What's Next for Financial Markets?

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Using a five-stage framework not unlike the five stages of grief reaction can help us take stock of the worldwide reaction to the current fiscal crisis. It can also help us understand the stage of the process we are currently experiencing and anticipate the events and responses that are likely to come.

The financial crisis has dashed the hopes and shaken the confidence of innumerable investors, investment professionals, financial institutions, and ordinary people, and the reaction of many individuals and institutions has been somewhat like that of a person experiencing bereavement or personal tragedy. Psychiatrists say that people confronted by such events often go through five stages of response—shock, denial, anger and bargaining, depression, and acceptance and resolution. I would like to use this five-stage framework to offer a journalist's (some might say an anthropologist's) perspective of the current crisis. I have used this framework once before (Japanese financial crisis of the 1990s) and found it quite helpful in making sense of the situation. I think it can help us comprehend today's crisis as well and perhaps offer a window on the near-term future.

Stage One: Shock

In the summer of 2007, we all suffered a terrific shock. In fact, we suffered two shocks in much the same way that the Japanese suffered two shocks in the 1990s. First, we learned that loans can go bad. Borrowers started to default. In particular, borrowers who had taken out subprime mortgages under utterly irresponsible—if not fraudulent—terms stopped paying off their mortgages, and bad loans were created in the banking system. So, the crisis is rooted in a tangible economic loss.

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The second shock was entirely psychological and was perhaps even worse than the first. The second shock was learning that almost everything we had come to believe about 21st century finance was completely wrong. Such a shock, such a crumbling of faith, is very similar to what I saw in the late 1990s in Japan. Until the autumn of 1997, many people instinctively had thought that Japanese banks were a bit dodgy. Not only had Japanese banks experienced the collapse of a big property bubble, but also it was becoming increasingly obvious that they had been lying about their accounts. Even so, no one worried too much because everyone believed that with the convoy system, under which the Japanese government always propped up the banks, in place, everyone would be okay. But in the autumn of 1997, over the course of just a week or two, when a couple of banks were not saved, the convoy system fell apart, and the faith that everyone had had in the system was shattered. Almost immediately, the money markets froze, retail depositors panicked, and the banks started to collapse.

Something oddly similar happened in the summer of 2007. All through the previous seven years of the decade, investors and investment professionals had known instinctively that something was a bit dodgy about the way the credit markets were developing. Structured finance was getting out of control. A few people were even bold enough to bet that it would all end in tears. Most people, however, continued to have faith in the system as a whole and thus carried on. After all, they told themselves, the credit rating agencies were putting AAA stamps on everything, and the regulators seemed to think that everything was okay, even more than okay. Alan

Greenspan and Roger Ferguson from the U.S. Federal Reserve were saying that financial innovation had made the system much safer than it had ever been in the past. So, people more or less believed that everything was all okay-ish.

Besides, believing in the system was certainly convenient. People were getting cheap loans, and anyone working in finance was making a fat profit and probably getting a fat bonus. But when the shock hit in the summer of 2007, we all suddenly realized that a AAA rating did not mean very much when the assets sitting inside Bear Stearns's hedge funds had collapsed to 10 percent of their value. The ratings agencies clearly were not a good guide to the likelihood of default, let alone market risk. The regulators clearly did not have a clue. Even senior management at the banks seemed not to know what they were doing. Many of the assumptions we had made about 21st century finance turned out to be completely wrong. Banks had not been shedding assets; they had been retaining assets. The process of slicing and dicing risk had not spread risk around the system; it had actually concentrated it in very unhealthy ways. And most pernicious of all, leverage of a staggering scale had built up in the system largely undetected.

So, the shock in the summer of 2007 was not about losing faith in a single asset class. It was not about losing faith in a single bank. It was about losing faith in the entire era of cyberfinance. It was shock on a scale that, until the very last instant, most people would not have imagined.

A week before the first of the Bear Stearns hedge funds started to go wrong, I went to a conference of the European Securitization Forum. It was a memorable event, absolutely awash in champagne—champagne salutes all around, many sponsored by monoline companies. One evening, in the middle of this wild jamboree, I was standing on a balcony overlooking the Barcelona waterfront, and a rock band started to play. It was a band that some of the bankers themselves had formed and that they called "Da Leverage," as in "It's da leverage, man!" I asked one of them if he didn't think such a name sounded a bit arrogant, and he assured me it was only a joke. Besides, the name was cool because leverage really was driving the banking industry.

