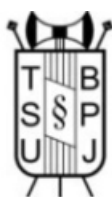


IN SEARCH OF A HUMAN WAY OF DOING BUSINESS

An interview with Richard Tropp



Richard Tropp studied political science and economy undergraduate, law in graduate school, theology post-graduate, and has been a military officer. After other policy positions in the U.S. Government, he was a special assistant to the Administrator of the US AID. His private company and he were invited as an advisor to help create the basic legislative and regulatory rules of the securitization in Chile, have helped US and other labor unions to restructure troubled industrial plants, and advised the European Bank on Reconstruction & Development on setting up the first venture capital and private equity investment funds in post-Communist Russia and Eastern Europe. He founded and ran an investment firm which dealt with transfer of capital to developing countries, while also trying to produce an “economic development” effect in those countries.

Mr. Tropp is also an excellent talker, with a rare ability to set forth the most complicated ideas in a straightforward but also very accurate manner. The lively examples he uses make the interview a great piece of reading, which gives a broad picture on relations between private and public investments, tensions connected with functioning of big government institutions and the drawbacks and highlights of adapting to a new local business environment, apart from the interview being a shrewd analysis on such specialized topics as: credit default swaps, organization of a security system or illiquid insolvency.

As Mr. Tropp is unconditionally in love with Cracow, I hope he will have a chance to visit the city once again in the nearest future!

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Joanna Śliwa: *President Kennedy once said that the United States have a moral obligation of a good neighbor to create an organization such as USAID. I was wondering whether this kind of motivation could be formative of any government's action and, if there were any other reasons, maybe of a more economic nature, which led to the AID's creation.*

Richard Tropp: The origins of USAID go back to the Marshall Plan of rebuilding Europe after World War II. The AID evolved in the 1950s under another name, concentrating on individual countries where the USA had some political involvement or affiliation, before, in the 1960s, President Kennedy transformed it into an official program. It was already shaped by then, though, having been in operation for twelve years. In very broad terms, there were three reasons for creating USAID: political significance – it was important for us that certain countries remain politically stable; economic reasons – in countries with which we had investment connections and finally, in some instances, we did it simply because we thought we should... What was it you called it? A moral obligation.

JŚ: *So there actually is something like conscience-based political action?*

RT: Yes! South Africa is a good example. Then there is Poland: here action was undertaken due to the strong relations between the Polish labor movement led by Lech Wałęsa and its counterpart in America which demanded support for Poland. The other motivation came from the Pope who cared greatly about the situation of small agriculture and asked for resource and technical assistance.

More recently, there are several million Poles living in America, reportedly hundreds of thousands in my city, New York, and probably over a million in the Chicago area. Not to listen to them would now be crazy from both a social and political point of view.

JŚ: *The legal basis for creating USAID is embodied in the Foreign Assistance Act. FAA is said to have undergone many policy changes over the years. At first, a lot of power was traceable to the Government which had a lot of leeway when it came to defining the actual ways of help, as those were very broadly set forth. Later on, this flexibility caused accusations that the AID was being used by the Government as a tool of political influence: support was supposed to be allocated under condition of playing along with US policies and goals. This was said to be the case with South America and Yemen. Afterwards, partially because of the accusations, the approach changed once again in order to fall in to the trap of bureaucracy. Given those historical turbulences, what is the present state of FAA?*

RT: There are a couple of questions here. First of all, do you know what a barnacle is? That's a plant that grows on ships. If you have too much of it on the bottom, it might literally slow the ship down. The Congressionally mandated bureaucratic restrictions and reporting requirements on each individual project, rather than oversight at the larger program level, are the barnacles of FAA. The Congress has already imposed hundreds of conditions that need to be complied with. Every year it is adding twenty new ones and, curiously, never eliminates any. The main political and institutional issue is, therefore, whether it is the Executive running the AID or is Congress taking it over.

To exemplify it, let's imagine that we (the AID) think a certain country should be given support, or that support ought to be taken away from it and allocated with some other country. Who makes the decision, we or the Congress? Similarly, if we want to spend money on policy reform or economic advice but the Congress considers it more important to pay attention to exports from, say, the Mississippi food industry, it may forbid us to give priority to policy issues. Due to the number of conditions imposed – reportedly over five hundred right now – it has become very difficult, for people actually working within USAID, to make any kind of decisions. Everything that is done has to be justified and that, of course, slows the organization down to such an extent that the Treasury has had problems with its functioning.

