

# Annual Meeting Keynote Economic Address

*John Plender, Senior Editorial Writer and Columnist, Financial Times*

*The following is a transcript from the AFIRE 2007 Annual Membership Meeting.*



The title of this conference and the subject of my address is: The End of the Beginning? What a wonderful time to be posing the question in the light of the turmoil in the credit markets. But let me warn you at the outset that it is exceptionally difficult

to provide an answer because a lot of endings and beginnings are going on simultaneously all across the capital markets.

I'm sure you all recall that it was only a short time ago that Ben Bernanke and Hank Paulson were assuring us this financial wobble was a containable problem limited to the US sub-prime mortgage market. Since then, hedge funds have been running into trouble from here to Australia via Europe. The US sub-prime market has infected an important chunk of the German banking system. The Bank of China turns out to own \$10bn-worth of US sub-prime paper. And last week in the UK, people were lining up in the streets to withdraw deposits in a 19th century-style run on a sizeable bank that was the subject of a rescue by the Bank of England.

The bank had no exposure at all to the US sub-prime fiasco, but was a victim of the generalised liquidity squeeze that started in the US. I've looked at many financial crises over four decades and this has the potential to become the worst I have ever seen. So what does it all mean? And what, more specifically, does it mean for real estate? Well, what I would like to do is to:

- put this extraordinary financial crisis into a broader economic context;
- look at the impact of the crisis on the real economy;
- consider the implications for asset allocation and for real estate; and
- hazard some predictions about where we go from here.

The crisis has been variously characterized as a liquidity crisis, a credit crunch, a re-pricing of risk. There is an ongoing debate about whether it is a crisis of solvency or of liquidity. Yet despite the tens of thousands of words that have been expended on the subject, there has been a tendency to ignore the wider economic context which holds the key to any real understanding of events in the markets. What this major financial dislocation is telling us is that the benign era of high global growth, low inflation, buoyant assets markets — sometimes referred to as “The Goldilocks Economy” — is at an end.

A vitally important part of the background to this economic cycle has been the glut of savings in Asia and in the petro-economies. These countries have been saving on a scale that is potentially deflationary because it reflects deficient demand in the same way that excess savings caused deficient demand and then slump in the US in the 1930s.

But we haven't had deflation. That is because we live in a globalized economy in which frenetic financial activity, including securitization — which is at the heart of our current problems — has temporarily provided a palliative. Securitization helped satisfy the surplus saving countries' demand for assets. As the savings glut lowered the risk

premium in all markets, banks responded to the resulting demand for yield by slicing and dicing risk in asset backed securities. Against the background of falling interest rates and yields, leverage in the system increased dramatically. Not only did households, hedge funds, private equity houses and other financial institutions increase their borrowings. They racked up economic leverage through derivatives, whereby a small outlay wins the investor very large exposure to risk and market movements.

We have been deluged with structural products, off-balance sheet vehicles of every kind, which appeared to offer attractive yields in a yield-compressed world. This was how much of the savings glut was recycled, while deficit countries — most notably the US — obliged by spending more than their incomes.

The recycling suited everyone because it solved an immediate problem — just as the petrodollar recycling episode did in the late 1970s. But as in the 1970s, there was a snag. The trouble with the solution to the problem of global imbalances between surplus and deficit countries was, in the economists' jargon, that it was morally hazardous.

The nature of securitization is that banks no longer keep loans on the balance sheet. So they no longer have an incentive to keep up the quality of their lending — that's become someone else's problem. With credit quality declining, standards and covenants weakened. And this wasn't just in sub-prime mortgages. Think of cov-lite loans in the corporate sector, for example. In fact, deteriorating lending standards were a generalized response to surplus liquidity in the global system.

So we ended up with a rip-roaring credit bubble.

The credit cycle was elongated, so that the credit default problem that builds up in every cycle reached bigger proportions.

But now the Goldilocks Economy is being dismantled. The first thing to give in the benign recycling picture was inflation. For a very long time China has been keeping everyone else's labor costs low. But now that's history. Wasteful Asian use of energy and metals has driven up resource prices. And now food prices are rising in China and elsewhere.

In financial markets, higher interest rates and soaring house prices have knocked housing

affordability, so US house prices are turning soggy. The same is happening in the UK and in the other Anglo economies, such as Australia, and in some of the continental European economies, such as Spain.

And while all this has been going on, the sub-prime saga has finally punctured the credit bubble. Risk is being re-priced across the system, not just in sub-prime.