People actually thought that leverage was safe, that securitization was a good idea. Thus, even in June 2007, the participants at the European Securitization Forum were so confident that securitization would keep booming that they began to make plans to move the next proceedings to Cannes because they were certain they would need more space for all the bankers who would be attending. The crash, when it came, was a shock even to those, especially to those, who should have known better.

Stage Two: Denial

When denial sets in, it can last a long time, as it did in this case.

In the middle of June 2007, senior members of the U.S. government were saying that the total scale of subprime losses in the United States would probably be about $50 billion, perhaps $100 billion if we were unlucky. Even in the autumn, most senior investment bankers were telling us that the damage had been contained and that the crisis would soon be over. More than one banker told me that the nice thing about a summer crisis is that it is over by Christmas.

They were not the only deniers. The regulators were telling us that a few tweaks here, a few tweaks there, and all will be fine. Rating agencies repeatedly assured us that there was nothing wrong with their models. By and large, the bankers who had been slicing and dicing debt continued to slice and dice. Granted, they said that the second half of 2007 would not be great for the CDO (collateralized debt obligation) industry but that it would come back in 2008. The denial even extended into the world of policy making. For the longest time, policymakers presumed that this was a problem that could be fixed with a bit of liquidity, a bit more action by central banks.

The pattern was disturbingly similar to that seen in Japan. The Bank of Japan jumped through all manner of hoops putting more liquidity into the markets, trying to plaster over a vast hole in the financial system. It took years for Japanese politicians to realize that they were dealing with a fiscal problem—in fact, a solvency problem—and that the banks would have to be recapitalized with public money.

Denial has lasted a long time in the United States and Europe, although not as long as it did in Japan, thank goodness.

Stage Three: Anger and Bargaining

Recently, we have started to move away from denial and are now in a state of anger and bargaining. The bargaining has come in several forms. Once the scale of the problem was identified, many policymakers continued to hope that central bank actions would sort it out and that they would not be called on to use public funds. All kinds of ducking and weaving and dodging were used to avoid recognizing the scale of the solvency problem.

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As for anger, we are still at a fairly early stage in the anger process because the full scale of the losses and their impact on ordinary people is just beginning to become clear. I spoke recently with some of the people who helped create the CDO industry and the world of securitization. Many of them—that is, those who have jobs at all—are now employed in trying to clean up the mess.

One of them has been traveling through Europe, trying to measure the extent of the problem, trying to identify and quantify the appalling sorts of CDOs in the market—the CDOs squared and CDOs cubed that were sold to pension funds, life insurance companies, and asset managers. He told me that in one week alone, he had gone through the books of a pension fund belonging to a large continental group and discovered that it had in its portfolio $750 million of CDOs squared that could now be valued at perhaps 10 cents on the dollar. Later, he stepped outside and walked along the streets of this little European town, looking around at the pensioners and thinking, "You people have no idea."

Soon enough they will get the idea. Soon enough they will know the extent of their troubles, and they will be angry. They will be pointing their fingers, and they will be picking out people to blame, and there will be plenty of people to pick from.

As for me, I do not presume to believe that the bankers are the only ones to blame. I am currently writing a book in which I try to explain how the system went so terribly wrong, and the method I use is to track a small group of bankers from a particular institution who were involved in creating a lot of the products that have caused so much trouble. I follow them over 20 years as they conceive of their products, introduce them to the market, watch them grow and come to fruition, and then watch the process unravel.

I have known a number of these people for years, and it is clear to me from telling the story at the micro level that it is not the case that all these bankers were greedy and evil.

Perhaps a few of them were greedy; perhaps one or two were less than well intentioned. But most of them were simply caught up in the mad exuberance of it all, the mania of the market. Certainly, they were at fault, but so were the regulators, so were the rating agencies, and so were the politicians. So, too, in fact, was the media—for not providing better scrutiny. Until a couple of years ago, 99 percent of the business media was writing almost nothing about the extraordinary revolution in credit that had occurred in the first seven years of this decade. That in itself is shocking.