What especially struck me based on my previous work before AID in several Federal organizations was the idea of prior “Congressional notification” (“CN”) at the individual project level before AID could obligate funds for any project and begin it. Say, that we think it necessary to run a campaign in South Africa on the topic of family planning and child spacing. Women shouldn't have babies one right after another because, due to this and the lack of proper medical care, they tend to die very young. In order to be able to start off with this program, the AID workers must provide Congress with a fifty-page notification that states exactly the details of the undertaking. And still, the Congress may refuse to accept it! This way thousands of notifications are being prepared by the bureaucrats, some of which get turned down, but most of which are a paperwork formality which can immensely slow down project implementation while not adding value to Congress's oversight process.

Significantly, not all agencies work this way. Usually, the Congress points out a couple of things that need to be done and that's about it.

JS: *They're not being checked?*

RT: They are, but on a sample basis. It is only the AID that undergoes this amazing amount of scrutiny and has to notify Congress of every individual project beforehand. This re-

sults in introducing political views represented in the Congress to the character of help that is rendered. Naturally enough, the procedure also burdens AID workers with this tedious, time-consuming writing exercise of the CN.

Moreover, some agencies, like the Environment Protection Agency, have what's called, carry-over authority. The amount of money that has been assigned to them needs to be spent over the year, however, if it is not spent, it might be transferred to the next year's budget and used in future. No big deal. With USAID, this is impossible. If you don't obligate the prescribed amount of money, it's gone as far as the AID is concerned – it travels back to the Treasury. The result is, of course, a lot of unnecessary expenditures at the end of the fiscal year. It's not just connected with the reluctance to give the once obtained money back to the Congress, but also with the threat of receiving less money next year. This threat might also come to be if the money has not been spent to Congress's liking. Shortly speaking, it's a very controlled system of which the latest examples are Iraq and Afghanistan. What mattered in those operations was speed in implementation. AID couldn't ensure the required speed due to the numerous barnacles, leaving the President and everybody else unhappy with the result of its work.

Another big issue is the constant toying with the question of how political AID's work should be. To get it straight, people within the organization are not politicians but experts and professionals in different areas. Just as with the Polish labor movement back in the '80s – the reason of it was partially political (AID's relations with the US labor movement), but that doesn't mean that what we actually did there was of a political nature. We allotted the money first to the American labor movement so that it could help the Polish movement organize, we supported agriculture co-operatives and organizations keeping it all very technical. This then boiled down to the fact that, while the experts simply wanted to carry on with their job and not be hindered, the AID itself was supposed to be the part of the US Government and back up its policy.

One more thing worth mentioning here is the extent of focus on specific subjects. Take the support of agriculture systems in Egypt during the mid '80s, substantially wasted! The Egyptians control and keep the food prices in the cities low to sedate the people politically and prevent rebellion which might be particularly dangerous in big urban areas in that region. Needless to say, artificially low food prices stop the farmers from producing, hence the supply problems. The point is there's not much sense in pumping the money into Egypt unless its Government doesn't change the economic policy.

Similar situation takes place with respect to the supply of fertilizer in Egypt by private and government sector. The fertilizer must be put in the ground in a certain, particular time in spring. If you apply it a week later or earlier, it is of no use at all. The private

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sector obviously has a strong incentive to provide the ware at the right time in order to be able to compete, while the government doesn't. Therefore, we would try to persuade the government to take a step back, stop setting the prices and leave the business to private parties as this is one of the things that the government cannot perform well. You cannot expect us to give money for agriculture if it is persistently thrown to the wind. Naturally enough, in Egypt and Africa, the supply of fertilizer also became a means of political control...

JŚ: *And let me guess: because of stepping in between the Egyptian government and the private sector the AID was accused of creating undue political influence?*

RT: Exactly. When we started to indicate in what way the ware should be allocated, so as to make the best use of it, we were accused by the State Department of Treasury and other parts of the US government of creating too much of a political hassle. On the other hand, we were expected to allocate the money in a way that would make a long-standing difference. We, therefore, strived to follow Congress's and State's conflicting instructions and introduce some economic development by way of achieving a self-sustaining result over time, but that obviously made us too politically involved. As you see, there was no easy way out of this mess.

