Transcript of Community Bank Conference:
Perspectives on the Economy and Evolving Financial Landscape
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JILL CASTILLA. Thank you so much. I am honored today to be here at this incredible conference. Thank you so much, Vice Chair Bowman and team at Federal Reserve Board for hosting this. My name is Jill Castilla. I am the President and CEO of Citizens Bank of Edmond and located in suburban Oklahoma City. We're one location, 400 million dollar community bank, women owned. And we were founded in 1901. We also launched two years ago the digital military bank ROGER, which has taken off, and is the fastest growing military bank in the nation. I'm so excited today to meet with Stephen Schwarzman with Blackstone. What a difference. I put in ChatGPT, I mentioned to Mr. Schwarzman where we have overlap in our lives. And it was saying like technically not a lot of overlap. But some of the fundamentals were very, very similar, as far as commitment to the community, entrepreneurship, and the mindful growth of assets. And we were talking about discipline right before we came into here. So, we're just going to jump right into it, because you have such extraordinary thoughts, both at a macro level, as well as how community banks operate in the environment. So, welcome to the Fed, and welcome to our conference.

STEPHEN SCHWARZMAN. I think it will work now. Well, it's a pleasure to be here.

JILL CASTILLA. It's so wonderful to be here. So, I'd love to just jump riot in. You are managing the largest portfolio and real estate. You have this incredible investment in AI. There's so much to talk about. But can you give us a view, just overall in the economy, how things are looking for you?

STEPHEN SCHWARZMAN. I tell you, with the overall economy, we have a very good look at it, at Blackstone. We own 250 companies and 13,000 pieces of real estate. And an enormous amount of, you know, sort of assets. And we have about 250 billion dollars in revenue and 700,000 people working in all these different businesses. So, we're like our own database. And it makes life really easy for us, because we have a real sense of what's going on. So, you know, you saw that the last quarter was reported for the economy at 3.8 percent, which is really robust for a big mature economy like the United States. A little bit of it was, I think, some, you know, pre stocking on the tariff issue. So, it would be probably less this quarter without having any inside information about it. But our company CEOs, 90 percent of them think we'll be around this kind of growth level, or better. That's pretty amazing. They're finding that probably three years ago, their number one concern was getting labor. Now, out of the nine things that we survey our companies, labor is the last. It's number nine. Because most of them can hire people now. We're finding that the cost of labor has gone down from about 5 percent a year to 3 percent a year. So, you can feel the economy settling our margins, profit margins in the companies are about as good as they've ever been. So, the economy is feeling pretty good, for sure. And that's reflected in the fact that stock markets are at record levels. The bond markets have gotten much better. The ability to finance things generally in the marketplace has gotten way better. So, it looks like things are lined up pretty well. And, and the most remarkable thing about the economy now is it's a little bit of a two tiered economy. There's the AI economy, and then there's the real world economy. And the amount of money that's being put into the full panoply of things for AI, which are basically data centers, which are around 30, 35 percent of the cost of a data center, actually building it, and the rest are the semiconductor chips and some other equipment. So, these, these things are going at sort of one gigawatt, which is like a really big one. That's like 30 billion dollars. And the amount of money that's going into these individual things is so stunning, it's powering the U.S. economy. So, when people say, well, you know, we're really going to have a slowdown, if they say things like that, on top of the economy you would recognize is this engine that's consuming more electricity than semiconductors. And, you know, the scale of it is like another 1 percent of GDP, just in the CapEx, that wasn't there two years ago. So, that's going to continue for a while. And it marks the U.S. economy out. It's a lot different than other places in the world, except maybe for China. So, we are the locus in the developed world of this technology. And it should not be underestimated.

JILL CASTILLA. So, with the normalization of labor cost, construction costs coming down, can you give us your insight on inflation, kind of overall? I know during the, over the last few years from COVID on, whenever rents were really important to be thinking about what inflation was doing, a lot of that information was kind of muddled and lagging. You have such a pulse on housing cost and other inputs into inflation. Could you talk about that a bit?