This serves to remind us

that we have been living through a pretty freakish economic cycle which has culminated in the unwinding of the credit bubble across the world. Leverage is being unwound. And we now confront a financial crisis in which nobody wants to buy CDOs, CLOs and all the other exotic paper products that the investment banks have churned out. Nobody has the faintest idea what all this paper is worth.

Trust in the interbank market has evaporated, while three-month Libor rates have soared. The junk bond market has dried up. The paradox is that while markets are drying up, there is still a glut of savings. But the savings are engaged in a classic flight to quality. The very non-toxic IOUs of the world's

**“In financial markets, higher interest rates and soaring house prices have knocked housing affordability, so US house prices are turning soggy.”**

biggest governments are back in fashion.

Everything out there is very messy. The opacity in the newer markets is such — the financial world has become so murky — that banks don't know how much they've lost. So the interbank market is in the grip of fear.

The rating agencies that cooperated with the investment banks, advising on the structure of exotic products, are discredited. No one trusts their ratings any more. They are already the obvious scapegoats for the politicians to blame, especially since their activity involves important conflicts of interest.

Bear in mind that there has never been much of a market for all this complicated paper the investment banks have churned out. The result is that there is a valuation problem. Instead of marking to market, banks have been marking to model and the models are flaky. The accounting for off-balance sheet entities is pretty flaky too, since profits have been declared on the supposed sale of loans that are now forcibly coming back onto bank balance sheets. On the Richter scale, this is a crisis to rank at least with the financial crises of the mid-1970s, 1982, 1990–91 and 1998. In my judgement, it is worse.

The current focus of the drama this week is on Northern Rock of the UK. It was over-dependent on wholesale market funding and thus vulnerable to the drying up of the commercial paper market. It would be nice to think it is an exception. But there must be a risk that this is a beginning, not an ending. The liquidity tide is going out. And to borrow a phrase from Warren Buffett, it is exposing all those who weren't wearing their swimming trunks.

Despite the best efforts of central banks to inject money into the markets, the key to preventing

further liquidity problems is not in place. Until we have some sense of the size of the losses in the system, confidence will remain fragile. And because the problem is global, we cannot do what happened in Japan earlier this decade when the authorities addressed a bad debt problem by launching an authoritative and intensive investigation to put numbers on the extent of the damage. We have no global authority capable of doing what is needed to permit everyone to price all the complex and toxic paper around the system.

What does this mean for the real economy?

The optimists say there is no need to worry because

the global economy is robust. Well, it is true that economic growth is robust. But that is a coincident indicator that tells you nothing about the future. In so far as there is merit in the argument, it lays in the fact that Asia, as well as going strong, remains largely untouched by financial problems. Continental Europe is performing quite well.

But it remains a mixed picture: Japan, the world's second largest economy is looking sick, under the weight of an excessively tight fiscal policy, and has not fully escaped from the risk of deflation despite a very long export-led economic recovery.

The key point, though, is that the US economy is not as robust as it looks. It has been characterized for many years by stagnant incomes. Growth has depended for far too long on households running down their savings and running up mortgage debt in the housing markets.

The fact is that economic growth has not been soundly financed, so the economy is vulnerable. The imbalances are such that the US current account

**“The fact is that economic growth has not been soundly financed, so the economy is vulnerable.”**



deficit peaked at a phenomenal 7% of gross domestic product (GDP). Now the housing market is weak. And believe me, it will get weaker. All those teaser rates agreed in the boom times will be recalibrated in a brutal adjustment that will continue relentlessly for an uncomfortable period of time. Compounding the problem is that growth has been unbalanced with financial services accounting for a disproportionate share of GDP. With the credit squeeze, that now becomes a serious disadvantage.

Growth in the UK is likewise very unbalanced in the sense that it is very biased towards finance, even more so than in the US. A great deal of economic growth and of corporate profit comes from financial activity in the Anglo economies.

These economies are also hostage to an extreme degree to asset prices, particularly for housing and equity. This vulnerability is exacerbated by the fact that, in these economies, defined-benefit pension schemes infect the corporate sector and its appetite for risk taking. If bond prices are going down, the value of pension fund liabilities is increasing. And there is heavy exposure to equities. Those prices have been relatively weak, which is a potential Achilles heel for the corporate sector. This is an issue that doesn't come up so much in continental Europe and other parts of the world, and because of it I feel fairly certain that the continental economies are going to be looking much more robust than the UK over the next two or three years.

