Life goes on ...

1. The right priorities?

After nearly two years of hogging the headlines, the financial and economic crisis was briefly almost replaced as headline news by swine 'flu. This would have had the attraction that a chapter of accidents entirely due to human error would have been replaced by an event that could be safely attributed either to the actions of a higher power, or to the impact of Darwinian evolution, depending on one's point of view. That would have brought at least temporary relief: for the big banks – still dogged by reminders of their recent unhappy past, despite some actual or merely supposed progress in restructuring; for the supervisory authorities, who saw so little for so long, and now want to regulate everything so much better; for the central banks, better kept away from the glaring spotlight of public attention; not to forget the politicians, only too well aware that their unparalleled fiscal generosity was heading for financial Never-never Land, and only able to hope that "après moi la deluge" would not come true before the next elections.

However, the virus from Mexico does not so far seem to be contagious or dangerous enough to generate sufficient anxiety to become the focus of attention, and push everything else off the front pages. It might still happen. Viruses mutate rapidly, and can become significantly more dangerous. Let's hope not, for the last thing the global economy needs is a real pandemic, faced as it already is with forecasted negative GDP growth rates of five, six or more percent for the current year in the developed industrial countries. Quite apart from all the personal unpleasantness that would be caused to individuals by a dangerous new flu – something that, given our experience of normally very high life expectancy, is well beyond our imagination.

There are also other topics that might have the potential to replace swine 'flu as headline news. For example, the Far East correspondent of the *Neue Zurcher Zeitung* recently reported on the fact, largely ignored by public opinion so far, that the Taliban, well known to be an extremely dangerous organization, is now a mere one hundred kilometres away from Islamabad, the Pakistani capital. Pakistan possesses nuclear warheads. It may thus be the case that the world will shortly be confronted with the reality of Islamist extremists in possession of "the bomb", and thus the best possible means of blackmail. The new American administration, with its rather more conciliatory approach to foreign policy, would then be faced with a real test – and such a crisis might well be the final straw for the global economy. For, apart from the wondrous Chinese growth engine, it is precisely the Indian subcontinent that is expected to generate such demand that it can replace the Americans as the ultimate global consumers.

The point of referring to the Taliban's march on Islamabad is not to go looking for trouble. Au contraire. The point we'd like to make is that neither "the financial and economic crisis", nor "swine 'flu", nor yet "a nuclear Taliban" is an adequate representation of the world as it is. A view of the world restricted to a single topic is basically false, because simplistic, and suited at best to the PowerPoint presentations of similarly simplistic consultants. And it is dangerous, inasmuch as it results in far too much effort being devoted to matters that may be of low priority. The converse of this insight is that the complexity of global systems, so much greater than it is perceived to be, means that there is always room for entirely different, utterly unexpected and – why not, for once? – positive developments.

After the review of the status of the financial and economic crisis essential to any Investment Commentary, we want in this issue to expand the perspective beyond the narrow topic that has occupied our attention for the last two years. Unsurprisingly, such efforts give rise to a considerably greater degree of optimism than is possible with a narrower perspective.

2. Why rising prices?

Four months into 2009, the financial and economic crisis appears, at first glance, every bit as dismal and forlorn as last year. Even worse: not only have fears of genuine collapse in the real economy proved well founded, but the negative expectations have, if anything, been exceeded. Practically all the consumption indicators in the USA are at historic lows. In Europe, one economic forecast after another is being revised downwards. Even governments, naturally inclined to

euphemism and threatened by approaching elections, are approaching the bitter truth in their pronouncements. Thorough-going pessimism prevails in Europe, particularly in business circles. Many of the once-proud exporters of capital goods are faced with falls in their order books of 50 percent and more. The crisis is also increasingly engulfing the durable consumer goods sector, though normal consumption and construction activity remain robust in Europe. But that will change when mass redundancies strike.