STEPHEN SCHWARZMAN. Yeah, about a year and a half ago, we started talking publicly about inflation really coming down. And we were a bit odd at that time. And the reason isn't that we're smarter than other people. We just had access to other data. And the data from being a large real estate investor, we could see what was actually happening with rent. And rents were coming down much faster than people would see. And rent is 35 percent of the consumer index. So, if you get rents wrong, because it's so big, that it really makes a difference. And we saw that happening about a year and a half ago. And to give you some idea today, the way inflation is reported, I think it's something like 3 6 percent, 3 8, something like that, in the numbers that is used by the Fed. And we think it's 2 1. And the reason we think that is that we see it. It is 2 1. And in that 150 basis point difference leads to roughly a 50 basis point difference in the reported CPI. And so having contemporary data, as opposed to the way data is conventionally put together now by the government, allows you to adjust for what's actually happening in the real market. And to give you some idea of how pro cyclical this could end up in 2021 when inflation we thought was really ripping, we thought it was over 8 percent. The numbers that were produced by the government were somewhere around 3.6 I think it was, like huge difference, absolutely huge. We stopped the Fed from raising interest rates, because they believed, because that was the numbers, that this all wasn't happening. But, of course, it was. So, this can be easily corrected with just more contemporary data and a different type of formula. The numbers that the Fed were using actually become right. Usually a year later. It's the way the formula works. They do get the numbers right. But in that year period, you know, it really, it is a sort of handicap for decision making. The way I knew this was happening is my partner, when I started Blackstone, was for a while Chairman of the Federal Reserve Bank in New York. And we could see that all of our companies at that time were getting really weak. And it was clear to me we were going into recession. And he was a good friend with Alan Greenspan. They used to play tennis together in New York. And I guess they have a meeting four times a year or something with the regional bank chairman. So, Pete was going down for a meeting. I said, listen, tell Alan that we're in a recession, and he should do something. So, you know, Pete was a good partner, so he talked to Alan. And Alan told him we're absolutely not having a recession. And that's what Pete told me when he came back. I said, Pete, that's completely wrong. I could see it in every one of our companies. He said, well, that's what he tells me. So, it took nine months before the Fed did something. So, this isn't about any group of people. It's just the preparation of those, that information. And once we get that changed, which I think, you know, the Fed is very open to taking a hard look at that, it will be an easier ride in economic cycles.

JILL CASTILLA. So, I have to ask. Did you ever get to talk to Chairman Greenspan and tell him I told you so?

STEPHEN SCHWARZMAN. That's not good manners.

[Laughter]

JILL CASTILLA. That's great. Thank you for sharing that story. Could you talk more about where you think the direction of monetary policy should go based upon your insight into where the market is?

STEPHEN SCHWARZMAN. Well, I don't have that low level of intellectual arrogance to tell the people who were doing this what they should be doing. I think we're going into a period where labor is not going to be growing very much, so there will be some softness there, which does provide an opportunity if our number that I just mentioned were in the right zone, that you could be cutting interest rates further. The only offsetting factor is that there will probably be some small inflationary impact from the tariffs on a one time adjustment basis, which I think everybody expects. But because it's one time, you could look through that, and, you know, continue a rate lowering cycle.

JILL CASTILLA. When you talked about labor softening, and you've talked about AI, as AI matures, could you discuss how you see labor changing over time?