So some of us do have a problem with an excessive financial orientation. An example is that a lot of the strength in labor incomes in the US at the moment has come from incomes swollen by real estate commissions, market-related bonuses, stock options and so forth. It's another effect of that financial orientation on the workings of the economy.

The final point I'll make about this — at the risk of repetition — is that although the global economy is growing very well, it's not being soundly financed. It's been overstretched by extreme global financial imbalances. I think the big risk now is that

securitization, which had been one of the means of mitigating the impact of excess savings in Asia and elsewhere, has seized up and the American desire to borrow is close to exhausted because of declining house prices.

To put the imbalances problem in very crude terms, continued global borrowing and spending requires the asset side of the US household balance sheet to keep growing. But what is happening in housing and financial markets today suggests pretty strongly that that is not going to happen, which is a real problem.

To put the situation in historical context, we have lived through what was the biggest credit bubble of all time. So it's hardly surprising if, when the bubble is burst, households become more risk averse and start to rebuild savings and pay down debt. The problem is that it means the global financial imbalances could unwind much less smoothly than we would hope.

One of the risks is a dollar slide. Many central banks around the world already are seeking more diversification in their reserves — there is constant talk among official reserve managers of a shift away from dollar assets. This certainly creates a vulnerability.

I am sure the Asians and the petro-economy people will continue to want to save excessive proportions of their incomes, but the trouble for them is that those incomes are going to shrink as the US economy slows (which it's certainly going to do) and as the US housing market continues to deteriorate. It is a fact that both the Japanese and the Chinese economies are very, very export dependent. Japan's recovery in this recent upturn from its terrible problem with deflation is primarily to do with exports, not with any revival of domestic demand. So I think there are real concerns on both sides of the imbalances.

At the risk of extending the agony, the history of financial crises provides another reason for skepticism about taking comfort in the robustness of the global economy in squaring up to the financial crisis. Back

in 1997 and '98, Asia's tiger economies were going like crazy — there were fantastic growth rates. Precisely the same argument you hear today could have been made then. But look what happened.

The trouble was that that growth in Asia was unsoundly financed. There were huge currency mismatches in the banking system. The phenomenal loss of employment created the seeds of the trouble we're now in. It made these countries so risk averse that they accumulated vast official reserves in order to protect their currencies from future shocks. Of course, that is one of the generators of the Asian savings glut.

So anybody who offered the robustness of these economies as evidence against trouble in the financial system was clearly wrong. And at the risk of sounding alarmist, much the same was true in the US in the 1920s. There are a lot of very interesting similarities between today and the 1920s in the US.

First, as was true earlier in this decade, productivity growth in the US economy was very high, as were corporate profits as a percentage of GDP, and there was a very high level of financial activity in extraordinarily buoyant asset markets. None of that prevented the slump or the subsequent problems in the banking system.

Against the backdrop of that sort of alarmist historical comparison, the good news about our present situation is that I think the US will not go the way Japan did after its economic bubble burst in 1990. You won't get a decade of incipient deflation like Japan had because I think policy makers here and across most of the developed world have learned the lessons of the 1930s.

I feel wholly confident that all the levers of monetary and fiscal policy will be used in this country to make sure that there is not a deflation, and I would take a modest bet with anyone here that, apart from a loosening of monetary policy starting this week, there will probably be a loosening of fiscal policy next year, including tax cuts. You can see the logic for the Democrats and it's hard to see how a lame-duck president is going to stand in the way of

a potentially popular tax cut. I think that's a pretty good certainty.

But there is still the problem of all economics: lags. We will see an interest rate cut, though we don't know how large, this week. But that cut won't show results for 12 to 18 months, so this not an answer to the immediate problem of a soggy housing market. There's also the question of whether monetary policy can do much in that circumstance.

In the early 1990s, monetary policy was loosened quite a bit in a situation rather like the present, but commercial property was in trouble as well. No matter what the Fed threw at the economy then, people could not be persuaded for a very, very long time to borrow and spend. If people have negative equity, if they've been badly hurt by falling housing prices, monetary policy does not work very effectively. This is part of the reason I think fiscal policy's tax cuts are more than likely to come along next year.

Some people hope corporations will come to the rescue, and it's true that the sector's balance sheet is in relatively good shape today. But, can you convince yourself that the corporate sector is going to invest very heavily when it can see that household demand is set to weaken? That doesn't sound terribly plausible to me.

