Asymmetric Collateral Damage

Basel II, the Mortgage House of Cards, and the Coming Economic Crisis

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It is a delight and an honor to see you all here, and I would echo John's comments on how wonderful it is to spend time with people who have a number of other things to pursue and have elected to take a few moments of their time to pursue what we're about to embark on, which I would like to describe as a bit of journey. And it's a journey that intends to both take us back and hopefully forward, to understand a bit of the dynamics that drive the logic behind what I would like to share with you today.

Before I do that, I will dispense with the obligatory, which is, who are you listening to? I love to be in meetings with various federal agencies and international entities around the world where people get up and say, “I'm speaking for myself and not for my organization.” I'm not going to tell you that. I'm actually speaking for myself and my organization and for a number of other organizations and interests around the world. So, I do not disclaim anything that I'm about to say. I actually take not only full responsibility but expect everything I'm associated with to bear responsibility for what I say, too. So, there it is: the anti-disclaimer disclaimer.

I'm the CEO of M•CAM, which is probably the world’s most interesting financial institution. We deal with intangible asset risk exposure on a number of levels, including everything from the risks associated with sovereign credits for major infrastructure projects all the way down to rural inventors in Northern Gujarat (for those of you who don't know where that is, I'm not going to help you find it) who actually are trying to figure out how to participate in an economy that seems to be jumping past the agrarian economy and into a knowledge economy without going through any of the other perturbations. And it's always an interesting thing to be involved in what is non-evolutionary but is, in fact, transcending evolution to actually jump forward in time. And so we do a lot of work in trying to understand the ways in which thought is developed, and valued, and contested, and managed, or mismanaged. And our job, ultimately, is to build a means by which there can be transparent stewardship of what we see as an emerging economy.

Now, I like to start with two parables, both of which happen to be both parable and, in some shred, true, somewhere.

The first parable actually starts June of 1815, which I mark as the date of the birth of the knowledge economy. Now, the funny thing is, most people go, “June 1815? Don't you mean 1980 or something?” We get uncomfortable with this notion that the knowledge economy was born before we actually had a mature industrial economy. June, 1815. I'm going to ask you a question, and I like, because I used to be a professor at the University of Virginia, I like to actually have people participate at this point in the conversation. Does anybody know what happened on June 18, 1815?

“I guess Waterloo?”

That's a great guess. What happened at Waterloo?

“Napoleon was defeated.”

I'm sorry?

“Napoleon was defeated.”

Napoleon was defeated by whom?

“Wellington.”

By Wellington. I love to have people who actually know what they're talking about in the room. I love the story of June 18 to June 20, 1815, because there was no battle at Waterloo. If you actually look at the battlefield you know that it wasn't Waterloo at all. In fact, it was quite a bit of a distance from Waterloo. As a matter of fact, if you actually look at the reason why it's called the Battle of Waterloo, you realize that the reason it was called the Battle of Waterloo is because the Crown observers were staying in Waterloo. That was the address of their Days Inn, or their Holiday Inn, or their Grand Hyatt, or their W, or wherever the heck they were staying for the battle. That's where they were, but that's not where the battle was.

Another interesting fact is if you actually look at how Wellington and Napoleon had engaged on that battlefield you'd realize that if you were standing in Waterloo and watching the engagement, Wellington lost. And lo and behold, the Crown observers who observed the Battle of Waterloo knew that Wellington had lost. And so, they promptly packed up their things. It's a good time to get out of town before, you know, people figure out you're there. And they got out of town and they went back to London. And sometime early on the 19th they reported that Wellington had been defeated by Napoleon at Waterloo.

You heard this correctly: Wellington had been defeated at Waterloo. None of which were true. All of which were true. None of which were true. I'm going to let that hang in the sky like a brick doesn't just for a second, because you're going to get to the “so what” of this in just a minute. Because there was another observer on the field. The other observer on the field was a young man who was under the employ of a gentleman by the name of Baron Nathan Von Rothschild. He, unlike the Crown observers, was actually on the battlefield. And it turns out that he saw a very different outcome. Oddly enough, because he was there. That helps. It helps to actually be there to report on what happened. That part helps a little bit. But what was great about it was, as a matter of fact, as Wellington had, as some accounts have it, actually struck colors. There was, in fact, a flanking maneuver by the Prussians, who, with Wellington distracted and Napoleon distracted, came in and actually decimated Napoleon's army, leading to Napoleon's defeat, not at Waterloo.

This gentleman, Rothwell was his name, hired passage across the channel and at 10 o'clock, give or take two minutes, on the morning of the 19th, knocked on the gates at the palace to report that, in fact, Wellington had won. Now, the Crown officially had it from their reliable sources that Wellington had been defeated and they sent Rothwell away saying, “I'm sorry, you don't have the facts young man, go away.”

What happened next is actually recorded in series of archives, and I have to give tribute where tribute is due, to Lord Salisbury, Robert Cecil, who lives north of London up in a wonderful old King James ex-residence. And it turns out that what happened was, Rothwell went to Rothschild and said, “Wellington has won and we believe we lost.” And Rothschild had an idea. He decided to go to the market that day, and most of the accounts establish the time at about 10:18, walked into the London exchange with "his usual lack of frivolity and pallor," and instructed all of his agents to sell all of his shares.

Now this was Baron Nathan von Rothschild, the guy that had the best facts on the ground, best information. And if he was selling everything, not to be too colloquial, but you know what that meant. He must know that the Crown had just been handed a massive defeat by Napoleon. At which point in time, everybody decided to sell, which they did. And by 2 o'clock in the afternoon the estimate is that 86% of the tradable securities of the entire United Kingdom – 86% of the tradable securities of the United Kingdom -- were liquidated in the market in four hours. At which point in time, Rothschild put in buy orders. Now, it was actually several weeks later when Rothschild was allegedly quoted as saying, "I care not what puppet monarch sits on the Crown of the empire upon whom the sun never sets. For he who controls the money of the empire controls the empire and I control the money."

Why would somebody say that? Why would a person make an allegation, which sounds dangerously close to treason, and not only get away with it but be able to keep title to the bank of England for the next forty-two years? Well, because it was true, because he controlled 86 percent of the floatable treasury and securities of the United Kingdom in one trading day.

Was that the knowledge economy at work? I'd say it's a pretty compelling knowledge economy kind of story.

(Question from audience.)

Well, that's a wonderful question and I've had the privilege of sitting down with the Rothschild family on several occasions and I suspect it's a larger number then we all care to imagine right now. But, it is still a large number.

(Comment from audience.)

They certainly still have what we would consider to be a relatively significant interest, in the most polite terms possible. Now the interesting anecdote to that story is that some people don't know Rothschild also was a fiduciary manager of the bank of France at the same time. A lot of people forget that. He was actually fiduciary responsible for the Bank of England and for the Bank of France. And you heard me correctly: they were at war. Remember, they were fighting each other. And this guy, somehow, sat between. Is that the knowledge economy at work?

Now, here's where I leave the reservation. That was a normal, nice little case history and all that kind of stuff. And you can go back and read all the documents and it's all cool. Here's where I leave the reservation. There's a story of an oracle that was outside the city of Troy. And I told you that this was going to be a mix of, kind of, the fantasy of mythology and the substance of fact. That's what I'd like to integrate. There was an oracle that actually stood outside of the city of Troy and said, "What fools are yea to bring this horse into the city, for I know that inside this horse there are men." And people go, well, you know, this is a crackpot futurist over here. This is… they're a member of an Arlington Institute and really, to appease the Gods, we really ought to haul this horse into the city. And that's it, just… that same brick sitting in the air like bricks don't. Okay.

Why do I start with these two stories? I start with these two stories to reassure all of us that neither of these could ever happen again because we now are in the knowledge economy. We actually have divined the difference between the Greek term *eidos** and the Greek term *gnosis.** In antiquities people thought they understood facts, but we now live in a world where we do. And so the reason I start with these stories is to remind ourselves of how far advanced we are and how sure we can be that none of this could ever happen again. You couldn't have a situation where in a single day 86 percent of the stock market could blow away.

That can't happen because we're in the knowledge economy. We couldn't have a day when a horse would be dragged into the city because, after all, we now listen to multi-faceted, multi-ethnic, multi- perspective voices. We respect them, we appreciate them, we've found ways to integrate those voices into our thought process. So, I'm going to take you forward two years. To show you how it could never happen again. There is an event that is certain and the event that it is certain is January 1, 2008.

January 1, 2008 is a very interesting day. Because it is on January 1, 2008 when a very large group of very smart people decided that the international banking and securities and risk transfer markets all need to be able to correspond with one another in fair and equitable and transparent manners. And on January 1, 2008 Basel II becomes the law of the globe.