JŚ: *So, would you opt for more freedom for the AID in order to enable it to make its own decisions at least on some levels?*

RT: I believe in the US constitution founders' "Federalist" philosophy of separation of powers. The Executive Branch of Government is there to govern and should be allowed to do so. Congress should state broadly what the goals are but, within those goals, there should be much leeway as to the ways of achieving them. Nevertheless, if the appointed people do not manage to bring about some significant changes and effects, they should be fired. The same applies to business and economically related matters: people should be given clear objectives and discretion in doing what they are supposed to do. Then, of course, they should be held accountable. I think the average Aid employee would agree with that, while the average Congress member would say that, sure, this is correct, except for his one particular minor exception. Now, if one hundred senators and four hundred and thirty five congressmen each have "only" one little objection, then you can imagine what kind of efficient guidelines this will produce.

JŚ: *What did your job there in the AID look like?*

RT: I was a special assistant to the Administrator who runs the Agency. This involved being his personal source for new policy solutions and representing him outside the AID with

respect to politically sensitive issues, e.g. negotiations with the American labor movement, with the White House and the Congress, creating a new economic policy reform program in a major Middle East country which wanted to move away from socialism, dealing with the Vatican on Africa and with the US labor movement on Poland at sensitive points of local, political-economic transition. Also, communication with groups that were not yet governments but were supposed to become ones in the context of changing from dictatorship to democracy, which was the case with Chile or South Africa at the time of shifting from apartheid to a country run by its black citizens. It was all mainly about conceptualizing the development of new relations and handing it over to the AID organization when the things were already pretty much settled.

JŚ: *So, the dirty work!*

RT: Interesting work would be another word for it, I believe. I was expected to think strategically. Other people tried to figure out what should be done tomorrow, I planned the next two or three years to come and tried to decide what we really want to leave behind, what should be the tangible results of our work.

I remember one case with rehydration therapy. The therapy basically took the form of producing small packets with certain kind of sugar, salt and a few minerals in them. If you give that to the child whose body cannot store water, it will almost immediately rehydrate again. In the Third World, at least in the '80s and '90s, most of the children did not die of malaria or other serious illnesses but because of dehydration. If you could stop that process, you could buy lots of precious time for other treatment of the underlying diseases which had originally caused, and were then being aggravated, by the dehydration. This, almost magical combination of minerals, was developed in our laboratories and it was immediately decided that we have now in our hands something very precious and significantly important, that should be taken out and applied. From a practical standpoint, this was the job of the medical crew, but I was there to check on the effects. I would ask questions such as: how many children got the medicine and were kept alive? How many children got it this month that didn't get it last month? My job was to push the technical experts from concentrating on the process itself to assessing its results.

JŚ: *Did you like the work?*

RT: Most of the time – yes. Although, I must say, there was a lot of politics involved both of an exterior and interior character. Sometimes I had to encourage the bureaucracy to do things it wasn't always comfortable doing... And it didn't like that.

JŚ: *No bureaucracy does...*

RT: I was placed between the whole apparatus and the head officer and people just hated the fact that there was a kind of another channel. Just after being appointed, I issued a memorandum entitled Completed Staff Work, which contained the admonition that you don't let any piece of paper go to the Administrator if it hadn't been checked first with every relevant department outside of AID (such as the State Departments' geographic area bureaus, US Treasury, World Bank, and International Monetary Fund) and every other office within AID, that might know something about the pending problem. The first thing that happened afterwards was the issuance of a briefing book about a Central American country which I returned to the originating office and refused to forward it to go to the Administrator simply because it didn't represent all respective issues and, thus, was inaccurate. People would omit certain things not because they were bad people, but simply because it takes time and energy to include everything that's necessary. Needless to say, this created a lot of tension. All in all, I encountered a lot of bureaucratic obstacles and that's one of the reason why I left, eventually, and started my own company. I swore then that I would never be involved with any bureaucratic machine to such an extent again.

