

# **The way forward: building a sustainable recovery and driving growth**

Lecture to the London School of Economics

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## **1. Intro**

### **1.1 Welcome**

- Good evening,
- I'm very grateful to Howard for his kind introduction and for offering me this chance to address you tonight.
- It is to the great credit of the university that it holds these public lectures, and although I can't match some of your recent speakers for book sales, I hope that my thoughts on this evening's topic will be useful to you.

### **1.2 Context**

- The events of the past two years in the global economy have caused even the most ardent free marketeers to question the foundations of capitalism.

- Friends that I never thought would say such things have questioned the very basis of our economic system. And I speak as someone who has quite a few friends in this business, having worked in financial markets all over the world for the last 27 years.
- However, personally I do not believe that this was a crisis of capitalism, the economy as a whole, or even of financial services. In my analysis, this was a crisis of excessively leveraged debt, opaque securitisation and loose monetary policy.

### **1.3 The topic**

- I come to this debate from the view that markets are not, and never have been, flawless.
- They are, very simply, the most efficient mechanism for matching capital to growth.
- We cannot entirely remove crises from the system. Irrational exuberance will be part of the market as long as it is part of human nature.
- However, we can seek to build a sustainable financial framework, which is able to better absorb these shocks.

- That is why I believe we need a new conception of the 'good economy'; one built around sustainable outcomes.
- And so I would like to use this evening to talk about how we can build systems able to sustain our flawed but precious market economy.
- I would like to focus on three key areas;
  - My thoughts on the causes of the crisis,
  - what a new economic settlement might look like; and
  - The steps that will take us there.
- And as you might expect from the CEO of Europe's largest stock exchange, I believe these steps will include a rediscovery of the benefits of equity funding and the exchange model, and in particular the model's integral qualities of transparency, neutrality and liquidity.
- Europe has had a tradition of funding growth through bank lending rather than through equity markets – a tradition which has been reflected in bank balance sheets. Over the years, policy makers and central banks have worked to ensure that this lending was economically sustainable.

- Historically, the preferred method of controlling lending was to introduce interest rate rises, which can be a blunt instrument and are almost inevitably used too late.
- In the longer term, we need to build a sustainable, diversified funding ecosystem which reflects a greater role for equity markets as a significant mechanism for raising capital, alongside the existing culture of debt finance.
- This will not be a question of regulation – restricting lending will create added and unwelcome barriers for business.
- It will be a question of ensuring that capital markets infrastructure is as efficient as possible in its crucial task of matching investors, companies, entrepreneurs and innovators.
- We have to work to recognise the important benefits of bringing products on exchange, both in the US and in Europe, but for differing reasons.
- In the US, capital markets are widely used, but not enough has been done on transparent exchanges. In the EU, both transparency and levels of exchange trading are lower than they should be.

- The current crisis gives us many examples of these problems, and is an excellent place to begin.

## **2. Content**

### **2.1 The crisis – credit and securitisation**

- This crisis was a ‘double bubble’ of credit and asset prices, which devastated the wholesale financial markets as a result of the complexity and opacity of securitisation, and failures in risk evaluation.
- It grew with what now appears to be inevitability, from the combination of suppressed interest rates, and low returns on many long term investments.
- I’d like to draw your attention to what I view as an important historical event. 11 years ago, the hedge fund Long Term Capital Management collapsed. It is important in any discussion of this crisis, not least because it was the last time a crisis could be solved by the intervention of the other market participants alone.

- But significantly, the response of US policy makers to the collapse of LTCM was to offer three sharp cuts in interest rates. In total between 2000 and 2003, the Fed cut interest rates from 6.5 per cent to 1 per cent. And they remained low, creating a false sense of permanence in monetary policy.
- The result was an asset price bubble in housing as mortgages became far more accessible. The limiting factor swiftly became how many mortgages the originators could afford to offer, rather than how many people wanted – and could get – a mortgage.
- And just as individuals and corporations were seduced by low interest rates, banks geared themselves up in order to improve returns.
- Every financial crisis since the war – with the exception to a large degree of the dot-com boom – has been a variation on this theme. Excessive leverage creates a bubble, which is then burst by a rise in interest rates and a collapse in market confidence.
- Running parallel to this abundance of cheap debt, the growth of China and the new economies on the strength of exports to the West created trade imbalances and a surplus of dollars, which were invested in the safest possible place - US Treasury bills.

- The result was a fall in the yields available to investors.
- Inevitably in this low yield environment, the more ambitious and enterprising asset managers began to search for alternative investments.
- They sought the higher returns demanded by a competitive industry and a society whose ageing demographics demanded significant returns on investment.

## **2.2 The securitisation pipeline**

- These two great oil tankers – a housing price bubble and a wholesale market searching for the next big win – crashed in to each other through the development of the ‘originate to distribute’ securitisation pipeline.
- This basic process, which is known as securitisation, is an entirely valid means of dispersing risk.
- But more and more complex and geared products were devised which relied on flawed assumptions and rating agency modelling which suggested that the underlying assets – property loans – were safe.