The situation of the big banks looks superficially somewhat better than it recently did. Despite palpable indications of insolvency, or at least extremely weak equity cover, the crisis-hit financial conglomerates have managed to survive the first quarter more or less intact. The changes in accounting standards have, however, made it (still) more difficult to understand the real situation. Given the extensive lack of market prices, the waiving of the mark-to-market rules is comprehensible, but it gives rise to suspicion that the new freedom in the valuation of assets and liabilities may be abused to polish up P&L statements. And no less so to speculation that this is being done with the connivance of the supervisory authorities. For nothing would be nicer than if the system talked itself back into good health, as it were, while ensuring, with extremely low interest rates, hefty returns over time from interest-rate arbitrage.

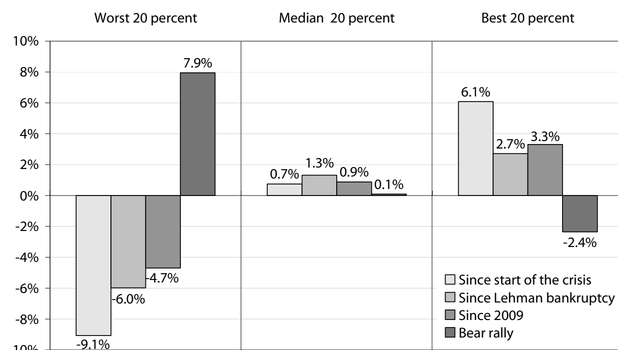
Below the surface, though, things do not really look any better yet. It must be assumed that, even more or less freed from their most toxic assets, the big banks' balance sheets remain seriously exposed to the American mortgage market. Sub-prime mortgages are no longer the real problem; this is now the higher-rated Alt-A (total estimated volume: USD 2.5 billion) and Prime (USD 4.5 billion) domestic segments, and particularly mortgages on business premises (in total USD 7 billion). Some concrete data here: of all mortgages on individual domestic properties (that is, houses for 1 to 4 families) regardless of quality, almost 8 percent were distressed at the end of 2008; that is, neither interest nor amortization was paid, or foreclosure had already occurred. 24 percent of all home-owners are landed with properties whose value is significantly below their mortgages; for Alt-A mortgages the figure is 45 percent. As we know, the crisis was triggered in 2007 by a wave of unavoidable renegotiations ("resets") of sub-prime mortgages. This wave has past, but the next one, in the Alt-A segment, will hit the banks from January 2010. Defaults of USD 250 billion (or 10 percent of the total volume) will have to be renegotiated in subsequent years. All in all, there is no reason to believe that the real estate problem in the USA is going away. Au contraire: the real problems for the banking system if the US economy continues to be recessionary still lie ahead.

It comes as no surprise, then, that the Fed, faced with such a mountain of unresolved problems, is trying to gain clarity on the resilience of individual institutions by means of "stress tests". This is, of course, a delicate undertaking, for the very results of such tests have the potential to serve as the nucleus for the next crisis in the interbank market. In the wake of the collapse of Lehman Brothers, people have become very wary indeed of real shocks triggered by the authorities. The reluctant publication of the results is an indication of such misgivings. Nor does scepticism about such possibly sanitized results, fed by experience, make it any easier to arrive at a reliable assessment of the results now available. Inasmuch as overall, transparency will be increased, these efforts are to be warmly welcomed, not least because the American banking system suffers in any case from a deficit in transparency and enables banks to appear better capitalized than the actually are, due to its more generous accounting standards (US-GAAP) with regard to possibilities for various balance sheet positions compared to the European IFRS.

If, then, the situation in the financial system, and the economy as a whole, has not really changed since the beginning of 2009, never mind improved; what can be behind the price rises, some of them hefty, that we have seen on the stock exchanges over the past two months? Why does the stock exchange rejoice when the bank of America reports a need for additional capital of USD 34 billion? What might be the reasons, for example, for the fact that Barclays Bank stock has gone up by no less than a factor of six since its lowest point at the end of February?

The simplest answer is irrationality, both for the fall and for the rise. We see things somewhat differently. There is one decisive element that has changed significantly in the meantime. It may not necessarily justify the better mood on the financial markets, but it may go some way towards explaining it. The market's perception of the danger of a big bank going bust has reduced significantly. Correspondingly, the high risk premiums priced in by the market to allow for the probability of bankruptcy are no longer needed to that extent. Stocks had in effect become little more than call options – which can be equated with a limited risk of loss resulting from very close proximity to zero (we recall UBS stocks falling to their low of CHF 8.20, or Citigroup falling to USD 0.97, compared to CHF 71.15 and USD 50.91 respectively in mid-2007) and a relatively unlimited recovery potential, so long as the worst conceivable expectations are not realized. These option-like financial instruments have now increasingly reverted to being genuine stock investments with symmetrical characteristics. Ground zero has receded further into the distance, both numerically and in economic terms.

