The future of capitalism: Credit, lending, and leverage

A distinguished panel of CEOs and business leaders debates the current state of credit, lending, and leverage—and discusses the emerging shape of financial markets, global rebalancing, and regulation.

This edited panel discussion is the second in our “Future of capitalism” series, which explores important issues shaping the business landscape in the aftermath of the credit and economic crises. A collaborative effort between Duke University’s Fuqua School of Business and McKinsey, the series comprises four forums over the course of the current academic year on energy, the financial system, globalization, and the role of business education in society.

An uneven credit thaw

MODERATOR [Anthony Santomero]: Where is the financial market now? What’s happening to credit? Let me turn to Alan Schwartz to start the discussion with what is in fact going on at the moment in the credit markets.

Alan Schwartz: Let me think of a way to organize, maybe to start out and let these guys jump in. The credit markets and how they’re behaving, I guess I’d organize it this way: they’re coming back kind of inversely to the problem situation that they had going into the crisis. All lending kind of spasmed, and the economy could have gone into a total freefall. But, fortunately, the US government finances were in decent shape, and developed countries—a lot of world governments—were in decent shape. And so the only credit that flowed for some period of time was the government stepping in to replace or support what was the private-market lending activities going on.

And in doing so and deciding to bring interest rates down to a very low level, they’re trying to force lending to go back into private sectors by taking away their return from being in riskless, or perceived riskless, instruments. Now, long term, I think what the government’s doing runs the risk that if we have another crisis the markets won’t be there for them. But that’s an issue for another day, probably, or another part.

So, the government was the first. Municipals, which eased up; taxing authority is something that was a good thing as perceived by the markets. So the municipal market has pretty much healed, and muni spreads—especially the higher-quality muni spreads—are relatively tight, and credit is flowing in those areas. Interestingly, unlike most credit cycles,
large corporate balance sheets were in the best shape that they’ve been in many, many years. So, large corporates came into the cycle in good shape, and therefore credit has come back the most quickly into the large corporate sector.

Large corporates tap into large financial institutions that are in better shape right now than smaller-firm lending, and they also can tap into the public markets and pockets of capital that get created to lend there. So the supply side is there, and the risk is perceived as having reduced a lot. And so I would say those markets are pretty much back to, you know, pretty normal functioning markets.

If you move through the curve, you get to small business and consumer. That’s where the markets are still far from where they were before we went into this crisis. Partially because, if you look at where the most overextended sectors were, the most overextended sector was consumer credit. Consumer balance sheets were actually in bad shape coming into this cycle.

If you look at where it’s come back in the asset-backed areas of things like credit cards and autos, those markets have thawed. They’re not nearly back to where they were, partially because consumer credit has weakened, partially because the securitization markets are not nearly as vibrant, and they were a big factor in supply. Partially because, you know, smaller banks are not lending. But I think the reason they’re back at least reasonably well is that the credit decisions that were made in those markets leading up to the crisis were made primarily around finding good, credit-worthy borrowers.

And then over here, the weakest part of the credit market is still in residential, and then commercial mortgages. But, to focus on residential for now, the underwriting standards were the most lax leading into the cycle, therefore it’s the hardest market to bring back to normal functioning because, in my belief, people were relying that the asset was going to go up in price anyway—“So what’s the difference if I have a weak borrower and I lend to somebody who really can’t pay it back? I always have the asset.”

With the asset now under pressure and the borrower under pressure, that market is still frozen. If you didn’t have Fannie [Mae] and Freddie [Mac] there—I mean, you have very high-quality borrowers who’re still able to get mortgages, but without government support, there basically is no functioning credit market.

Very quickly, let’s just talk about, then, small business. Small business is a much more heterogeneous group to talk about. I think that it’s hard to sometimes [distinguish between] small business [and the] consumer and what’s really which; a lot of people borrow against their credit card for their business, et cetera.
But if we get a little bigger into the small-business sector, I think 1) they have less capacity to ride out a cycle. They have less than what large corporates have, cost to take out and everything else to keep their credit worthiness, and 2) the channel that used to lend to small businesses is broken. You know, the CITs of the world, the community banks of the world, the smaller banks—those institutions are not there that have the ability to sort out and underwrite small businesses.

And unlike large corporate, you can’t get enough due diligence from the big ones or from the public to do all the research. So there’s a broken channel of lending to small businesses, and that has a lot of negative implications for the economy. So, the credit markets are at different levels of coming back from the crisis depending on the conditions that they went into this cycle with.

**MODERATOR:** That’s a good summary and a good mechanism for analyzing where we are by breaking up the markets. Panelists, from your vantage point, where you’re most heavily engaged, what are you seeing?

**Bruce Karsh:** Well, I’ll elaborate on the corporate side, which is the area that I specialize in. I think Alan has it exactly right. The thawing that took place on the credit side in corporates started investment grade, and that probably began at the beginning of ‘09, when we started to see, finally, some thawing.

But then, as the months unfolded, I suppose the equity markets turned up first in the middle of March, and I think debt investors tend to take their cue from the equity markets. And it took about almost a full month of the equities going up off the bottom—where debt investors started to believe that, “Hey, this looks like it may be the real thing”—before they started moving in.

Well, here’s an interesting statistic. I think about 85 percent of all the high-yield issuers were trading at, quote, “distressed levels,” unquote, which means 1,000 basis points or more above treasuries. That’s a staggering statistic for those of us in a $1.6 trillion or $1.2 trillion or $1.4 trillion market.

But that was how scared people were. And the fear was that there were going to be 25 percent defaults, that it was going to be another Great Depression. But as the equity markets took hold, as the recovery in the equity markets took hold, some of the braver investors started to come out and buy high yields, and the spreads started to come down. And in retrospect, the high yield was probably the best place to be in 2009 because I think, probably, the market was up about 55 percent versus the investment-grade market, which may have been only up about 20 to 25 percent.
MODERATOR: So if I hear the story on the corporate side, things are indeed on the mend. I know, Seth, you were engaged very heavily on the consumer side as it relates to mortgages and auto finance. What’s your perspective on that piece of the market?

