

Dear Friends, Colleagues and Family:

I am writing to you now having recently returned from my experience of speaking to banking regulators (FED, OCC, OTS) at an investment management conference sponsored by the Board of Governors of the Federal Reserve. I had been invited to address the topic of ERISA Fiduciary Governance and the governance model I co-authored with Douglas Foster, co-founder of Denali Fiduciary Management. I had specifically been asked to address the applicability of that model to the task of banking oversight.

I was told my presentation was well received. Indeed, one senior staff member of the Fed said I would be invited back. While I am grateful for the opportunity to have addressed this gathering and appreciate the sentiment expressed to me about the presentation, what I learned in my three days in Washington DC was deeply distressing.

For those who don't know me, it may be useful to know that the author of this letter has been married for 26 years, has two children, is a mountaineer for 30 years, loves the outdoors and finds great satisfaction in gardening. I am not and never have been enamoured by the political world. Indeed, the culture I found in the federal banking oversight infrastructure is the equivalent of a cesspool of inauthentic behavior. It is a culture built on and sustained by the power of creating illusions. It is so pervasive that in general, I think the inhabitants of that culture have an impossible task - staying grounded in a culture that incentivizes deceit and delusion. Those who support and sustain the culture thrive in the space defined by the difference between what a word is intended to mean and how it can be justified to mean something else. Engage in that kind of distortion enough and pretty soon you have an environment that stimulates delusional thinking. If one embraces that delusion pretty soon you cannot tell the difference between reality and the delusion.

I am reminded of Warren Buffet's quote: "What the human being is best at doing is interpreting all new information so that their prior conclusions remain intact." The prevailing culture of our nation's capital exemplifies that statement. In fairness, this is not strictly a banking oversight or Washington DC phenomenon. Witness the new

CEO of Phillip Morris (quoted in Business Week) how PM is the "socially responsible" cigarette company. His evidence: PM doesn't put its logo on racing cars any more. How exactly that statement jives with the World Health Organization's estimate that cigarette smoking contributes to the death of 5+ million people worldwide every year is not clear.

During the conference I had the opportunity to talk with various bank regulatory personnel privately. I thought this country's fiscal situation was bad before I went. I am pained to say that it is worse than I imagined. In one conversation after another (WITH NO EXCEPTIONS) I was told how it looks to be an insider in a banking oversight system that is broken and lacking in a moral compass. The institutional leadership lacks the emotional intelligence to know its limitations. Thus, the only lens used to gather and assess information is "how can banks make money".

Here is what I learned:

1. The work of bank examiners (from any federal agency) is not intended to serve as a rigorous examination of banks. No examiner from any federal agency "audits" banks. Rather, the intention is to "assess" them. If you thought the "stress tests" of the banks occurred in an audit-like manner - you'd be wrong. This is NOT a semantic difference. It is a difference in substance that explains why the American banking system and the regulatory infra-structure that oversees it was ALLOWED to become what it is - an illusion. De facto, there is no one with the responsibility or accountability to interfere with the cascade of events that caused the collapse. This is the source of my worry. My worry comes from the fact that we have done nothing to change the circumstances that would discourage another catastrophic collapse. We are more than two years into the collapse and still we have no 911-like commission examining, under bright lights, the sum total of events. This is not good. We cannot expect the people who were asleep, irresponsible or inept to create a 911 like commission. CITIZENS MUST DEMAND IT.

2. As a practical matter, most people who work as bank examiners have not worked in banks prior to becoming an examiner. As one person explained to me; there is a real question of whether or not

bank examiners really "know" the business of banking. They might know something about credit card operations because they personally have some credit cards. They know how to go into small banks and examine whether loans are performing or delinquent. However, they don't know or understand bank trading operations, positions, risk or profits because collectively they lack the sophistication of being familiar with trading desk operations and exposures. This perspective was affirmed by personnel who work at the Federal Reserve. WHAT?????? Shows you how dumb I am, I thought that meaningful oversight was what they are supposed to do. I was wrong.