STEPHEN SCHWARZMAN. Well, I think with AI, it's not just labor that's going to be changing. There are going to be lots of things changing. And when we met before, which was a fun meeting, that I was saying that, you know, human intelligence, for geniuses, is 180 to 200. And within five or six years, most of the experts in the AI field think that AI will have the intelligence of 12,000. So, 12,000 compared to 180, you're dealing with something that's so powerful that as it gets harnessed and people figure out what to do with it, it's going to have enormous consequences for human beings, for the economy, for efficiency, for government deficits potentially, because if machines can start doing things that humans were doing, and in some cases, more accurately, and way, way faster, that it will have an impact on a variety of different parts of the economy. And ultimately when AI is able to basically train intelligent robots, you'll have a different manufacturing base. That's not for the next five years. But it's probably for the next 10 to 15. And it will take, you know, sort of developed world economies and make them much more competitive for manufacturing. Because you can, assuming you can have enough money to buy that technology, you'll be able to do things at about the same cost as other places in the world. And you won't have transportation costs. You can make it all here. So, if you look at how the world is going to evolve, you know, whether it's with drug trials, and most people in this field believe that you'll be able to double or triple the amount of new drugs that get invented through of use of AI, education is going to really change. Imagine you could individually program education for people all over the world. So, you could get theoretically areas that are having real economic problems, and all of a sudden there are people who can have the ability to get absolutely first class education just tailored to them. What's going to happen in that kind of world? The answer is something profound. So, we're going to be living through some very interesting times in not just America, but around the world.

JILL CASTILLA. Could you talk a little bit? I'm interested to know how you're using AI both at Blackstone as well as if you're personally using it. Has it matured enough to be of use to you right now?

STEPHEN SCHWARZMAN. Well, in Blackstone, we're using it in a number of ways. We started off a few years ago, you know, screening resumes using AI. And we've found that for certain tasks, jobs, rather, that just hiring the smartest person from the best school turned out to be a losing strategy. That the talent you needed for that particular job was different. And so we would screen for that. And that works, because you don't need the same talent for every, you know, type of jobs. We're using it in our investment committee memos, because we can keep a file of all the old ones, we can create our own databases. And it can help you write that kind of thing a lot faster. And AI, we're using, in our companies, we have, you know, besides those 250 companies, we have minority interest in other ones. And we're finding that every company faces the challenge of somebody else using AI, and you're not doing it. Because if it lowers their cost and makes them more efficient, that competitor will be able to take share or have more money to invest in new products. And so there is a requirement for all of our companies to be engaged with AI, because you can't afford to make pretend you're an ostrich. The ostrich strategy is not successful. And even though it's early days, there's certain applications that work. But for AI, we'll be sort of looking like this. And when you control assets and you control companies, it's really important that if you know something is going to happen, that you make sure that the companies where you're the custodian is alert, we have the person who is handling that part of our business was the senior partner at McKinsey that was advising all these other companies how to adopt AI. So, that's just, that's a part of today's business.

JILL CASTILLA. So, if so many community banks that are watching online and are here in the room, our community bank, we are a commercial real estate concentrated bank, so we're sending them downtown, we're lending to, in our same geographer, we know it very, very well. And, you know, we see you all in the market, in private credit, and the way that you are investing in real estate. Can we talk more specifically about the real estate market, where you see that going? Do you feel optimistic or concerned about what the status of it is currently?

STEPHEN SCHWARZMAN. This is real estate.

JILL CASTILLA. Real estate, yes.

STEPHEN SCHWARZMAN. About a year, year and a quarter ago, we sort of called the bottom of real estate. That turned out to be a correct judgment. We said it would be a U shaped recovery, not a V. I would have liked a V better. But apparently I wasn't going to get one. And so what's happening that's fascinating about real estate is it's very much just a simple supply and demand business. And certain categories were overbuilt, like, you know, some of the apartments. And what's happened is that construction, new construction, as you would all know in your local communities, is just dried up, you know, for commercial buildings and new units. And so they're probably down somewhere in the 65, 70 percent range. Now, when people don't build new things and the economy continues growing, it's only a matter of time before those things go into shortage. They were in surplus. They'll go into shortage. And that's when rents really start trending up. And that's going to happen. It always happens. And before it always happens, people deepen their hard beliefs it's not going to happen. But it does always happen. And so it's just a question of when the lines cross. And, you know, it's not necessarily going to be tomorrow. But it is going to happen. And we're already seeing some very good signs in real estate. The number of transactions is going up. The amount of financing in real estate is really going up. And the spreads are coming down. The market's valuing real estate better in effect as a lender than they were before. So, these are the precursors of when you're going to get a turn. The only area that's really in distress was office. It's hard for me to imagine that people wanted to work from home. If I saw one more person in a sweatsuit or pajamas, or usually they were hanging their bathrobe in back of the Zoom place. I don't know why people did that. What kind of signal was that? You know? You want to see my bathrobe? You know? And now people have very much returned, you know, some places not five days a week like us.

