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The Future for the European Debt Capital Market

I congratulate Greg Hammond on what can only be described as a tour de force. I originally thought that my principal task would be to comment on his paper, but I now realise that is completely unrealistic.

Greg's scope is so broad that someone like me – with far less experience of the capital markets legal work – cannot hope to match him. Furthermore, my experience of Australian practice – and the Australian market – is non-existent, so that I can only hear and wonder at the bravery of Greg's predictions.

It was, I think, Mark Twain who said,

> "It is dangerous to make predictions, especially about the future".

Greg himself said that his "crystal ball is clouded" when he asks himself what the innovations will be.

But if Greg knew what the next innovations will be

- like anyone else in any market-place
- he would not waste time telling you
- he would go out and make money out of it.

So I fear, once again, from me all you will get is a very personal view –

- based on limited experience.

I will start by repeating my theme of this morning – Cherchez les Americains

If you want to predict what is going to happen in the European capital markets –

- look at the US markets

What they were doing yesterday, Europe will likely be copying tomorrow.

It is not just the size, but the diversity and inventiveness of the US markets which mean that they lead the way.

Let me bravely try a few predictions:-

1. Regulation

In the UK we are currently going through a radical reform of our regulatory structure – combining various semi-autonomous member organisations into a single statutory body.

Yet it was only in 1986 that we instituted any kind of formal regulatory structure at all.

"Tea with the Governor" was the way regulations were conducted by the Bank of England in the 1970's.

When I started practising, there was no Takeover Code at all. The first, when published (in 1968?), was barely 10 pages long. It was the first attempt at "voluntary regulation" – designed to stave off the threat of statutory regulation -

- the awful spectre of a SEC – equivalent

30 years later, a SEC equivalent is precisely what we are getting.

The Japanese are going through a similar process. They have a new FSA – replacing the mysterious MOF - which is visiting various financial institutions in Japan -

- apparently to determine whether they have assisted Japanese companies to conceal losses.

This is moving the goal posts with a vengeance

In the 1970's and early 1980's, American bankers in Europe tended to be apologetic about their regulators –

- they were beguiled by the apparent freedom to do what they liked
- until they started to lose their shirts

The SEC too fell for this "line" to some extent –

- and relaxed some of its rules to a minor extent.

The fact is – as I said this morning – the USA is the only country in the world with any real experience of managing a

- multi-ethnic
- multi-cultural
- even multi-national

economy and capital market.

And what they have learned is, if you do not have detailed written rules specifying what is forbidden, it will be regarded as permitted.

European financial markets have developed as gentlemens' clubs – where the members know what is unacceptable behavior without having to be told.

This is only possible in a culturally homogenous society. In the international market-place it simply cannot work.

So – the regulators are going to tighten up – all over the globe -

- and heaven help those who break their rules –
- because to start with they will be determined to flex their muscles -
- to achieve credibility
- to demonstrate that they are better, tougher, more effective than the SEC

- Because they and their political masters have also made another error –
- namely to allow the belief to develop that regulation prevents dishonesty and
- insolvency.

It doesn't – it just makes it marginally more difficult.

But the regulators need to encourage this idiocy in order to justify their existence

- and politicians need to encourage it in order to persuade the press and public that they are "doing something".

So we can expect a long period – probably never ending –

- of ever more detailed rules
- ever more frequent "inspections"
- increasingly savage penalties

2. Capital and Measurement

Both managers and regulators of financial institutions seem to be turning their attention more and more to the concepts of

- risk management
- leading to the concept of "value at risk"
- and so to methodologies for measuring the amount of "value at risk" and
- the amount of capital required to support that value at risk.

I have to confess that, while I believe that I understand the principles behind this approach to evaluating and managing risk, I have no involvement in the detail.

However, I think I understand enough to predict – as many others are predicting – that this increased concentration on setting aside capital to support "value at risk" –

- will lead to a continuing and increasing interest in methods of taking assets off balance sheets –
- in order to release capital for other, more profitable activities
- or for what are perceived as growth opportunities.

As a result there will be an increasing use of securitisation

- and an increasing use of derivatives.

Again, I refer you to the US markets which are – and always have been – the leaders in both these technologies.

3. **3. In connection with securitisation**, perhaps I ought to mention one respect in which I think I disagree with Greg Hammond. He says that he expects the importance of rating agencies to decline. My colleagues tell me they expect the opposite – for two reasons:

(a) The increasing complexity and sophistication of securitisations will make it all the more important for the average investor to have access to independent analysis and assessment of the products on offer

(b) The sheer volume of information available to the average investor in the electronic age will be too much for him to cope with without the help of independent analysis and assessment.

4. As to derivatives – perhaps I should offer 2 comments:

(a) The need for standardised / commoditised derivative products will not go away, i.e. products which can be traded over the telephone on terms which are common to all and properly understood by all.

My one claim to a place in legal history is that I was actually present at the meeting in 1977 when the currency swap was first thought of.