Add to that, I was also told that most examiners are personally intimidated by the bankers they regulate. This intimidation factor is a key problem for the regulatory oversight function in our government. The banks know this and count on it in formulating their lack of responsiveness to the civil servants with oversight responsibility. I was told the story of one problem bank in which one aggressive banker held off the inquiry into the bank's status by literally holding up the efforts of 32 regulators who were in the room. I was told another story about how a request for a document led to the receipt of 26 boxes of paperwork. Just like the common tactic in litigation, bury the opposing side in paperwork, the large banks overwhelm the capacity of the regulatory system to understand let alone deal with the complexity of the largest institutions.

OBSERVATION: The strategic placement of hard core business minded personnel in bank oversight regulatory teams would go a long way to change the culture on both sides of the regulatory gauntlet. Project managers who do not tolerate excuses for non-compliance or non-cooperation would change a culture that has learned how to stonewall the efforts of regulators or to acquiesce to it. This is a simple solution that would cost something but the cost would be minimal relative to the increase in effectiveness of the entire regulatory oversight function.

3. Senior level personnel told me that whatever the job of banking oversight is supposed to be - it does not, as a practical matter, include ANY credible oversight of the 10 largest banks in the country. That's right. You read it correctly. That is exactly what I was told - verbatim. I was told by several individuals representing different

federal agencies that the top ten banks in the country constantly and consistently thwart the efforts of the regulators (even those who work for the Federal Reserve in DC) to understand the business operations of those 10 institutions. Indeed, I was told that the examiners didn't know if senior executives at the regulatory agencies (including the FED itself) had credible access to understand the business operations of the biggest banks. Mind you, these conversations occurred after the "stress tests" were completed - or should I say negotiated. I was told repeatedly that bank examiners, after hitting their head against the wall of trying to learn about the biggest banks, have learned that banging their head against the wall hurts. In effect, they have learned to leave the biggest banks alone.

In part, this condition has been fostered by the very structure of the Federal Reserve system in which the district Federal Reserve Banks are autonomous from the Federal Reserve Bank in DC. The district Fed Banks are owned by the same banks the bank examiners are supposed to examine. Add to that, the bank regulators are housed in the regional Fed facilities and PAID BY the same regional Fed Banks owned by the banks those regulators examine. It doesn't take a PhD in economics to figure out that this oversight structure was and is doomed to fail. It is structurally flawed. As a governance matter, it is a dysfunctional structure that has been ALLOWED to continue. Think about that for a moment. This has been ALLOWED to continue. Until this condition changes, expecting a different result from the same circumstances would be foolish. I might add that "foolish" is not as strong a word here as I should be writing.

OBSERVATION: I am not a fan of heavy government regulation. I have that point of view not because regulation is bad per se but because the people who design regulations usually don't know the business they seek to regulate well enough to know how to design EFFECTIVE regulation. That is why I was asked to speak at this conference. We designed an effective governance system for retirement fiduciaries. Our methods were adopted by several very large companies. By contrast, the rules that comprise the regulatory infrastructure of most government functions is inefficient and ineffective. It was deliberately engineered that way to thwart transparency.

The best way I can think of to put a kibosh on this illusion that we have a banking oversight infrastructure is to support proposed legislation (HR 1207) to audit the Federal Reserve. This legislation has over 200 co-sponsors in the House. It is necessary because the Federal Reserve is now exempt by statute from an independent external audit. YES, you read that right. Right now, the citizens of the United States have NO LEGAL RIGHT to compel an independent audit of the Central Bank of the United States. The organization that controls this country's cash flow and currency can and does conduct its operations under the cover of secrecy. I had heard this before from what I used to think of as my craziest friends on the far right and far left of the political spectrum (yes, I have friends on both sides). I used to think they were all "out there". Now, I think their understanding is much closer to the truth than the people who occupy the middle of the political spectrum. One often hears the retort that the Fed must conduct its operations without the market being aware of its actions. While I don't disagree with that sentiment – an operational audit is not a real-time phenomenon.