Seth Gardner: I’m a bit less sanguine about whether there’s real recovery going on in real-world lending. Certainly there’s been a flight to quality, which would be a rational reaction by lenders. But there are two things that are going on. One, there is a lot of artificial stimulus in the system, vis-à-vis the government. So from a true capitalism or future-capitalism perspective, it’s a little bit hard to say that we’re on track as a capitalist society with the amount of stimulus that’s still bubbling through our veins.

Number two is that when you look at some of the core statistics about what’s going on with availability of credit and lending, just last week in the New York Times it was reported that the credit card companies have withdrawn $1.3 trillion of unused credit lines in the last two years. That was a third of the capacity of credit cards.

So whether or not those individuals or small businesses should have had this in the first place is a debate for later on. But there is a continuing contraction at the lender level of not seeking risk. When you look deeper at Fannie’s credit statistics, just as an example, their average loan to value in 2007 was at 77 percent. Their most recent book in 2009 is at 66 percent. The average FICO [credit score] that they were underwriting in 2007 was at 711, and they’re up to 762. And FICO [scores] below 620 comprise 7 percent of the 2007 origination book, 0.3 percent of the 2009 book. Now, is that good or bad in terms of underwriting standards? This is something that we can debate. But it highlights the fact that the constriction of credit or the gravitation toward the highest and the best is still going on, and it’s difficult to forecast a true organic recovery unless the credit starts flowing down into riskier levels.

The long healing process

MODERATOR: So a very mixed message. We have the corporate side somewhat healing and the consumer and real-estate side still pretty far from where they were and probably where they ought to be.

Brian Cartwright: When you look at the leveraged nature of, let’s say, the consumer, it’s about 70 percent of the economy. So, if we’re going to have an economic recovery—and I would say the liquidity crisis is over, but the economic crisis is far from over—the consumer has got to come back.

But US households are carrying debt that’s about equal to the GDP. Put that another way, just unpack it: that means all of our households in aggregate have borrowed an entire year’s worth of the production of the entire economy. When I was growing up—that was a while ago, but still—it was about half that. And I’m not sure where the right number is, but
it would seem quite plausible that we now need to do a good deal of deleveraging, which means people have to save rather than consume. That would seem to be a big negative for an economic recovery.

And we’re also hearing that on the small-business side; whereas the capital markets, investment grade, high yield, even, are working pretty well, in fact maybe very well under the circumstances. And that serves larger companies, because you’ve got to be big enough before you can actually sell securities.

For smaller companies, that side of it isn’t working. And in fact, it’s not clear how soon it’s likely to start working again for various reasons we can talk about. So, isn’t the bottom line—and this really is a question; sounds a little tendentious, but it really is a question—isn’t where we are today that we’ve gotten past the capital markets crisis but that the economic crisis looks pretty bleak?

**Toos Daruvala:** One rough-and-ready way to think about this is we’re about two-thirds of the way through. Banks have taken down about $1.8 trillion in losses on US-originated assets globally. By our reckoning, the total number should actually cumulatively wind up being about $2.5 [trillion] to $3 trillion.

So we’re about two-thirds of the way through the write-downs and the mark-downs that have happened. We’ve got about a third of the way to go. That’s going to take a little while longer. And as certain others have pointed out, the consumer sector, particularly the residential-real-estate sector—credit card losses—are very much yet to come.

**Bruce Karsh:** And he didn’t mention commercial real estate.

**Toos Daruvala:** Commercial, absolutely—another huge, huge sector that had huge leverage buildup before. So that’s one observation. The other point we haven’t really raised here is that this buildup of leverage that we’ve had leading up to the crisis is a global phenomenon. It’s not a US phenomenon.

And it becomes relevant, I think, as we think about the economy and the broader healing that’s going to be required at a global level, frankly. Because, you know, heading into the crisis, the US was at about 275 percent of debt to GDP. But you had a whole bunch of countries—the UK, Japan, France, South Korea, Spain—all of which had debt-to-GDP levels that were 350, 400, north of 400 percent, in the case of UK and Spain.

So, this buildup of credit, of leverage in the global economy, is a phenomenon that’s happened well beyond the US. I think we just need to keep that in mind. And my final point is, is this a demand problem or a supply problem? Which is, there’s an awful lot of bank bashing around credit, and, you know, [the notion that] banks should lend more. And,
of course, to some extent that’s true. But the reality is, coming out of a recession, you’re going to have consumers with bad-credit histories. You’re going to have small businesses with really impaired credit situations. And you can’t, on the one hand, expect the banks to recover and heal the balance sheets and, on the other hand, expect them to be also lending money to marginal borrowers. And I think we’ve got to keep that in perspective as we think about this problem.

Global rebalancing

David Rubenstein: The situation, with respect to credit, in my view, is that because our financial institutions in the United States were so levered and that we had so much debt and we really exported that concept more or less to Europe, that as we de-lever—and it’ll take years to do this—the markets that are going to pick up and benefit will be the so-called emerging markets, which were not as levered as we were.

And by the year 2014, the GDP of all the emerging markets, so called, will bypass the GDP of the so-called developed markets. So not only are their GDPs going to be greater than ours, but their balance sheets are going to be much better. All of us on this panel grew up in a world where the US was the dominant economy in the world. Many of you are going to live in a time when US will not be the dominant economy in the world. And your children are going to be in a time when the US will certainly not be even close to the dominant economy in the world. China will probably be the largest economy in the world by 2030 or 2035, and then India will probably be, not long behind that, number two in the world.

We won’t be marginalized, but we won’t be as big as we have been. But I do think that the emerging markets are going to be able to take even more advantage of this situation because their balance sheets and their banks are not anywhere near ours. A perfect example, as you, [Toos], said, our GDP in the United States, roughly, is 70 percent as consumer spending.

The equivalent number in China is 30 percent. China is trying to increase consumer spending, but they’re not going to get to 70 percent anytime soon. And so I think that the emerging markets, particularly the largest ones, the ones that, quote, “have emerged”—China, Brazil, India, Korea, Taiwan, Turkey, Saudi Arabia—those markets are going to zoom past where they would otherwise have been, because they’re not going to be hobbled by the kind of debt that we have.