JS: *One of USAID's theme programs is allotting credit to the developing countries. What are the rules of transferring the capital so that it can be used in the most efficient ways and not destroy local economics?*

RT: It is for the Congress to decide, based on average income measures, when a country switches from being a poor country into a middle income one. Then, theoretically, the flow of money should be stopped. However, this is not quite that simple. Take Brazil for instance. Brazil is no longer considered to be poor and much of middle-class São Paulo is certainly not a poor city, but if you look at the rest of the country which is, by the way, bigger than Europe, you will see that 98% of it suffers from poverty. We have been fighting with Congress over these evaluations as we were of the opinion that in such situations the programs should change but should not end. There also arises the philosophical question: when exactly should the money be first supplied? At the moment when the country is very poor or when it is about to "take off"? Actually, if you decide to support the country which has just reached the middle income level, your money is bound to have a much bigger effect.

Other factors, apart from the rate of growth, that need to be considered are: the size of the country, which translates to the number of people you are able to help, the country's internal efficiency of using the money, and the fundamental underlying reality (in the Swiss-German expression: the country's Gestalt). This requires a deeper insight into the country's attitude towards its people and the private sector economy. If the govern-

ment allows the competition's growth and backs up individual initiative instead of trying to maintain too much control, the provided capital might serve a good purpose.

JS: *Isn't that one of the things that your company was doing? Transferring capital to developing countries? Do principles of such private money allocation differ much from those undertaken by the governments?*

RT: The differences are enormous. The first thing that comes to my mind is the problem of overhead, meaning, the costs you have to incur in order to have anything done, e.g. rent for an office or a lawyer to conclude an agreement. When I was working with the AID it was all very simple; if we needed a legal opinion on something, I would go to the agency's General Counsel, tell him that we needed a lawyer and just ask him for one. Being on your own means that there will be a bill for everything; the same with accounting. Typically, when you go into a Third World business, you will see that the accounting books haven't been kept very well, if at all. So, the first thing that needs to be done beforehand in places like, say, Argentina, is to send a person who will go through the books and check the content because what is in the books does not necessarily comply with reality. And every time you use the help of a professional, it will cost you no less than two hundred and fifty thousand dollars. Additionally, you need to go through this painful process more than once, just in order to assess whether a certain company is, or is definitely not, the one you want to do business with.

JS: *How does it feel when you realize that, after spending that much money on studying a company, you cannot make profit out of the business and therefore shouldn't invest in it?*

RT: Terrible frustration and a desire to reach across the table and strangle the local people if they haven't told you something that should've been said at the very beginning.

Another big issue is connected with the necessity for speedy and drastic decisions. Once we were dealing with a successful company manufacturing shirts. Everything was well until we discovered there was a leakage of money somewhere. Subsequently, we got engaged in restructurization until it became clear that one of the directors was secretly gambling away the company's money. Back then, I was convinced that the matter should be dealt with much caution. I saw the main accountant on a Sunday to hear about the problem and arrive at the best solution. In the end, as the director was liked by the union leadership of the workers, we decided to give him another chance and let him stay in the company under the condition that he will undertake treatment. What I should've done, then and there, was to call the local police and put the man in jail. The result was that he stole more money and we had no choice but

to fire him on Christmas Eve. At that very moment, I became a business person and that company, after losing a painful amount of money, went through a critical three months of change.

In the government-run business, such a person would probably be moved to another position where he would still have a salary. Why? Because, all in all, he is probably a nice man and it's not your money you are dealing with but the taxpayers' money. If you run your own business the golden rule is: the first time somebody lies to you – out! If you are not tough, you lose money.

JŚ: *But, at the same time, you need to gain respect and trust, so that the local people will want to do business with you and not treat you as an outsider but one of their own.*

RT: Absolutely. You need to be human too when doing business. (*Laughter*)

JŚ: *z possible at all? Is there any place for a company to care about behaving in a moral way when, according to its definition, it should multiply the profit for the stakeholders? I've already discussed the problem in other interviews but I'm curious what a financialist has to say in this matter.*

RT: Basically, a privately-owned company is free to do whatever it wants, whereas, in publicly-held companies, you owe an obligation to the shareholders as the money is not yours to spend. I think CSR is good and possible when it is able to both pursue worthy goals and, at the same time, bring profit to the company.