Some of you don't know what Basel II is so what I'm going to do is take us back in time and think about what Basel II was supposed to address. Some of us will recall periods of time in our own banking system where we haven't had, necessarily, full and candid disclosure of how liquid reserves are that back credit obligations and debt extension and securities extension. And so out of that, we actually evolve things like the 1933 Securities Act as amended, the Banking Reform Acts that most recently took place in 2000. We actually amended our own laws and at the same time the world decided to get together and say, well, we really need to have a unified way to report transparency in financial institutions. And specifically, we need to understand three fundamentals of how banks work.

One is internal process controls, the ability to know that what you're doing is standardized and reproducible, Think OCC in the US, think FDIC rules, think Fed rules and you've got the picture. But you also have to look at your own internal process: this is a bank and you understand how far you can extend credit, how far you can extend treasury management into non- traditional securities after which you've jeopardized the stability of your credit infrastructure. And it turns out that everybody, in a series of conferences that happened to start in Basel, wound up agreeing to what was then Basel I.

And before Basel I could be promulgated, they realized that a lot of what they put in Basel I didn't cover everything, so they came up with Basel II. And after seven and a half significant meetings and probably thousands of insignificant meetings, Basel I and Basel II now stand as this wonderful moment on the horizon where all financial institutions need to report how on earth they actually measure and quantify the financial risks that they take on. Okay. That's what Basel I and Basil II is.

Now what makes Basel I and Basel II fascinating is that, as with many other international entities and enterprises, there are wonderful sets of proposed rules and regulations and so forth and so on, but all of them are undefined mandates. Thou shalt, but we can't tell you how you do it, so go figure it out.

One of the things that I find very delightful about it is, one of the things that you have to do is, you have to test all of the collateral adequacy you have in your lending environment. And for those of you not overly involved in the banking industry, that's actually a very interesting question because when you actually take out credit as a consumer or as a business, you are supposed to offer up some form of collateral as secondary source of repayment if you, in fact, become insolvent. That's actually, kind of, how it works. Now the problem with that is that we live in a world which, according to the Standard & Poors' study of 1998, suggests that somewhere around 1993 our economy cut loose of tangible assets as the primary denominator of value. In 1993. That, by most people's account, was when we entered the knowledge economy, when balance sheets no longer reflected value. That's when we started getting into the wacky world of price-to-earnings ratios that were 5,000 or 38 or 72. You pick the number because it doesn't matter because none of the numbers are right because we don't have any way to measure it.

So it's -- oh my goodness, doesn't it sound like 1815 again? Where was the value? How can you lose 86 percent of a market cap from an entire country's market in one day? That's right. You can lose it because the value isn't on the balance sheet. It is not the tangible assets. It is not the cash held in reserves. It's not -- oh, but I digress, that was 1815, that wouldn't happen now. I'm telling you why it can't happen now. That's right. I just had to get my mind back on track because I was almost back in 1815 there for a minute. So what you have is a world that in 1993 said, we no longer have tangible balance sheet value that can be quantified and that can be recognized as a basis for commercial transactions in the financial sector, particularly in the banking sector.

And over a period of time, from 1993 until 1998, it became increasingly evident that that absence of transparency was creating significant problems. Some of us can recall little events like the Japanese banking collapse of 1998. We can recall little events like little disruptions in the financial institutional practices of Russia and Argentina and a few other places. And this can't happen, remember. This can't happen here. We've got it all covered, don't worry. Because on January 1st, 2008 we've got rules that say it will never happen here. And because we have those rules we have great confidence in the fact that on January 1, 2008, when we have this wonderful promulgation of rules that come into place and we know capital adequacy will be reported, and will be reported accurately, and will be recorded consistently. And the FDIC and OCC just released a report yesterday saying not a single bank on the planet is on track to be compliant with Basel I and Basel II on January 1st, 2008. But that's okay. Don't worry because it can't happen. And the reason it can't happen is because if we don't like rules, we'll change them. And that's the good thing about the knowledge economy. You can set up all these rules and you can set up all these accounting things and you can set up all these things, and if it doesn't quite work out right, change them.

Now, just to show you how close we are to 1815, but to highlight the distinction between 1815 and 2008, I want to give you a distinction that took place just a few short years ago. Because, actually, a few years ago we were dangerously close to being more like 1815 then we are 2008. And that was when we decided to eliminate pooling-of-interest accounting.

Now, some of you will remember that if we eliminated pooling-of-interest accounting the market would cease to exist. John Chambers reported that in a Senate banking committee round-table hearing with the CEO of Medtronic and the CEOs of a couple other corporations, and all of the engines that drove the economy -- all of the innovation engines of the knowledge economy -- would come to a screeching halt if we got rid of pooling-of-interest accounting. Now, what was pooling-of-interest accounting? It was a way to do a very interesting thing. To pay anything you wanted for something, tell your shareholders, no trust me, it's really worth it. And then have the ability to, kind of, fritter it a way when you needed a loss here, when you needed a gain here, you could, kind of, play around with it.

But you had this giant slush fund, which is really convenient, that you could use whenever you wanted to. And all of a sudden revenue smoothing was, well, I shouldn't say that. Nobody actually did that. People like me could corrupt the intent of people to suggest that maybe what they were doing was falsifying their reporting process. That didn't really happen. I'm just speculating what an evil sinister person might have done had they had the opportunity to do that. But it didn't really happen much. Well, okay. We didn't see it so it didn't really happen much, I think. Maybe it happened at Waterloo, but it didn't happen here.

So, pooling-of-interest accounting… If we take that away, then the world's going to blow up. So, what the FASB did was, the FASB said we're going to promulgate rules that say that you have to report the value of the things that you buy. And you have to tell somebody in a financial disclosure that you paid X and it was worth X and that's why you bought it for X.

Well, it didn't quite work out that way. It didn't quite work out that way. So the rules were promulgated and the next year… and this is really cool. We have some interesting linguistic genomics technology that we can apply to financial reporting. And we could, actually, without looking into a document, we can tell you whose accounting firm had actually prepared the financial statements going into the year that FASB 141 and 142 were promulgated. And we could do that by looking at the number of footnotes under the financial statement, which essentially said the following: "The Financial Accounting Standards Board of the United States has promulgated Rules 141 and 142 that tell us that we have to report to you the true value of the things that we bought. We have no clue how to report to you the true value of those things and as such, we reserve the right to restate our financials." That's what the footnote said. Apparently the FASB didn't mean that when they said it was a rule. They didn't mean, put in your financial statement that you don't know how to follow the rule. They meant follow the rule. Silly how they were old-fashioned that way. And so, the next year you had about half of the reporting companies saying, and I quote the following: "We have tested all of our intangibles for impairment and have found none."

I'd like to walk you into a case study to show you how wonderfully transparent and accountable that was. There's a company called the Caterpillar Corporation. Caterpillar Corporation is not a little bug, it's the big giant things that roll down and plow out highways and build walls in Israel and do cool things like that.

The Caterpillar Corporation. Now, the Caterpillar Corporation actually had an enormous amount of technology that they found to be no longer core to their business. Some of which they had acquired and some of which they developed internally. And they decided to donate it to a university. Now, the university that they donated to decided that they'd be willing to take donation of this technology and they'd be willing to let Caterpillar in for round numbers. Let's not pretend that we're going to get all the numbers right here because it really didn't matter in the first place. Let's say they were worth 50 million dollars. And so, they donated all the patents to a university and they said, “here, university, have these patents. They're worth 50 million dollars.”

Now, the university, being an academic institution of higher learning and being fully committed to fairness and accountability and everything else, which is what we try to instill in our youth coming up through university. Good stuff, instill-fairness-and-accountability said, “we'd love to take that 50 million because we need to tell the federal government, to get these grants that we're trying to get, we have to tell the federal government that we've gotten institutional and industrial matching contributions to justify our federal grants. And so what we'll do is we'll take this crap that you -- I'm sorry, core technology -- crap that you want to give us. We'll let you say it was worth 50 million for your tax deduction. And we'll tell the federal government that we got a 50 million dollar contribution from a company, thereby generating a matching grant that justifies getting a federal grant.” It's a pretty good racket isn't it?

And that wouldn't have happened, obviously. I was just using this as a case study. It couldn't have happened. I was just making that up. It wasn't really Caterpillar and it wasn't really a university. Or, you know what, it was. I'm sorry. It was. It really was them and it was the university. Yes, that all happened. And 50 million I'm low-balling. There was a higher number. And the interesting thing about that was that that was more cool knowledge economy stuff.

If you come up with a bogus number and you tell somebody that that's what the number is, and then they tell the federal government that, then guess what? You get a tax savings as a company. You get a donation as a university and the taxpayer gets to pay twice for nothing.

That's a good racket, so let's do more. And we do more and more and more. And if you look at their financial statement, the interesting thing is, Caterpillar shows you that their intangibles are worth 300 million dollars. They donate 50 million dollars and their intangibles right after the donation are worth 311 million dollars. Now, I'm really into multi-dimensionalism. like multi-dimensionalism and I'm sure there's a vector that I can stand in that makes perfect sense. When I give away fifty million dollars and I net out eleven positive to me. I haven't found that vector yet, but I'm sure when I find it I can come back to the Arlington Institute and talk about the vector where you can give away 50 from 300 and net out 311.