I hasten to add that I was not the one who first thought of it – I was merely there when it was first thought of.

In those days it would take 2 or 3 months to negotiate a currency or interest rate swap. Nowadays, they are common-place.

ISDA has made a considerable contribution to this process of standardisation / commodisation. At the moment they are tackling credit derivatives.

My colleagues tell me we can expect many more of these, especially if a degree of standardisation can be achieved.

At present, I understand there are two principal difficulties:-

(a) securing agreement on one or more standard definitions of a "credit event".

(b) Finding an effective, fast and independent mechanism for dispute resolution.

These needs were highlighted by the fiascos triggered by the Russian financial crisis last autumn.

I am told that one city solicitor claims to have made more money in one month advising his clients on the problems created by their defective documentation – than in 3 years beforehand advising them on the documentation itself. In other words, yet again, in boom times, standards slip.

(b) Secondly, I wonder whether the bailing out of LTCM last autumn was a good or or bad thing! I wish I knew the answer.

Those of us who do not understand derivatives – (and that includes me) –
- tend to be frightened of them and believe they have incalculable consequences.

That fear and belief were fuelled by the Barings / Leeson disaster. But that was actually a simple case of fraud.

What frightens me about derivatives is that they are all based on simple unsecured contract. When you enter into a credit derivative, you do not get rid of the credit risk –
- you merely have a contract with someone else to pay you money if the risk comes home to roost – and he has a contract with someone else.......- and so on......- and so on.

But perhaps that is where the strength lies. The reason why the FED –
- of all central banks, the least likely to intervene, surely - organised the "rescue" of LTCM was not because the financial system was at risk –

- it was because it did not know whether the failure of LTCM would put it at risk or not,
- it did not know what would be the chain reaction,
  first on LTCM's counterparties,
  then on their counterparties and so on.

In the case of Barings – the Bank of England made a calculated decision –
- that to rescue it was not necessary to the continuing health of the financial system.

- In the event ING acquired it anyway –

- In the case of LTCM – only 4/5 years later – the FED made a different decision.

I do not know enough about the 2 cases to be able to do more than guess at the difference between the 2 cases –

- but it seems to me likely to lie in the increasing intricacy and complexity of the system over the intervening period.

When people first started talking about the global market, some 10/15 years ago, one of the things they worried most about was the lack of a lender of last resort.

It is not clear to me whether we need to worry more about this –
- in the light of the LTCM saga - or less

5. National Champions

I mentioned this morning the search for –

- National Banking Champion in almost all main European countries
- except the UK (perhaps?)

This will lead to a wave of mergers in the banking world in Europe in the next few years. It is triggered at least as much by developments in the world's capital markets, as by the establishment of the Euro.

It will be successful – in the sense that the principal European countries will each have one or more substantial banks capable of competing in the global market.

The process of consolidation will result in
- considerable cost savings
- loss of banking jobs (the same as cost savings)
- increased competition across Europe
- reduced fragmentation across Europe (similar to the upheavals in the building society movement in the UK).

6. Will the Euro succeed?

Why not? I don't know!

The current weakness of the Euro (relative for example, to the pound) will mean delay – at least – in the development of a single Euro debt market.

The initial weakness of the Euro seems to have surprised most commentators. Maybe the English have become so used to the weakness of their own currency that they can no longer believe in it continuing to maintain its value.

The most convincing explanation for the weakness of the Euro I have heard is that the creation of the Euro reduced investors' diversification opportunities. This may not mean that they are keen to buy pounds, but may well mean that they are not at all keen to sell them.

7. Does / will the Euro present any interesting or difficult legal issues?

NO!

In my experience, the introduction of the Euro was one of the most boring legal stories of my practising life – indeed, hardly a story at all.

8. Finally, the Internet

What will this mean in the next century?
What effect will it have?

We all know that information technology already enables transactions to be negotiated
- completed, - settled

quicker than ever imagined i.e. in "real time".

We also know that –

it enables financial services businesses to be measured
- monitored
- controlled
- regulated

more quickly and efficiently than ever before.

But the Internet is something new again – the financial world until very recently thrived
- made its money out of
- limited knowledge
- and delays in the delivery of knowledge.

That is what arbitrage is/was all about
- what investment decisions were all about

Except in the USA, the concept of "transparency" in financial markets is a relatively novel idea.

How can one imagine a world in which ALL the information in the world is INSTANTLY available to EVERY single person in the world?

Need for intermediaries? Need for recognised, reliable name / reputation?

An IT expert recently suggested to me that the Internet revolution will turn out to be as momentous as the Industrial Revolution –
- with equally incalculable consequences.

If you had asked Hargreaves in 1760 to forecast the consequences of the spinning jenny – the consequences of mechanization - he could not have done so.

The human mind is incapable of that kind of foresight.

So it is today, I suggest, with the Internet –
- which enables me to end – as I began – with Mark Twain –

"It is dangerous to make predictions especially about the future"