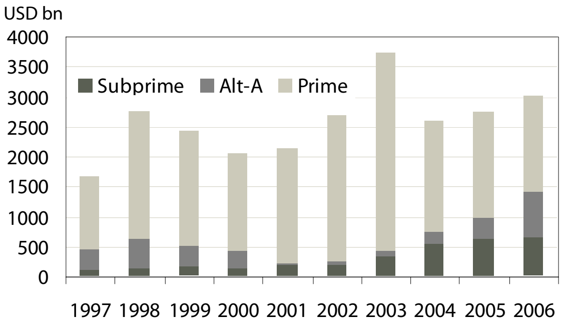
Survive and reflect

1. The disaster unfolds

There is not much more to be said about the credit market crisis. It's in full swing. So far, the financial system has been hit by two waves; the first in August and the second, significantly more serious, in November and December 2007. Worst hit were big banks like Citigroup, Merrill Lynch and UBS, together with some institutions that, although themselves farther from the epicenter, had in recent years overindulged in supposedly risk-free fixed-interest investments. In both phases the stock markets remained comparatively stable; only financial stocks have experienced a general collapse of up to 50 percent since summer 2007.

What are the dimensions involved? How big is the reservoir of disaster that feeds these waves, a couple more of which may well have yet to break? What is still to come? In the figure below, we try to show how extensive the excesses in the American mortgage market may be. How much money has been pumped into a sector whose recoverability has probably – with the benefit of hindsight – been falling rather than rising for some years (roughly from 2005 onwards)?

Misallocation in US real estate financing



Source: International Monetary Fund (IMF)

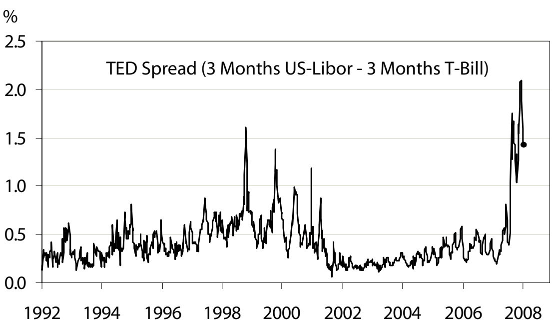
It is hard to imagine a clearer presentation of the phenomenon of excessive leverage. For years the proportion of mortgages on properties of dubious quality was ten, perhaps fifteen percent of total American mortgage business. From 2003 onwards, this proportion began to rise, both in absolute terms and relative to the mortgages on so-called prime properties. By 2006 it represented almost 50 percent of all mortgage business. By this yardstick, the order of magnitude of the problem is around 1,000 to 2,000 billion dollars, which have largely disappeared into thin air and will, if they have not already done so, also have to disappear from overinflated balance sheets.

At the moment two things are clear. Firstly, with each wave of the crisis there is increasing evidence that the American economy may fall into recession, in the wake of a collapse in prices that has now extended to all areas of the real estate market, and the sharp rise in risk premiums. Last October we were still able to point relatively reassuringly to the substantial growth of real wages in the average American household, and could at least to some extent rebut arguments for a decline in consumption. Today, things look bleaker. Real estate represents just on half of domestic assets. For a long time now, Americans have been happily surrendering to the illusion that domestic property valuations would go on rising and that they would be able to spend against their homes indefinitely. All of a sudden, they are confronted with a fall in the value of part of their assets – indeed, with a genuine price collapse. The logical reaction is to start saving. In economic terms, saving is "deferred consumption". Because it is deferred, this consumption will be absent from the national accounts in the coming quarters. Orders for goods from across the Pacific will decline. The balance of trade deficit will be reduced. Ultimately, the global flows of capital and goods will be "more normal". But it is increasingly difficult to imagine that this can happen without a recession in the USA, and possibly elsewhere too.

The second thing is this: so far, the hardest and most immediately hit have been the big banks. It is difficult to estimate how serious these institutions' problems may become if credit positions from other, so far more or less unaffected, real estate sectors (Alt-A, prime) get hit. The financial instruments (Mortgage Backed Securities) with which the mortgages from these sectors of the American real estate market are securitized are probably significantly better distributed across a much wider investor base than the sub-prime paper, which was only seriously hyped quite recently. It is unlikely that this very large market, whose substrate is relatively intact, will dry up completely. The same may be said of certificates on credit card debt and for automobile and student loan financing. There's no need to go looking for trouble.