Now, the cool thing about these case studies is, I wish I could make them up. I wish I could make this up. The funny anecdote at the end of that story is that very recently those patents were sold in auction for a lot less than 50 million, a lot less then 50 million. But an auction, as you know, is not a willing buyer/willing seller environment. It's totally contrived -- people are pressured into going to auctions and bidding auctions to ludicrous high values and that's why it doesn't matter at all, because it doesn't matter. So let's get this straight. Where are we going with it? Basel II, financial accounting, knowledge economy, intangible assets, where are we going with all this? The good news is -- and this is why I'm going to tell you we can all breathe this collective sigh of relief -- the good news is that according to Business Week… I'll let that one sit in the air like brick doesn't just for a second, the good news according to Business -- right. Okay.

The good news according to Business Week is that we can outsource our blue collar jobs and we can outsource our white collar jobs and we can outsource all of our other jobs. But the cool thing about being an

American is that we're the guys who really have every creative thought on the planet. And doggone it; it's just good to know that we own the knowledge economy space.

Yes, sir. We are… we are the pinnacle of civilization and we own the knowledge economy. So when Basel II comes along, and when our banks have to explain the collateral adequacy of the enterprises that they fund, we won't have a problem. We won't have a problem because we clearly know that whatever everybody else says their stuff is worth, ours is worth more because it's better, of course. It's better because it is. The best part about it is Basel II says that you have to value intangibles. Wow.

So, we have to value intangibles. You have to actually tell people that you have enough collateral in intangibles to actually justify your credit rating, to justify your loan adequacy to a bank, to justify the rating that you have on your bond. You have to do that. And it all happens on January 1, 2008. Now the good news is that nobody's ready for that. That's okay. Don't worry about it. We're still good because there is a plan. But there was a little wrinkle in the plan and we're going to spend a minute on a little wrinkle in the plan.

I have had the good fortune… and by the way I'm being absolutely serious right now, right now. This part. I'll tell you when I'm not being serious anymore. This part I'm really serious about.

I had the good fortune of traveling throughout the Middle East over the last several months working with Shari'ah Boards. Now, a lot of you believe that Shari'ah Boards are things that were blown up in the Afghan conflict and, you know, it was the people who were repressing these people and repressing those people. And that's what Shari'ah Boards are. And I'm sure you're right because that's what it said in the New York Times so it must be right. But the people I've met with, actually, are not in Afghanistan right now getting bombed. They're in really wonderful places that are actually nice tourist destinations and some places that are fun to go to but not really tourist destinations but they're in a really interesting area of the world. And the interesting thing about Shari'ah Boards is, their job is to actually build products called Islamic Finance Products.

Now, why does Islamic finance enter into this conversation about 1815 and 2005 and FASB and Basel II and everything else? Well, for a very good reason. The reason it enters into this conversation is, there has been one voice missing. Missing from the WTO negotiations, from the Basel negotiations, from all of the negotiations about financial accounting and standards at the IASB, at the FASB, at every other… and that voice happens to be Islamic Finance.

Now, if you haven't recently traveled to Dubai or Qatar or any of those other wonderful places over in the Persian Gulf and you fly in there, one of the things that strikes you right when you come into those wonderful, really rural, rustic, nomadic areas is that there are more cranes there than in Shanghai. When people want to build a building and they actually want to create a skyscraper that looks like a tulip they do. And they pay for it in cash. They pay for it in billions of dollars of cash. And you heard me right: billions of dollars of cash.

Now, there's a funny reality because what we have is a situation where the treasury -- liquid treasury -- of the world has progressively gone through our Hummers and our SUVs -- oh, I was joking there, that was the joking part -- has gone through that and has shown up in a different part of the world. This is liquid capital. Okay? This is unimpaired liquid capital.

Let me stop and just frame up a picture for you, just for a second. I was privileged to give a lecture in Tehran on Easter Sunday last year. That's right, me. You know, bald guy, boots, bow- tie, lecturing in Tehran on Easter Sunday last year. And in that lecture I had the opportunity to advise Iran about whether they should join the WTO. I advised them not to. And the reason I advised them not to is because WTO regulations and the treaties do not afford an ability to have a superseding, sovereign ability to weigh in on things like corresponding bank and securities issues. You're supposed to all play together. You're supposed to all do things together. You're supposed to follow the leaders. And the leaders of the WTO are the developed countries. And the developed countries don't include those countries, do they? No. But those countries seem to have a lot of cash, a lot of cash... And those countries have a lot of cash and they have very strong ties to some other countries with a lot of cash… Some of which have very strong energy dependencies… Energy dependencies, like, I don't know, let's pretend, natural gas, oil, something like that, which might actually be really important, strategically at some point in the not-to-distant future, in 2008.

So they have cash. They have energy. They keep getting more cash. The words "an extra billion dollars a quarter" are spoken there very, very frequently. And so you're sitting there going, gosh, there's a bunch of pieces, but how do they all come together? What's the come-together piece here? Well, I'm going to try to give you a come-together scenario which I find to be not only interesting and compelling, but something that I'm actually working to achieve. It's a true realignment of what we see as financial institution practice of the world. And I'm going to give you an estimate on when that's going to happen. It going to happen in 2008 and I'll tell you why. I'll tell you why I think that's a pretty good bet. The reason I think it's a pretty good bet is because a few years ago we decided to prop up our economy.

Now, I'm not going to point fingers at, you know, Treasury secretaries or anybody in that kind of environment. Seriously, I'm not pointing fingers. I'm just saying we did a very interesting thing. We decided that we had a very dynamic need in 2001 to get our economy back on track. And so, what we did was, we poured a significant amount of capital into what market? What market in 2001 wound up contributing to the majority of the growth of the GDP in 2001? What market?

"Housing."

Housing. Ninety percent of the growth of the GDP in 2001 to 2002 was in the housing market… 90 percent. Did we all get, like, castles? Are we Europe? I mean, did we all, like, move into castles in 2001? This is bigger than 86 percent, isn't it? Did we do that? What did we do with that alleged housing market money?

(Comment from audience.)

Now, we bought our consumer products stuff with our housing market. Now, there's a very interesting statistic that you can trace from 1938 to present, and that is the default rate between consumer debt and mortgage debt. They're not the same, by the way. One of them is significantly greater than the other. One of them has accelerated at a considerably greater pace than the other. Insolvency in one has been much greater than insolvency in another.

But what we did in 2001 is, we decided that we were really bummed out about certain things that we were legitimately bummed out about and so, to get ourselves out of being bummed out, we'd spend. And we spent a lot. We bought a bunch of cars and we bought a bunch of iPods and we bought a bunch of flat-screen TVs and we bought a bunch of things. And we did all that because it made us feel better about ourselves. And then in 2002 we realized that, hold on a second, we've done all that stuff but now we actually had a lot of consumer credit. So what we did was we -- that's right -- put more money into the housing market. And just hang with me, because all this made perfect sense then. Okay? And it still all makes perfect sense now. So we put more money in the housing market. And we put more money in the housing market and lo and behold, it looked like we're really on track. Consumer confidence is really high. We're really doing well. We're buying durable goods. We're getting those cool refrigerators that make ice and tell us the weather and do all that good stuff. It's really awesome and it's all happening and it's really exciting. And we're spending more and more and more. And what are we doing when we run out of money? That's right. We're going back and saying, holy cow, look at the capital gains on my house. I can go and get more debt.

Something happened last year. I don't know if any of you were watching, but something happened last year for the first time since 1933. Does anybody know what significant financial function happened last year?

(Comment from audience.)

Not only inverted growth but for the first time since 1933, and that's true. For the first time since 1933 something very interesting happened. We actually went negative in savings. Negative in savings. We had a four percent… in one calendar year, a four percent reduction in savings. That means for every dollar you earned, you spent a $1.04. That's for those of you who were saving. Important, listen to what I'm saying. This is not funny. That's for the people who were saving. For the people who weren't saving *which is a statistic that for some reason never quite hit the press) we actually had 120 percent spend-over-earned in 2005. For every dollar you earned, you spent $1.20.

Now, was that in the housing market? Is that where that went? Into our houses? No, it went into more consumer spending. And while the Feds started talking about, gosh, we're getting a little queasy about this whole growth trajectory and we're seeing the lines start to flatten and everything, we're not really worried about it because were going to eke out a little more consumer credit. And so what we did was we actually decided that we'd add 1.8 trillion dollars in the last quarter of last year that was entirely leveraged commercial consumption -- one trillion in a quarter. I don't know where you come from, but I come from, like, rural southeast Pennsylvania and California and places like that. One point something trillion is actually a big number to me. And I understand that people, some people, can get their arms around 1.7 trillion or 1.3 trillion or 1. something trillion but it's the trillion that gets in my way. That's a big number and I have problems when I get to trillion things. Those are big.