Brian Cartwright: I would just like to underscore what was just said, in terms of the significance of a global view. The United States became the largest economy measured by GDP in the middle 1880s. And we’ve been there ever since. At the end of World War II, because of the devastation of the rest of the world, we actually were about half or close to half of global GDP. We’re now somewhere between a quarter and a fifth. But, the point
is that the rest of the world matters, and because we’ve been so big for so long and we’re such a large country and most of us all speak English, I think we have a somewhat inward-looking perspective.

And when we have a problem like the one we just had—and it’s absolutely true, it was a global problem in many dimensions—we talk about house price inflation. Well, the house price inflation in the United Kingdom, in Spain, in Ireland, and you could go down a very long list, was actually more than two times as great as it was in the United States.

So there’s a lot going on in the rest of the world. If you just pay attention to the headlines and what you’re seeing through the usual sources, you don’t give enough weight to that. If you pay more attention to what’s going on elsewhere, you’ll have an edge, I think. Because, I think what David said is absolutely right. We’re not going to be the number one GDP economy forever, in all likelihood, and even if we did, it would be a much smaller number.

David Rubenstein: What will also change, I think, is our ability to influence people. And let me explain what I mean. Even if you’re the largest economy in the world, that doesn’t mean people have to listen to you. They probably will. You’ll have some ability to influence things because of your size. But, many times, people have moral authority and they have the ability to be a role model even if they’re not the largest. Nelson Mandela is a great role model for people. He may not have been the most powerful business or the most powerful political leader in the world, but he was clearly an enormous role model for people, even though he came from a country that wasn’t a dominant country in the world.

Our ability to be a role model isn’t as great as it once was, because we don’t have the moral authority we once did. We used to be able to tell people, “Here’s how you should conduct your economies. Here’s what you should do. Here’s how we’ve done it in the United States. Follow our lead, and you’ll be fine.”

Well, now people are looking at us and saying, “Well, wait a second. How are you telling us what to do now when you screwed up so much?” So not only will we be going down in terms of GDP and influence, but our moral authority has really reduced a lot.

Alan Schwartz: And therein lies our recovery. I think that there’s a lot of issues, though, that it’s great to put out there as separate issues, but they’re all interconnected. Seventy percent of the economy is the consumer sector. Doesn’t have to be. Used to be 62 percent. Doesn’t have to be 70 percent.

Part of that came from a maturing population. Part of it came from a maturing economy, and you kept the credit bubble going. We used to say that when the US got a cold, the rest of the world got the flu, right? Now we’re sitting here, and I said just the other day, “If you
look at what’s hitting the markets, one day China might tighten monetary policy and the US market goes into a tailspin.”

Who’s the engine? Who’s the caboose in that equation? Greece has a problem, all of a sudden the developed markets are—the interconnectedness of this says there’s a whole new model, and we can’t reflexively say, for example, “If the consumer doesn’t start borrowing again, then the economy can’t go.” You look at our current-account deficit. If you take away commodities, which are pretty self-financing, our current-account deficit has moved back into just about balance.

That was a huge drag on GDP. So we could produce goods that Chinese consumers buy, and that has one impact on the economy that allows US consumers to save. The issue is that all of these things come together. I would argue that a lot of what happened with this asset bubble came from the first wave of globalization. The productivity boost that we got from China and India providing goods and services at very low cost created a tremendous excess global liquidity that went into assets that started some of this chain. The way out isn’t simply going to be to go back to the old models and say, “We’re going to have to see the economy behave the way it did when we were the dominant economy.”

**Brian Cartwright:** The point on that is, you’re correct. Their interconnectedness was misunderstood. People thought that the emerging markets, and maybe Europe, were decoupled from the United States and that if the United States had problems, the others could survive.

We’ve now learned that everybody is completely coupled. And not only is everybody coupled and interrelated, but because everybody has instant access to news and information about what everybody’s doing, everybody responds instantly. People in any part of the world know what’s going on in the United States instantly. And so the ability of some markets to really not be affected by what happens overseas is reduced. Because it’s such a small world now and everybody knows everything, we are really more coupled than we’ve ever been, and we’re probably going to get even more coupled in the future.

**MODERATOR:** How do you think all that stuff will evolve over the short run?

**Brian Cartwright:** Well, I think there’s little question that the interconnectedness of the globe is well understood by regulators around the globe. The problem is that there are national interests which diverge, and even within, let’s say, the EU, which we tend to think of as a block sometimes, there’s plenty of national-interest divergence there as well.

So there will be for some time—because we’re unlikely to get world government anytime soon—for some time there will be an ongoing pressure that will lead some measure, but only some measure, of results for greater harmonization, greater convergence. I mean,
[the] Basel [Committee on Banking Supervision] is an example. The council is a body that makes recommendations. It has to be implemented by national regulators. And it has clout; that is, when it makes a recommendation, it is taken seriously. So, it is not simply a waste of time. Accounting standards is another example. Most of the countries around the world have adopted IFRS.\(^1\) It’s well over 100 now that either have adopted or announced that they’re going to adopt. Here in the US, we’re moving in some direction towards convergence, but it’s going to take a while, I think.

**Alan Schwartz**: I actually think it’s going backwards for a time, though. I think harmonization is more like the old light-beer commercials now. They’re standing across the hall screaming at each other, “It’s you fault!” “No, it’s less filling!”

**Brian Cartwright**: If you look back to the ’30s, we’ve been very fortunate in the extent to which we haven’t yet developed globally a beggar-thy-neighbor policy economically. That’s a big difference. And I hope it holds up.

**David Rubenstein**: To some extent, the phrase “globalization” to many people outside the United States means “Americanization.” And many people don’t like that. Or, “Anglo-Saxon capitalism,” in some cases, people call it. So, when we talk about harmonizing things, most people around the world are afraid that what we’re going to do is adopt an American standard, and the American standard is not one that many people like. And so, I know when, for example, [Economic Recovery Advisory Board chairman] Paul Volcker’s rules were announced by President Obama, the immediate reaction in Europe was, “We’ll never do this. Why? Well, we didn’t get briefed on it in advance, and anything the US does we can’t necessarily just jump up and do it.” So, I think you’re not likely to get a lot of harmonization. There will be some discussion about it at G-20 meetings, but they’ll only be discussions.