Nevertheless: any negative surprises would hit a system under extreme tension. The figure below shows how drastically the risk premiums in interbank business have changed. The "TED Spread" is the difference between the rate at which the banks make liquidity available among themselves and the risk-free interest rate for American Treasury bonds. Since the Asia crisis of 1998 the financial system has twice been under similar pressure: at the millennium and after the terror strikes in September 2001. By contrast with the latter event, the banking crisis of 2007/2008 is an entirely endogenous occurrence – a self-created problem, so to speak. What would happen should an exogenous shock also occur does not bear thinking about.

Risk premiums: the banks don't trust one another



Source: Bloomberg,

The most dangerous scenario in this context would undoubtedly be the bankruptcy of a major institution. We have been spared this so far, not least because the public trusts that central banks would always intervene to prevent such an occurrence. However, since the clumsy rescue of Northern Rock, a relatively minor British bank, we may well wonder whether the processes for such bailouts are really sufficiently well defined and tested. While a desire for secrecy in such situations is understandable – too much explicit planning might lead people to conclude there were real dangers in the offing – the effect of uncertainty about the extent, likely course of events and ultimate success of such action by the authorities is equally problematic. Things left undone in earlier, quieter times can hardly be made good when the situation is critical.

2. Avoiding errors

However one spins it, at the start of the year the outlook for a trouble-free 2008 is not too good. Despite excellent economic conditions – during the last five years the global economy has grown practically simultaneously in all regions, at rates that we could only have dreamed of in times past – low inflation and thus few fiscal problems, we must now expect a significant slowdown; indeed in America, with its dominant position, even a contraction. Asset deflation will affect crucially important consumer behavior.

Those stock prices that have not already done so will fall, as company profits cannot be maintained under such conditions, never mind increased. The collapse in the price of Marks & Spencer, a typical consumer stock (down 18 percent in a single day), shows that not only American securities are subject to reassessment, and that the markets are currently reluctant to take up stocks. This is why volatility on the equity markets is higher than it has been for a long time, and comparable with the nervousness in interbank business. Virtually all of the indicators we have reviewed suggest difficult months ahead.

And our recommendations are correspondingly reserved. They address what seems to us to be the most probable scenario: a slow, difficult but generally accident-free overcoming of the crisis and a perhaps mild, but no less genuine, recession in the USA. At the same time, they factor in the possibility that we are too pessimistic; that the positive forces in the global economy, which we have become so familiar with over the last five years, will prove stronger than the recent threats. From this perspective, it would be foolish to abandon stocks entirely, as one never knows exactly when the nadir of a crisis has been reached. The most difficult question, however, concerns one's own personal crisis management in the highly improbable, but extremely dangerous, event that a big bank becomes insolvent. This risk will only have subsided once the TED Spread has reduced significantly – and not just because of liquidity injections by the central banks, but because the banks have begun to trust one another again.

This is the key issue for individual investment behavior. So long as there is no trust in interbank business, there is no reason for individual investors to believe in the complete security of their assets. In the Christmas Investment Commentary (No. 253) we already recommended paying utmost attention to counterparty risk, and we reiterate this advice again here. Placing excessive confidence in a specific debtor – expressed in share of the overall assets, including all assets and financial instruments – or concentrating funds in a particular economic sector would be negligent in current circumstances.

In addition to the considered distribution of account balances and fixed deposits across various institutions, investors seeking to invest substantial liquid assets would do well to look in particular at short-term bonds from top-quality debtors. For once, we may be glad that there is such a thing as securitized national debt… We do not, though, recommend long-term engagement in bonds, as we cannot exclude the possibility that the flood of liquidity necessitated by the banking crisis will bring with it expectations of higher inflation.

In all three scenarios, stock remain absolutely, or at least relatively, attractive. As long as they are reasonably highly capitalized, liquid stocks of companies with no serious debt problems in their balance sheets, they will behave like crisis-resistant tangible assets. If things go well, they will gain value in absolute terms; in the event of a recession, they will have the potential for recovery; and even in a worst-case scenario, they would be preferable to the kind of assets one has to chase around after in New York or the Cayman Islands.

The strategy of including some physical gold in one's portfolio for emergencies has so far paid off mainly in price terms. Furthermore, gold is crisis-resistant. Unlike other raw materials, such as oil, gas or uranium, anyone can store it, and this, no matter how often it may be disputed, is precisely what makes the metal so attractive.

So much for individual crisis management.