Stage Four: Depression

At the same time that people are moving into anger and bargaining, we are also seeing signs of depression. Pick up any issue of the *Financial Times*, and examples of extreme gloom pervade the stories on the financial markets. For example, the spread between high-yield bonds and Treasuries now implies a 21 percent corporate default rate in the coming years, which is higher than it was in 1933. Similarly, the iTraxx Europe Crossover index has gone through a thousand recently—again implying extraordinarily high levels of default in Europe. The credit default swap on U.K. and U.S. government debt is spiraling upward. Default insurance on McDonald's is now less than twice the cost of default insurance on the U.S. government. That is the level of gloom.

House price inflation is apparently the lowest on record, and car sales have collapsed by 37 percent, year on year, which is the steepest decline since 1980. One night recently, I went to an event for my daughter's school in West London, a section that is dominated by bankers, and as I was chatting with other parents, I estimated one-quarter to one-third of the group had lost their jobs. Recently, I gave a speech in London to a group of students. Afterwards, a large number came up to me and said that they had originally intended to study physics as preparation for going into finance but the recent turn of events had caused them to change their minds. They asked if I had any career recommendations. I asked them not to go into rocket making.

Unfortunately, the situation could get worse. Some market watchers are saying that we are at the nadir and that we now have before us the greatest buying opportunity of our lives. Others are warning us to be cautious, that there may be more pain to come.

Weak Spots in the System. About a year ago, I sat down with the rest of my team and asked them to draw up a list of all the weak spots in the financial system. If a financial tornado were to hit, I wanted to know which parts of the system were likely to crumble. Among the weak points we identified at the time were monoline companies, AIG (American International Group), Iceland, and Eastern Europe. The good news—if I can call it that—is that most of the dominoes on our list have already toppled over. Yet, despite the extraordinary run of apocalyptic events that we have witnessed, when I look out on the world of structured finance, the towering edifice of shadow banks, of CDOs, of all the slicing and dicing and financial engineering and all the extreme forms of leverage that arose in

the first seven years of this decade, I would have to say that the deleveraging process has not yet run its course. Nevertheless—and this is good news once again—there are not many shadow banks left. The number of shoes still waiting to drop is a lot smaller than it was a couple of months ago.

Two Shoes That Might Drop. Unfortunately, two of those shoes are particularly worrisome. The first is the likelihood of corporate defaults. Most of the riskier private equity deals done at the peak of the credit bubble—that is, in the second half of 2006 and first half of 2007—were refinanced at a late stage in the boom and were often refinanced with few, if any, covenants. Such loans probably will not start coming due until the second half of 2009 or even some time in 2010, but when they do, they will send another shock wave through the system.

The other shoe waiting to drop is the government bond market. Thus far, investors appear to have reacted to the financial crisis by choosing to invest in government bonds. This is perfectly understandable because investors have few other places to put their money right now. The risk, as we are seeing in the sovereign CDS (credit default swap) market, is that people may start asking how long the U.S. government can continue bailing out its banks. After all, as the government pays out $700 billion here and $700 billion there, it will not be long before we are talking serious money, even for the U.S. economy. We have not yet reached a point of concern for the viability of U.S. government bonds, but it is something to consider. It is also worth noting that during Japan's banking crisis, 95 percent of Japanese government bonds were in the hands of domestic investors who understood that they needed to stick together and share the pain, so there was little likelihood that investors would pull out of the Japanese government bond market. That is not the case, unfortunately, with the U.S. and U.K. government bond markets. Foreign investment is heavy in those markets, and the investors have no particular loyalty to the United Kingdom or the United States. So, that does remain a risk.

Stage Five: Acceptance and Resolution

Although we may not have yet reached the nadir of depression, I can see a few hints of comfort as we pass through this terrible storm. When I consider what has happened in the last 18 months, it seems to me that as recently as six months ago, I was still observing a surprising degree of denial. Many governments were still thinking that they could get through this without spending taxpayer money to bail out the banks. In fact, some senior Japanese officials were warning their U.S. counterparts as far back as July 2007 that the situation would end with a government bailout. But denial continued until just a few months ago.