- Mortgage providers were reaching further down the socio-economic chain, offering greater numbers of sub-prime loans, which became packaged into more risky securities.
- By 2003, the number of mortgage applicants rejected had halved to just 14 per cent, and sub prime backed bonds grew into a trillion dollar market.

### **2.3 Over leverage**

- And with hindsight we can see that the decision of US regulators in 2004 to lower capital buffers increased further the amount of leverage swilling through the system.
- This decision meant investment banks could hold 1.6 per cent capital against these investments, rather than 8 per cent. That's just sixteen thousand dollars per million.
- In 2001, three years before this change, Merrill Lynch's leverage ratio was 16 to one. By 2007 - three years after - it had risen to 32 to 1. Morgan Stanley and Bear Stearns were leveraged even higher at 33 to 1.



## 2.4 The crash

- And then suddenly the game changed.
- The debt fuelled bubble burst. In 2006 interest rates rose above 5 per cent here and in the US.
- Consumers started to find their mortgages unaffordable. House prices on both sides of the Atlantic fell by over 20 per cent.
- Defaults grew on a truly astonishing scale.
- The banks' prized cash cows were suddenly worthless. The result was devastation played out daily across the markets.
- AIG, who were one of the principal insurers of the market, collapsed into the arms of the US taxpayer, Bear Stearns was acquired by JP Morgan, and Lehman was allowed to fail.
- In Iceland, a whole economy, built on a financial sector invested in these markets, declared itself effectively bankrupt, taking large amounts of British savings with it.
- British banks - who were heavily invested in these securities - queued up to announce record losses.

- And the Chancellor with our most distinguished bankers found themselves gathered, shell shocked, staring into the abyss.
- But the actions they took seem to have averted a global depression, and despite continuing economic challenges, attention has turned to how we plan for a recovery that can deliver sustainable growth.

## **2.5 The value of the sector**

- However, I am not here to offer a defence of the decisions and behaviours which led to the crisis.
- Instead I want to focus on how we can put right the problems of the past economic cycle, and redouble the efforts of a sector that remains hugely valuable to us all.
- I would just like to highlight that at the start of the crisis, financial services only accounted for less than 8 per cent of the total GDP of the UK, but provided 27 per cent of its corporation tax and 15 per cent of its income tax.
- Despite serious problems, it remains a vital sector punching well above its weight for the UK.

- The real concern lies in the fact that over the last decade, manufacturing fell by over a third. The challenge to me is clear, not in how we restrain a bloated industry, but how we re-focus financial services on funding and supporting balanced growth across the UK and EU.

## **2.6 A sustainable recovery – learning the lessons from debt**

- In this context, the crisis has exposed the limits of excess leverage by demonstrating its brutal nature in a falling market.
- It is clear that we need to find greater balance in our economy towards equity, as a means of increasing the funding options for business, and also encouraging a savings culture in the UK through investment in UK Plc.
- Let me be clear, debt finance is not bad.
- But debt, lent to unreliable customers, secured against volatile assets, securitised and priced using dubious methodology, leveraged again and again, and funded using wholly unpredictable short term credit markets, is a recipe for economic disaster.
- There are two issues here.

- First, investors came to see debt instruments as having superior returns on investment.
- Traditionally, equities will provide better long term returns than basic government and corporate bonds 99 per cent of the time.
- But bonds built from securitised debt – and indeed leveraged quasi-insurance products like credit default swaps – seem to offer greater returns than the stock market, but clearly they are too volatile.
- Investors must be far more restrained and retain a long term focus in the returns they expect.
- Second, cheap interest rates for retail customers and the wholesale market, coupled with a tax system which makes debt hugely efficient encouraged this credit bubble.
- We cannot sustain interest rates at today's levels without laying the foundations for another bubble. 'Greenspan's put' was effective at restabilising the economy, just as it appears Bernanke's put has been.
- But if we wait until we see evidence of a bubble before raising the rates, as was the case in 2006 on both sides of the Atlantic, we

may find ourselves repeating the events of the past 18 months.

## **2.7 Value of equity**

- And of course the impact of debt on the downside would be lessened if a greater proportion of our economy was financed through equity.
- A key difference between equity and debt is that equity financiers are incentivised to 'follow their money' and support companies during a downturn rather than seize assets.
- To use our markets as an example, we saw equity raising in excess of £106 billion pounds last year - the vast majority in further issues - as companies started to repair and rebuild their balance sheets with the significant support of their existing investors.
- Equity finance for companies and equity investment by individuals are two sides of the same coin, fundamental to economic growth and prosperity in a modern society. On the one hand, equity finance plays vital role in supporting ventures large and small by helping companies meet their various needs for capital. On the other, it provides strong, sustainable investment returns.

- It is an investment in jobs, wealth creation and in tax generation. It is the mechanism that matches capital to opportunity efficiently; the economy's engine of growth.
- The decline of manufacturing in the UK has a number of causes, most notably the difficulties in competing on price with the new economies.
- But the manufacturing sectors of the future - biotechnology, advanced engineering and clean tech will rely significantly on equity funding.
- I said earlier that the tax paid by financial services was a significant percentage of the national total. In simple figures, it's just under £30 billion pounds.
- In comparison, the total tax paid by companies in the FTSE 100 – all of whom are in part equity funded – is around £78 billion pounds a year. That's more than the Government's combined spend on housing, defence and transport.
- Equity finance is a powerful tool for delivering sustainability. At the height of the crisis, the FTSE 100 lost 48 per cent of its value. But the shares remained liquid, the prices transparent.