**Alan Schwartz**: I’ve got a friend at the Fed who said to me the other day, “When the Greek thing hit, all the regulators over there, they’re screaming at us all the time.” He said, “They know damn well that somehow the way we made a loan to somebody in Iowa is what screwed up Greece. They can’t quite figure it out yet, but they’ll try to find a way that everything happening in Greece is our fault and we better chip in.” And so it’s not the right environment for harmonization.

**Rethinking recovery**

**MODERATOR**: Let me pick up on that, because we’re looking at the crisis and it’s recovery that we think is underway, and we’re seeing the implications of the real economy going into recession. In this coupled world, what’s wrong with the following logic: things are getting better, Asia’s growing, the US economy had a very strong fourth quarter, things are looking

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\(^1\) International Financial Reporting Standards.
up for the United States as everyone else is lifting it up, rather than it being the engine of growth—what’s wrong with that view?

**David Rubenstein:** Let me tell you what I think might be wrong with it. We went through what some will call the Great Recession. Now why do we call it the Great Recession? We have recessions in our country roughly every seven years, and they last, on average, nine to ten months.

And on the average, the stock market goes down about 25 percent or so in these recessions, and on average unemployment goes up, like, two points—so if it was four, it will go to six, or something like that. In this particular case, unemployment went up from 4.5 to about, let’s say, 10. So it went up by more than two points. It more than doubled, which is very, very high.

The stock market went down 58 percent, peak to trough, so a very big decline. And it lasted for 24 months, more or less. So, it was the deepest recession we’ve ever had. By comparison, the Great Depression, for people who want to compare it, actually lasted for several years. The stock market went down peak to trough 90 percent, 11,000 banks failed, and there was no FDIC\(^2\) in that period of time. And the unemployment rate went from about 8 percent to about 35 percent in nonfarm unemployment.

So it was staggering. Now this Great Recession, theoretically we’ve said it’s over. Now, why do we say it’s over? Because we have two consecutive quarters of negative growth not occurring anymore. But that is a flawed concept in this sense: we measure recessions by GDP growth or nongrowth. And as you may know, or some people may know, the US government is afraid to say whether we’re in a recession or not in recession. They’ve outsourced that job. They didn’t outsource it to India or China. They outsourced it to the National Bureau of Economic Research. They determine whether we’re in a recession or not, and they’re very careful, and economists are very thorough. And they let you know about a year after you’re in the recession, or a year after you’re out of the recession, whether you’ve been in or out, because they’re very careful.

The problem with our saying we’re out of the recession is that, one, we have debt. We have $14 trillion of debt in the United States, $5 trillion of Fannie Mae and Freddie Mac debt we effectively have, and $41 trillion of unfunded pension fund liabilities for Social Security, Medicare, and Medicaid—about $57 trillion or so.

And to get it in context, a trillion dollars—many people don’t realize how big that is. If the day that Jesus Christ was born a million dollars was put in a bank account and another million was put in a bank account every single day for the next 2,010 years, you still

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\(^2\) Federal Deposit Insurance Corporation.
wouldn’t have a trillion. Well, we have $57 trillion of this stuff we’ve got to pay off. The annual deficit is $1.6 trillion. $1.6 trillion. No other country in the world has a budget of $1.6 trillion. We have a deficit of $1.6 trillion. The president’s budget projects another $10 trillion over the next decade or so to be added to that.

We also have the problem of the dollar. The dollar is better right now than maybe it should be. It’s like what Winston Churchill once said about democracy, “It’s the worst form of government, except every other one.” Well, our currency is the worst form of currency, except every other one right now. The euro is worse.

But the dollar today is worth 15 cents of a 1960 dollar. About 80 cents of a 1980 dollar. And as a result, we’ve been steadily losing the value of the dollar, and it’s going to keep going down because when we have this much debt and annual deficits, unless we do something about it, it’s going to go steadily down.

Unemployment is another gigantic problem. Maybe we should measure recessions by unemployment. The unemployment rate at the low point in the Bush administration was about 4.6 percent. It’s now, theoretically, 9.7 percent. Theoretically 9.7 percent. For black unemployment, it’s about 16-and-a-half percent. Hispanic unemployment, about 12-and-a-half percent. Teenage unemployment, about 25 percent.

But the reason I say “theoretical” is that people are counted as being employed if they have a part-time job. If you counted people who have part-time jobs but who wanted full-time jobs, the overall unemployment rate would be not 9.7 [percent] but 16-and-a-half percent. And we cannot really survive before we solve the debt problem, the deficit problem, the unemployment problem, and the dollar problem.

And these things, as they combine, are going to make our economy very, very weak. Now, where’s the economy going to go forward? How gloomy can I be? Well, the truth is, there are ways to solve the problem. When I worked in government, I managed to get inflation to 19 percent in the Carter administration. So, there’s always inflation that can inflate our way out of this.

But assuming I’m not invited back into government to get inflation back, the only way we’re going to really solve these problems is another D. I’ve mentioned debt, deficit, and dollar, but the other D is dysfunction. We have a dysfunctional Congress and a dysfunctional government in many ways, and unless the dysfunctional government were to agree on spending cuts and tax increases, we’re not going to solve the deficit and debt problem, and therefore you’re probably not going to solve the unemployment and the dollar problems.

The only way I think we can do that is with some type of commission that actually binds Congress in some ways—the same way we close our military bases now on
recommendations of a commission, and it goes into effect unless Congress overturns it. The only way Congress is going to deal with this is if some commission comes forward and recommends tax increases and spending cuts and it goes into effect essentially unless Congress overturns it, and Congress shouldn’t have a vote on it because we’re not going to be politically able to get this resolved.