We outspent and overshot our GDP. That's pretty cool. And it felt pretty good. Christmas looked all right, a little slow, here at Tickle Me Elmo, it wasn't quite a good year for Tickle Me Elmo but by and large we were doing okay at Christmas.

Now here's a very fascinating statistic that our company, kind of, teased out of financial data in 1998. And I actually am honored to have in the room one of the gentlemen from my organization that helped us find that number. and that's David Ferren. David Ferren and I were very interested in looking at historical default rates. And we were looking at different types of credit and different types of defaults. And one of the things we were looking for is whether or not default rates happen in normal curves. Whether you're as likely to default Month one as Month 12 as Month 24, as Month 36, as Month… and you know what? It's not very linear. Debt actually looks like it works really well for about 14 months. And if you look past 14 months and you go out a little further and you go to about 17 months, you actually find out that debt starts feeling a little squirrelly.

That's when you start not making your payments. That's where you get into things like technical defaults and these kinds of little bumps in the road. You try to make a payment. You can't make a payment. You can't this, you can't that, and so on. But somewhere between the 17th month and the 24th month, all of a sudden, the fecal matter hits the rotary oscillator and it's bad. Everything that looked like a good credit starts to look like a bad credit.

So let’s see… Christmas of 2005, January of 2006 is, kind of, when we over extended our credit. So let's see, 17 to 24 months would put us in January 2008, wouldn't it? The day that banks have to report their capital adequacy happens to be that magical day when a new president gets sworn in. Oh, hold on a second. That actually was kind of funny, wasn't it? Ladies and gentlemen…
(Comment from audience.)

…Yes, there is and it's worse than just the military outcome. Could 1815 happen again? Could we find ourselves in a situation -- and here's where the challenge is today, because one of the things I hate… and I got this hatred from my mother… and if you know my mother, you'll find a great deal of fondness in me saying that my mother gave me anything of hatred. But, that was kidding. Well, it may not have been all kidding but it was somewhat kidding.

My mother said she hated anthropologists. And the reason she hated anthropologists was because they could tell you what's wrong with civilization and what's wrong with cultures and why they fell apart, but they weren't a damn bit of good telling you how to fix it. So in the interest of paying homage to my mother, I thought I shouldn't just talk about January 2008 as though, gosh, it could be a really bad January, but it could be a really bad January. But in the interest of my mom, I thought maybe we could think about, well, what really will happen in January 2008? And now, I'd like to put in the caveat that every accounting firm that is still in operation… we currently have the big four, I'm holding out that we can keep big four, but you know, my bet is on maybe we might get to three... Maybe. A little tax issue here and there, you know. Well, we have four big accounting firms. And long about January of 2008 we still might have big four accounting firms and they still might be in a position to actually go into financial institutions and say, “we've got your Basel II solution.”

I like the word “solution.” It's a really cool word and it’s how people sell cool things: consulting services and IT systems and everything else. And people will be selling Basel II solutions. And those Basel II solutions will be ways in which you can comply with -- well, maybe not comply with -- but get ready to comply with... Okay, maybe not get ready to comply with but at least say you have a program that's trying to comply with Basel II. And so, somewhere around middle of 2007 we should have this wonderful program going on where people walk in going, “we can help you be compliant with Basel II” and somebody will have a job. It will be a business card. You'll have your Compliance Officer for Basel II. And somebody's going to be a Managing Director of Compliance for Basel II. And in every bank and in every insurance company and in every securities firm... and it will be really exciting. There's a whole new career. I highly recommend it if you have a short career horizon. Lasts about through 2008, third quarter. But between now and then there's a lot of money to be made.

So, somebody in this room should be bright enough to figure out how to print out those business cards and hand them out. And we can all be Basel II experts when we walk out the door and go sell our services.

So, what would happen if banks don't know what their exposure is but something close to three quarters of their exposure right now is in the housing market? But the housing market isn't a housing market; it’s consumer credit being called housing. But it's not really housing, it's consumer credit. That's pretty interesting.

(Comment from audience.)

We’re talking food lines, bread lines, lines at the gas pump. We're talking where's Carter when we need him? That was really mean. I'm sorry. I actually like Jimmy Carter. I've been to his house.

(Comment from audience.)

I'm talking about durable goods. I'm talking about iPods. I'm talking about going out to TGI Fridays. I'm talking about every time you ring…

(Comment from audience.)

Oh, no, and thanks for giving me this, because the good news is that Fanny Mae and Freddie Mac are all there for us because they're government-insured.

(Comment from audience.)

Damn. That's why it's not going to happen. That's government insured. And who bought those? Oh, that was the Federal Reserve, so that's good. And they're the ones that bought the collateralized mortgage obligations which aren't mortgage obligations. No worries, we've got that one covered. We'll come back to that one.

(Comment from audience.) You know, we're going to get there in 2050. So what we have is an interesting situation where we're going to have an interesting confluence of events. The very day -- and this, by the way, you can set your watch by -- the very day that we have to report capital adequacy … and remember capital adequacy is whether or not I have enough cash to cover a $20 obligation based on $20 I gave you. You told me that you had the ability to repay it. I, as the credit extender, had the ability to set that aside and sequester it and make sure that I could perform and let out the right amount of capital and retain the right amount capital to make sure I could stay solvent.

And, long about January of 2008 we will have something on the order of 27 to 28 percent of the market that's allegedly mortgaged-backed securities supported by credit card debt. They're basically the same, right? Debt's debt, right?

Now, I think I established earlier in this presentation, debt isn't debt. Mortgage debt -- 30-year mortgage debt -- and I-feel-like-going-to-spend- more-money-at-Christmas debt isn't the same. So pray tell, how does a financial institution in the United States and Europe actually tell the market what their intangible exposure is when they're calling something mortgage and it isn't mortgage? And let's say you were off by 25 percent, a little tiny window. There's not a single bank in the United States that could handle a 25 percent loss reserve call. Not one. Not one.

(Comment from audience.)

That's where Islamic Finance becomes very interesting. Wouldn't it be funny to be standing in 2006 and say that the people that way too many of us hate might actually be our only salvation? Wouldn't that be a hoot? Wouldn't it be a hoot to actually realize that the one entity that we spend more time, as Americans, despising could actually have the capital adequacy that is required to prop up the capital inadequacy of our financial institutions? Well, holy crap, wouldn't that be funny? Wouldn't that be funny?

Well, let's play the tape on that one because it stops being funny and it starts having profound implications if you stop and think about it. And here I am dead serious.

Over the next three quarters we will pump literally -- no pun intended -- a lot more cash into the Middle East. With oil at the price it's going and natural gas at the price that it's going, even if oil starts to stabilize, as many of the analysts on Wall Street tell us it will do... And prices will start falling at the pump a year from now… After all it's an election coming up. We have to get the prices falling at the pump or God knows what could happen.

So, if we get to that horizon and oil starts to fall, we will have pumped about 1.7 trillion dollars of additional liquidity into the region. That will add to the 1.3 trillion estimates from this past year. And that's of excess liquidity. That's of cash. That sounds like a number that comes dangerously close to the capital insufficiency of the credit we extended last year, which will be the capital adequacy requirement that we will need to make sure our banking system stays up and running.

I'm going to do something which is really mean right now. How many of you know what a Sokouk is? There are two people that raised their hand. Good. I'm hoping that some of you are just shy. I'm going to ask you again: how many of you know what a Sokouk is? Raise your hand high. High, high, high. You will be the proudest people for raising your hand if you know what it is, because by 2008 that term will be much, much, much more familiar to all of us. Why? Because that's how you build Islamic-compliant financial vehicles to do financing of long-term credit obligations. And guess what? The country that actually has the most liquid market for Sokouks is the United Arab Emirates. The city and the emirate that has the most liquid market for those securities is Dubai.

The first Dubai Sokouk in excess of a billion dollars was issued to a company called PNO. Come on, people, work with me here… Port Authority.

(Comment from audience.)

Oh, crap. We did, didn't we? Oh man, my whole idea just fell apart. Because I thought we could go to Dubai and say, “guys, help us.” I thought we could go there and say, “but we've been your allies. We've worked with you. You've been an alliance of the willing in the war on terror…”

And the same company that has the security contract from the United States Navy to safeguard our vessels in the Persian Gulf -- oh, hold on a second. I didn't say that right, did I? The same company that has the contract with the U.S. Navy to safeguard our vessels in the placid, tranquil Persian Gulf, where nothing bad ever happens and everybody sings Pirates of the Caribbean songs. That same company that our government has hired to protect our navy was not stable enough to unload stuffed animals in the New York port because they may be terrorists. But, no worries there. When we ask the Dubai financial markets to support our collapsing banking system in 2008, I'm sure that they'll forget about it. And the comic irony is I think they will. I know a lot of people there. I work with a lot of people there. And you know, the cool thing about Dubai is, they're thick-skinned traders -- traders, T-R-A-D-E-R-S, traders. They are people who understand that sometimes, in the interest of keeping your economy alive, you actually had to service pirate ships. In fact, the Dubai Creek, for those of you who don't know history, was where the pirate ships went to be re-masted, re- watered, re-fed, re-armed for a long time, including 1815.