Such denial is certainly on the decline, both among policymakers and financiers. Central banks are slashing interest rates, which is merely one sign that the policy making world is waking up to the seriousness of the problem and the need for radical, bold action to combat it. The financial industry at last realizes that this is not a blip on the radar screen. This is not a case of one or two models having gone wrong. This is a crumbling of the very foundations that have underpinned 21st century finance. If the financial industry wants to reshape itself, if it wants to avoid throwing out the baby with the bathwater, if it wants to have a future in which it is not a state-owned utility, it needs to get its act together and rethink how it does finance.

Financiers are at last recognizing the folly of allowing brokers to be leveraged 30 to 50 times, as some were in the last couple of years of the credit bubble. They are recognizing the folly of allowing banks to create all manner of shadowy, off-balance-sheet vehicles—shadow banks of indeterminate size that are and are not part of the banking system and that have no rights of access to the lenders of last resort that could actually rescue them if a crisis hits. Finally, they are recognizing that it was folly to allow such a large and opaque derivatives sector to run on the OTC private market. I am not saying that private bilateral contracts are a bad idea in themselves, and I certainly believe there is a place for OTC derivatives markets. The problem is one of proportion. Allowing an OTC credit derivatives market that is the same size as the corporate bond market is perhaps appropriate, but having such a market that is 10–15 times the size of the corporate bond market creates a problem of proportion. At that point, the tail begins to wag the dog, which is exactly what has happened.

The good news, therefore, is that most bankers and policymakers at last recognize these flaws and are having serious discussions about remaking the rules for capital adequacy, even rethinking some aspects of Basel II. They are recognizing the need for regulation. They are even talking of returning to some old-fashioned ideas, such as leverage ratio rules. The Central Bank of Switzerland has been blazing trails in that respect.

The Influence of Ideology. One of the luxuries of writing a book is being able to talk with the people who have been involved in building this market and learn where their ideas originated, what

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shaped their thinking, what was the zeitgeist in which their thinking was formed and matured. It is clear to me now that the development of the markets for much of the 1980s and 1990s was based on a free-market, libertarian view of the world. Call it Thatcherism or Reaganism if you will. Certainly, it was deeply influenced by the University of Chicago's School of Economics. And those who took this view of the world assumed that free markets could solve their own problems. Rational economic actors would deal with imbalances, and investors—caveat emptor—could look out for themselves. We did not need a centralized system of planning and control. Thus, the credit derivatives market had no centralized clearinghouse. Investors could and should write their own contracts, and if there were problems, free-market principles would sort them out. Markets, it was assumed, would heal themselves.

The small group of bankers that I have followed through the narrative of my book believed in and was deeply committed to this intellectual framework, and until about three months ago, most of them were still clinging to it. But the collapse of Lehman Brothers, the bailout of AIG, and the shocking decline of markets have shaken their belief in this framework. Some still cling to it; many do not. In fact, one of them said to me the other day that they were wrong to put their faith in free markets without recognizing that the incentives inside the financial system were so warped that the markets were not really free. Many of these movers and shakers are now recognizing that the state ought to be involved in an intelligent way—not a controlling way—to prevent the world's excesses. Regulators need to do their jobs.

Such a change is not going to happen overnight, nor is it likely to be done in the most intelligent and effective way. The sad history of the last century of finance is that many of the worst excesses have occurred in reaction to a piece of stupid regulation, which itself was enacted as a reaction to an even earlier episode of excess. We tend, therefore, to stagger from one frantic effort of regulatory overreaction to another. If we have any hope of avoiding such a response today, we need a real dialogue between financial practitioners and policymakers. We all need to recognize that finance cannot be treated like an activity involving just a tiny class of people who speak financial Latin. We need to recognize that the entire congregation (taxpayers, pensioners—all of us) has a place in the chapel, a stake in finance. One of the greatest failings of the last 10–15 years was the sheer arrogance of bankers who assumed that it was entirely appropriate to live in a world in which only 0.001 percent of the population understood the financial markets.

Bloomberg Machines and Financial Latin. Two anecdotes go a long way in making my point. First, about two years ago, a couple of senior bankers came to visit me at the *Financial Times*. They were very upset that I was giving so much space to discussions of potential problems in the financial system, problems like a looming credit crash. They complained pointedly about the *Financial Times'* criticism of the market's opacity. They insisted that the credit markets were not opaque. Anybody, they told me, can get the information he or she needs by going to the right page on the Bloomberg machine. So, I asked them what they would recommend to the 99 percent of humans who do not have a Bloomberg machine. There was a pause of about 15 seconds while they considered such a circumstance, one that they had apparently never considered, even though it applied to many of their clients and many policymakers.