That’s the only thing I think we can really do to solve this enormous problem. The economy will grow probably this year about 2 to 3 percent. It grew last quarter, theoretically, about 5.7 percent, but that was really a false positive because of inventory purchases. The truth is, 2 to 3 percent is what we’re doomed to, I think, for many, many years in the future. The same is true of Europe. And I think the emerging markets are going to grow at a much greater pace, as I mentioned earlier. So I think our economy has problems for a while, and it’s unfortunate that we’re technically out of a recession, because some people have forgotten that recession means still a lot of unemployed people.

The final point is, I don’t think we’re going into a double-dip recession, because we’re in an election year. Members of Congress will have, what I call, the “kitchen sink approach”: they will throw the entire kitchen sink at this problem. And therefore, they will spend whatever it takes to make sure unemployment is coming down and there’s a perception of unemployment coming down. And the Federal Reserve has made it clear that it’s not increasing rates any time soon. And any time soon means, I think, probably after the election. But after the election, we’ll have to address these problems.

**Bruce Karsh:** But isn’t it possible, though, for the markets to force discipline upon the United States? And that’s why I look at Greece, because basically the markets are forcing Greece either to get bailed out by Germany or to clean up their house in some way or a combination.

**David Rubenstein:** It’s possible. We have one thing that Greece doesn’t have: we can print the money. We can print this money, and nobody else can print money.

**Alan Schwartz:** It doesn’t mean rates won’t go up, but look—I agree with everything you said there. You covered a lot of ground. The markets today are a debate between the long-term bears who—on the outlook for the economy, government spending, and where we are long term—think that zero percent interest rates currently are going to force people to keep chasing return and drive up asset prices, and the long-term bears who think that people will stop chasing asset prices and start to bring them back down.

But nobody has yet painted a picture that’s long-term bullish. And so, we’re going to have to invent that. And part of it is this lack of fiscal discipline. Every time you run into a problem, you say, “Let’s get some more debt to keep the thing going again.” Now we’re back to the last borrower who we can push that onto, which is the government. And so the
government is doing all the borrowing. The problem is, they’re doing all this borrowing during the period where you say, “Before the baby boomers start retiring, we have to pay all of that out. We need some reforms.”

And the period, instead of getting reformed, is we just keep borrowing more and borrowing more and kicking the can down the road. So again, I think ultimately we’ve got to look at a global solution. I just want to paint one thing: back in the ’70s, back when you, [David], were driving the economy for the Carter administration, we had a global situation. We had stagflation. We had terrible conditions in most economies and markets. And if you had predicted at that time—if you had predicted in the ’60s going into the ’70s—the 1970s we went off the gold standard. We went from fixed exchange rates to floating exchange rates. We went from capital being controlled within borders to capital flowing all over the world. We went from deposit ceilings to money being deregulated.

The whole system had to be redone, and I would pick up, David, on what you said, somewhere in this mix part of the reason there are no good currency alternatives is that the places that people want to put their money in the emerging markets are either too small today or you can’t move money in, like China.

None of us can sit here today and paint the picture. But somewhere in here there’s going to be a new global system that emerges out of this, and we’ve got to hope that we become part of that in a positive way.

**Seth Gardner:** David, I just want to note there are some very smart people like yourself that are equally critical of GDP as being the driving metric. Just yesterday, there was released a financial-conditions index that takes into account 42 individual factors in assessing the state of the economy, particularly the US—many of those factors that they’re promoting as being the 2.0, if you will, of economic assessment include credit statistics: the state of the securitization market, the state of lending, things like that; some of the things they were talking about today, not all of them. But the point is, there is a trend and a movement towards a more thoughtful and comprehensive measurement of, how we are doing? The point being that maybe we can see a little bit earlier. Because GDP was going along nicely in 2006 and 2007, but if you probably had an index like this in effect at that time, the hypothesis would be you would have seen things beginning to fall off the tree earlier.

**Preventing the next crisis**

**MODERATOR:** Let me to try to turn the panel’s attention from the recovery and what’s going on now to what’s going to happen in the future. When the president describes the bailout as a “root canal” and we’re looking at regulatory change, there’s a lot up in the air in terms of what’s going to happen to the financial sector. When regulators are done analyzing,
what’s going to happen? What’s that likely outcome? Where will we come out of the reevaluation of our regulatory model as we go forward?

**Brian Cartwright:** First of all, we have to think globally. We have *global* markets, but we have *national* regulators, and we can’t spend a lot of time in the short time that we have here today dwelling on that. But it is an inescapable backdrop of almost everything one would want to do in the regulatory regime.

Then, when you look domestically—first thing when you’re thinking about a crisis is you have to figure out, “Well, what do we need to address?” And for that, you need a theory as to what went wrong. You know, we all read the papers, so I bet everybody in this room has a theory or five or six about what went wrong.

Congress created this commission, the Financial Crisis Inquiry Commission, to look into what went wrong. Its report is due December 15 of this year, after the election. And Congress enumerated 22 areas of possible problems as to what might have gone wrong that the commission should look at.

So, you first need a theory about what you’re trying to do. And one of the things you might be trying to do—and you’re trying to do different things on different time scales—one is, work our way out from where we are today, and that’s a big problem. Another issue, which might be quite different, is, “How do we prevent this from happening in 25 years?”

We know this stuff happens all the time. We just haven’t experienced it recently in our own lifetimes. Every time it comes up, and we’re not really ready for it. Some people say, “Well, I”—and some people even wrote articles and whatnot—“I thought of it. I knew this was going to happen.” But the fact is that the broad consensus view was not that way.

The IMF[^3] is in the business of dealing with crises around the world. So they ought to know when they’ve got hot and cold running, PhD economists to help them out and whatnot, and they do a world economic report twice a year. In the early part of 2007, just before everything went bad, they put out a report that said the risks to the world economy were exceedingly low. And it’s understandable why they did that. You can tick off all the reasons. It wasn’t irrational to be at that place at that time. So what do we do in terms of regulation?

Some of the problems we’ve talked about here are, I would say, macroeconomic. To make a maybe not terribly good metaphor: you’ve got a steep hillside up in the mountains, and the snow is falling down, and it falls down on it year after year after year. And it gets bigger and bigger and bigger and steeper and steeper and steeper. And then, suddenly, there is a loud noise, and there’s an avalanche.