As a matter of fact, the Dubai Port Authority in 1815 was actually supplying Napoleonic and British ships. Damn it, I like when a story comes all together. I love when you take something from 1815 and cram it through a bunch of bad analogies and have it come out the other end, still in 1815. This is fun. That's the part that I love, its fun. So where do we go? Where do we go when we realize that we need to learn something? You realize that you can't just show up when you're Morgan Stanley or you're Lehman or you're, you know, any of the other banks and you can't knock on the door at the DIFX and say, “we got a world of hurt here and we'd really like your help and we just realized that we were about to report our financial statement under Basel II but we can't be compliant because mortgage isn't mortgage and it's consumer credit and everybody's defaulting in it.” Doesn't look good for us.

You can't just knock on a door and go, help us. Not because they don't want to help. It's because you have to sit down with people who you might not understand. You have to sit down and have dialogues with people who you might not share common values. And you might have to get expediency pushed aside and sit down and understand that Shari’ah finance law isn't just calling credit, credit by another name. It isn't. You actually have to pay attention to a culture and to a religion and to a system that doesn't play entirely by our rules. And you have to smile about it because you're asking somebody to help you. You have to sit across the table from people who are saying things that don't make sense. You have to say, do you realize that the very consumerism that you railed against, as Islamic mainstream cultural rejection of certain Western practices, is what got us into the trouble that we're asking you to help us out of. We get pissed off when we hear some cleric say, “well, Western consumerism is bad.” Did it ever occur to us that maybe they're right? Maybe there was something to that.

And by the way, I'm not advocating that all of us change anything about our persuasion. I'm simply saying, wouldn't it be interesting if we actually were able to tolerate the hypothesis for a second, that there might be some granule of truth in what makes us slightly uncomfortable? And if we could, merely, cross over that threshold we may be in a position in February of 2008, in March of 2008, to sit down and have conversations and not go, “my gosh, I don't know what these people are talking about.” Might it be a good idea for 50 people in Arlington today to start inquiring what is a Sokouk, what is Shari’ah Finance? How would one aggregate 1.7 trillion or 3.4 trillion into a pool that could be used to enhance the credit indebtedness of our banking system?

(Comment from audience.)

So, 2008 -- January 2008, we’re there and I'm wrong. The wheels were set in motion a long time ago because the one other hypothesis is that we say the rules don't apply.

There is a country that's pretty large. It has people who actually have been around a few thousand years longer then we've been around. That very large country made a strategic decision a while ago to start buying our treasuries. And they bought our treasuries, and they bought our treasuries, and they bought our treasuries and they built alliances with countries, some of whom we like and some of whom we're not overly fond of. And they signed energy deals with some countries that we're not overly fond of. This is where your war scenario comes in, by the way. And sometimes when it looks like the war that you're in isn't going very well, you actually decided that maybe another war will help distract the war that's not going very well. Look over here, look over there, look over here, look over there, look over here. Distraction. This is not shock and awe, this is distraction. Pantomime, it's a pantomime war over here. Don't pay attention to this war over here.

Now, close that circle. That circle closes, kind of, in an interesting scenario, doesn't it? Because along about this time next year, when all the troops are home, when we've tidied up that little mess that we’re just closing the loop on right now, but when it's not as tidy as we thought it would be, and we're still trying to close it up, and when -- I don't know -- a couple of border disputes erupt between an ally of ours and some of their neighbors with whom they don't get along… And words are spoken like, “we're going to bomb them back 20 years” and things likes that… When that kind of thing has happened, we could find ourselves in a very interesting summer, and that's a year from now.

And that very interesting summer, a year from now, is when we have a very interesting opportunity as a society. We can take the course we've been on or we can take another course. The course we've been on says that it might be expedient to have a war of distraction. That's okay, it would be tactical. It would be quick. We'd be in, we'd be out. Maybe. But the infrastructure that we would hit in that war would be financed by our treasuries. You heard me right. The infrastructure that we would hit would be financed by our treasuries. So we would blow up our federal reserve. Wow! Talk about asymmetric warfare. This is so asymmetric that we bomb ourselves. Because that capital adequacy problem, which is backed by our mortgage thing that we don't worry about, because it's our mortgages and they're good and stable, and our need to rely on Islamic Finance as a potential scenario to save our hide, could all, kind of, just blow up in smoke when we take out the gas lines, the seventy billion dollar refining facilities and the other strategic targets that we have in places where we don't like people who don't understand us. About four or five months before we need those people to support our banking system.

Just for a point of clarification, today our financial ally for 2008 is in the Middle East. And you heard me correctly. No cross dependencies on the equities side. No cross dependencies on the banking side. The one that doesn't sink when other things sink is the Middle East. It's not China. Lord knows it's not Japan, because

Japan can't keep anything rated above B, B+ right now. In fact it doesn't have any A-rated financial institution at all. So, they're not going to be there for us. We don't find ourselves in a particularly financially strong position right now as a country and our treasuries are owned by China.

In that world, what I hope you heard in today's presentation isn't hopelessness, because it isn't hopeless. What it says is that we have an unusual opportunity. And the unusual opportunity is to stand on a precipice before you fall over it. To stand at a point in time when the events of our own construction could very well turn on us in ways that we can't imagine, and look to our neighbors now in a much broader sense of that term and say, that between today and New Year's Eve 2007 we may have a little bit of bridge work to do.

Halliburton can't bid on this contract. It's not going to be a sole-source award. It's not going to be a single-party interest. And it's not going to be somebody winning who insists that the world does it your way. Those of you who believe in that world... read the last debate on the Doha Round on WTO and if you still have questions drop me an e- mail and I can send you a picture of what it looks like. The fact of the matter is, the day of arrogance is what I'm really talking about coming to an end. That's what I'm talking about. And John and I had a great conversation because he said, “Dave, why are you still optimistic? You see all this stuff and it looks like everything's falling apart and for some reason you just seem to be optimistic.” And so I'm going to leave you with a picture. The picture comes from Tehran on Easter Sunday night last year.

I sat with the Ministry of Interior, the Foreign Ministry. And I sat across the table from a group of young women who are part of the Foreign Ministry. And on what was the most lavish table that you could imagine… it was filled with saffron rice and kabobs of every variety and with some of the most fragrant foods and vegetables and everything else mounded across the table… in what would be a perfect set for, kind of, a Knights of The Round Table Camelot picture... I sat there surrounded by women and men of Tehran having dinner. And on the table were oranges. Now, these were beautiful oranges. And when I call an orange beautiful, that's actually really special because as a kid, we lived at the homestead estate of the Pure Gold Orange Grove in California, and if you haven't ever heard of that, my condolences. It's how the gold rush really happened. It was California oranges at their best, pure gold orange.

We had 27 of those orange trees still in the early seventies at that house. And for Christmas, we'd go out and pick oranges off those trees and that was Christmas presents for us. And that sounds weird. It sounds, kind of, corny that you get an orange for Christmas. But the oranges were that good. They were that good. They were really oranges. Amazing.

And I was looking at this table, which was spread out before me and on the table were oranges. And they looked dangerously close to as good as the oranges that I remember when I was a kid. So I thought, I'd ask a very polite question, are these oranges for decoration or are they to eat? So the young lady across the table said, no, sir. They're to eat, enjoy them. And so I peeled an orange and I peeled off slice of the orange and I popped that slice in my mouth. And unless you have ever had an orange from Shiraz, you don't know what I'm talking about. Because there is no orange juice, it's orange syrup. It is the most amazing, delightful, electrifying, wonderful flavor you could hope to have. Even if you don't like oranges, you'd sit there going, wow. That's oranges the way oranges were meant to be. And I said, “would you like a slice?” And I handed it across the table to this young lady. She recoiled.

I said, “don't you like the oranges?” “Oh no, sir, I love these oranges.” “Well, have a slice.” “Sir, here a man peeling an orange and giving it to a woman who is a stranger at the table would be considered inappropriate.”

“So, I'm not trying to offend somebody, but this orange is really good. I'd like you to have some.” And she said, "no, I can't do that." And so I said, "well, what if I were to break it in half and set half of it on the table. I wouldn't give it to you, I'd set half of it on the table and then you could pick it up and I wouldn't have given it to you." And she looked at her friends and she said, “I think that might work.” So I cut it in half and I put half of it on the table. And she picked it up. And it was wonderful to see the expression on her face when the first syrup of those oranges came into her mouth. And it was a beautiful moment. And I said, "this has got to be the best orange I have ever had." And she said, "of course, they come from Shiraz." Well, silly me, like I knew that. I didn't know that if it came from Shiraz it had to be that good. But then she said, "do you believe in God?" I said, "well, why do you ask?" She said, "well, do you believe in the Garden of Eden?" And I said, "I'm really not following. What does believing in God and believing in the Garden of Eden have to do with this orange?" She said, "Shiraz is the Garden of Eden. This is the orange that was the first orange. Oranges here have never been hybridized. Oranges here have not ever been mass produced. Oranges here have always been the way they were planted when the first orange was planted." She looked at me and she said, "you've never had an orange."