Junk on the rise



Note: Companies in the MSCI World Index were analyzed for their ability to generate cash and their financial stability and placed in five categories. An equally weighted return was calculated for each of the five portfolios. The chart shows the overperformance of the three portfolios that interest us, against the equally weighted benchmark return for the given periods.

Source: Factset, analysis

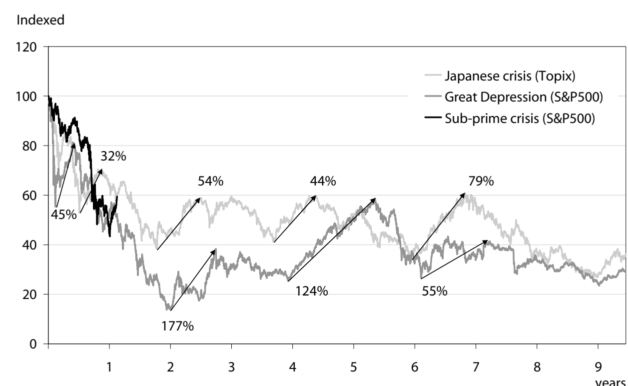
Put simply, we might say that the last two (highly positive) months on the stock exchanges have been devoted to the junk stocks of the financial crisis, to the disadvantage of the stocks of more serious businesses. But they had not previously fallen off the cliff. If, which is, of course, by no means certain, it turns out that the partial fall in risk premiums due to the reduced probability of insolvency is justified, the valuation of non-junk stocks will follow suit, for there is something like a self-fulfilling prophecy for the future prospects of businesses: "a rising tide floats all the boats" – in the same way as a downwards spiral has universal impact. Why? Because risk premiums affect all market players, if to varying degrees. So their disappearance comes as a great relief to all. To this extent, the higher market valuations appear rational.

3. A flash in the pan or something more?

Investors would of course like to know whether this recovery – surprisingly premature in its timing – represents the longed-for normalization of the markets, with more or less predictable returns, or just a flash in the pan, that in the worst case might trigger an even more catastrophic slump than the one we experienced up to mid-March.

There is no certainty. The future can be probable or random. We can look for patterns from the past, or for indications that may enable us to develop scenarios, and, if possible, allocate them degrees of probability. Let us first try the "historical method". If we hold that the current financial and economic crisis resembles to some extent previous sustained and momentous crises, then comparisons with the relevant price histories will be justified. The more so, if we accept that a succession of disappointment and hope represents a constant in human behaviour, so that rising and falling waves of euphoria and despair are "typical". Let us take a closer look, and compare the current crisis with the Great Depression of the 1930s, and with the development of the Japanese stock market after its peak at the end of 1989. In both cases, the markets took a very long time to achieve a sustained recovery – that is, one that was not followed by a further, possibly even more dramatic fall. It is also the case that the interim booms were fairly massive: 40, 50, even up to 100 percent were not uncommon. Dangerous waves! For they could encourage people to get in or out towards the end of the wave, in a pro-cyclical fashion, and thus to destroy more value than the overall movement of the market would have done.

Recovery in stages



Note: Index starting points: Great Depression; 16.9.1929: Japanese crisis: 3.1.1990; Sub-prime crisis: 10.10.2007

Source: Bloomberg, analysis

It is a sobering picture, and one that discourages presumptuousness. The probability of being able to exploit tactical skills to always get the timing exactly right is low. Extreme tactical manoeuvres can go badly wrong; holding on to positions is likely to be more successful, but demands nerves of steel.

It would be possible to take an even more fundamental economic position, and argue that the Japanese slump is actually still going on. And that the first really sustained upturn in the economy, and on the stock exchange, after the 1930s was triggered by the unparalleled stimulation caused by the Second World War. Does it take war to put an end to stock market slumps and economic crises? A disturbing question.