[^3]: International Monetary Fund.
And, after that, everyone focuses on the loud noise and says, “What we need is no loud noises around here, and we’ll be okay.” And when you look at a fair spectrum of good things—maybe we shouldn’t have loud noises; that might be very sensible—but if the underlying problems are macroeconomic and we are dealing with multidecade credit cycles, then that’s all to the good, but it may not actually be addressing what we really need to address.

**David Rubenstein:** I don’t think there’s enough wisdom in Washington, DC, to actually figure out exactly what caused these problems and exactly how to prevent them in the future. In most cabinets in the United States, over the last hundred years or so, the presidential cabinets have on average had 50 percent of the people in the cabinet with private-sector experience. The lowest we’ve ever had is 25 percent. This administration’s is 8 percent.

Now I’m not critical of the administration, I’m just saying that by not having a lot of people with private-sector experience, they probably don’t have people sitting around the table who have the same perspectives on business as people who have been in the private sector.

There are bubbles that are coming about all the time. And typically, when they come about, governments mishandle the problem and overreact and do something wrong. And probably that will happen in this case as well. Just as some people would say Sarbanes–Oxley was an overreaction to Enron, some people will say that what Congress is likely to do now will probably be an overreaction.

Congress won’t be able to pass what the president has proposed, and it’s unlikely that everything that [Representative] Barney Frank has proposed will get passed either. Something will get done. The members of Congress are unable, are unwilling, to go back to their voters before this next election without having passed something that will be seen as a solution. But in truth, nobody can figure out how to solve all these problems.

Greed and fear are always in the balance. And greed will ultimately come back, and whoever is working on the economic system, the financial system, will find some way to find a loophole through whatever antidote is now proposed, and ultimately you will have another bubble in some other area. But I don’t think we should think that Congress is going to be able to come up with some solution right now that’s going to solve this problem and prevent another Great Recession from occurring.

**Seth Gardner:** Particularly if the goal is the silly goal of trying to eliminate asset bubbles, which is like Don Quixote tilting toward windmills. You can’t eliminate asset bubbles no matter what you do. The question is, is it possible to try to limit the amplitude of the cycles so that the peaks and valleys are not quite as devastating? But any type of regulation that purports to have a purpose of eliminating asset bubbles from a capitalist society is silly.
Alan Schwartz: Well, actually you could argue that part of what drove this bubble was quote, “the great moderation.” The view was, we had figured out how to eliminate cycles, and telling people you’ve eliminated the excesses in the market just creates the excesses. But I think, by the way, point number one: I think what I’m hearing out of Washington from the guys working on it, the odds of a bill on financial regulation are low.

There may be some face saving, maybe the Consumer Protection Agency part of it, but there’s just so much dysfunction. Number two, the people working on it say, “That’s good, because most of what we’d have to put in the bill, we, the people working on it, believe, would actually worsen the situation.”

But to make Congress be able to look at something they could take to the world and say works—and they think there’s enough regulatory authority to actually quietly work with the regulators to put in some new ways of looking at things—that will fix some of it. Because we’ve got to remember that a big part of what drove what happened in this last cycle, a lot of it came from things that we deliberately wanted to happen and we set in motion through legislation, regulation, et cetera.

It’s been talked about—Fannie and Freddie wanting to expand their mandate, et cetera. That was considered to be a great thing that we would lend to subprime borrowers. A lot of what happened in the securitization markets came because there was a big concern in the past that all of the bad assets of a credit cycle were stuck on bank balance sheets.

Therefore, when you wanted to get a recovery, banks couldn’t lend and they wouldn’t—so wouldn’t it be great if we pushed all those assets out into the marketplace? And therefore, the banks would be able to lend when the cycle was over. And we came back, and of course what happened is we created this lack of transparency nobody thought about, and it all came back and clogged the system worse.

I think that you’re better off getting underneath and saying, “Look, we’re not going to stop asset bubbles.” There were recurring themes. But there are things that you can look at—that tools were created that took a crisis and made it accelerate and get worse.

And a lot of what happened in securitized vehicles, a lot of what happened in the derivatives market, in OTC derivatives, what happened in the repo markets, were accelerants. Personally, I think it would take a number of bilateral instruments today to create a total lack of transparency in the markets and put them on to exchanges. And I think there’s a big push back against that, but I can’t for the life of me understand why that would not be a better thing for the marketplace.

When people are looking to do repo, it would be much better to say, “Let the market look into an exchange,” say, “I want to lend against that security,” as opposed to, “Am I going to
lend against that security to that guy when there’s rumors about that guy and everybody runs the other way?”

David Rubenstein: And Congress will do something because I just feel they can’t go home without having done something. I’m not sure it’s going to solve the problem, but if there is one more gigantic problem that occurs between now and November, a gigantic stock market drop, a gigantic drop in the dollar, another company or country like Greece goes bankrupt (not that Greece has, but other countries have problems), Congress will feel they have to do something.

And I don’t know exactly what they will do. I always remember what Will Rogers, famous American humorist, once said, which is he’s never quite safe—and the country’s never quite safe—as long as Congress is in session. And I feel you never know what Congress is going to do, certainly before the end of the session.

Toos Daruvala: I agree with both Alan’s and Dave’s points. I think some of the most important things that can be done on the regulatory front are things that you can do without any Congressional approval—things like higher levels of capital, things like a better mix of capital in terms of more common equity in the mix of tier-one capital, things like higher risk-related assets for market risk, things that you can get done through the Basel Committee and through the regulators essentially unilaterally embracing these shifts would all be for the better. Those would all tilt the balance somewhat in terms of the system becoming safer and sounder.

And frankly, if you look at the kind of capital levels of banks going into the crisis, the banks who had capital levels of two to one, below 6-and-a-half, 7 percent, were the banks that were under most distress, without question. So I think some of these shifts can be made and should be made. I think much of the other stuff is overreaching and probably shouldn’t be done.

David Rubenstein: You forgot to mention the preservation of carried interest taxation for capital gains to private equity. That’s the most important thing.