We were about the first back. But that's tightening the office market a bit more where I come from, which is New York City, we now have more people in office buildings than we did in 2019. We're the only City of scale in the United States where that's the case. So, so we started a year and a half ago actually buying office buildings. And things of that type will slowly happen. Some places won't come back. And the equity will be lost in those buildings. But if you pick your spots, even San Francisco, which was almost abandoned, has now got a new mayor. They're doing a bunch of reforms. And their offices are doing better after really being in very bad shape. So, that's what's happening in the office world. That's great.

JILL CASTILLA. Thank you so much for sharing your expertise and perspective on that. So, I've been in this role at this bank for 16 years. And during that time period of seeing an explosion of private credit, very sophisticated private credit, and some kind of smaller boutiques, but, you know, and some statistics I've seen is that it's actually tipped over 50 percent of all the credit that's being out there has been on a private credit side. You are an expert in this, in this, that field. And it would be wonderful to hear your perspective on private credit. Is that a risk to the system? And as we think about having to regulate an environment in banking in more of an unregulated environment with private credit, you know, how does that work together?

STEPHEN SCHWARZMAN. Well, apparently private credit has become really fascinating to people. To not actually that fascinating. You know, lending money isn't that fascinating. You just have to make sure you lend it to good people.

JILL CASTILLA. You're talking to a bunch of bankers, so—

STEPHEN SCHWARZMAN. Good people with good businesses. And so what we do, we have about, closing in on 500 billion dollars of private credit. So, that's, you know, we're no longer community bankers. And, you know, we keep it really simple, you know, we keep loan to, loan to total enterprise value, senior debt, senior security around 40 percent. You have to be a really bad assessor of risk, of significant sized companies, if you can manage to lose money on senior secured debt with 40 percent. I mean, you have to be really creative to lose money doing that. We do something different than you all do. We don't get our money from deposits. We have people, like insurance companies, who are looking for longer term holds. And will raise a pool of capital. And so when we make a loan, we can make it for quite some time. And we don't syndicate the loan. We are the owner of the loan. And so we're easy to deal with. Because if you just talk to one of our people, you know, and we take it to committees, and we have a very orderly complex process that we say yes, there's no variability on the interest rate, we would tell you, here's what we'll do. We'll hold it, no road show. You're done. So, that makes us very user friendly. We're leveraged no more than one to one. Sometimes we don't leverage that loan at all. Whereas, you know, the banking community tends to leverage through deposits, you know, whether it's 10 to 1 or 11 to 1, or, you know, if you're really conservative, 9 to 1. And, you know, so we have low leverage to no leverage. We have matched funding. So, nobody can get their money back. And we're senior secured. So, what can go wrong? Not much, except fraud. And I've been defrauded I guess three times in my career. I've been doing this 50 years. I haven't been doing private credit for 50 years, but, you know, every once in a while, you have some unpredictable weirdo who climbs you. And you get left holding the bag. Some of these people are unbelievably clever. I mean, if you've ever been defrauded, and probably most of you someplace have, these are slick operators who are, who are credible, and that's how you get it in a situation like that. But, you know, other than that, we have, you know, sort of non performing loans of like 50 basis points. Almost every bank is higher than that. So, we view this as a non controversial activity, which, for some reason, some people in the media thinks this should be an area of massive concern. We basically like to partner with banks. We're not that interested in generating our own stuff. If somebody like yourselves has a portfolio where you'd like to sell it, we love buying these things, because then, you know, you can keep servicing, keep your customer, offer them more money, and we'll put up the money. It's almost like a dream. Right? So, it's a good thing. And sometimes with some of the regional banks, we do what's called flow agreements where basically as they produce, we will just regularly take it. And that's good for us, because the people who give us money want that for longer periods of time.

