16th Annual Banking Law & Practice Conference
Sheraton Mirage Resort, Gold Coast

THURSDAY 10 JUNE 1999

Session 1, 9.00am – 10.30am

CHAIR:
Roger Drummond, Partner, Bell Gully, Wellington New Zealand

SPEAKERS:
Francis W Neate, Group Legal Adviser, Schroders Plc, London, UK

Kevin Jarry, Former GM, Business Financial Services,
National Australia Bank, Sydney

David Krasnostein, Group General Counsel,
National Australia Bank, Melbourne

Year 2000

1.

Two weeks before leaving S & M to join Schroders –

18 months ago

Telephone call to attend next meeting of Subrodes Year 2000 Steering group due to take place the week before I joined.

What was this Year 2000?

Explanation –

Shock / Horror

Never used a PC in my life, and don't intend to start now.

I took one of my younger partners to lunch

Specialist in IT law etc

I learned all I needed to know about the Year 2000 problem over a single lunch

Since then actively engaged in Schroders Group's program to avert the Year 2000 problem, and I have become experienced and very confident about the legal issues involved.

So you can imagine my relief when I received my invitation to attend this conference – together with a list of topics I might like to speak on. With "Year 2000" at the top of the list. I faxed back an immediate acceptance, and thought no more about it until I received the draft programme – maybe 2 months ago, not more.

You can imagine my shock / horror when I realised that the organizers had a completely different idea of what they meant by "Year 2000".

2.

I should start by emphasizing that by moving from S & M to Schroders at the ripe old age of 57, I have not taken up a second career.

I have not become an investment banker;

I am employed by Schroders as "Group Legal Adviser"

In fact, I am probably doing more legal work in each day than I was doing in my last few years at S & M, where I ended up managing the litigation department comprising about 150 people in all;

Furthermore, I am not a member of Schroders group board, or its group executive committee, where the strategic planning is done (I hope!)

As legal adviser, my nose is strictly to the grindstone of the conduct of daily business, the daily transaction, the instant problem

3.

So I am not at all convinced of my qualifications to address you on the topic I have been given, and I have been struggling for the last month or two to work out what I can usefully say, and how to put it in context.

I have come to the conclusion that, because what I have to say is essentially personal, my views are entirely my own, developed over a life-time of legal practice closely connected with leading practitioners in the financial services industry. I should start by setting them in the context of my own personal experience.

4.

I started my adult life at Oxford University reading Law. I got a respectable degree in 1962 – respectable enough to gain a place at the University of Chicago Law School, which with generous financial support from Ford Foundation, I attended in the academic year 1962 – 1963

In moving from the University of Oxford to the University of Chicago, I experienced a culture shock from which I have never recovered.

It wasn't just that as a student you were expected to work , and to <u>work</u> twice as hard, and ALL the time.

It wasn't just that the teaching methods were different, they were very different, and better. They were <u>much</u> better, more rigorous, more demanding, setting the law in a wider social, political and economic context, mixing the theoretical and the practical in a helpful way to the future legal practitioner well beyond the scope of the average Oxford don.

There was also a wider, cultural difference exemplified by the attitudes of the students themselves –

Very determined, very dedicated
Extremely hard-working
Extremely thorough
Astonishingly single-minded
Totally success-orientated

I know that there are other circumstances which help to explain some of this, especially the fact that the Law School at Chicago, like all the US Law Schools, is a graduate school, where as Oxford was undergraduate.

So at Chicago, the students were older and inevitably more focussed. Nevertheless, I became convinced then, and have become even more convinced over the following years, that at Chicago what I experienced was a fundamentally different culture.

The American professional and business elite is simply - \

more rigorous, more thorough
more determined
more success-orientated
more aggressive
more competitive

And therefore being drawn from a larger pool of talent than its equivalent in other countries, and untrammeled by long standing traditional ways of doing things, is always likely to be more successful. In other words, in the economic game of competition – TO WIN.

5.

After Chicago, I spent nearly six months with Davis Polk & Wardwell, one of the leading Wall Street Law Firms, before returning to England to join S & M.

All I can say is that this experience simply re-inforced my experience at Chicago.