JŚ: *One may argue that it is not CSR any more, just another form of conducting business...*

RT: Still, I consider it the best solutions both for the company, itself, and for the other actors that get involved, such as the employees or the environment.

At my own company, we used to spend tens of thousands of dollars on helping small businesses in South and Central America, simply because we cared and, once we obtained the possibility of helping them, we wanted to do something that would make us feel good about what we were doing in our lives. Later on, this might have actually proved profitable because the local big business owners also cared for the microeconomy in the area and, while working on helping the smaller enterprises, we got to meet them on less formal, different occasions than talking about their business. However, we didn't know at the time that our "do-gooding" work would turn out to have positive effects at the larger, strictly business level... Our intentions were pure, so to speak. But, although we never touched the investors' money while

doing this and only used the capital that really belonged to ourselves, some of our advisory board members felt that we were wasting the time that should have been used in a different way.

I'm circling around your question now because I don't like the answer I'm about to give you. Pure CSR is very doubtful and if it's someone else's money you're doing it with, not your own, it shouldn't exist...

JŚ: *...Obviously, unless the owners, themselves, would want you to spend their money in such a way.*

RT: Of course. But then another question arises: how do you know that? Imagine a company with fifty thousand shareholders of which forty thousand want you to spend the money on helping small agriculture whereas the remaining ten thousand say: "What has that got to do with me?" Are you morally entitled to spend ten thousand people's money when it's their and not yours? I don't really think so.

JŚ: *I get an impression that CSR is closely related with the issue of companies and religious motivation. Do you think it is possible for religion to influence business on a large scale?*

RT: This is a question I've been wrestling with for over twenty years. The sad answer is that it doesn't really work. Unfortunately. My company's board consisted of members of various religions, all of whom wanted to do some good in the world. That's why, e. g. we started a teaching program in Africa on the management of new, mostly locally-owned, minority businesses we were helping to organize. Our goal was to make local people familiar with efficient ways of conducting business, of how to think about it and analyze it. The program proved to be time-consuming beyond all reason and we spent hundreds of hours on the job. No wonder the advisory board members got impatient and started to ask about the benefits of this local "empowerment" work to the company, itself, while here we were, striving to do something that really should've been done by the Swiss, Dutch or Swedish Aid.

My friend, a head of a big US private equity firm, who is also religious, calls this kind of involvement "a mixed agenda". Taking my experience into account, it cannot be really applied.

JŚ: *Did the program in Africa succeed?*

RT: On the level of individual local companies with whose management we were working, of course, yes. But then you have to consider what economists call the "opportunity costs",

meaning, what other things could we have been doing at that very time but were not. The opportunity costs of doing good are unbelievably high.¹

JŚ: *To lighten up a bit – a question from a different area. You studied at Yale; can you objectively assess the standard of the famous university? Is it really as good as it is said to be?*

RT: Yale is an excellent place. It's relatively small, hence, you can really interact with your most senior professors instead of only with a young student assistant. The people working there love to teach and the standard of the courses is extremely high. However, I am of the opinion that nobody should go there unless he is at least twenty eight, twenty nine years old because only with a certain level of experience and knowledge of what is really important to you, can you appreciate the opportunities the university is giving and maximize what you get out of the environment.

The finance world has an interesting way of handling this maturity dilemma. Big corporations accept people straight after college and get them to work as slaves, seventy, eighty hours a week. In between, the young people really learn how to do financial analysis, they learn the special way of thinking which, with finance, is eighty percent of success. After about five years spent in this way, one really acquires a sense of what he wants to do, what is boring and what he would be good at. Equipped with this precious kind of knowledge one may make a conscious decision if he wants to pursue financial education in the academic form and then come back to the company in a different capacity.