Why would I end with that story? Why would I end with that story?

(Comment from audience).

I'm not answering questions today, people. Why would I tell you that story? I'm asking you something. Why would I tell you that story? Your own memories of your own culture. The thing that you knew was the best that could ever happen aren't always the best. What else? (Comment from audience.) I found a way to share something in a taboo environment that wasn't taboo. By doing what? Changing what it meant to give. I didn't see a problem with handing her a piece of orange. I still don't see a problem with that. But she did. And to share that moment, I had to change what was merely good in me, not bad. I had to change what was good in me to be impersonal. But by being impersonal I was being personal. And I didn't know that. What else? Why do I end with this story?

(Comment from audience.)

Humility. I'm telling you I was wrong. Not wrong in some sort of binary world. Not wrong in some sort of there's an empirical yes and an empirical no. I brought myself into that interaction. My instinct was to be instinctively the way I would be and that was not contextually appropriate in that place. Had I insisted on being kind in my way, at best I would have offended and at worst, God only knows. Why else am I telling you this story? Hope. Hope. Did you listen to the set up of this? An American was in Tehran last March. You know the facts, that can't happen, particularly on a diplomatic visa. We don't have diplomatic status. Why do I have a diplomatic visa? Well, because sometimes things can happen, even when they can't happen.

So hope. I hope you take something away from this. My heart hopes that you take something away from this. And the reason why my heart hopes you take something away from this is because it's not just about January 2008. You all know, and we've all lived long enough to know what happens when we perceive that our world is collapsing.

When we perceive that our world is collapsing we do things that we really, in kinder, gentler, calmer times, we wouldn't do. Why? Well, we do it because that's a human thing to do. That's not wrong, it's a fact. And it's a fact. That's not going to be something we change between now and January of 2008.

On January 2, 2008 you all may go, gosh, January 1, 2008 seemed to come and go and nothing seemed to happen. Phew. Missed the meteor, missed the comet. We're not going to miss this. We're not going to miss the challenges when we have negative savings. When we have financed our economy for the last four years on collateralized mortgage obligation liquidity that's being supported by a closed-loop cycle. If that cycle breaks, and it will break, and we can't not break it, that's going to happen. Between now and January 2008, we will continue to fill up our SUVs, we will continue to fill up our cars. We will continue to throw plastic away. We will continue to talk about bio-diesel. We will continue to do all kinds of things but at the end of the day, a couple more trillion dollars would probably find its way to people who aren't like us.

Those are all things that are very likely to happen. If you want to bet on any of those odds against me on those, I'll be happy to take it. But what I'm going to pay you with is U.S. treasuries that mature in the second quarter of 2008.

Thank you. Questions:

(Question from audience.)

It's a corridor that goes there. Now, the reason why I say that is not just because I think it. The reason I say that is, that's where the money is right now. That is where growth is happening. As you catch in that the majority of the Indians in the continent. You catch in all of the Persian Gulf area. You catch a lot of the stands that nobody likes to pay any attention to, but oddly enough a lot of those stands are doing quite well, thank you very much. And they're actually gaining significant treasuries, each one of them. That's where I see that access.

Now, the South America question is a very interesting one. And as you all know, the northern portion of South America right now is actually on an interesting field test. I'm not going to weigh in on Chavez and where he is or isn't, but I'd encourage you to read the history of our relationship with Castro and the history of our relationship with a few other places and see if there's any pointers there. But I'm not going to comment on it. But the interesting thing about South America is, it's in the middle of a transition experiment today and I believe, quite regrettably, for much of Mesa and South America, not just South America. I think this is going to come north, and I think it may actually come all the way up to Mexico and dare I say, potentially into our own country in certain parts of the southern part of our country. We may find ourselves in a situation where the experiment in which they are now engaged doesn't have time to run its course. If you look at the infrastructure issues, if you look at the financial issues, if you look at where the infrastructure is going right now, telecommunications and power, particularly if you look at Chile, Argentina and Brazil, right now, you realize that they're in the midst of discussions on how they're going to re-engineer infrastructure. The first efforts that are being seriously undertaken in that area are in Chile, no question. They are miles ahead of much of the rest of South America. They are very advanced at looking at alternative energy. They are very advanced at looking at alternative water purification, extraction, distribution. Telecommunications distribution, and so forth. And the problem that South America looks at, as we look at 2008 to 2010 horizon, is actually a capital illiquidity problem at our end. Because if you look at who is selling into that market at the infrastructure level, you see an inordinate imbalance of U.S. and Japanese credit supporting those projects. Which I believe may very well be an inversion of development cycle, if 2008 to 2010 goes the way I think it probably will go. Now I'm not bearish on the whole picture. think that there are others who will step in to support it. But if you look at where the FID right now is coming from, all of that direct and indirect investment is coming, predominantly, from U.S. and Japanese credit sources who are likely going to be the ones with the greatest immediate term exposure.

In the insurance market, remember after 2000 -- in September 11, 2001 -- remember what happened to the insurance market. Great initiatives and all of a sudden, it's September 12 and every new initiative was off the table and all we focused on was premiums that we could jack up in property casualty. All the other stuff went away. Why? Not because it wasn't good. It was because you could sell property casualty for 3X the premium. So you didn't leave the market from the standpoint of it was no longer attractive, you went to a market where there was high degrees of liquidity. And I think South America could find itself in a very unattractive position in 2008 and 2009, because as you go through the ripple of capital adequacy testing, a lot of that credit currently is being provided from financial institutions which probably have the greatest exposure. The instinct is to say, the Bank of China, Construction Bank, People's Bank. The problem with that instinct is two-fold. One is U.S. equity ownership. Those banks have gone public. And they've gone public in our domestic and European domestic markets. That's not a good place to have your stock trading if you're trying to raise more money.

Secondarily, China is going to have to figure out what it does with Iran when you actually wind up with a treasury that's a little squirrelly because the currency issues and everything else that's going to happen domestically.

So I believe that where most of the time in, kind of, classic economic theory you'd see a Chinese presence stepping in, in a closed model system, I think that the co-dependency China has based on their current treasury exposure and based upon what they've done with their banking system to privatize it and put it into tradable securities right now, may actually disable their effort to step in. Which leaves us with who, that still has cash? (Question from audience.) My grandfather is a very, very wise man. And I recall many dinner table conversations around his house in Silver Spring where he vigorously advised about stating things in a matter that tips your hand as to your political predilections, as it were. But I'm going to answer your question in a fair but agnostic way. I believe that where we stand today we have a zero probability chance of success if we try to reform those cultural incompatibilities by intervening in the current march of our foreign policy side.

Left to the State Department, everything that I just described goes to hell in a hand basket. But once again, in honor of my mother, who says don't ever only talk about the down side. There are very clear opportunities that we could look at. I think we're in a very interesting time with respect to WTO. And I think we're at a point where WTO is unraveling functionally is already on course. But I think in the absence of WTO you're going to see emergence of small sequestered units of free trade agreements that go between potentially sovereign interests. But I think in excess of sovereign interests, you may find other non-governmental interests entering into strategic partnerships. And think this is where public private partnerships between both commercial interests and NGO interests may very well have a chance to build some of those interdependencies, which one day could be very valuable to us, at a pace that the public policy side cannot match. The challenge, therefore, would be to say how could one build interdependency where it becomes in the financial interest of parties to build alliances, where potentially the geo-political alliance building ran out of time? Even if somebody started today and said, okay, from today on we're going to fix this… we get to January 2008 too fast.

So I guess what I would encourage is to be creative about how we look at how the problem gets solved. I think that looking to the State to solve the problem doesn't happen fast enough. And I think it's a place where, truly, the only way we address your issue is to say that we'll fall on private sector interests to actually build cross- dependencies which will be strong enough and valuable enough to be those tenuous threads that hold us together when the natural free disposition is to fall apart. I would offer an example, a very bad example, and that is the pipeline that allegedly could go from Iran to India. Now, whether that gets built or not is an open question, but I use it as an analogy because it's a good one. The analogy is a good one because, if you think about it, it kind of doesn't make sense at all. You're going to run a pipeline from Iran across -- oh, that's right, Pakistan. You heard me right. You're running a pipeline from Iran across Pakistan into India. And you're hoping that what you've put into the pipeline in Iran actually makes it to India.