Anyone who has spent any length of time with one of the leading New York Law Firms will surely agree that nowhere else is the law practiced with such rigor, such thoroughness, such sheer professionalism.

Of course, the American approach to legal practice has its flaws – leaving aside the approach to litigation, I am talking here only about the best Wall Street Firms, it can nevertheless be too thorough, too wordy, too expensive, not always value for money.

All the same, what I learned from Davis Polk was how, in a perfect world, legal practice could and should be conducted.

At the time, when I went back to S & M, I took with me a picture of the standard of legal practice to which we should, all of us, all the time, aspire to attain.

6.

At the risk of repeating myself, it is my view that all the necessary ingredients for success in the business and professional world are built into the culture of US society to an extent greater than in any European Country, possibly in any other country which wishes to compete economically with the USA.

I report what I observe. It is not for me to speculate on the reasons why this should be so – nor is that within the scope of this paper. I merely introduce my subject with the observation that in the heat of the intense competition now taking place in the developing global capital market, the American investment banks are more likely than not to come out on top.

7.

There are several other factors which support this conclusion.

First, the US is the ONLY country with prior experience of developing a multi-cultural, multi-ethnic, multi-national economy and capital market.

Europe is just embarking on a process of building a similar economy, while the US has been engaged in doing so since the beginning of economic time, and Europe has the further disadvantage that it does not have a common language.

8.

Secondly, let us reflect on the sheer SIZE and DIVERSITY of the US capital market. No other country can match it. The population of the EU is greater than that of the USA, yet its GDP is smaller. I forget the figures, but at least the EU's GDP bears comparison to the US. The EU's capital market bears no comparison at all.

I emphasis I am not talking only about size, but also about diversity. Let me give you just one statistic which struck me very forcibly when I saw it the other day.

INVESTORS IN EQUITIES

In 1960, 83% of US corporate equity was held by households and non-profit organizations. In 1997 the percentage was still 44% and the gross value had increased substantially, although of course in the intervening period pension funds and mutual funds had taken a far greater proportion of the whole. The important point is that only in the US is there a culture of private, direct equity investment.

The importance of the US capital market became clear at the outset of the privatization spree which was started by Mrs T. in the mid 1980's. These were the first multi-jurisdictional offerings and I can still remember my partner, Giles Henderson, and Ton Joyce of Shearman & Sterling (now with Freshfields), explaining to a rapt audience in Paris at a seminar which I organised for the IBA's banking committee, how they learned to marry together the two systems' very different disclosure obligations and marketing and underwriting techniques.

The fundamental point was, and still is, that public offerings of this size simply must access the US capital market. There is no other capital market of sufficient size and diversity to cope with them, i.e. to supply the demand.

9.

So we come to my answer to the question I think I have been asked to discuss –

"What is going to happen to the investment banking market in the year 2000 and beyond?"

My answer is clear – the American investment banks are going to win – they are winning and they are going to go on winning.

And the fundamental reasons are –

(A) Access to the US capital market is a fundamental requirement for those wishing to access the so-called global capital market, and the US investment banks dominate that market – it is their home market, and it is so large and so diverse that it is, in fact, itself the dominant part of the global capital market.

(B) In an intensely competitive and fast-moving environment, such as the global capital market, the US investment banks are culturally far better equipped to win the competitive battle.

10.

I have put this theme to several leading bankers among my acquaintances in the last few weeks. I had better not name them, but one of them was chairman of one of the UK's largest banks, and without exception, their comment was the same – it is not that the US banks are going to win, they have won already.

I am not myself convinced that this is correct, although it accords with my thesis –

Which amounts to the proposition that if they haven't won already, they have such important in-built advantages that they are almost certain to win in the long run – but let us examine what has happened, or is happening. to the competition.

11.

The UK has more or less surrendered

> Our 2 leading clearers, Barclays and Nat West, both tried to build investment banking businesses at the time of Big Bang – Both have now given up.

In the meantime, in the domestic market, they have both been overtaken by their main competitor, Lloyd's, which never tried to play in the investment banking business or global capital market, and saved itself a lot of money as a result.