What is currently being tried is unparalleled stimulation without the higher-order "legitimation" of war. This may work, but it may not, and here precisely lie our serious doubts about the sustainability of the current recovery on the stock exchange. The stimulation measures, running into billions, initiated by the American and British governments and, at some remove, also by European politicians are aimed mainly at structural preservation in the financial and automobile sectors, and in other seriously affected economic sectors. No place is being made for new developments. What will certainly remain will be a

crushing load of state debt. The mere thought of the additional tax burden that this will impose on individuals and businesses has the potential to trigger the next slump.

Furthermore, we have no idea how far states may go in burdening the capital markets with this refinancing. We have already referred more than once to the danger of the "crowding out" of private borrowers by the supposedly or actually more secure state debtors. And the nationalization of part of the financial sector means that some of the big banks are now playing a significant role in the crowding-out process. All in all, too much capital will flow towards largely or totally unproductive factors in the (Western) economies.

The impossibility of raising capital to refinance individual states – virtual insolvency – is an entirely conceivable scenario for the coming months and years. Behind closed doors, there are already discussions about a European forced loan, should Italy, or some other economically distressed country reach a state of insolvency. Forced loans, the legal obligation on investors to make funds available for a particular purpose, belong in the arsenal of countries at war, and generally end in expropriation.

There remains the possibility that heavily indebted governments may be tempted to meddle with the activities of "their" central banks, and force them to allow a little inflation. To influence the decision, in other words, as to when to return to normality after a period of monetary policy aimed at extreme stimulation. This is of course an enormously delicate decision, in an economic environment just on the turn from recession to upswing. For that is exactly when the siren song of "a little inflation" finds a sympathetic ear well into otherwise rational political circles. This susceptibility can already be detected; the current generation lacks any direct negative experience of inflation, and even in academic circles, those who believe that everything is possible are waffling about it being entirely possible, and therefore desirable, to generate "a little inflation". The *vox populi* is somewhat more realistic here. A few days ago, a Japanese friend brought us a US dollar note with the face value of "One Trillion Dollars" – USD 1,000,000,000,000! On the reverse there was an image of Barack Obama with a broad grin. Apart from these minor modifications, the note looked astoundingly genuine. Inflation anxiety, should it grip the market, would also put an end to any stock exchange euphoria.

A flash in the pan, or something more? Objectively speaking, more grounds speak against the beginning of a genuine, sustained recovery. Even if the most pressing problems have been relocated from the disaster area of the global economy – the financial system – into the even more disastrous area of state intervention, it is still highly improbable that this mountain of problems will not sooner or later seize hold of the public consciousness. With the overweighting of stocks that we have now initiated, our investment policy continues to follow the trend, within the familiar narrow bandwidth. But we remain extremely vigilant, and will try to anticipate the re-emergence of any (justified) anxiety.

4. Where optimism is justified

These are hard times for realistic optimists. They must fight against the mendacious euphemism cultivated by the authorities and by crisis-hit businesses. They must be prepared to call a spade a spade. Nor is that enough: they must outline conceivable scenarios, possibly with severely negative characteristics. And because such threatening scenarios possess a degree of probability and practical relevance, they must also seek answers and solutions. The "real assets portfolio" presented in the last Investment Commentary as a hedge against the possibility of future depreciation was (and still is, for the danger of inflation is by no means averted) such a proposed solution.

There is a real danger that sceptical negativism will take over, and positive developments be dismissed and ignored. Both for the author of the Investment Commentary and for investors, it is important to deliberately make oneself think positive thoughts. To do anything else would be wrong. For, firstly, so far the world has not yet come to an end; there is no empirical evidence for doom. Secondly, and indeed quite contrarily, as long as there has been an economy to observe systematically, there has always been growth, both overall and for long periods of time. Growth is synonymous with greater prosperity and, to a degree depending on the prevailing political order, the less well-off social classes have also enjoyed a share in this growing prosperity. Wherever "getting rich" has no negative connotations, and thus is not punished fiscally, a sufficient degree of optimism will regularly be found, regardless of what has happened previously. Thirdly, despite all negative prejudice, people are enormously adaptable, intelligent beings capable of making strategic decisions that will optimize their individual situations, and of carrying them out.