There are a number of ironies in all that's going on. Alan Greenspan and other central bankers welcomed the high degree of financial innovation. They welcomed the tremendous growth in the derivatives markets and structured products because they expected it to disperse risks around the system and that risks would end up in the hands of those best able to bear it. Central bankers also welcomed the fact that securitization was removing liabilities from bank balance sheets, since this was assumed to reduce the risks of a systemic shock in the financial system.

Well now we know better, or at least we know that we are pretty ignorant about where the risk has ended up. We are finding out only as the liquidity tide recedes. The liabilities that were supposed to have been removed from bank balance sheets turn out in



many cases not to have gone — there were special investment vehicles (SIVs), banks provided contingent credit backup. Now nobody will refinance those SIVs and conduits and the liabilities are coming back onto bank balance sheets, which means that the bank capital positions are much more constrained than everybody thought.

I think that leads to the question of who is going to carry the credit that's gone wrong? The accountants probably have something to answer for, because if there were contingent credit agreements with the conduits, it seems pretty bizarre to me to have said that they were off-balance-sheet and should not be consolidated in group accounts. This is flaky accounting to my mind, so I think fingers will probably be pointed in the direction of the accountants.

Another worry is that central banks' management failed to recognize that the sub-prime problem was a harbinger of the unwinding of the wider credit bubble. The irony is especially striking since Ben Bernanke's academic work was heavily focused on the relationship between financial markets and the real

economy — he's a noted expert on the 1930s and the slump. But his response to the present situation has not been terribly reassuring.

I think when the fuss is over, everybody will recognize that the current style of monetary policy, which focuses almost exclusively on retail prices, has not served us well in this credit bubble. In the future, central bankers will have to focus much more on the behavior of asset prices, which have been sending some very important signals that have not been considered as fully as they should have been.

Let's turn to asset allocations and where all this leads for investors. It's early and it's quite hard to make predictions, but it seems to me that

among the various asset classes, the biggest casualty involves the hedge funds. They promised to deliver absolute returns, in many cases regardless of market conditions. Hedge funds are a very diverse universe, I acknowledge, and lots of different things go on there, but to the extent that they were attractive as an alternative asset class it was because they were interested in absolute return and many claimed to be able to live with that regardless of whether the markets were going up or down.

I think that notion has been delivered a near-terminal blow by the numbers so many hedge funds have produced for July and August. These results suggest that these are not institutions that deliver what they claim to, and that they have been far less

effective managers of money than they led us all to believe. I think many pension fund trustees and other institutional folk will question whether hedge funds really are a genuine asset class or just a reward system for greedy managers. I think there is a real crisis of credibility in the hedge fund business, a perception

problem they will have to address.

Private equity has a rather different kind of problem. Clearly the credit bubble delivered it a huge financial windfall, and with the re-pricing of risk, the going will get tougher. Many private-equity firms now have funding problems, and it's always been an extremely cyclical area of the markets. And this cycle has been so extreme on the way up, it will be amazing if it isn't pretty extreme for them on the way down.

Unlike the hedge funds, I think private-equity firms can put up a pretty good case for being a genuine and interesting asset class with something very positive to offer. There may not be a very high

**“Private equity will show its worth over the long run even if it goes through a bad patch.”**

degree of diversification relative to quoted equity, but they do have an answer to the biggest corporate governance problem of the quoted markets, which is the principal-agent problem. The fact is that there is a better alignment of interest in private equity than there is in the quoted markets. There is a discipline, and if people in private equity do badly, they lose money, which is not the case in the public markets. It's very hard to perceive a real correlation between performance and reward in the public markets when you look at the way managers are rewarded there, with the stock option rewards and bonuses that have been dished out.

I think private equity will show its worth over the long run even if it goes through a bad patch. The problem in private equity is the wide mass of institutional investors. There is a huge disparity in returns between the very good and the very bad. While a handful of extraordinary private-equity houses in the US and Europe do appear to be able to deliver consistent out-performance, it's very hard for institutional investors who are coming late to the party, or who don't command large firepower, to get access to them. So it's an asset class that delivers for big, powerful, long-standing clients like the big university endowments, but for anybody who hasn't been there for years and who isn't a favored client, this is an area that isn't going to deliver terribly happily.

Turning to mainstream investment, one positive about the financial crisis is that equities have been rather resilient. Compared to historic measures, price-earnings (P/E) valuations don't look particularly stretched. But the worry is two-fold on equities. First, the earnings side of the P/E equation is vulnerable for all the reasons I've talked about in connection with a lower-growth environment. In the US and the UK, far too much of earnings is coming from the financial side, where there is inevitably going to be a slowdown. We're going to get an indication this week when the big investment banks on Wall Street release their results.