As to the merchant banks, when I started with S & M in 1964, the City of London, or at least its Capital market and legal world, was dominated by the 14 members of the Issuing Houses Association. I cannot now even remember all those 14 names, but with the sole proud exception of my own bank, all the other leading names have disappeared, either into the minor league like Rothschilds and Lazards, or into the Continental embrace, like Warburgs, Kleinwort Benson. Morgan Grenfell, Barings – Hill Samuel has just disappeared.

12.

What is happening on the mainland of Europe? Well, first and forecast, they are having to deal with the heightened competition which they are experiencing as a result of a continuing process of deregulation throughout the EU and the introduction of the Euro.

In almost every country, there is occurring a process of consolidation – or this is forecast – which seems likely to be designed to achieve – not merely the traditional aim of cost sharing and cost reduction – but also the creation of one or more national champions.

This is certainly happening in France and Switzerland, also in Spain and Italy. It is not yet happening in the UK, because our competition laws probably prevent it, but there are numerous voices arguing that it ought to happen.

Only in Germany and Holland are at present banks which appear to be ready and willing to join the battle for global supremacy. The Swiss might claim to be there too. I have to say that I seriously doubt their ability to succeed.

Deutsche Bank appears to be the most ambitious, with its acquisition of Bankers Trust, which does give it access to the US capital market, but they will have dreadful cultural problems absorbing Bankers Trust. Their acquisition of Morgan Grenfell has not been a success, and in my view, Deutsche does not have the cultural background to succeed. It has built its position in the German market by inserting its own money in its client companies, the result of which is a very cozy, dominant position in a relatively uncompetitive market.

My guess is that Deutsche simply does not have the experience of the cold, hard, competitive climate of the US and global capital market to compete there effectively.

Obviously, Bankers Trust did not think it would succeed on its own – or it would not have succumbed to Deutsche.

The Dutch have more experience of being alone, on their own in a nasty, hard, competitive world, so culturally they may be better equipped to compete, but neither ABN-Amro nor ING has serious US capability, nor I suspect any prospect of achieving it. It is part of my thesis that without serious US placing power, you cannot become a serious player in the global capital market.

The Swiss are a similar case –

But as I have already indicated, they seem at present to be dominated by the need to create a National Champion, and while that continues, they are unlikely to be major players on a global scale. Furthermore, the search for a National Champion suggests a fundamentally defensive mentality.

It might be worthwhile to examine for a moment this process of finding a National Champion, because, as I have already indicated, it seems to be happening all over Europe. It is undoubtedly fuelled by the creation of the EURO, which is going to lead to a unified capital and financial services market across Europe. Most mergers are defensive in nature, reactions to the competitive success of others, which lends to the need to create a stronger competitor by way of response. many mergers are justified by the need to consolidate i.e. to share and/or reduce escalating costs in order to compete better. What this means is that the merger partners can't see a way of increasing income from what they do at present, so in order to continue to improve profitability, they have to reduce costs.

The search for a National Champion in the banking industry is similarly defensive, with the additional likelihood of political support, and it is largely driven by fear, by a recognition that the European banking industry is, and has for years been, thoroughly uncompetitive.

13.

Let us turn briefly to the Japanese banks. Clearly, they are not going to be competing with anyone, for some time to come.

I mention them only for two reasons –

(A) It is going to be extremely interesting to see what happens when the Japanese banks actually embrace the concept of transparency.

This is a very American concept, a very real "free market" concept, to which, until now, most of the rest of the world has given only lip service. I suspect that if the Japanese banks were to embrace transparency tomorrow, they would all be demonstrably insolvent.

Balance sheet doctoring has been the name of their game for years. We all know that. It has also been the name of the game (at least to some extent) for many European banks. If transparency really enters the financial system, I believe the consequences are incalculable, especially for the Japanese

(B) The second point about the Japanese is to remind you that it was only a very few years ago – in the 1990's – during President Clinton's first term, that the Americans were seriously worried, and made aggressively defensive noises about Japanese competition, about both Japanese financial competition, and Japanese industrial competition.

At the end of the 1980's, the Japanese banks were perceived as the coming giants of the world's financial systems, and Japan was perceived to be the coming, dominant economic power.