In the over-saturated West, we are far too little aware of the positive energy of the billions of these "Resourceful, Evaluating, Maximizing Men" (REMM), who are by no means so well situated that they are satisfied with either their situation or their prospects. We complain about the fact that the Americans, with their love of excessive consumption, and the fact that their excessive consumption has been bankrolled by other countries, will remain the ultimate source of demand for all conceivable sorts of goods. But we forget that, as well as the 300 mil-

lion US citizens, there are billions of Chinese and Indians who have never in their lives consumed "too much".

And it is here that we find what is for us, because it is largely decoupled from all the problems of the financial system, the most important glimmer of hope. From India, we hear that the recession is already over. This may indeed be taken with a pinch of salt, but it is not inherently impossible or improbable. For the Indian subcontinent has a strong domestic sector, that may well be in a position to absorb external shocks. This is particularly so inasmuch as Indian property-owners are virtually debt-free. From China, there comes news that indicates that the enormously expensive infrastructure projects will be able to support the Chinese domestic economy, including the consumer sector, reassuringly. This too may be taken with a pinch of salt, for the Chinese are past-masters at talking things up. Nevertheless; there has been no statement by the Chinese authorities tending in the wrong ideological direction. We gain the impression that excellent economists are at work.

There is even good news from Japan, if somewhat concealed. A country, or in economic terms a continent, accused of suffering a "lost decade", and which is believed to have come to a complete standstill. Appearances may be deceptive. For if we see things correctly, there has been a paradigm shift in the Japanese labour market. It has become – who would have thought it? – flexible! Acknowledgement of the grim outlook for the Japanese automobile industry has resulted in massive redundancies – an inconceivable occurrence well into the 1990s, but now a reality. A Japan without rigidity in one of its key factor markets – an unexpected, but stimulating notion!

All in all, there are enough reasons for believing that life will go on after the crisis. But it might be the case that this life will not go on mainly where we would like it to – that is, around us – but rather in countries that have not driven themselves into fiscal disaster through decades of misallocation resulting from the subsidizing of financial market conglomerates.

5. Stimulating structural changes

Rather than continually whining about the well-known prevailing mismanagement in the Western banking system, we might be better employed thinking about what medium and long-term changes may result from the crisis. We must assume that the very big, overweight banks like Citigroup, UBS, RBS, Fortis, Bank of America or Hypo Real Estate, many of whose balance sheets will not be rendered any less toxic by the recession, will have little room for manoeuvre, not least on account of the role that the state will now play as the whole or partial owner. It also all looks very much like more, and more complex regulation; like still greater hordes of ultimately unproductive auditors, lawyers and supervisory bodies; like ever new and ever more refined stress- and other tests; like the harassment of managers for the populist purpose of limiting bonuses; and like significantly higher tax rates. In other words, it should be assumed that these banks will be able to fulfil their function of providing the economy with capital only to a limited extent. State control is likely to involve two sorts of inefficiency: too little money for the economy on one side, and on the other, too much money for politically attractive projects. In the United Kingdom, for example, the government is already forcing the nationalized banks to increase their mortgage lending. We shall be plagued by efficiency problems in the banking system for years to come.

It would be a tragic error to suppose that the fetters imposed on the semi-nationalized banks by government will not also impinge on those players in the financial system that have so far survived without any state rescue operations. There will be a demand for a "level playing field", and harmonization of this kind is invariably achieved at the cost of freedom. The Deutsche Bank, HSBC, Barclays, Credit Suisse and many others will have to look to themselves, but the smaller institutions should themselves be under no illusion: the saving embrace of the state will, as ever, reveal itself as a choke-hold.

But what does the predictable inefficiency of the banking system mean for the vital function of allocating funds to business? In the 1930s, things were clear enough: no banks; no capital. Via their balance sheets, the banks had to provide the functions that enable the distribution of capital. First, transformation of scale, which make it possible, via the balance sheet, for vast numbers of very small savers to have an indirect share in the large-scale financing of engineering works, dams or power stations. Then, term transformation, with which the banks ensure that financial requirements of varying durations can be met with funds made available by the public mostly on a short-term basis. And risk transformation, which enables sufficient diversification, through engagement in differing types of financing projects, so that the collapse of one single project does not threaten the funds made available by the public to the bank. To these must be added the wide variety of transfer functions, from letters of credit to securities trading. They were all absolutely dependent on the bank's balance sheet, acting as a reserve and a buffer.