Second, I recently had a chat with a senior investment banker who was deeply involved in the development of the credit derivatives market. He told me that the ISDA (International Swap Dealers Association), which is the industry body that represents the derivatives world, was in the process of appointing a public relations group to explain to the rest of the world what exactly their market does. I told him that was a fabulous idea but asked why the ISDA had not done such a thing five years ago, or even three years ago. He granted that I had a good point and said that until recently, Alan Greenspan and Roger Ferguson appeared to be doing the ISDA's public relations for them. That, frankly, tells us everything we need to know. The arrogance of the industry in assuming that the financial priesthood who spoke financial Latin could stand next to the altar and keep the rest of the congregation at bay is a key reason that this crisis has occurred. If we are to move forward and create a better financial world, such arrogance needs to be addressed.

Value of a Catastrophe. To avoid ending on a pessimistic note, I will comment on the psychological juncture at which we find ourselves. A process of acceptance is now under way, and we will see increasing resolution going forward. I do not know what the financial industry will look like five years from now, but I do know that by that time, it will be run by a group of professionals who will have lived through a bruising experience, and that should be extremely beneficial. Aside from those who experienced the Japanese banking crisis, most people who have worked in finance over the last decade or two

have not lived in a world in which banks can collapse. Having witnessed such an event will add a large dollop of humility to their thinking and make a big difference to their behavior in the future.

Challenge to the Next Generation of CFA Charterholders

Finally, to those 200,000 individuals who are scheduled to sit for the CFA examinations this cycle, I present this challenge. You have now seen financial markets collapse. The future of finance is in your hands. For the past decade or so, we have allowed the financial markets to be taken over by the whiz kids, and they have made a terrible mess of things. Most of us are not whiz kids. We do not intend to spend our careers creating CDOs cubed. Therefore, I challenge you to create a saner, calmer, more honorable vision of finance, one in which finance again becomes the rational engine that supplies money to the rest of the economy in the most efficient and functional way possible.

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Question and Answer Session

Gillian Tett

Question: Does the blame for the crisis rest on the creative financial products or on the extremely low cost of capital that triggered the frenzy, thanks to Alan Greenspan?

Tett: I would say there are two sides to that coin. Capital was too cheap. There was too much liquidity swilling around in the system. There were a number of global macroeconomic imbalances having to do with China, the United States, and Asian reserves. These were well documented, and the macroeconomists spent a lot of time debating them.

What the macroeconomists, including Alan Greenspan, got wrong was that, although they recognized that the scale of liquidity in the system had increased, they failed to recognize that the channels through which that liquidity was moving had changed dramatically.

One reason for this failure was that many macroeconomists tended to take a rather snobbish theoretical view of the world. They thought macroeconomics represented the world as it is and that financial markets are a side show, a bit of an irrelevance. Therefore, the people who were running nations' central banks were not, for the most part, terribly interested in how the channels were actually operating. So, the proliferation of new channels, subterranean channels—the shadow banks, if you like—went unnoticed.

This failure to attend to the channels meant that in addition to the liquidity running through the system, a huge amount of leverage was also being created that central bank policymakers simply did not see. The cause, therefore, was a combination of low interest rates and financial innovation.

Question: Is it less that bankers kept their businesses secret than that the public, mollified by rising markets and common greed, did not care?

Tett: Politicians and the public certainly bear some blame for what has happened. Too many borrowers were happy to take that cheap mortgage without ever asking why it was so cheap. Too many politicians were happy to see the markets booming without asking why.

Back in May 2007, I became particularly worried about the lack of understanding between the bankers of London and the members of Parliament. In fact, I wrote a column saying that politicians are from Pluto and bankers are from Mars. Barely two miles separate the city of London and the Houses of Parliament, but I could not find a single banker who had ever been in Parliament. In Parliament, I found few members who understood 21st century finance. When I asked them whether they knew what was driving the city of London's revenues, most of them thought it had something to do with stocks and shares. They had no idea of the scale of CDO activity.

So, the fault lies on both sides. Politicians were lazy; they should have done more to understand the actual conditions. Nevertheless, what the banks were doing was not transparent. How many people had any idea what was happening in Merrill Lynch's CDO machine? How many people knew how UBS was making its extraordinary profits? A lot was going on that was not at all clear.