Chairman Bernanke's comments notwithstanding, the audit proposed by HR 1207 is NOT about interfering with the Fed's interest setting policy. Indeed, the proposed legislation says NOTHING about that. Rather, the audit is about shinning a bright light on the Federal Reserve's operations. Here is more evidence that such independent audit is needed. This is a video of the Congressional testimony of the Inspector General for the Federal Reserve. It speaks for itself. <http://dailybail.com/home/there-are-no-words-to-describe-the-following-part-ii.html>.

We MUST demand accountability. We MUST be unrelenting and uncompromising in that demand. I can think of no single activity that would have more dramatic impact on beginning to construct a credible "fix" of this country's financial system than the proposed legislation that would compel the General Accountability Office (GAO) to conduct an audit of the Federal Reserve. The fact that an independent audit is being resisted is evidence enough that it is needed. Contrary to Chairman Bernanke's comments, this effort will not politicize the Federal Reserve - it will democratize it.

This is a good time to tell one on the Fed. If you wonder whether the Fed needs to be democratized – READ THE NEXT TWO PARAGRAPHS. This is something few people know about – “tying relationships”.

“Tying relationships” is the term applied to the circumstances in which an investment banker walks into a CFO’s office and say something like: Hey, CFO, we’ll give you a discount on our investment banking services (a benefit to the business) if you let us manage a billion dollars of the pension fund. To engage in tying relationships describes the inducement of the company’s finance officer to breach his fiduciary duty to the pension fund participants by seeking to put the corporation’s interests ahead of the best interests of the pension plan participants. Tying relationships were made illegal by the National Association of Securities Dealers (the NASD is now known as FINRA) a few years ago (I believe it was 2003).

Within 30 days of when the NASD passed the rule that prohibited tying relationships, that Federal Reserve released a 32 page memorandum that offered commercial banks under Fed “supervision” (I use that term loosely) a regulatory path to nonetheless engage in tying relationships. The path represented in the Fed’s memorandum stipulated that so long as the bank’s affiliated investment brokers brought a commercial banker (someone NOT licensed to sell securities) into the meeting with the CFO AND the commercial banker did the talking – then it was OK because the commercial banker’s conduct is not regulated by the NASD. So long as it was the commercial banker who told the CFO that the Bank wanted to increase the profitability of the relationship, then if the CFO agreed to the proposed tying relationship transaction, in so far as the Fed was concerned, NASD rules weren’t violated. The Fed wasn’t concerned about the breach of fiduciary duty to the pension plan participants because the Department of Labor “regulated” that aspect of the transaction – not the Fed.

In effect, the Fed institutionalized the deceit of the transaction. When one senior staffer from the Fed told me he worked for “the American people” I asked him to explain to me how it is that he and his colleagues were so willing to promote deceit with the citizen on the

losing side of the transaction. He was rendered speechless by my revelation about tying relationships.

Clearly, the Federal Reserve represents banking interests and that is why it must be overseen by an independent audit function with impeccable credentials.

4. I had numerous conversations in which I asked about the heavy hand of regulation and the power of the regulators to impose sanctions, fines and criminal charges if they ever found any activity in a bank that would warrant such a response. What I came to understand was that on the books there are all kinds of laws by which the regulators could bring civil and criminal charges against bankers if the regulators found egregious activity. However, such laws are not used and no one could recall any significant prosecution of any kind in the past 20 years. The existing laws are a paper tiger (a.k.a. they mean nothing) and everyone involved in the banking system and banking oversight knows it.

The federal banking oversight regulatory apparatus isn't designed to regulate banks the way most citizens think of that function. One implication of this observation is that members of Congress, being mostly ignorant of finance anyway, are also, as a technical matter, not equipped to exercise effective oversight of the country's largest banks. (That is obvious isn't it?)