So in valuation terms, equities are not as good as the historical yardstick would have you believe. But I think there's a much more fundamental point in the US and the UK, which is that the corporate sector has provided equities huge support. The corporate sector in both countries has been running a huge surplus of savings over investment, much of which has gone into equities, partly via stock buy backs, but much more importantly through mergers and acquisitions (M&A), especially those driven by private equity. The fact that the corporate sector has been the main equity purchaser rings alarm bells because it seems to me that part of the support is now likely to be withdrawn, certainly the private-equity part. A lot of ordinary M&A is now going to be harder to finance and will go to the back burner. So I think that big prop for the equity market, here and in the UK, is likely to be eroded if not removed.

At the moment, I don't think bonds look particularly attractive, unless you think the deflationary forces in the global economy are going to win out, which I don't. I think the central banks and the governments will do their jobs, with the possible exception of Japan.

Of course Japan is a slightly troubling element in all these judgments. The Japanese economy is going to be in serious trouble next year because of the extraordinary fiscal squeeze the government has imposed over the past three years. It seems to be a repeated pattern in a way. In the second half of the 1990s, just when you could see the Japan beginning to recover from its long period of stagnation, the Ministry of Finance knocked it on the head with a huge fiscal tightening at precisely the wrong moment. The same thing seems to be happening in this economic cycle.

Japan has had its longest economic recovery since 1945, but it's been almost entirely driven by export demand rather than domestic demand. Nevertheless, some extraordinary, almost religious belief in fiscal conservatism has the government squeezing the economy unbelievably hard at the

worst possible moment. As a result, you can't be certain policy makers will do the right thing when confronted with deflationary problems. But I have greater confidence in US policy makers than in the Japanese ones in this regard.

Getting back to bonds, there is a tremendous amount of inflationary pressure around the world.

I think there's also the possibility that the solution to today's crisis will be inherently inflationary. Central bank bailouts are always morally hazardous in that they carry the potential for future inflation. They encourage excessive risk taking, and liquidity itself can lead into either asset price bubbles or excessive retail price inflation.

I have one or two brief points on real estate, about which I am modestly optimistic. In the short run, there's a problem. Some deals have been pulled, and some are on the back burner. To a large extent leveraged buyers have been removed from the market, which is not helpful in the short run. It's also the case that secondary property is vulnerable at a time of financial uncertainty and declining expectations for economic growth.

To the extent that property benefited hugely from yield compression, any reversion to the mean is potentially dangerous. Having said that, a very important aspect of the present crisis is that it's not like so many we've seen with origins that lie in speculation and excessive supply in the real estate markets.

Another factor is that yield compression in the real estate market wasn't exclusively a function of the credit bubble. After years of being out of fashion as an asset class, property came to be recognized as an alternative asset with genuine diversification benefits. I don't think that's going to change, and I think people perceive that property does deliver portfolio

diversification far better than many alternative investment categories. Given the extraordinary uncertainty at the moment, this defensive quality is particularly attractive to some investors just now.

For my money, the worst scenario in this market is that some of the froth will be blown off the cappuccino. That'll be good news for committed

long-term investors, since it will create opportunities. In the company that I chair in the UK, we're rather excited that a bit of normality is coming back into this market and will create new and interesting opportunities for us. To come to my conclusion, the market you've been operating in has been

hostage to all sorts of forces having nothing to do with property that have distorted the credit and capital markets. But now we are getting back to a bit of sanity and, amid some transitional uncertainty, a period is beginning during which property will retain a well-merited place in the process of asset allocation. I think in this crisis you have a great deal to be cheerful about in a way that many of us do not.

Thank you very much.

**“The worst scenario in this market is that some of the froth will be blown off the cappuccino.”**

## Audience Question and Answer Session

### Question

Can you share your views about where securitization will go in the future? Will we see simpler structures? Will we return to the good old days of portfolio people originating and holding on to their assets? I am curious what you think will replace this. It seems very deeply embedded in the system right now.

### Mr. Plender

What an excellent question. While clearly we're in a period of hiatus now, some of the securitization market will come back. I think the private-equity stuff will

come back sooner than the mortgage-related stuff. But the degree of disillusionment means that it will take a very long time get back to the more complex and exotic instruments, if we ever do. I will be surprised if we see the sort of exotica that arose in the more remote reaches of the market in the next five years.

### Question

(Partially inaudible question about where the overflow of Asian and other saving will go if the securitization channel is closed, even temporarily.)