Alan Schwartz: The most important. But remember, just like the IMF, the Fed, in looking at balance sheets, said in ’06 that the bank balance sheets that they oversee are in the best condition they have been in all the years that they’ve been auditing them. So one of the things you have to look back and say—and they could have required them to hold a little more of this or a little more of that—they thought they were the cleanest balance sheets they’d seen in their entire careers. Why? Because when you change one thing, it’s the laws of unintended consequences. So when you say, “Let’s securitize and get these assets off our balance sheets,” one of the things people forget is that one of the reasons capital ratios or leverage ratios rose was on purpose.
It was supposed to happen to keep the capacity higher in the system. The idea was, instead of me keeping all my loans where I have first-loss position, how much capital do you have to hold against a first-loss position versus how much capital—would you rather have the top 10 percent of $2 billion in loans, or the bottom tier of $1 billion in loans? That was the way the system works.

They said, “Well, obviously I would rather lend to somebody who just had the last loss on $2 billion than the first loss on $1 billion.” So people started saying, “OK, I’ll take the Triple A stack, and therefore I can hold $12 to $1 instead of $6 to $1,” whatever. So, we forced leverage ratios up.

The underlying premise was that the way I’m going to regulate all these banks is—since I’m no longer looking at their underwriting standards of their loans—I’m going to look at what the rating is across their loan portfolios. And if somebody’s got a lot of Triple As, I [won’t tell] them to hold that much capital.

So this outsourcing of credit rating from the regulators is the type of thing that you can get underneath, as regulators, and say, “Hey, wait a minute, that was the flaw.” In my opinion, the flaw in the bank regulatory system was the reliance on ratings to tell you how much capital you needed. And all that does is, if you’re in the business you force yourself to go, “OK, my best return is to hold this little capital against those assets,” so people end up accumulating assets that they shouldn’t have in that kind of quantity.

**Reform measures**

**MODERATOR:** How does the industry itself address what it sees as the problems that became more visible as a result of this crisis? To what extent will the markets go back to where they were? To what extent will they be different? To what extent will the markets, if you will, heal themselves?

You talked about the need for clearing and settlement systems that will give us more transparency, more counterparty offsetting, and less exposure. What else is likely to happen, or are we just destined to have the next Kendall bubble in seven to eight years, which is his estimate of the cycle period?

**Alan Schwartz:** It will take longer, but I would put it on the laundry list. I don’t know what’s going to happen, but I would bet some part of this list will probably happen. I think there will be some consumer protections built in, certain standards as to what you can and can’t do in lending money or issuing credit cards or things like that to consumers.

I think that one of the big causes of the crisis is that when you separate underwriting standard from risk, you’re going to get low underwriting standards. So I think that some measure of “if you create it, you’re going to have to eat some of your own cooking” is
going to come out. I do think that one of the areas that they’re going to look at for greater transparency is the whole area of repo.

I think it makes no sense to have all bilateral repo agreements, and I think that what you would see is that whoever was the clearing agent would have earlier warning as to whether there’s a problem with one of the counterparties to there, because they have that role.

I think that things like derivatives, the bulk of derivatives, should be put into more of an exchange type—and again, with margin posted on a regular basis instead of these bilateral food fights over raising margin requirements at the last minute. Looking at the business models, I want to say one thing. I think this Paul Volcker idea that the problem is that these depository institutions take on too many other areas, and there’s a lot of risk—actually, personally, I have huge respect for Chairman Volcker—but I think that’s backwards. I think that if you look at this crisis, and we’re talking about what the taxpayers should be on the hook for, where’s the concern about the taxpayer stepping in? The diversified financial institutions, the large ones, are where the taxpayers had to put up money, but they’ve gotten paid back at a profit.

If you look at the biggest drain on the system, it has been Fannie and Freddie, and they are monolines. So, it’s not saying that diversifying their business model got them into trouble, it’s actually saying, when the business line you’re in is the only business line you do, you’re more likely to go over the edge than pull away. It isn’t the business model that caused the problem. What it’s really about is this issue about what assets are flowing through the whole system in a nontransparent way.

**Seth Gardner:** I would add that the credit-rating agencies are a sitting duck for reform. The role that they played in their imprimatur on the rates, and their lack of transparency in the assumptions that were underlying their ratings, is something—and the appearance of conflict of interest, being paid by the issuer for the ratings. If you’re negotiating over ratings, there’s something intrinsically wrong. That also speaks to harmonization globally, that there could be a consensus on transparency and disclosure of credit-rating agencies and their assumptions.

**David Rubenstein:** The rating agencies need much more respect, and also they need to compensated better. How many people grow up and say, “I really want to go work at a rating agency.” Not that many people. That’s because they’re inadequately compensated, certainly for the responsibilities they have. We need to really change that, I think.

**Brian Cartwright:** The rating-agency problem, however, is not as straightforward as it might seem at first blush. There has been much attention paid, appropriately, to the conflict of interest that the issuer, who wants the good rating, is the source of the funding
for the rating. The leading competition for that is subscriber pay—Moody’s with subscriber pay from around 1920 to around 1970.

And the reason that they moved away from subscriber pay is the same reason it’s not good to be in the music business right now. It’s the free-rider effect. It’s very hard to capture as a proprietary right the benefits of a rating when it’s information and the information wants to be free, as we’ve all been told. So, it is difficult to restructure the industry. And the third alternative, most people shudder at, is to have the government do it.

MODERATOR: So how will things change as a result of what has just transpired? And, if you have your pick list, let’s hear it.

Toos Daruvala: If you look at much of the industry over the last 30 or 40 years, the return on equity in the industry, in the banking industry in the US, has been basically around cost of capital: low to midteens. Sometime in the mid-’90s, when we embraced securitization and more leverage much more aggressively than we did before then, there was a disconnect, and you see 10 to 15 years of 20 percent ROEs for the US banking industry.

My prediction is, we’re going to see low- to midteen ROEs. You’re going to go back to an industry that’s going to settle somewhere in the middle, between the last decade and the prior 25 or 30 [years], but an industry that is somewhat safer, somewhat more boring. Yes, securitization will come back. It’ll come back in more plain-vanilla structures, Alan, much along the lines of what you’re alluding to.