3. The pocket planetarium

The last four Investment Commentaries have been devoted to the gathering and ever-increasing credit market and banking crisis, and several of the contributory circumstances we discuss, such as the reasons why risk premiums were far too low until June, or the problematic conglomerate nature of investment banks, have also been adduced by other observers to explain the events on the financial markets. Now, we need to take a broader view of developments. This is because we believe that achieving a profound understanding of the major, decisive trends at an early stage can guard us against wrong moves or short-sighted strategic errors.

We increasingly believe that the current banking crisis is the result of an inadequate understanding of the securitization process that has been changing the financial sector for the last 20 years. Or, more plainly: an inadequate understanding of what structural changes securitization should have triggered in the infrastructure of the financial system – in the banks, the stock exchanges, the clearing houses, the central banks, and so on.

What does "securitization" actually mean? Technically, it is a mechanism that allows banks and other providers of funds to sell their loans on the market in the form of securities, and thus to manage the asset side of the balance sheet. In terms of its impact, however, is it simply an enormous machine, a freak of nature – the combined effort of all the sorcerer's apprentices, whose output in no longer controllable? The final, despicable manifestation of the capitalist system, the home of money-mad blowflies, a poison in the system, a destroyer of the economy?

Clearly not. Securitization is part of a major, irreversible megatrend away from collective systems and structures and towards decentralized, individual ways of engaging in economic activity and meeting needs. We are all part of this megatrend, which has been in progress for at least two decades now, and has accelerated significantly in recent years.

Here's an entirely non-economic – and, admittedly, somewhat far-fetched – example. The author received, as a Christmas present from a colleague with a sense for the newfangled, a small box, about 20 by 10 by 10 centimeters in size, with an eyepiece and a small screen. Called "Sky Scout – Your Personal Plantetarium", its two batteries power a GPS (Global Positioning System) and a computer that enable you to search the heavens, actively or passively. Actively, by focusing on stars whose names and positions in solar systems, galaxies and suchlike can be determined, or passively by simply letting the device guide you through the starry firmament. And of course the commentary is available in a wide range of languages via the earpiece.

Only the cold and my family's impatience put an end to these nocturnal pleasures – pleasure that, until recently, one would have had to visit a planetarium to enjoy. A planetarium is an institution, a structure, a collective undertaking:

a noble building, founded by philanthropists, subsidized by the state, equipped with expensive instruments, only open at certain times, with staff who, seldom multilingual, repeat the same remarks year after year, and who could thus be replaced by a tape recorder. Its program has to be experienced collectively, and offers little opportunity for addressing individual interests. Nothing against planetariums – but my "Personal Planetarium" is infinitely superior. I can use it whenever I want (the only restrictions are the time of day and the weather); I can look at whatever I want; I can put it away when I want; I don't need to make a journey for my astronomical studies; I can look at the same star over and over again without needing to feel ashamed of my astral ignorance.

But, more seriously: a praiseworthy educational activity, based on a rich Greco-oriental-western scientific tradition, and one that flourished from the 19th century onwards, opened up to a broader public in the form of public planetariums, has been rendered superfluous by the "Personal Planetarium". Obsolete. There is no further need for the buildings, the structures, the organizations, the subsidies. From now on, everyone has access to the stars in the sky from their own backyard. Planetariums will in future be of historical interest only.

In the financial system, it is the banks that are the planetariums. Securitization does the same for them as that small device does for the night sky: it makes a complex universe available to every individual, anywhere in the world. But before we take these fascinating thoughts further, let us try to look at this megatrend as a whole, and identify its impact.

4. Decentralized emancipation

To see how adaptable humans are, we have only to look at mobile phones and the Internet. One of these was off the map before 1990, the other until 10 years ago. Telephoning was a highly collective activity. When one was traveling, it required a public phone box, a switchboard staffed by large numbers of busy women, an extensive infrastructure of cables, conduits, switches and relays, a management that ran the whole system and collected the monopoly charges for the state. Telephoning was a privilege. And while it was then possible to communicate verbally in private, this was not possible for written communication. The transmission of a telegram was a ceremonious activity involving a number of officials. For a long while, it was impossible to own a telephone: they belonged to the (state) post office. And their distribution was correspondingly sparse. Today, more often than not, the number of phones exceeds the number of people in a family. Today, every kindergarten child operates these highly mobile multi-function terminals with ease.