I just want to say, whoever came up with that suggestion, I really respect. Just saying that in a room of any size, in anything other than the Hall of Mirrors in Versailles when you're alone, sounds like you're saying you're going to take a pipeline from Iran and run it across Pakistan to supply India. That's what it sounds like. But if you think about… think about what happened after that deal was announced. Somehow or another, bus exchanges on the northern border of India and on the southeastern border of Pakistan started. And nobody here seemed to even pay attention to that. Bus exchanges, where people who had been separated, sometimes for generations. Kids who hadn't seen their parents, grandchildren who had never seen their grandparents, actually went across that border on buses. Who did that? Who did that? Was that a giant state department initiative? Was that a giant let's get New Delhi and let's get Islamabad and let's get them down to the table and let's make all of this happen that way, or was it a few brave souls who said, you know what, you can move things across this border. And people got on buses owned by the Homeland Security Department -- no. Got on buses that were parked in Louisiana -- got on buses and actually went across the border. Now, how do I get from pipelines to buses to the answer to your question? And the answer is I just did.

The solution is to say, figure out a way where you can throw the first chord across the chasm and make that chord so desirable that people really want to protect it. And do you know what those bus exchanges did, they became myth.

I was in Omnibad when that first bus exchange happened. That's right. The city where Hindus and Muslims can never get along. That's the city of 10 million in Bujirad. Oh man, I just told you where I was. I told you I wasn't going to tell you, but now I told you. In India. But, I was there. And do you realize that at the restaurant where I saw those bus exchanges on TV, half of the patrons were Hindus and half of the patrons were Muslims. And all of the patrons hugged one another when that bus exchange happened.

That's the best I could do. I think that's what it takes. Because I can't fix what has too much momentum for me to fix. But doggone it, I can be creative and outwit it.

(Question from audience.)

And figuring out how to say credit and debt in some acceptable Arabic term. That's what I thought.

I'm being frank with you. Because, honestly, I try to be open-minded, but honestly I thought Islamic Finance is, just you're calling it something else and it's basically what it is. And I would submit to you that some of the folks I've bumped into in Bahrain and Qatar and places like that, they cross their fingers behind their back and go, “no, trust me, it's not.” So, I'm not saying that it's all of one tapestry at all. However, what is it? I would say that the focus of most Western financial engineers is on the usury issue, which is the transparency of cost of capital. The degree to which you reserve the right to, kind of, charge somebody something but you reserve the right to change what you charge them and you reserve the right to move things around so yields can support an introductory rate of zero percent, 17.8 percent, 27.3 percent, blah, blah, blah. Follow the magic hands: where's the rock under the walnut shell? I thought that was what the primary objective was. But I was really wrong. The primary objective is not about not charging interest. The primary objective is about ethical investment. And you heard me correctly: ethical investment.

Now, this is not the social awareness fund of Morgan Stanley or, you know, CSFB or whoever else. It could be that kind of thing. But ethical investment goes deeper than that. You actually look at the use of capital in those parties who receive the capital. And ethical investments can be in healthcare. They can be in many forms of infrastructure. They can be in many forms of sovereign development projects and so forth and so on. And depending on the Shari’ah Boards -- and you heard me correctly; this is not one cloth, it’s many cloths -- depending on the Shari’ah Boards, it can be anything from an omnibus authorization to a management of funds to a case-by-case review of each individual fund. If you're in Cairo, it's probably the most conservative Shari’ah Boards I've ever heard. If you're in Tehran, I've never seen more liberal Shari’ah Boards anywhere -- kind of, weird. I didn't think I was going to say that, but it's true -- the irony is that a lot of places that you think you're going to go in, and you're all prepped for the, you know, gosh, I'm going to have a lot of conflict, and you don't. And places that you think, well, I could walk in there, they've got a KFC right outside. So if I walk in its KFC, Shari’ah Board. And you go in and you're whammed up against this wall of no, here's what ethical means and here's what we have.

Ethical investment is the primary unifying theme that I've heard in every one of them. So if you're going to pick the thing to figure out, you may find yourself having to go through credit facilities in the U.S. and be able to segregate credit facilities and the Islamic Finance-fundable piece may be actually segregated. So, you may not be able to go to JP Morgan Chase. You may not be able to go to Morgan Stanley. You may not be able to go to Bank of America and say we'll offer you an omnibus facility, with the exception of Bahrain. Bahrain has done this before. But that's the only place I've seen it done. Everywhere else, you actually have to go in and say, the components of the facilities are, in fact, ethical investments as determined by either, an Imam or by a Fatwah that says, in this board this is what ethical means.

(Question from audience.)

Absolutely. And returns have to be done in a bilateral, fully transparent disclosure of terms and conditions. Now, where most of the western mind gets caught up in Shari'ah is the notion that either you can or you can't get interest. The fact is you can get interest in a form. But the form is that you need to be in a situation where you can disclose your ability to generate yields on your capital, which becomes the rate online when you let somebody else use your capital. In other words, you as the lender have a disclosure requirement to the borrower that says that when I hold my money here's what I get from it. So when you use my money you are obligated, under contract, to perform so that I'm not damaged and I'm not going to over-extract from you a damage.

Now, we could easily dismiss that and say, that sounds like interest. It isn't interest. It acts in a way like it, but it is a fundamental different thing. And it is the absence of transparency that is driving the Basel II crisis, which oddly enough is where we're going to have to come clean and say, what is it that we really have? What is it that we've really extended and what is it that we really legitimately make on our money? Because when you have collateralized mortgage obligations over here, and you've got securitizations over there, and you've got derivative swaps, credit default swaps, all this kind of stuff, nobody can keep track of who actually has the money at any point in time. Because all I've got is a bunch of paper that says I've got your shorts and my longs and something. So one of the challenges is going to be, we're going to have to live up to Basel II, because if we don't live up to Basel II, we can't get past an Islamic Shari'ah board.

Now, there's an interesting problem. So is Basel II going away? I don't think so. Because if it ain't Basel II it's going to be something else. And the something else is going to require that we change our parlance. We're going to have to change how we communicate these things. And we may, God forbid, actually have to be accountable.

(Question from audience.)

Do you remember Russia when the ruble started getting a little crazy? That was real fun times, wasn't it? Do you remember Argentina when you see all the caballeros, you know, running across the pampas and you're going, hey yipee ai ay, kind of, western thing. And then it's, kind of, not western thing and it's kind of, how do we get out of Argentina? And how do we get corrupt politicians in and out of Argentina? In and out, you notice I said that… had them going both ways there. No, it's a mess, that's what it is. I mean it's a mess. How do you not do anything and just, kind of, ride this one out.

I was on a 21-city speaking tour in Japan right before the Japanese banking collapse and I suggested that the Japanese banking system was about to collapse. And I was in Inuyama which is north on the JR line off of the station at Nagoya and I was in a room full of, about, 500 people and a lot of them had come up from Osaka and a lot of them had come up from Nagoya and it was a wonderful, kind of, traditional Japanese, really beautiful actually, vacation spot. If you want to go I highly recommend. On the Auto River where they still do cormorant fishing. Where they have those burning baskets and they have the ducks on the leashes and the ducks dive down and catch the fish. It's really cool, you ought to go.

I was there. And at that meeting after we had seen the cormorants fish... at that meeting I suggested that the reason why the banking system of Japan was going to collapse was because the underwriting guidelines for issuing credit were based on five-year historical cash-flow financials.

Man, you're really with it. Man, you're really futuristic there. You're really seeing something. That's what everybody does. But the problem was, and I used a little Old Testament biblical metaphor, which was an instruction given to the children of Israel before they crossed into the promised land. And it was when God said through Moses, when you enter into the land and you live in houses that you did not build, and you harvest fruits from the vines you did not plant, and you walk down the streets you did not pave, and you manufacture goods in the factories you didn't build, and you use production lines that you didn't design… see where we're going? Remember, you didn't build it.

And the reason I said Japan was going to face a crisis was the following: when Mitsubishi heavy industry decides to get into the semi- conductor business, do you suppose it’s good to use credit models that were good for a steel industry when you're talking about semi-conductors? Oh, hold on a second, that's exactly what we're doing today. Go to any bank, any commercial credit officer in the United States today and what will they ask you for? Could I see five-year historical financials?

Sounds good, right? So when I have my Basil II compliance program, what I'm going to do is collect that data. So I'll have exactly the right data for an economy that no longer exists. And I said that in Inuyama and I almost got thrown out of the city, and for crying out loud, almost thrown out of the country. How could you say this about the Japanese banking system which is the most centrally regulated banking system on earth? After all, everybody has this giant tower in Tokyo and everything happens there and it's all clean. And I just suggested that maybe infrastructure bonds for the steel industry and fabless construction for the consumer electronics industry might not behave the same. Maybe. Guess what the distressed asset portfolio of Sakura Bank was? Steel industry, really stable five-year historical financials… Spectacular. Auto industry, stable growth through the five-year historical financials. Stable growth. Stable growth. Default.

Thankfully it doesn't happen here, because I have it on very good authority that S & P and Moody's all rated Adelphia really strong. Gosh, that was mean, wasn't it? I just said something that was mean. That's okay; they got Enron right. Oh, no, I'm sorry. I feel like I can't say anything. But they'll get Kodak right, won't they? That's the problem. The problem is we have a situation where the information that we're collecting in our knowledge economy is the wrong information.

(Question from audience.)

That's the amazing thing about it. We knew that - that was GIGO back when I was, you know, learning what that Tandy 64 really was.