JŚ: *Speaking of financial matters and the ways of conducting business, is there anything special about how, from the economical standpoint, the rich Middle East countries are being run? Take Dubai for instance... We constantly hear of the building of new islands on its coast where whole agglomerations are created from scratch, not to mention investments in the manner of Burj Al Arab. Of course, they have the natural resources but I was wondering if there is anything more to it?*

RT: All of Dubai's money comes from oil but the young sultan Sheikh Mohamed or "Big Mo", as the Westerners call him not to his face, is a very forward-thinking man. He is aware of the fact that someday the oil will run out. Therefore, it is necessary now to use the money in a cleverly prudent way in order to diversify economy. Dubai is now going through a very conscious process, similar to the one that took place in Singapore a cou-

¹For comparison, see: discussion on legal education with Sarah Duggin ("We ought to let companies be socially liable!" An interview with Sarah Duggin, p. 27-28) and with Leah Wortham (A nation held together by laws. An interview with Leah Wortham, p. 56-57)

ple of years before. Unfortunately, it does not have the Singapore's respect for education that resembles the Chinese-Confucius model and also other issues, like security, tend to appear, but basically Dubai's government is introducing the right policies.

JŚ: *I've heard that it's characteristic for the Middle East to conduct business in a family sort of way...*

RT: ...They run whole countries in a family sort of way!

JŚ: *It seems to work there, doesn't it?*

RT: It is a very effective method at the start, when you are trying to get things going for the first time. It is then good to just have very few people who are making the important decisions and creating a sound vision. As an enterprise gets bigger, a completely new system has to be applied. Dubai is not at that point yet. Sheikh Mo and his brothers still manage to run almost everything themselves but they know that, some day, it won't be possible any more.

JŚ: *Moving back to the USA and into your particular area of specialization, could you briefly describe the origins of the securitization system in your country?*

RT: It all began with the central banking regulators called the Basel Group. The name is connected with the fact that their seat at the Bank of International Settlement that coordinates among individual countries' central banks their decisions on regulatory policy questions, is in Basel, Switzerland. It was they who set the requirement that banks have to have a certain amount of capital for a given amount of assets. The capital has to be sterilized – put away as a loss reserve – and cannot be used for normal money-making operations such as lending, so that, in the worst case scenario of a loan's collapse, this amount will be immediately available to cover the loss when it happens. This capital is not producing income (only during the last quarter's financial crisis did the US's Federal Reserve Bank begin paying banks' interest for the first time on the loss provisions which they were required to keep at the "Fed" as their Basel regulatory capital); it's just a cushion against loss. That is also what prevents the depositors from getting nervous and drawing all their money every time the bank gets in trouble.

In late '70s, the regulators got worried about a bunch of loan assets going bankrupt and then, all of a sudden, bad things started to happen. There was the Middle East embargo on the USA, prices went up at a great speed, interest rates and unemployment in the States went up to twenty percent, inflation went up to over twenty percent, to get gas you had to queue from like three, four in the morning... it was all a mess. The banks started to get into trouble, as they couldn't raise new capital without selling their shares

at a reduced value, which, of course, they hated. At that point Lewis Ranieri of Salomon Bros. came up with an idea that, during the difficult economic situation, when lots of people stopped paying back their loans, the banks don't really have to raise new capital if, instead, they reduce the assets so as to keep in line with the Basil standards. And this, reducing assets on the balance sheet by securitization rather than having to raise new capital in a distressed market to meet the Basel capital-to-asset regulatory standards, proved to be the solution.

JŚ: *An interesting change in the US credit granting can be observed with respect to the housing policy. It was always considered a good thing that people have their own homes and, accordingly, the amount of equity capital needed as an input to obtain the housing loan diminished over the years up to a point where no starting capital was necessary at all. What, in your opinion, should be the policy now?*

RT: Twenty percent equity... People need a strong incentive not to walk away from the property. If they have invested some of their money in it, they will be inclined to take better care of it. If they have nothing to lose, there is nothing at stake for them; it's all somebody else's money. That creates a "moral hazard" not to continue paying on their mortgage if their house loses value by more than the diminished amount of their equity.

The mid to late '90s policy of a minimal down payment (rather than the formerly customary 20%) was a social idea, not an economic one. The bigger question here could be whether you can ever decide economic issues based on social policy. The answer is that, however well motivated it is, it doesn't really work. There are now people who own houses although they shouldn't, not for moral but economic reasons. They are simply not in a position to own them. Nowadays, the capital requirement in the USA is going up and some estimations are that it will reach as high as twenty five percent.

