's tough to make predictions, especially about the future."

It is particularly difficult to make predictions about the future of our industry. What will be our role in the New Normal? Such uncertainty makes us all anxious.

Yet, some things are clear. It's clear that our industry will be shaped by macroeconomic and regulatory developments and, of course, by the capital markets, themselves.

It's also clear that our deepest challenge is not an external one. It's something more basic and intrinsic: It's trust.

As stewards of the capital markets, trust is our most valuable asset. It's what gives investors enough confidence to engage with us, to entrust us with their savings with the expectation that we will help them achieve their investment goals, protect their money and provide appropriate liquidity.

Yet over a period of several years both prior to, and indeed through the crisis, our industry as a whole has squandered this trust. We forgot the most basic principle that finance is a means to an end. That whether we work for a bank, a broker or an investment manager, our core function is that of an intermediary and service provider.

In short, too many of us forgot the second word: "services." We're in the financial services industry. We exist to serve others.

Restoring trust means once more acting as stewards. Stewardship must be our guiding principle as we restructure our businesses, work with regulators and interact with clients and the public.

If we succeed, our reputations will rise, our contributions to society will spread and our pride will be reclaimed.

Tarnished trust

But we face a difficult challenge.

Trust in our industry has fallen to new lows. The most recent reading of the Financial Trust Index, which is based on a survey done by the business schools at Northwestern and the University of Chicago, shows that only 27 percent of respondents trust banks.

As an industry, we've fallen into the same boat as lawyers and journalists. I suppose we can take some comfort in the fact that Congress still ranks lower. Or then again, maybe not.

But, our low standing shouldn't come as a surprise. Now, in the fifth year since the onset of the financial crisis, millions of Americans remain unemployed; levels of wealth, stored in homes and retirement-savings accounts, remain far below pre-crisis levels. The human suffering has been immense and the fallout may last for generations.

Far from helping, we've been hurting our own cause. There's been a steady stream of dismaying news. Just this year, we have witnessed the robo-signing debacle, the collapse of MF Global, the failure of Peregrine Financial, the alleged violations of anti-money laundering laws at HSBC, the billions of dollars in trading losses by the London Whale at JP Morgan, and now the latest, the Libor rate-rigging scandal.

What these and other scandals show is that whether it has been simple incompetence or deliberate action, some within our industry have been guilty of deceptive communication, duplicitous motives, and in the most egregious cases, outright dishonesty.

As a representative of the asset management industry, it's tempting to lay the blame on bad bankers. But the Financial Trust Index shows an even lower reading for the mutual fund industry – at 25 percent.

We have a trust deficit!

Trust is developed on a personal level. It's achieved by acting consistently and honestly; by demonstrating expertise and competence; by communicating openly and accurately; and by showing concern and compassion toward the clients we serve.

On these dimensions – we all have work to do.

The New Normal

Our job of restoring trust will be even more challenging because the ground has shifted in fundamental and distressing ways. The decades leading up to the financial crisis were an era of deregulation, globalization, and credit entitlement. These forces produced economic growth and outsized returns for financial assets. Most of us lived in this environment for so long we stopped noticing it; we began to take it for granted.

That is until it stopped – and suddenly – and then went into reverse. Now we have re-regulation and creeping nationalism. Rather than credit entitlement, we have de-levering, de-risking and financial austerity. Economic growth has been anemic, even with massive fiscal stimulus and three rounds of quantitative easing.

We've entered a new era, one that my colleagues and I refer to as the New Normal.

We coined this term at PIMCO in 2009 at our Secular Forum, an annual gathering of our investment professionals from around the world where we formulate our three- to five-year outlook for the global economy and the implications for our client portfolios.

When we first published our New Normal thesis, we were criticized for our gloomy view that we had entered a multi-year process of balance sheet rehabilitation and restructuring. But, few would dispute today that the New Normal has arrived. In fact the concept has gone mainstream. Just this morning I Googled the term "the new normal" and got 24 million hits. It's even the name of a TV show which premiered last month on NBC.

I guess it's a healthy sign of acceptance that the New Normal has entered the vernacular.

But the New Normal means tougher sledding ahead for the markets and for us. At PIMCO, we believe the markets have entered a period where de-levering will be the gravitational pull that compresses both nominal and real returns.

In 2008, we learned that leverage has its limits and that housing prices do not grow to the sky. In 2012, we are learning that this large stock of debt, regardless of the rate of interest on that debt, is itself an impediment to growth (just ask the Japanese as they have been living in this netherworld for nearly two decades).

And we've also learned that this large stock of debt is, again, itself a source of inherent economic and market volatility (on this one you can ask just about anyone who lives in the Eurozone).

In a statistical sense, the "normal" distributions of investment returns that we took for granted have given way to greater volatility and "fat tails."

The New Normal also enhances policy risk. And, as Dr. Greenspan discussed over lunch, policy has never played a more central role in the functioning of the financial markets.

This raises the risks of policy error – especially since authorities have been forced into experimental mode as traditional policy tools have had limited and decreasing effectiveness.