(Question from audience.)

I never thought I would -- and this is pretty interesting because I grew up in a pacifist family. In the early 70s I, actually, was one of those little kids with signs that got on the news. What do you want? Peace. When do you want it? Now. And was walking around naval bases in San Diego during the Vietnam war because that was the cool thing to do back then.

And I never thought I would live to see the day when a war was actually good for something. But I had a moment of seeing a war being good for something, not long ago, which was kind of funny for me. I thought it was funny. And what I thought was funny was, I was with the Senate Finance Committee and we were working on closing a tax loophole that I may or may not have referred to earlier with a company that may or may not make very large heavy equipment. And the actions that they were doing, which may or may not have defrauded taxpayers out of millions of dollars, that story. And we were working on closing that loophole with the Senate Finance Committee. And one of the majority staff persons, and I won't identify who it was, but he may or may not have an association with Iowa. One of the staff members was actually going, "David, we've got wholesale stealing from the Treasury. People knowingly are taking fraudulent donation values and charging them off. And then they're being used to fraudulently procure funds from the federal government. And it's fraud, it’s fraud, it’s fraud."

And we find ourselves with a problem because if we actually tell somebody that the patents that they donated were worthless, it sounds like we might indict the Patent Office because the Patent Office issued that thing. That's like the government saying that what we issued wasn't worth crap and so how do we deal with this? We need a sound bite. That was a quote: "We need a sound bite." I said try this on for size.

It costs 1.4 billion dollars a year to run the United States Patent Office. How much we spend every year to issue counterfeit innovation, 1.4 billion dollars a year. The estimate is that in one tax year we lost 3.4 billion dollars in Treasury collection. And I was about to say my next thought when the comment from across the room was, stop right there. Even the president can do that math. That wasn't being pejorative. It sounds like it, but it wasn't. When you're in an environment where you've painted yourself into the corner of saying I can't raise taxes, but I have to collect revenue. But I can't raise taxes. Then, when you're being stolen from and you're trying to pay for a war, you've got to figure out how to get something in the coffers. And in the space of seven and a half months, we went from no legislation on closing this tax shelter to it not only being closed, but a full-blown IRS enforcement action supported by the commissioner himself, to close what was estimated to be the third largest tax shelter in U.S. history.

Now, I've been told that the IRS can't move quickly. I've been told that Congress can't move quickly. I've been told that a lot of things can't happen on the Hill. And the fact of the matter is a lot of things can't happen quickly on the Hill. Let's just establish that as a Newtonian apple, kind of, falling to the ground thing. But there are times when you can present a case compelling enough where action is quick.

Now, I would not advocate that we necessarily try to apply that analogy to what we've talked about here. But I would suggest that we could find it in our financial best interest as a country to actually act in certain ways to, at least, hedge our bets even while we're doing some things that may not, necessarily, support our hypothesis. And so the issue is, accountability in government is likely not going to come about because people suddenly are going to get struck with this compulsion to be accountable. But there's an outside chance that we might be able to gain accountability if what we're presenting is so pathologically obvious that the penalty for not acting is actually higher then the penalty for letting the status quo be preserved.

Lest you believe that I'm talking in fantasy terms, I'm going to share with you an example of what I'm talking about. Less then eighteen months ago, the United States Navy began a project. And in that project it was trying to develop GPS independent navigation systems for unmanned undersea vehicles. Fish that can swim without having to talk to the surface. It was a very important program. And the Department of the Navy issued a Request For Proposals and sent out a Request For Proposals and said, “please let us know how we're going to solve this problem.” A bunch of companies came together and said here's how we'd solve this problem. And a large procurement was lent to companies to build guidance systems and navigation systems for unmanned undersea vehicles. We have a huge patent database in our company. That patent database is drawn from all countries in the world. And the Department of the Navy was particularly embarrassed by the fact that we pointed out that the very system that they were procuring, which President Bush at the Annapolis graduation last spring announced as the bold, new technology initiative for our country's Navy, not only had been counter-measured by a Chinese university where the exact specification in the award had already been both engineered and counter- measured in a patent in China. But more interestingly, that the Chinese university that had patented the counter-measure sent their patent application to the United States Patent Office and got a U.S. patent issued on the countermeasure for the system which is the bold new direction for our fleet.

I wish I could make that stuff up. I wish I lived in a world where I just pulled that one out of loose hair. Oh, I don't have hair. That's the problem. Let me tell you what happened there. What happened there is, in a record period of time, the defense procurement interests of our country started going, maybe we should think about that before we actually buy stuff that maybe somebody else had.

And oddly enough, the Department of Defense is the first department, not the last, to actually procure through a filter that says, look to see if what you're buying is really unique and novel and new. Or whether what you're buying has already been developed, commercialized and counter-measured before you buy it.

Now, if I can reform, in one case study, Defense Department procurement... if I can reform in an afternoon the IRS to shut down a big tax loophole which everybody said could never be shut down because it was good for America, then I'm naive enough to believe that creativity says what you have to do is, find a more compelling interest.

And on that note I would suggest that the challenge that we all face is how to find the more compelling interest. How to find Orpheus's music, which is sweeter then the sirens, even if it sounds like Rap.

(Question from audience.)

That's a great question. I would suggest that you take a family vacation to, at least, one country that borders the Persian Gulf and teach your kids that these people are wonderful people, number one.

I think that you cannot do anything in the life of a spouse, a friend, a parent, a child that is more valuable then making sure that there's a place that doesn't hate you that you can live. You can have good times. So, that's number one. And by the way that is not a touchy-feely answer, people.

Despair comes from believing that you're on an island. That's where despair comes from. If you're not on an island, all of a sudden you, at least, are not on an island. It's actually a good thing. That's Number One.

Number Two is, find a currency that is largely not floating on the U.S. dollar.

(Question from audience.)

I knew that was going to come up. Yes, such as? Libya. Who else? (Comment from audience.) Buy copper. Yeah. How about silicon? How about commodities that you know are going to need to be there, like water purification polymers? Like organic light emitting chemicals. Like, how about looking at things that are not necessarily pure currency? Like, looking at things that are likely to come out of the back end whole. The best answer to your question is answered in 1849. In 1849 there were a bunch of companies that started and by 1890 most of them ceased to exist. Most of those companies were mining companies or had a mining interest.

One of those mining companies was an 1852 unmitigated failure. It was named Kennecott. They looked for gold and found copper. And everybody said, "oh, bummer there, dude." Nobody uses that much copper. There are only so many bullets that you need and so many pennies that you need. Well pennies weren't copper in 1849. There are only so many things you do with copper until there was the thing called the trans-continental railroad. And when the trans-continental railroad was built, and you heard me right, railroad. And that's steel, yes I know. I'm not in the wrong metal. There were trees that were planted along the railroad. The trees were planted in 150 foot increments all the way across the country. And on those trees vines were hung. And through those vines current passed. And the biggest winner of the California Gold Rush was Kennecott Copper Mine. Why? Because it was the knowledge economy. And what you had to do is move things faster then stagecoach and rail and the only way you could do a wire transfer from the Bank of San Francisco to the Bank of New York was telegraph. And guess what. The first wire transfer of funds -- hold on a second, wire transfer that's a modern thing. That's an e-commerce thing. Yup, 1856, the first depository wire transfer was completed in a closed network on copper. Guess what, we're still there. You just have to be creative. You have to look at the fact that everybody thought it was a gold rush. So they went to gold. Somebody said, people are actually are going to be transporting value. And that value is going to transport and it's not going to be on the railcars that get held up by people with guns. No, it's going to be transferred across wires. And Kennecott Copper Mine became the only legacy of the gold rush. It's kind of funny.

But that's the answer. Look at what you still have to have at the other end. Polymers for clean water. Remote fuel distribution and storage. Hey, now all of a sudden I'm starting to talk about things that you actually know what they are. Why? Because they're already here. The cool thing is they're still already going to be here because we're going to need those things. That's where I'd go. Because the fact of the matter is that it would be tough for us to buy enough currency to hedge this thing. It'd be tough to buy a security that's not affected, somehow, by this. But it isn't tough to figure out how to get interested in necessary commodities, necessary chemicals, necessary structures, designs, engineering and so forth and so on. And I would say, to answer the question the way you wanted me to, not to travel the world and hang out with people, but the other way. That's where I'd go.

* The Greeks had several words for what we refer to as "knowledge". One - *gnosis* - conveys a sense of awareness and insight growing out of intense scrutiny, contemplation, and judicial discernment. A byproduct of intentionality, gnosis describes an ideal attained in matters of higher order thought or in intensely intimate interpersonal relationships. The other - *eidos* - describes awareness derived from visible inspection. This term was used to describe pedestrian information in the visible world. It also is the term to describe the appearance of gods when they masqueraded on earth and took on appearances other than their true form. As we explore the Knowledge Economy, I would encourage you to carry these competing metaphors with you and conclude for yourself which knowledge most accurately characterizes our present state of affairs.