There are no substantive consequences to those who engage in behaviors that caused the catastrophe. There is NOTHING that compels the people, organizations or leadership structures involved in the oversight apparatus to look in the mirror and ask themselves what they did to contribute to this mess. Without a public vetting of personal testimony as to how individuals contributed to the mess we are in - we will not "fix" the problem. It is inadequate for the Chairman of the Federal Reserve to say it is painful to him to have to bail out companies that behaved poorly. The more interesting and useful conversation would be testimony as to where he failed in his leadership and where his organization failed in its mission. After all, the Fed's job is to access the safety and soundness of banks. Their economic mission is to maintain price stability in the economy. So what grade do you give them for their effectiveness in fulfilling their

mission. A "D-" would be generous. Someone needs to ask the question and Chairman Bernanke needs to publicly answer it - how and why did you and your organization fail to see this coming? Why do you have an Inspector General who doesn't know anything about the operational integrity of her agency? Why does the leadership of that agency ALLOW for such inept performance by senior personnel within it.

OBSERVATION: The best solution would be to find the equivalent of the untouchables - a modern day group of Elliot Ness-types whose purpose cannot be compromised. The only people I know of who are even close to being capable of examining the factors that contributed to this mess and constructing a template more authentic regulatory infrastructure are pension fiduciaries. These are people whose job it is to manage billions for the long-term benefit of others. Let me be clear, not all of them have the intellectual or emotional courage to maintain an allegiance to their duty. Some are more diligent and rigorous in the exercise of their duties than others. However, many whom I know have internalized the responsibility of serving as guardians on behalf of others. This is not something politicians or bankers are good at.

As a group, pension fiduciaries aren't perfect but they are more capable of asking the right questions, diving into details of investment operations and constructing suggestions for a regulatory infrastructure that would reflect the mission at hand. I don't know of any other group of individuals who implement a guardianship framework in the context of their daily work in a complicated finance environment. If I were asked to solve the problem of creating a regulatory oversight function that worked, I'd start there. I'd hire a team of pension fiduciaries to examine the entire fiscal crisis and make recommendations that would make the entire system more responsive and purposeful. These folks are good at separating delusion from purpose. I even know the people I'd choose for the job.

With regards to the insubstantial nature of the banking regulatory oversight infrastructure I go back to the HR 1207 legislation that will have the GAO audit the Federal Reserve. This audit is needed because in this country we cannot do what the People Republic of China did a few years ago when they found

bankers who committed fraud. They took them out and shot them. It is a bit harsh of a regulatory oversight function, but you have to admit - it was effective. There are now fewer Chinese bankers willing to engage in fraud.

5. I met with one of the senior lobbyists for the American Banker's Association and in a private conversation asked her the following; "Given what you know, if you didn't work for the ABA and you were asked by a friend what three changes you would make in the banking system to improve it, what would you say?" After ten minutes of rambling, she turned to me (now in the presence of several regulatory personnel) and said; "I haven't answered your question, have I?" My response; "No, you haven't." She then gave me an authentic response; "I don't know". I give her credit for offering me an honest statement.

OBSERVATION: It isn't that banker's are evil or that they cannot be trusted - it is that they, LIKE ALL OF US, exemplify the truth of Albert Einstein's dictum: "You cannot solve a problem using the same thought process used in creating the problem in the first place." Ultimately, the antidote to be blinded by self interest is NOT MORE GOVERNMENT. Rather, it is more effective GOVERNANCE. If it is to work efficiently, effective governance must include training that develops the emotional intelligence (if you are not familiar with that term - please spend a moment to look it up) of the people in positions of responsibility and accountability.

I suggest that you put Einstein's quote on your refrigerator or over your desk. Look at it often. It implies that the thought process used in generating the problem (rather than the person who used it) is the source of the problem. The dictum identifies the thought process used during the period of time in which the problem was created as a poor choice of tools to use when seeking to craft a solution to the problem.

I know some of you are uncomfortable in forwarding any kind of message to others. I respectfully submit to you that the time for either seeking comfort or allowing ourselves to be lulled into wanting comfort must end. It is time to pay close attention. If you allow a rise in the domestic stock market to lull you into inaction - you will be allowing the status quo to stand.

This is not a "red" or "blue" Democrat or Republican issue. It is an issue that requires action. Please pass this along to others. Supporting the proposed legislation - HR 1207 is the most credible basis for stimulating the process that will lead to a more authentic oversight infrastructure.

Thank you for listening.

Respectfully,

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