Regulatory reform

So what are we dealing with? We've got a financially wounded consumer whose distrust of us has never been greater. We've got an anemic economy and more volatile markets whose growth prospects are being hindered by structural headwinds.

And it's in this context that we're making the most sweeping overhaul of financial regulation in our lifetimes.

And frankly, so far we haven't done so well. There's a widespread sense that the regulatory responses have fallen short. Many people on Main Street – and Wall Street, too – remain unconvinced that the fundamental sources of systemic instability within the financial system have been resolved.

All this is why we believe informed and responsible reforms are called for. But reforms need to be smart and coordinated, not protective or motivated by politics. They need to differentiate among the various types of financial intermediaries and how they should be treated. And, they need to spur growth by promoting the market's ability to discover prices, provide liquidity and allocate risk capital efficiently.

For instance, I think it is important that we differentiate between regulation that is designed to ensure the safety and soundness of balance sheets, which is the foundation of our depository institutions and the banking system, and the regulation that is used to govern the capital markets, which is designed around the tenets of transparency and disclosure.

As someone who is a capital markets guy, let's remember that the overarching role of the capital markets – is to provide a forum, an exchange – that allows and supports the flow of risk capital from those who have it to those who need it.

Our capital markets have served this purpose well for generations. We have the largest and deepest capital markets in the world. They serve those who need capital to support and grow their businesses, to innovate, and to create jobs; as well as they serve those who wish and need to invest, to preserve and grow their wealth, to be there for their retirement, to fund a college education, or to buy a first home.

Our markets are the envy of the world. We attract and facilitate the flow of international capital like no other market in the world. Our markets are one of this nation's most prized assets.

But for the markets to function properly, we need to ensure the integrity of balance sheets. Whether you are a capital market participant or a simple depositor with a passbook account and an ATM card, we learned this lesson in the near-death experience of 2008 when the capital markets froze when it became clear that the balance sheets of some of the largest and most venerable financial institutions had been compromised.

There should be no question about the importance of preserving the integrity of balance sheets. However, I would urge regulators, both domestic and foreign, to consider the impacts on the global capital markets as they institute their reforms.

Consider that about a year ago the World Economic Forum and McKinsey estimated that global credit levels would need to double over the next decade to more than $100 trillion just to support consensus growth projections. So our challenge is to expand credit, but to do so in a way that is both safe and sustainable. If we are to achieve our long-term growth potential, then we will need well-functioning capital markets.

Let me say one other thing about regulation. Considering the low esteem the public holds of our industry, when we weigh in on regulatory issues, it would be wise to stress that our approach is not just about increasing profits. Yes, I expect that all of us in this room work for profit-seeking institutions, and yes, profit maximization has been our mantra.

But, we should not be all about profit. In fact, we **cannot** be all about profit. Rather, once more, we are stewards, protectors of the capital markets that are so essential to our open economic system.

We need to stress that well-functioning markets are essential to economic, and human, development.

Now, that's a broad statement. But I believe it's more true today than ever before as we are being forced to deal with the aftermath of the financial crisis and its precursors.

Toward a culture of trust

Of course, regulations can only take us so far. They can quickly become outdated. And they cannot guarantee that fraud and other financial misdeeds won't happen.

That's why I said at the outset that it's imperative that we restore a culture of trust in the financial services industry. It's time we enter a new era, an era of cultural transformation. We need to rediscover our core values.

Several months ago I wrote a piece about culture in our industry. I said that the culture of the financial services industry should rest on three basic principles:

Number one, the client must come first. It's an old adage but one that has never been more true. This principle must be more than mere words printed on a page in an employee handbook or memorialized on a plaque in your lobby or cafeteria. All the financial services we provide must meet a legitimate client need. **We must live, honor and respect this value above all others.**

The second element is risk management. Risk management must be integral to everything all financial institutions do.

The third and broadest element is that we embrace a sense of stewardship. Yes, this is a word I've used repeatedly during my remarks today, and for good reason. It's a simple concept but one that can reliably guide us in the right direction.

Making things happen

I've laid out some cultural principles that I believe most of us would agree with. So the question becomes: How do we make them happen?

The simple answer is that it starts at the top, with us, the leaders of the financial services industry. Both as firms and individuals, we need to personify trustworthy values.

Great organizations are built from the inside out. We should strengthen and reinforce the key elements of our service culture, including a re-examination of management objectives. We should put in place reward systems that incentivize our people to place the interests of the client ahead of the firm, and the interests of the firm ahead of the individual employee.

We all make mistakes. But mistakes have consequences and the individuals and institutions who commit them need to be held accountable. Willful violations of the rules should not be tolerated by any of us. Firms should adopt a "Culture of Compliance." This involves increased training and a stronger emphasis on ethics and integrity.

Once lost, financial trust, like any other kind of trust, is hard to restore.

But it's not impossible. I have absolutely no doubt that if we can commit ourselves to reviving a culture centered on client needs, risk-management and stewardship, then we will all be better off.

Thank you.

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840 Newport Center Drive
Newport Beach, CA 92660
+1 949.720.6000

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