The financing of the economy via banks' balance sheets, which basically represented collective buckets, was always more or less in competition with direct financing, via private loans, direct participation or bonds placed on the capital market. Here too,

though, the banks often played an important role, particularly on account of their skill at taking on the whole risk of financings placed on the market. This is the world of investment banking: of classic investment banking, before it was ruined by the drive towards excessive own-account trading.

Narrow regulatory limits were, and still are, placed on direct financing, in that every collective effort at raising funds is regarded as a "banking-like activity", subject to the supervisory authorities. These close constraints on collective fund raising, customary in all countries, are the basis for the cartel-like position that banks have in the economy and society, and systematically, are closely related to the concept of the state as the ultimate debtor, standing behind the banks as a whole. For both the banks and the state, the financial crisis has revealed the questionable nature of this close interdependency. The incentives in the system lead to dangerous collective excesses and abysmally nonsensical risk-taking. In the political system those who must ultimately carry the risk – the taxpayers – are not in a position to exercise a controlling influence on these generous guarantors. Ultimately, a financial system based on the banks and the state as guarantor represents a mechanism characterized by too many false incentives, inclined to extreme misallocation, and with the potential for self-destruction. It needs to be replaced by a system more efficient in every respect.

A pipe-dream? No: the alternatives already exist. Examples:

- "Prosper". An Internet platform that brings together players on the financial markets who are looking for credit with those ready to invest. Investors can decide how much to lend to which of the pool of borrowers, and the interest rate is set by an auction process. Investors can independently determine the scale of their engagements, optimize the maturity structure and achieve the desired degree of diversification across various borrowers. That is to say, with the help of the Internet, they can perform all three classic banking functions. Prosper is not yet really prospering, on account of regulatory obstacles put in its path by the Securities and Exchange Commission (SEC).
- "studienaktie.org". An Internet platform on which students can hawk themselves as investments. They offer investors a profit-participating loan – a debt that comes with a repayment date and the promise of a future participation in profit, in the form of a percentage share in the annual salary when a student enters professional life. According to the *Economist*, the "Qifang" platform in China, which has a similar structure to "studienaktie.org" has already issued 2,500 loans with an average value of USD 400.
- The refinancing of major industry transactions. It appears that borrowers are increasingly carrying out preliminary negotiations with institutional investors about firm commitments and conditions. The classic banking functions of scale transformation, risk transformation and term transformation occur almost automatically, through the maintenance of banking-like relations by borrowers and the broadly diversified structure, both materially and with regard to term, on the investors' side. What need, then, of an intermediary bank balance sheet? The technical and legal structuring of the deal by an investment bank is all that is needed, and this does not justify a high level of compensation.
- The sector of "peer-to-peer financing", the placing of capital via the Internet, is growing strongly. The high, monopolistic returns that characterize such an important area for the innovatory power of business as Initial Public Offerings (IPOs), for example, cry out for platforms such as "wrhambrecht.com". Pricing is done much more efficiently by means of an auction process – to the benefit of both investors and borrowers.

There are several dimensions to the exciting idea that the banking system might slowly but surely be made obsolete by network functions such as the Internet, or less virtual platforms. Undoubtedly important is the greater efficiency gained from dispensing with a weighty intermediary. But what seems still more important to us is the prospect of the partial abolition, or at least a decrease in the importance, of a system that has acquired too much influence in business, society and politics in recent decades, that has too often caused crises, and that has simply cost the general public too much money as a result of its misallocations and crises. A decrease in the importance of the banking system would have a clearly beneficial impact on our prosperity.