But you’re going to find ROEs that are more midteens, as opposed to 20-plus percent. You’re going to find lower levels of leverage, and the regulator, like it or not, is going to be a force to be reckoned with in the US. The balance between innovation and safety and soundness has gotten pushed to an unsustainable direction, and we’re going to see a much tougher push towards safety and soundness.

MODERATOR: Brian?

Brian Cartwright: Well, prediction is very difficult, and I think as we sit here today, we’re in a certain environment. But if we experienced a dramatic shock of some kind that we don’t envision right now—since the world is unsettled, it’s not too unthinkable that three months from now something dramatic might happen—then all bets are off in the political process, and who knows what might come out.

Alan Schwartz: I think there is a huge expected difference in the underwriting of equity securities and the underwriting of a credit or debt instrument that flows through the economic system. So, I think that underwriting standards of equity and debt have been
different for a long time. And then we all of a sudden brought debt right to the equity equivalent. And I don't think it works for that instrument.

**Brian Cartwright:** Putting that aside, let me leave with one final point—and I can only give a theme, because there's not enough time. I think underlying much of what happened is that not so very long ago, banks were the principal intermediaries in the credit markets. Savers saved; they put their money in banks. And banks lent and held to maturity, to make your point.

And we had all those crashes that all these books have accounted for, and over literally centuries people made efforts to try to figure out how to deal with those problems. And it took until 1913 to come up—in this country at least, not in others—with the lender-of-last-resort concept with the Federal Reserve. And that didn't do it, because we still had a bank panic in the Great Depression.

What was ultimately required, and what saved us for so long, was deposit insurance—something that nobody responsible at the time seemed to have really liked. The economists said it was going to cause moral hazard. President Roosevelt didn't support it. But the people demanded it, and that prevented the underlying instability and fractional reserve banking from giving rise to panics and, along with a lot of other things, capital ratios, limitations on activities, all that other bank regulation stuff worked.

Around 1970, we shifted—slowly, incrementally, year in and year out—from that sort of bank-centric system to a system that involved capital markets. The capital markets are more efficient. They're better for both lenders and borrowers. But it meant that a large portion of credit was coming from somewhere other than banks, and we didn’t have in place a preset system that knew what it was supposed to do for a market maker of last resort.

And in key markets, we didn’t have the equivalent that were, in many respects—and repo is one of them, actually—money markets, including money market funds; repo is probably bigger and, actually, more important; it’s wholesale, it’s not so visible to people. We didn’t have what was developed so excruciatingly over so long.

What we really need, probably, is not “no loud noises around here” but to address that shift. And I think going back, a lot of people are saying, “Oh, we liked the old days.” Maybe Chairman Volcker is a little bit of that school. That’s not going to happen, and it’s probably not a good idea, because we’re not living in that world. But we need to move forward, and that kind of thinking hasn’t been done, I don't think—you don't read about it in the newspaper. It needs to be done in a much more focused way.
**Seth Gardner:** I will remain skeptical about any aspirations about significant macroeconomic recovery until I see a sustained retrenchment in unemployment—consistent retrenchment. And that is not going to happen until there is credit flowing back to small businesses, because those will ultimately be the employers that will absorb the unemployment. It won't be the big corporations that will then go on a hiring binge, in my view. They're too lean and mean and too strict about it right now. So until credit starts flowing to the small businesses, I don't see an unemployment recovery. And without an unemployment recovery, I don't see a true macroeconomic recovery.

**Bruce Karsh:** Well, I worry about the next shoe to drop: commercial real estate. It's going to be a big problem. And also, I'm concerned about the withdrawal of the government stimulus, which is starting to happen and will accelerate at some point. And I'm particularly worried about when interest rates start going up from zero. All those things concern me. And I wonder whether we're not living a little bit in a fantasy land right now, given where security prices are, credit spreads, backed credit, equity prices—given what's still ahead of us.

**David Rubenstein:** Let me just add to what's already been said: I worry about the demonization of the financial-service industry. The financial-service industry has been one of the great industries in the United States. We dominate the global-financial-services world. We dominate the private-equity world in the United States.

And yet, now, we're here in a situation where, if you make too much money in the financial-service industry, you are feeling like you should be penalized, and you will be penalized. And I think it's a very sad state of affairs where people in Washington now feel that the financial-service industry is more or less a piñata they can beat up on. That's going to discourage bright people from wanting to go in the financial-service industry.

It's going to drive some people out of the financial-service industry who just don't want to be beat up everyday or have their bonuses in the newspaper or have people criticize them for the amount of money they may have made or something. I hope that we can get past this period of time relatively soon, so people in the financial-service industry can once again be proud to be in it and it can once again provide the services that are so useful to our economy and the global economy.

**Alan Schwartz:** I'll say one last thing on that, because I think it's a very good point—not just about financial services but as it relates to the attitude towards business and investing. I think, to Bruce's point about withdrawal of the stimulus, the best thing that could happen to the economy is to withdraw the stimulus and let those same dollars be in the private sector to invest in ways that are actually productive, instead of allocated by district.
But that’s not going to be replaced. Part of it is the mechanisms, but I’m actually less worried about that. If you go back to the Depression, when historians look at the Depression, you start with the great panic and depression, and then what’s called the Great Continuation. Why did the economy just not recover over all of that period of time?

My belief is, it was the lack of private investment, and I’ve seen a lot of studies that say the lack of private investment correlates very well to an antibusiness attitude coming out of Washington. What I see out there by talking to people is they, small businesses, are not going to hire. The ones that have credit, the ones that have the balance sheet, they’re not hiring people until they figure out what the cost of hiring those people is going to be through things like added mandates and things like that.

And so the attitude toward business and toward thinking that the private sector should be doing the job instead of thinking the government should come up with another round of stimulus, I think, is going to be the critical issue. It’s amazing, with all of the problems we have, if you let the private sector actually go, and you let the entrepreneurship that’s talked about here—and talked about other places—find places to put capital and grow, if you encourage that and let it happen, it’s going to be a lot better than if you think the government’s going to come up with all the answers.

**MODERATOR:** On behalf of everyone else, thank you very much to the panel for spending the time.