What has happened? Within a few years, competence – both legal and material – has passed from a higher-order collective to the lowest conceivable level of the individual family members, including kindergarten children. And the higher-order structures have become largely obsolete. They have been hived off from the postal services, and transformed into (partially) private service providers; telephony has been opened up to competition. Even the paterfamilias, who once had control over telephone usage in the household, has had to give up his authority. This new megatrend – decentralized emancipation – goes far beyond telephony.

The changes brought about by the Internet are even more radical and far-reaching. Where once it was the prerogative of a small class of the educated bourgeoisie to posses their own library (the populous could only access books via public libraries), today literally anyone with a moderately dependable computer and Internet access can funnel virtually any knowledge from the web to their desktop in whatever form they please. Access to knowledge is no longer a privilege, but has become fully socialized. Decentralized emancipation on the one hand, loss of competence on the other. Like planetariums for astronomy, libraries as highly subsidized public institutions for books have become obsolete.

The same is true of cinemas. Previously, to watch a film one had to visit a collective showing. This is still an option, but no longer the only one. And what is offered has changed correspondingly: giant cinemas to meet large-scale collective needs have given way to smaller theaters with almost individual programs. And those who wish to enjoy rather more adult entertainment now no longer need to creep shamefacedly in, and can entirely avoid the embarrassing confrontation with the ageing cashier; they can enjoy themselves in an entirely private environment. Decentralized emancipation. Until a few years ago, in most Swiss towns there was systematic film censorship by the authorities – when enjoyment was still a public experience, and so might collide with public order. How times have changed!

Large-scale collective entertainment does still occur, of course, and perhaps to a greater extent than before: big cinemas, concert halls for rock concerts, stadiums for football matches. The possibility of decentralized entertainment seems to have stimulated the demand for collective experiences, for human beings are, among other things, still social beings. The essential difference is that seeking amusement in a collective experience is today a matter of choice. In the past it was a matter of necessity.

Decentralized emancipation has penetrated virtually every area of our lives. The ability to access knowledge, but also goods and services, at every level of society, has characterized the last two decades and will remain the most important social and economic megatrend in the years to come.

5. Independence and substitution

Decentralized emancipation has made us all more versatile and autonomous – more self-sufficient, in a way. Take energy supply, an area particularly dominated by the state and over-sized conglomerates. While a few people do now permit themselves the luxury of deep drilling and heat pumps to access geothermal energy, the pay-back period, even with high oil prices, is relatively long. But this cost should be weighed against the advantage of being independent of Mr Putin and his colleagues. This is the heart of the matter. It is very likely that the substitution of oil will be brought about not by the pressure of high oil prices alone, but rather as part of the megatrend towards decentralized emancipation. It is true that we have heard less recently about "micropower", the possibility for individual households to generate their own energy. The main problem has been storage and the difficulty of feeding surplus power into public networks. In the meantime, however, there have been such great improvements in batteries and battery management that it would probably only take a minor energy crisis for people – right down to the lowest social level of the individual household – to start seriously considering the potential of micro-turbines and solar energy.

Calculation models that simply include the price of energy in evaluating the probability of substitution of a method of energy production or an energy provider probably underestimate the price that many are prepared to pay to enhance their autonomy. The markets for mobile phones or mobile stereo systems in the form of the iPod were long underestimated in exactly the same way. Autonomy has an economic value of its own. How naturally do we now exploit the autonomy we have gained: a click is all it takes to download a "second opinion" after a visit to the doctor, or call up a gourmet recipe for next Sunday's lunch.

This is where securitization comes back into the picture. Doctors are not the only people confronted with "patients" much more ready to look elsewhere. So are asset managers. There are now hardly any investors who do not use the Internet and other media to gain a fairly precise picture of the financial markets, financial instruments, or particular stocks. Nobody these days follows advice blindly, which is not to say that collective error is now a thing of the past. Information and interpretation are two quite different things. The infinitely better possibilities for obtaining information have, however, made investors far more autonomous, more self-sufficient. Those who wish to can now manage their assets themselves, on highly attractive terms, and you no longer have to be a millionaire to diversify your risks effectively.

This has been made possible by the practically unlimited range of instruments that the financial system offers, from the whole universe of the financial markets. These instruments – "securities" – reflect the liability side of the real economy. They are the means by which the real economy is financed. The contrast to previous times could hardly be greater. Twenty or thirty years ago the financing side of the real economy looked entirely different. In place of today's securities there were then the big banks with their enormous balance sheets. The role of the general public was to provide the savings that powered these enormous balance sheets; the holding of stocks, and largely of bonds too, was reserved for a privileged elite of wealthy individuals.