Question: Would it be fair to characterize Western societies as having gone through an industrial age, then a financial age? If this is the end of the financial age, where do we go next?

Tett: I would say that during the last 15 years, we have lost sight of the idea that banking should not be that different from the water industry. It is a utility; it is about pushing money around the economy in the most efficient way possible in order to allow other activity to take place. Of course, there is room for innovation. Of course, there is room for competitive pressures. But I would not expect the water industry to be earning an ROE (return on equity) of 25 percent every year. If it did, I would begin to wonder what exactly it was doing with the water supply.

It is not normal for the financial industry to account for 25 percent of the U.S. stock market. Nor is it normal for every bright graduate coming out of Oxbridge to want nothing more than to work in London or for half the class of physicists coming out of the Imperial College to have ambitions only to be financial whiz kids. That is not a healthy thing, nor is it sustainable.

I think we are in a period of retrenchment, which is good. The other day, an analyst showed me a graph of the banking sector as a proportion of the Nikkei by market cap between 1980 and 2000. It started at about 4 percent, peaked at 22 percent, and then fell back to about 4 percent. The European banking sector appears to be following a similar trajectory. It may not necessarily fall all the way down to its starting point, but I do think we are entering a world in

which finance is no longer treated as an industrial game unto itself. And that's a good thing.

Question: Do you agree that the shoes that have already dropped pale in significance with those that are hanging by a thread? I am referring to the real economy and government bonds.

Tett: The shoes that have not yet dropped are indeed big. The issue of corporate defaults is certainly important. I am not convinced, for example, that the potential scale of credit card defaults has been fully priced into the markets. So, more shocks could hit the banking system. We are almost certainly heading for a period of severe economic retrenchment. It's going to be nasty, although I doubt that we will fall into a full-blown economic depression because policymakers are taking action. Whether what they do will be enough remains to be seen.

As for the government bond market issue, I would lay 60/40 odds that government bond investors will not panic, that they will retain their belief in government securities and will continue to buy them.

Question: If different countries are at different stages in the grief process, might Germany, for example, still be in denial?

Tett: I think we have yet to hear all of the unpleasant news about what some asset managers have done in the CDO world. But Germany has the benefit of having a large number of companies that actually make things, and the old-fashioned idea of a manufacturing-based economy has a lot of appeal right now and going forward. So, Germany has some strengths.

Question: Would a globally coordinated monetary policy help us avoid a Japanese-style meltdown?

Tett: I believe it is a necessary step, but it may not be sufficient. First, a fortunate circumstance of the Japanese financial crisis was that it was a bounded problem. It was extremely nasty, but it basically involved only Japanese banks. That turned out to be very important because in the early part of this decade, I became quite apocalyptic about Japan. I thought the country was sliding slowly into the sea. The banking system seemed to be getting only worse. And it seemed a bit like the situation today with Western banks.

One analyst would project the value of the bad loans at x trillion, and the next would say, no, it is x plus 1 or x plus 2 or x plus 3. There was an almost inflationary gloom among the analysts. But there turned out to be a light at the end of the tunnel. Aside from the fact that the Bank of Japan slashed the interest rate to zero, that the Japanese banks finally came clean about their losses, and that the government finally required the banks to adapt a more intelligent way of banking, the key element in eventually pulling Japan out of its banking woes was that China boomed, something that no one had projected or counted on.

China's boom created an extraordinary surge in demand for all manner of Japanese industrial goods. Cement mixers, coat hangers—all the goods of Japan's manufacturing sector were suddenly being sold to China, at least until the Chinese learned how to do the manufacturing themselves. Suddenly, the stodgy old sector of the Japanese economy had a new lease on life. And that provided the reflation that turned sentiment around.

I have spent a lot of time thinking recently about the spark that is needed in the current situation. Unfortunately, today's problem is not bounded. It is, in fact, a global problem, which makes it hard to foresee an external spark. Might it come from China again? I don't think so. Perhaps from the old producing countries? Maybe not right now. Perhaps from India? I have heard India being suggested.

But aside from the difficulty of obtaining an external jolt in a global system, there is the problem of policy coordination. It seems clear that no single national solution is going to sort out the mess. But coordinating international solutions will be a challenge. I hope that we will suffer less pain than Japan suffered, but the going will be hard.