14.
I was reminded of this by one of my colleagues in Schroders when I was discussing with him my theme for this talk. While not disagreeing with my fundamental thesis, he reminded me that it was only 10 years ago (or less) that the US economy was in the doldrums. Indeed, that perceived economic failure was thought to be one of the main reasons why president Clinton defeated George Bush in the 1991 election.

My Colleague also reminded me – or rather told me something that I didn't know - about that time serious consideration was given to down-grading both Goldman Sachs and Citibank as a credit risk.

This is a salutary reminder that there are always cycles in economic and business affairs, it is really only in the last 3 / 4 years that the US investment banks have burst through to dominance of the global capital market scene, and they have achieved that against the background of a booming domestic economy.

Indeed, my colleague went on to argue that in addition to my two fundamental factors –
(A) Culturally, better equipped to compete and
(B) access to the largest and most flexible capital market.

I should add a third factor to explain the success of the US investment banks, namely, a strong domestic economy.

He may be right – if he is, my thesis is clearly not going to be proved wrong in the near, or even medium term, but there may yet be hope for the rest of us in the longer term!

15.
There are two other subjects I would like to deal with, albeit briefly –

(A) What does this mean for smaller financial services businesses?
(B) What does it mean for the legal profession?

16.
As to the first –
What I have been talking about is the <u>global</u> capital market, the market in which huge sums are raised, by way of debt or equity or a mixture of the two, for the world's leading companies.

This is only part of the financial services industry, albeit the one which receives the most attention. Because it makes the most news, the best returns, the largest sums, the toughest competition, and attracts the brightest people - but it is really only the top part of the iceberg.

Underneath, there are national markets, regional markets, emerging markets, and within each retail and wholesale markets.

It is worth reminding ourselves of the infinite variety and scope of the financial markets.

What gets talked about most is globalization. But what we are actually seeing in the world at present – not merely in the financial world, but more generally – are two trends – the trend towards globalization, and the reaction to it, the trend towards individualization. You cannot have one without the other, least of all in a free market. And between the two extremes – globalization and individualization, there are infinite varieties in between - national, regional, wholesale, and retail.

"Segmentation" is another buzz word in banking, particularly, but not exclusively, in retail banking. The belief is that the customer is becoming, and will continue to become – increasingly discriminating. The key to success, will be to identify the service or product which will appeal to enough of these discriminating customers to provide a profit – i.e."segmentation".

This is where hope lies for most of us. If the Americans are going to rule the global capital market, we can do just as well in the rest of the market. Here also is the answer to the argument that there is no longer going to be room for the middle tier – only the global players and the niche players will survive. But why can one not have more than one niche? Two, three, or even four niches? The key is the same as it has always been – identify what your customers want and provide it better than anyone else.

The further one moves away from the global capital market, the more differentiation occurs, the more history and culture has an effect, the more local, domestic and national characteristics predominate.

One thing the Americans have never been good at is sensitivity to other cultures – the ability to understand and adapt to local circumstances. This is not going to change, not in our lifetimes anyway, and the size of this iceberg is truly enormous.
No-one is actually going to develop a full-service, truly global financial services company in the foreseeable future, and I doubt that they are even going to try.

Not every one wants to drink Coca-Cola, and no-one wants to drink Coca-Cola all the time. Where we talk about a global product, we are talking about a product which can be sold everywhere, not one which will be <u>bought</u> everywhere.

We would all like to produce a global product, but for those of us who can only produce something which appeals to more sensitive palates, there are still millions of people willing to drink wine.

So when I talk about the US investment banks dominating the global capital market, I doubt very much that their dominance will go beyond that.

And when I talk about the movement towards establishing National Champions, I do not mean to suggest that this will not be successful, merely because I doubt their ability to compete in the global capital market. Success – at least initially - in their own markets is almost guaranteed.

In the short run, these banks -

Deutsche, SBC / UBS, Societe General / Paribas / Nat West / Barclays – will be dominated by the need to establish themselves as the National Champion.

In the longer term, they may be ready to compete with the US banks in the global market place, but they will then face another hurdle, the cultural hurdle.

In my view, there is all the difference in the world between commercial banking and investment banking – and no single organisation has yet succeeded in combining these two, fundamentally different cultures into one organisation.