At the individual level, saving, a thoroughly collective activity, has been progressively replaced by investing in securities. In exactly the same way as the use of public phone boxes has been replaced by mobile phones, telegrams by e-mail, encyclopedias by Wikipedia, public planetariums by "Sky Scout". The enormous bank balance sheets – collective financing conglomerates – are being replaced by decentrally emancipated, individual portfolios: individual financing conglomerates. This is securitization: each and every citizen becomes, so to speak, his or her own bank.

In those countries, such as Germany or Japan, which were until recently characterized by a strong national identity, this process has only recently got under way. But there are two reasons why this development is unstoppable. Firstly, because the enormous reduction in information and transaction costs has made possible the risk/return management of individual financing conglomerates, which is infinitely more effective than collective management. Savings collectives are ultimately crude and inefficient structures, because their financing activities must be based on average preferences (of all the savers together), so that it is impossible to achieve an optimum risk/return management on the asset side.

In addition to the obvious benefits to the national economy, the second reason for the triumph of securitization is the rise of personal independence. The fact that one no longer has to save, but may do so, that one is free to invest today as one likes, represents a great gain in individual freedom, in self-sufficiency. In the same way that we now enjoy a plethora of mobile phone models and brands that would previously have been unimaginable, the financial markets have been flooded in recent years with an immense number of new and extremely diverse financial instruments. These have found widespread acceptance – though, to my knowledge, they have not yet filtered down to our kindergarten children.

6. Do we still need banks?

If we think things through to their logical conclusion, a fully securitized world would have no need for banks in the traditional sense. Instead, there would be packagers or "arrangers" of financial products who would issue their instruments to distributors – asset managers, brokers, Internet platforms – and that would be it.

Brave new world? Yes and no. Yes, because, as described, the result would be an immense gain in efficiency for national economies, and a significant improvement in the position of the general public, at the individual level. No, because this will not, and cannot, happen to such an extreme extent. Firstly, such a division of labor in the financing structure would bring with it the problem of debtor management and control. Arrangers and their henchmen are not necessarily the best credit specialists, particularly if they are rewarded on the basis of risky incentives (read: turnover). The more the better! This is exactly the incentive structure that has been so popular in the American mortgage business. It "explains" why Countrywide threw mortgages and other financing solutions at any and every remotely solvent American. This is the incentive structure that has resulted in practically every investment bank yielding to the temptation to lash together apparently respectable financial instruments out of large numbers of rotten loans. This is the incentive structure that has inclined the rating agencies to certify such structures on the basis of pseudo-statistics, in flagrant disregard of common sense. This is the incentive structure that led the board of a major Swiss bank to blithely put its other, genuinely problem-free divisions at risk in pursuit of supposedly risk-free and lucrative business.

It is obviously the case that the division of labor in the management of debt and debtors will not function unless the incentives are so set that whoever is closest to the debtor shares in the risk, with, for example, his own assets. And this is exactly why institutions specialized in rigorous debt management will continue to retain their raison d'être.

But there is another reason why banks, apart from those institutions specialized in credit management, will continue to play a large, indeed, an excessively large role. It is much too comfortable to be a big bank for any of them to wish to forgo the privilege, even in the era of securitization. Au contraire.

For, in the same way that there are still planetariums and libraries, the structures in the financial system have remained practically unchallenged and basically unchanged, despite the march of securitization. This is because an economy that was previously almost entirely financed by the banks has remained dependent on the continued existence of this unique credit pipeline. Thus arose, in the mid-19th century, at the beginning of highly capitalized industrialization, the concept of the central bank as the ultimate creditor – the "lender of last resort". Public institutions –representatives of the common weal – whose purpose it was, among other things, to prevent the insolvency of one or more banks so as to forestall a potential economic collapse. In return, the central banks were granted a territorial monopoly on money creation.

This public demonstration of confidence – in the system and in the banks – was probably right, and largely unproblematic, in a world dominated by commercial banks with big balance sheets. Whether, and how far, it will be so in a world transformed by securitization is open to discussion. For if, in the wake of securitization, the general public – each and every individual and all individuals as a collective – have effectively become banks, it no longer makes much sense for a single body – a public institution in the form of a central bank – to function as an ultimate creditor. We are looking at a tautological construct.