6. The example of Ole Kirk Christiansen

For platform-based financing to develop beyond the merely anecdotal would, however, require a couple of preconditions. So far it has been restricted to placings within a given community – a community in the sense that, while basically open to all, it remains clearly in existence after the transaction is completed, with some form of influence on the success of the investment. The community clearly has a positive disciplinary effect. Default rates on loans granted via Internet platforms seem to be lower than when banks are involved. The student loans financed by the banks in the USA are by now well known to represent one of the crasser problems generated by the financial crisis.

Nevertheless, term, scale and risk transformation are only possible to a satisfactory degree if flexibility

remains after the conclusion of the transaction. It must be possible – at a given price and for a given discount, of course – to exit the transaction. The Internet platforms are handicapped by the lack of a secondary market; that is, the possibility of passing on the acquired entitlements via a market mechanism. It is not possible, for instance, to disengage prematurely from a loan with a three-year term. A secondary market can, however, only come into being when there is sufficient transparency, so that a previously uninvolved third party can have confidence in the price offered. Without a degree of standardization, and without a qualitative component that always confirms the standards, platform-based financing will not take off. A market is based on the possibility of comparing, and trading, like with like. Otherwise the information and transaction costs are too high.

Standardization, qualitative confirmation: the platform providers, whether Prosper, Studienaktie, Schweizer Börse, Deutsche Börse, Scoach or whoever, are challenged. With the banks' structural crisis, they urgently need to acquire investment banking and rating expertise. The aim must be to do what the Dane, Ole Kirk Christiansen managed to do in 1949: to create plastic bricks that can be fitted together and built into any imaginable form or structure – Lego bricks, in fact. They are standardized, of invariably consistent quality and unlimited in the variety of their potential composition.

7. Securitization 2.0 is coming

In the wake of the financial crisis, the media, the authorities and even representatives of the banks have been indefatigable in presenting securitization as one of the main causes of the crisis. There is always a danger of turning the symptoms into the disease. There is, of course, no doubt that many products and instruments, intransparent to begin with, became distressed – that is, were no longer saleable. That was disastrous. But was it the fault of the instruments themselves, or rather of the mechanisms that stood behind their production and distribution? Let us take as an example the rating agencies. Who were they paid by? Investors? Secondary market operators? The supervisory authorities? No, it was the investment banks. Unlike Lego bricks, the ratings of financial instruments, which confirm their compliance with standards, are a public good. The compensation of their production costs is thus precarious. And the financing of the public good of rating information by the investment banks is not merely precarious, but dangerously negligent, for the ratings will tendentially be too positive. There is no way round these production costs being taken over by a more neutral body. The operators of secondary markets would be logical candidates. The state as the owner of the rating agencies would be a second-best solution, and distinctly inferior. Ebay, the consumer goods platform, shows us the way: it provides reliability ratings for its participants, and makes them fully transparent. Good behaviour is incentivized.

Not only the principle of the ratings, however, but also their production requires rethinking. Does it make sense for investment banks, which act as the interface between the capital market and individual borrowers, to build their own Lego houses? They should manufacture the bricks, and seek for ever-new forms; that is, new risk categories and investment projects. But no more than that. And certainly not build their own towers.

What, then, is left for the state to do in the future? It has to do one thing only: to ensure order. This is synonymous with ensuring that contracts can be enforced and ownership is clear. By this, securitization stands or falls. Things get interesting when securities are exchanged at global level. This requires clearing houses, and their success depends almost entirely on the reliability of the legal system applicable where they are situated. They can only function as central and virtually risk-free counterparties if they can rely on the enforceability of contracts, at all times and in all circumstances.

What we are forecasting is not merely the displacement of banking functions by platforms and clearing houses, but also the return of those structured vehicles that have been so thoroughly demonized in the course of the crisis. The Collateralized Debt Obligation, the notorious CDO, for example, with its cascade-like liability structure, still seems to us to be an appropriate product for managing a variety of similarly situated financing projects. As long as CDOs are not based on one and the same underlying credit, and piled up as quasi-risk-free assets in the balance sheets of state-subsidized big banks, there is really no objection to them. They can certainly not be accused of intransparency: au contraire!

Life does indeed go on. The next version of securitization will come and it will work. And Bill Gates will prove to have been right when he said in 2000, "The world needs banking but it does not need banks". To the greater good of us all.

KH, 11.05.2009