### Mr. Plender

The short answer is that the alternative is quite conventional. You get a flight to quality, which is part of what you see going on with T-Bills at the moment — there is a flight of money into conventional government debt. But it's not very satisfying because the return is not high, and there is a change of fashion in how managers of official reserves think about their portfolio approaches. They are all interested in diversifying and in yield enhancement. So while at the moment they haven't deserted the US (if they had the dollar would have been a great deal weaker than it has been), it's quite interesting that the dollar hasn't weakened in this crisis in the way some would have predicted. I think there must be a risk, particularly with China trade shifting a bit toward Europe, which would further expose the dollar against the Euro. I think we've simply got a temporary retreat into short-dated government paper, which you would expect in a crisis. What happens after that is where the dollar vulnerability might occur.

### Question

I didn't catch whether you said the Federal Reserve would ease or not?

### Mr. Plender

I think there's no question that it eases this week. The question is whether it's a quarter of a point or half a point. In defense of Ben Bernanke, about whom I have not been wholly complimentary, he has been concerned about the risk of moral hazard, about

bailing out people who have behaved imprudently. The reduction in the Discount Rate without a counterpart change in the Federal Funds Rate was designed to address that problem. A reduction of only a quarter of a percent now I think would send the signal that he's not panicking, that he's conscious of the inflationary risks in the economy. With half a point it looks like he's saying we're in real trouble. If I had to gamble, I would predict a quarter of a percent, though I don't have too much confidence in that forecast. But I have no doubt at all that there'll be a cut, no question.

### Question

John, you started your talk giving us some context about previous financial crises. I think the audience can take from your remarks that this one perhaps won't be a 1930s-style or a Japan-style, decade-long slump, but are you also saying that unlike the 1997 Asian contagion and the '98 problem at Long-Term Capital Management, this one is more systemic and feels longer to you? I know it's unfair to ask how long this would last, but what does it feel like to you in terms of the squeezing and tightening of credit? How long will that be?

### Mr. Plender

Your characterization of my points is absolutely right, but the issue of timing is hugely difficult. The basic problem is the one about opacity. We haven't had a crisis where it's been so hard to identify what's going on, where or what the size is, and we've got these new elements. No central bank has been able to quantify embedded leverage. It's not like financial leverage, where there are easily-verifiable, transparent numbers. We know only that there are all those structured products out there and that they all involve huge degrees of leverage, but how much we just do not know. It doesn't lend itself to quantification.

So I can only give you an instinctive judgment, which is that I think things will get worse before they get better. My worry is that continuing uncertainty will affect confidence and that it will be more likely to

become contagious in the corporate sector. I would be surprised if there weren't still central banks having to pump liquidity into the system beyond Christmas.

So the best I can say is that although I think some parts of the credit market are already coming back, if you are a sound borrower in real estate you shouldn't have too much of a problem. The ones who have problems will be those with mismatched maturities. Anybody in real estate who has been stupid enough to finance in short-term wholesale markets with long-term commitments is going to go bust. It happened in the mid-1970s and it could happen again now, although it should probably have happened already if it was going to. Maybe people have financed themselves pretty sensibly this time round.

The honest answer is that I just can't tell you about timing; it's in the lap of the gods. All I can say is that it's a very unusual crisis in that so much is obscure and hard to read.

#### **Question**

One of the lessons that we learned in 1998 when the debt crisis hit the CMBS market was that the

lower-rated tranches had a permanent rise in risk premium because of the risk that was revealed as the higher-rated tranches found their premiums being compressed back pretty much to what they had been. How do you see this crunch sorting out in terms of the quality of the paper?

#### **Mr. Plender**

Well, that's what ought to happen, but with structured products, so much of the judgment about their risk has been in the hands of the rating agencies. There's such great disillusionment with the judgment of the rating agencies on this that I'm not sure it will pan out like it did back then. I think the best judgment is that that's the way things should go, but people have just ceased to trust the rating agencies at all and their judgment is fundamental to the valuation of all tranches and all instruments.

Thank you very much. ★

## **AFIRE News Articles Being Accepted**

Do you have information to share with other AFIRE members? Want to see your name and that of your organization in print? AFIRE relies on members for articles that appear in the newsletter. If you are interested in writing an article, please contact Lexie Miller a 202.312.1403, or by e-mail at [lmiller@afire.org](mailto:lmiller@afire.org). Articles usually run between 1,000 and 2,000 words and may include a brief description of your company and the services you offer.