The problem is that this tautological construct brings with it distortions in the national economy. The existence of "lenders of last resort", who are no longer needed in a securitized world, creates an implicit state guarantee – a gratis assurance of survival for institutions, not because they are worried about a financial collapse but simply because they are such an inherent part of the infrastructure of the financial system. "Too big to (be allowed to) fail" is the motto for Citigroup, Morgan Stanley, Barclays, Deutsche Bank, UBS, and CS. No-one is ever in any hurry to give up free insurance cover. Which is why we might until recently have rightly predicted that there would be no change to the "lender of last resort" concept, despite it having become tautological and obsolete, and that the competitive advantage of the big banks would remain set in stone for all time.

But that was before the mortgage crisis struck. Because it was far too easy, for far too long, to finance risk-free investments at low rates, and because it looked for far too long very much as if there was practically unlimited demand for certain credit layers, the system of the big investment banks and their downstream vehicles raised the level of debt for real estate, automobiles, and consumer credits to dizzying heights, in some sort of collective insanity. A recession now looms, and, given the clear evidence of how damaging these obsolete structures can be, now is the time to brave a wide-ranging intellectual debate on the issue. For we are not just talking about planetariums and libraries, but about the central mechanisms of wealth creation in a capitalist society.

7. What's worth preserving and what not

The megatrend towards decentralized emancipation, greater autonomy, more self-sufficiency, even, for citizens and households all over the world, depends on the uninterrupted functioning of a generally accessible infrastructure. However much fun the "Personal Planetarium" is, without a functioning GPS – that is, without the system operated by the Americans via an expensive network of satellites to ensure that their soldiers do not get lost in the deserts of Afghanistan and Iraq – it would not be much use. Without the forest of aerials on every roof, tower and mountain, there would be no mobile telephony. Without glass-fiber cables, servers and network providers there would be no Internet. The stability and performance of the infrastructure is decisive, whatever the sector concerned. The individual providers, by contrast, are anything but decisive. Assuming there is sufficient competition, they can be exchanged at very short notice. How difficult is it to switch from Vodafone to Orange?

The same applies for a modern financial system that allows for securitization. Here too, it is the stability and performance of the system that are decisive. Under no circumstances may payment transaction, clearing or settlement systems be allowed to collapse. An hour-long breakdown would be enough to cause an inextricable chaos of pending transactions, never mind the risks arising from ownership confusions. Action on the part of the authorities must be concentrated on the core functions of the financial system, and the individual providers – Citigroup, UBS or whoever – relieved of the privilege, and the accompanying obligations, of an implicit state guarantee. This would make excessively low risk premiums a thing of the past, and the real impact of the cyclicality inherent in investment banking would remain within tolerable bounds.

Will this issue be tackled? Probably only under duress. For there is a logically explicable attraction between high-risk, cyclical and sometimes highly profitable activities like investment banking, and partially obsolete structures that are in part embedded in the essential infrastructure. This is precisely why the Glass-Steagall Act's prohibition of conglomerates was rescinded in 1999. The demand for stable cash flows from other parts of a conglomerate made by the extremely important but highly speculative investment banking function, its engagement in the essential infrastructure of the financial system and the resulting implicit state guarantee, the unmistakable and uncritical proximity of many players to state structures, and conversely, the ingratiating attitude of the authorities towards those who are "too big to (be allowed to) fail", are all indications of a problem that might best be described as a "self-justificatory cartel". Both sides share similar incentives: the one because it understandably does not want to give up its lucrative sinecures; the other because it wants to preserve its obsolete structures.

The banking crisis of 2007/2008 has brought us close to the point at which this dangerous set-up will drive itself into the ground. If, once again, structural reforms are not forthcoming once the most acute danger is past, it is only a matter of time before the next disaster occurs – whether in five, seven or ten years. Surviving is not enough: we need to reflect on how to improve things for the future.

Another phenomenon may help to galvanize the debate: the desire on the part of sovereign wealth funds from the East to invest in Western banks, or rather the current urge to accept these funds with open arms. For there is one critical aspect to these engagements, to which there can otherwise be no objection: their potential impact on the essential and almost irreplaceable infrastructure. The significant involvement of sovereign wealth funds in Western banks means that the immensely valuable financial infrastructure of the Western world is in part at their disposal. This triggers uneasy feelings. For while it may be acceptable for the quasi-state institution of the Camorra to manage Naples' waste disposal system, it would be far less acceptable if the minions of unknown, and historically unproven, regimes were to gain control over the financial infrastructure.

KH, 14.01.2008