JŚ: *Let's move on to the field of credit default swaps for a while. Credit default swaps are a financial instrument which allows the risk transfer from the original party to the contract to a third party. The "buyer" pays periodically to the "seller" in exchange for the right to a payoff in case of the debtor's default. How is it possible that, in some instances, upon insuring only the interest, the one who is supposed to bear the risk is also obliged to pay the principle when the maturity date comes?*

RT: It's all contractual. The problem is the system's uncertainty – nobody knows how many different kinds of contracts are out there. When the default swaps started, the practice was, don't ask me why, to insure the full principle although what the buyer really cared about was the interest flow in the next couple of years as the sum was usually not due for a long time. There are hundreds of thousands of contracts shaped solely by the will

of the parties and nobody seems to have any idea to what total, notional (principal) value they amount to and how it should be regulated.

JŚ: *The solution then would probably be to create one common, comprehensive system of those instruments.*

RT: Absolutely. That's what the Federal Reserve is trying to encourage financial institutions who buy and sell these "CDSs" to do just now by indicating that, no matter the content, there should be one, standardized contract in usage.

Another thing that is closely connected to the credit default swaps is the so called netting of capital owed by each of the two parties to one another, in order to protect the regulatory liquidity of banks. Say, I have a default swap with Deutsche Bank, which owns an obligation to me, depending on the payment of the principal by a third party on January 1, 2016. I owe Deutsche Bank the swap equivalent in 2018. The problem with netting is that whichever party receives the money first, the second party is at risk for those two years that the first party will go bankrupt. Nobody thought about it earlier because there was the interbank loan market and big institutions could borrow from it through central banks.

Last summer, all of sudden, first in England and then partially in the US, the banks just ceased this practice when they began getting worried that they might not be able to get their money back from another bank to whom they made an overnight interbank loan. It then became obvious that it is well possible for a big bank to go into regulatory insolvency which basically means that the bank possesses assets which should be able to sell and turn into regulatory "capital", but in today's distressed market, it cannot transfer them to cash at the very moment. Actually, such a bank is illiquid but not insolvent. The regulators now are thinking about changing the definition of regulatory insolvency for it to be more long-term and not to encompass the situations of being illiquid for an hour or one day.

JŚ: *That seems reasonable enough. Are there any consequences of labeling a bank as regulatory insolvent?*

RT: It has to shut down! That's exactly what happened in Britain. When the banks couldn't borrow the money from one another to fund their obligations, their regulatory solvency became immediately threatened. In the banks' world, it is normal that the liquidity line will rise and fall and there will be many times when a bank will be temporarily short on cash. Regulatory insolvency implies that, if the bank cannot borrow the money overnight to have it ready the next day, it should be closed. This is not the true economic reality, so the relevant bank regulatory accounting rule has got to change as now there's

really no way for the regulators to say how much money has to be pumped into the system to sustain liquidity.

JŚ: *Is that what happened in Argentina? All the people wanted their money back at once and the banks ran out of cash?*

RT: The question of regulatory insolvency is one that comes to being at the level of an individual institution. What happened in Argentina was that the country, rather than any one single individual bank, was about to lose the ability to pay its obligations in dollars and Mr. Cavallo, the economy minister, circled about freezing people's dollar bank accounts. When the word started spreading in the street that the government fears that there is an insufficient amount of dollars to support the amount of peso, the people turned up at the banks' counters asking for dollars instead of pesos, thinking that the next day they will be able to trade the dollars for pesos at a great advantage. This appeared to be a self-fulfilling prophecy and the banks really ran out of dollars, although, normally, they wouldn't have. The bank accounts were frozen and people panicked. The ironic thing was that, mostly, people had money, they just couldn't get it out of the banks.

When, afterwards, everything unfroze again the value of peso comparing to the dollar was something about four to one. The consequences were awful... Middle class women were forced to go on the streets as prostitutes because this was the only way left to feed the children. A new profession of "ragpickers" developed and the whole families would do that after dark. I was there at the time and the police warned me that it's not safe for me to go on the streets because of all the people there. I asked: "Who are those people? Are they criminals?" "No", the police said, "there are just poor people."