This brings me to my second point, which is that, unfortunately, the experience of Japan shows that when a loss of faith of this scale occurs, banks can be given all the money in the world and ordered to lend, but if they do not feel confident, they will not lend. In Japan, the government drew up all kinds of targets for banks to lend certain sums of money to small and medium-sized enterprises. (The British government seems, in fact, to be taking a leaf out of those playbooks right now.) Unfortunately, the Japanese banks would agree to such guidelines and then find a subdivision of a subdivision of Toyota and lend to it. They did not lend to the companies that needed the loans, and I suspect we are in a similar situation now.

Question: The rating agency model is clearly broken, but what could feasibly replace it?

Tett: One of the reasons that rating agencies have been used so extensively, both in the investment community and among policymakers, is that they provide a quick and cost-effective rubber stamp. It is much cheaper to buy external branding than it is to develop and maintain internal

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research. Having independent internal research is costly and time consuming. I know a manager who spent three or four years building an alternative way to model and value CDOs precisely because he thought the rating agency system was terrible. Unfortunately, by the time his system came online, the credit bubble was about to burst. So, now he is using the system to help him mop up the mess.

We need to recognize that the financial industry relied on rating agencies so heavily because it was a way of cutting corners. If an alternative is going to be developed, it will cost money. We can either have an unstable financial system that leads to periods of cheap capital in which all the gimmicks and mechanisms seem to work interspersed with periods of crisis, or we can move to a world of greater stability in which the cost of capital rises at every point along the food chain.

Question: Even if financial institutions clean up their balance sheets, transaction volume will likely not return to previous levels for a long time. What kind of institutions do you think will emerge from this crisis in two to five years?

Tett: My best guess is that we will see a dichotomy. I think we will have some stodgy, highly diversified behemoths along the lines of JPMorgan. They will not be wildly risk taking or wildly leveraged. I do not believe we will go back to Glass–Steagall. Today's products will not allow for that.

I suspect, though, that these big, stolid banks will become part of the regulated system. But around the edges of the system, we will see nimble, unregulated players. The hedge fund sector will almost certainly shrink, but it will not die. There will always be a place for risk taking.

Animal spirits and innovation will not disappear. But common sense and balance will dominate the overall system. Hedge funds and unregulated risk will be a small proportion of the financial system, and that is very different from the world we saw two years before the credit bubble burst.

Question: Is mark-to-market accounting partially, if not completely, responsible for accelerating the crisis?

Tett: Anyone who lived through Japan's crisis came out evangelically convinced that mark-to-market accounting was a good idea because the Japanese banks had sat on their problem assets for years without revealing them and wouldn't come clean about the losses.

I suspect anyone who has lived through the last two years has come out with the idea that mark-to-market accounting is a bad idea because it has certainly accelerated the way of deleveraging and probably taken it beyond what it needs to have been.

As with all other things, the solution is probably a matter of balance. Unfortunately, it was almost impossible to suspend mark-to-market accounting in the middle of the crisis. Without a doubt, though, it was utterly misguided to allow institutions like shadow banks to fund themselves in short-term markets but buy long-term illiquid assets while using a mark-to-market accounting system.

Question: Being the first journalist to predict the crisis in 2007, how did you position your portfolio as a result?

Tett: Being a journalist, I do not have much of a portfolio. Most of my money is in a bank account, not because I'm particularly wise but because that's all there is.

Question: How will the current crisis affect the CFA charter? Does CFA Institute have an opportunity to be an influential part of a much more positive future?

Tett: CFA charterholders have an immensely important role to play, perhaps more important than at any point in their history, frankly. As I understand it, CFA Institute is all about analyzing the way that money goes around the world and how to allocate it in an efficient, rational, and honorable fashion. Such values seem to have been lost in the last few years.

If you dig down deep inside the banks that did some of the most egregious things with CDOs in the last few years, if you look at the way some asset managers were treating these products, they were by and large flouting many of the principles in the CFA Institute Code of Ethics and Standards of Professional Conduct. Therefore, CFA Institute does not need to reinvent the wheel. It simply needs to make sure that the wheel is rolling and that the next 200,000 people who sit for the exams go forward to put its principles into practice.

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