JILL CASTILLA.What type of tranches, like size wise, are you buying from community banks? Is it 20 million and up? Or is that too small?

STEPHEN SCHWARZMAN. Mike, what's the answer to that?

MIKE. It could be really big or really small. We're user friendly.

JILL CASTILLA. All right, that's great. Well, that's good to know. Thank you. Yeah, it's been wonderful seeing the news that the collaboration with community banks and how that they can then manage their exposure to commercial real estate by partnering with Blackstone. I think some of the discussion around private credit is that you're not the only player in that sandbox. And that others who are trying to capitalize maybe don't have as much discipline. I love your discussion about discipline and how you decide to do a deal versus at scale you would think there maybe wouldn't be as much discipline as what you described.

STEPHEN SCHWARZMAN. You know, I just want to say, just as background, when I joined the financial industry the second time, I was there for six months before I went to, in the Army, in business school, but when I finished business school, I joined Lehman Brothers. And somebody looked at me, and they said, you're going to cover banking. So, all I knew about a bank was that I put some money as a kid, and I got interested in, you know, I could take the money out of the bank. That was my level of sophistication. But I ended up, you know, starting out with savings and loans and savings banks. And so I visited them all around the country. And then I graduated to commercial banks. And when I started, there were, you know, as I started learning about the industry, there were 14,000 commercial banks. And I was 24. And I was going, that sounds like a lot of banks. And then I learned there were, you know, banks in every town in the United States. And sometimes, you know, there were two banks or three banks, you know, competing. And, you know, First Federal Bank of whatever. It was very interesting to me. And I always thought that was probably a few more banks than were needed. And that there would be a consolidation. So, I found out now that there are like 4,500 banks, you know, in one working lifetime. So, I don't know what the critical mass is. But I learned it's good to have local banks, because local banks can assess providing local credit. And you know the people. You socialize with the people. You know who are good people that you want to bank, want to support. And so that's like a, for those of us who hang around the J.P. Morgans and Bank Americas and Wells Fargos and, you know, the monster sized institutions, which for us now are like normal size, it's really good that you all do what you do. Because I think you have a better way of reaching the customer. And so you provide a very valuable function, you know, for the country.

JILL CASTILLA. Well, with that introduction, I'd like to have a challenge for you. And so if tomorrow we wake up and we have switched places, and now you're the CEO of a 400 million dollar community bank in Oklahoma City, I get to be the CEO of Blackstone for a minute, what are you thinking when you wake up and that you're now sitting in the lobby, you're interacting face to face with these customers, and kind of responsible for a community in its prosperity?

STEPHEN SCHWARZMAN. Well, if we switch places, I'd have a better deal than you would.

[Laughter]

STEPHEN SCHWARZMAN. And what I'd do is I'd go out and I'd start merging with all these other banks. And I would build like a monster. That's what I would do. If we switched, if we switched places.

JILL CASTILLA. So, wow, that's a challenge. Now I feel like I can't see you like a couple years from now, and I'm going to be like, well [inaudible] 450 million. That's great. And so what does that excite, whenever you're building something that's so big in scale, like you built Blackstone, and then whenever you're thinking about leaving a community bank, it's about scaling that's invigorating and exciting for you, can you talk about kind of the why behind that?