I became convinced of this when acting for the Bank of America in the late 1970's when it was trying to convert itself from a huge California – based retail bank into an international bank. All it succeeded in doing, was to lose practically all its money in loans to South America – an experience which persuaded the banking industry that lending your own money is a mug's game. One bad debt can destroy your entire annual profit.

Just as there are colossal cultural differences between wholesale and retail banking, so there are between commercial and investment banking. Look at the experiences of Barclays and Natwest, Deutsche with Morgan Gwenfell. The disappearance of Hill Samuel into TSB. Citicorp? J P Morgan?

17.

Nevertheless, my basic message remains the same - Cherchez les Americains – and that brings me to my last topic. What does that mean for us lawyers? In the last 10 / 12 years the legal profession, almost worldwide, has been dominated by an unprecedented international expansion of law firms, mainly UK firms, and lately also US firms.

I had the privilege, throughout that period, until recently, to be involved in the management of S & M and to have the responsibility of struggling with the difficult often unanswerable questions which arose, and continue to arise.

I date this development from the merger of Clifford-Turner and Coward Chance – to form Clifford Chance – in 1987. Interestingly, that merger was initially perceived, and I believe it was also perceived by the principal participants themselves, as a reaction to domestic competition – in other words, an attempt to position the 2 firms more effectively in the domestic market place.

Coward Chance had an outstanding banking practice, but virtually no reputation in corporate finance. Clifford-Turner had a good corporate finance practice, but were not among the leaders in banking practice. The 2 firms complemented each other and by putting them together, the proponents of the merger hoped to make more than 4.

I believe that it was not until about 1989 / 90 that the management of CC – possibly triggered by the onset of recession in the UK at that time, turned their attention seriously to international expansion, I think that what dawned on them was that they had – perhaps unwittingly, introduced into the equation of law firm management and law firm marketing – the necessity of growth, the need to be seen to grow.

Clifford-Turner already had several well-established overseas offices and they began to build on that network. Aided substantially by the total shortage of lawyers in central and eastern Europe, and the relative shortage in some parts of the Far East.

Did they really foresee and anticipate the colossal and amazingly rapid growth of the global capital market? You must ask them - I don't know. What is certain is that to be successful, it is important to be lucky. What is also certain is that it was the growth of the global capital market, and the fear that Clifford Chance would capture a large share of the legal business in that market – which led to their main competitors in London – Freshfields, Allen & Overy and more recently and perhaps reluctantly – Linklaters to follow them into international expansion.

A few American firms were there at about the same time, notably White & Case who, by their own admission, went for international expansion for similar reasons to CC, a perceived second class status in their domestic market. But the leading American firms – Sullivan & Cromwell,Cravaths, Davis Polk, Simpson Thacher – stayed away, and still do. Even those who dabbled a bit in the international game – e.g Shearman & Sterling – really only dabbled in comparison to CC and the other English firms.

Make no mistake – what has driven this international expansion by the English firms – and certainly what funds it and provides the prospect of profitable legal work – is the capital market, not the European market, though that may also have been occasionally a contributing factor. No, it was the global capital market which, it must be remembered, started as "the Eurodolla Market" under documentation governed by English law. But today it is a very different thing, far, far, larger, a market for equity capital as well as debt capital, no longer a "Eurodolla Market" but one dominated by the US capital market.

That is why my basic message – "Cherchez les Americains" remains true for the lawyers, Just as the global capital market has come to be dominated by the US investment banks, so will the legal work come to be dominated by the absolute need to comply with US law.

It is no accident that in 1995, Linkleters announced their intention to hire a dozen NY lawyers in their New York office by the end of the year, that Freshfields took Tom Joyce into partnership, and Allen & Overy Jeff Goulden, and now apparently Clifford Chance are to merge with Rogers & Wells.

But watch this space. Keep an eye on Sullivan & Gromwell, Cravaths, Davis Polk, Simpson Thacher – the key players.

Clifford Chance could not hope to merge with them -their profits per partner are probably twice or even three times higher.

Do they need to merge with anyone?

Why should they?

Won't this work – or at least as much of it as they want – just fall into their lap anyway?

Cherchez les Americains

z