Argentina is a complicated story. It is sad, because the middle class there is so well educated, which gives it the country an extraordinary national potential. However, the system was not transparent, the ethics of the country's business culture were not commensurate with their intellectual quality, and the courts and the privatization system was widely seen as having been completely corrupted. There was no confidence in the institutions and, even though, at the beginning, the dollar was equivalent to peso, people feared a breakdown of the currency followed by an outburst of panic. What is more, Cavallo wanted to maintain a sound peso at all costs and never let it inflate in the natural way which would maintain what economists call the equilibrium national exchange rate. The result was that there was too much import because the dollar was cheap and too little export because the peso was too expensive. Everybody knew the system was artificial and that, at some point, it would crash. What was mostly lacking in Argentina as especially local investors perceived, was the honest business environment.

JŚ: *When setting up a securitization system in a country that has never had it before, one has to take into account not only financial matters but also the specificity of the environment in which one is about to work. You were part of a group that was requested and invited to create the basic legislative and regulatory rules of the securitization in Chile. What country-related elements did you have to consider while on the job?*

RT: Mainly policy issues, e. g. maintaining the loan servicing human relation between the borrower and the originating lender of that borrower's loan, if the lender sold the loan into the investor markets. From the national point of view, it was important that many people got loans. From the financial standpoint, there also had to be provided means to get as much as possible of the loan repaid, once the borrower got into trouble. At the same time, the seller had to have enough incentive not to turn away from the borrower by repossessing the home, rather than doing a "workout" with the borrower, the moment some difficulties appeared.

I remember when, after arriving in Chile, the Executive branch was telling me the process of creating the system is going to take no more than six months while the head of the Chilean securities commission pulled me aside and said, "Rick, three years." We were expected to approach Chile's Congress and explain the adopted solutions so that the originating lender could always quickly step in and work out the troubled loan with the individual borrower, if something started to go wrong. We needed to get the local people to become comfortable with the social policy of what was happening. Shortly: process versus substance. All the key actors that might be involved later on in the running of the system had to be made aware of what the changes would mean operationally, at the level of individual borrowing families, once their home loan had been sold to someone else besides the bank they knew and which knew them.

For example, one change was on the legal question of obtaining the borrower's consent before transferring the loan. In Chile, just as in Poland, such consent was obligatory but you obviously cannot securitize hundreds of mortgages if you have to have consents from all the individuals. In the end, we managed to get rid of the condition (the requirement for individual consent by the borrower before his lender could sell his loan to investors and get the cash back to use on another new loan), provided that the borrower could always return to the original creditor and work out the individual problems with him. In Chile, their Congress and their regulators very wisely required that original lender remain the "servicer" and maintain the human relationship with the borrower even after the lender had sold the loan.

JŚ: *A compromise?*

RT: Yes.

JŚ: *What did your job in Chile look like on the day-to-day basis? What was the very first thing you did after getting there?*

RT: By way of a happy accident I hadn't planned on and thanks to a local friend, I got a Chilean serious girlfriend! And believe it or not, it really helped! I learned the language very quickly, I stayed in the country for the weekends, I got to see very nice and interesting local people, who had nothing to do with my business; they were kind enough to explain many things to me in depth about the culture and history of Chile and to teach me, and after a while, I was seen as one of the locals... and this was the small thing that gave both me, and some of the Chilean government people I was working with, confidence (as well as a lot of amusement).

Doing business has much to do with the atmosphere. Instead of being formal in an office I used to turn up for coffee or be invited to a banking executive's house for lunch, where we could really talk things over without twenty bureaucrats peering over our shoulder. In such circumstances, you are not embarrassed to ask questions that you think might make you look ridiculous and, additionally, this way is simply quicker. What I learned there and what the Americans scarcely think about is the fact that informal set of interactions is fifty one percent of getting things done. Especially in a country where they are not used to dealing with the outsiders. Say what you may, but Chile is on the other side of the world, and geographical distance still does create some difficulty in getting past the social distance! Easy, informal access is the key to success for both business parties, but you have to genuinely like being in a particular country for it to work.

JŚ: *Considering everything that was said here about the financial instruments, would you agree with what Warren Buffett, an investor, philanthropist and CEO of Berkshire Hathaway said about derivatives, namely, that they are a deadly, financial weapon of mass destruction?*

RT: Not inevitably, and certainly not all kinds of derivatives. But the unhedged ones, in particular, those in which a trader is just speculating on some outcome without having any underlying risk exposure which he is hedging by the derivative can well become such a weapon, if not properly risk managed by the trader's institution and by regulators.