STEPHEN SCHWARZMAN. Well, I still think we're running a small company. I mean, I started this. I know all the people at the firm who, you know, have important positions, you know, I meet with each one of our businesses, which are large. But, you know, we have everybody in the world in each of our businesses, whether it's private equity or real estate or credit or infrastructure, numerous businesses. But I meet with everyone every week. So, I can look at everybody around the world. There I am. I'm at the table with the rest of you. I can tell who's alert. Nobody's allowed to drift. We keep the meetings moving. And I could tell if somebody's off, you know, something, they just don't look right. And I'll say something to the person running that group. And they'll say, well, they had a family problem or something. And so the key to running a successful business, at least in finance, is having really firm core values that everybody understands. You know, openness, honesty, excellence, you know, meritocracy, no glass ceilings. I could go on with basic principles that you would want if you were working in someplace. And, you know, I talk to every group of new employees and I tell them how to be successful and that they were hired because we want them to be successful. Apparently, that's not normal on Wall Street. I don't know, I can't believe it, but people who join us say you're so different. You want me to be successful. And you say, well, why else would we hire you? We don't want to have turnover. We want you to be great. And so you can run a business with very tight control on very human scale. And you need a great team of people who are well trained to believe the same things. You can have different core values. You can, you can have different books you read, different TV shows, different politics. None of that stuff matters. On business stuff, everybody's got to sign up for the same hard work. If you work harder, you win more. Right? It's the same with sports. Teams that don't practice, they don't do so well. But you need the basic talent. So, you know, I think we can, you know, you asked me what, what excites me. I love doing new things. I love learning new facts, because finance is a lot about paradigm recognition. So, I've found in my career, there's always new facts that come up. And if the world is going well, people tend not to look at the one new fact that doesn't make sense in the context of everything working well. But that fact actually exists. And humans won't pay attention to it, because why bother? Things are working well. Doesn't make sense. That's what interests me. So, I keep thinking about those things and say, what does that mean? That's telling us something. What's it telling us? And I sort of keep that going. And I'm always looking for a second piece of discordant information if I can't figure it out on one. And once you get two points, it tends to make a straight line. And meanwhile, everybody else is doing the same thing. And you can build a big business around that. And I get a real kick out of that. It's like seeing the open, the open person in a basketball court. And you just get the ball to him. It goes right in. Nobody's guarding them. It's a simple concept. But we do it with data, with information. I used to call it information. And you can't get too much information. So, as long as we can keep doing that and keep the scale of our individual funds, we now have 85 different strategies, and we started with one. So, it sounds like a lot. It's basically one and a half a year. Maybe two a year. So, we don't, we don't look at that as like pushing ourselves. And you only do things that are great for customers. If a customer doesn't have a wonderful experience, it's like going to a bad restaurant where they poison you. And all of us have probably gone, in our life, to one really bad restaurant where we spent most of the next night not in bed. And you tend not to visit that restaurant again, for at least a year or two. If you try it out the second time and the same thing happens to you, you will never ever go back. And it's the same thing in finance. You always have to give people a good experience. And if you give them a bad one, they never forgive you. People are like elephants. They have lifetime memories for somebody who did something disappointing to them. They don't forget. And so that's why you have to be unbelievably careful when you commit capital or do anything when you're using, you know, other people's money, because they trust you. It's a lifetime of trust that can be destroyed, you know, with one stupid decision. So, you have to be a bit of an on your toes type of person and recognize that every time there's a capital commitment, you're betting your whole institution's reputation. And if everybody at the business, at the firm, shares that view, then people are super careful. And that's why we're the biggest in the world. We see things earlier. We have great data feeds. And we have wonderful people. When I started, nobody wanted to join us. For those of you who lend to entrepreneurs, it's not so great to be an entrepreneur unless you're really successful. And nobody's successful at the beginning. It's just always harder. And, you know, you never forget those lessons. And when you can finally attract amazing people, it's like the most wonderful gift you can have. So, I have a fun life. I'm very happy. And I came here because, you know, all of my experiences in banking over the years, because I graduated to the big ones, and I've gone through all of these crises with the financial institutions and the GFC, you know, I was helping Hank, and people, we, everybody was like making it up. Nobody knew exactly what to do. And there would be a group of us that would talk on a regular basis to say, well, why don't we try this, why don't we try that? And so Washington, people do really important work, because on those rare occasions where the system is at risk, the people here who know what to do, what the right instincts are, it guarantees the system. That's the real guarantee; those people in those seats. So, with that, you've had more than enough of me. I may want more of you, but I'm getting the hook. So, thank you very much.

JILL CASTILLA. That was amazing. Thank you.

[Applause]