- Now, the market has returned to nearly 80 per cent of its peak value.
- Fundamentally, with a direct equity investment you can only lose the value you invested, and are not so heavily leveraged that a move in interest rates would cripple your balance sheet.

## **2.8 Tax**

- But as the IMF argued in June this year, the balance of debt to equity has been significantly affected by the systemic bias of our tax system.
- And this bias was a contributory factor to the crisis, distorting corporate financing behaviours towards excessive leverage through what amounts to a significant subsidisation of debt.
- In the UK, debt costs are tax deductible, while equity capital is taxed four times through its lifecycle; at purchase through stamp duty, corporation tax, dividend income, and capital gains on sale.
- It is not clear why such an extraordinary situation has come about but as long as it remains in place, the leverage imbalance will remain.

## **2.9 Household re-equitisation**

- And there is an additional problem of domestic indebtedness. The UK has a significantly higher level of personal debt than many other countries; double the levels in the London Stock Exchange's sister market Italy, for example.
- I would suggest that this stark difference points towards a lack of a tradition of financial capability and domestic financial management.
- I would like to see – and not just because it would mean more business for my shareholders – the growth of the citizen investor, as in Italy.

## **2.10 The Value of the Exchange model**

- And the way that the majority of investors access equity – the exchange model – has significant qualities of its own which could be employed to great systemic benefit across a wider range of assets.
- This model enables efficient interaction between investor capital and business entrepreneurialism. But it also has crucial benefits for the structure of the market, including relative simplicity,



product standardisation and clarity for investors.

- But I will focus on three key benefits in particular, which I believe underpin the wider advantages of the model; transparency, liquidity and neutrality.

### **2.10.1 Transparency**

- Sunshine is very often the best disinfectant.
- The most universal benefit of the exchange model is its inherent transparency, which can refer to the visibility of trades, of asset prices, or the structure of the assets themselves, or even in the disclosure requirements that regulators and exchanges impose on their listed companies.
- Off-exchange trading can result in significant structural inefficiencies in favour of groups with greater access and information.
- Compare for example the relative cheapness of asset price information on the stock exchange to the cost of engaging the team of advisors necessary to value a Collateralised Debt Obligation.

- And there are systemic implications to a lack of transparency.
- In comparison to the informational inefficiencies of over the counter - or OTC - markets, the exchange mechanism provides real-time and unarguable market pricing data. Movements in prices are therefore easy to see, allowing the market to absorb them on a 'live' basis.
- Shocks are less damaging. The stringent disclosure and corporate governance requirements ensure that price sensitive information is released promptly to be interpreted and contextualised by the network of professionals which has developed to support the market.
- Bear Stearns offers an excellent example of the problems of asset price opacity.
- When Merrill Lynch, one of Bear's principal creditors, became concerned with their business model and threatened to sell the CDO assets against which their debt was secured, even the possibility of a mark to market price terrified the market.

- The difference between the assumed value of the assets and the real market price was likely to be significant.
- Equally, the growth of off balance sheet vehicles highlights crucial problems of transparency and capitalisation.
- Investors, managers, rivals and regulators must be able to see as accurately as possible the risk profiles of banks with whom they operate.
- In a general sense, the suitability of capital requirements at 8 per cent is the subject of industry debate.
- But when that 8 per cent doesn't reflect the most at risk assets the bank holds, and indeed assets which become impossible to value the moment the market loses liquidity, we cannot hope to have a sustainable system.

### **2.10.2 Liquidity**

- The second characteristic, liquidity, refers to the ease with which an asset can be bought and sold. Lots of buyers and sellers means a liquid market.

- It is far from a purely technical concern. It has very direct implications for the price formation mechanism, and therefore investor returns.
- The large gap or 'spread' between the prices at which buyers will bid, and sellers sell a share, is a significant cost for illiquid stocks. For example, 2000 BP shares bought for around £11,000 and then immediately sold would incur a 'spread' cost of just £2.
- But a similar sized deal in a relatively illiquid stock, would incur a spread cost of around £130.
- Perhaps more importantly, the 'spread cost' when shares are sold is priced in to the amount that an investor will be willing to pay for a company when it first sells its shares to investors.
- Put more simply, an illiquid market between investors will significantly reduce the growth funding available to companies and employers across the UK.
- And during the crisis, the liquidity was constant – it did not evaporate as it did on the OTC markets.

### **2.10.3 Neutrality**

- These benefits of liquidity and transparency are matched by a commitment to neutrality
- Market participants can be confident that the system on which they rely has not been designed to the advantage of any particular user; buyer, seller or part of the infrastructure.
- Nor does the exchange use its access to price sensitive information to trade from an advantaged position.
- The Exchange provides a high quality venue in which everybody has the opportunity to participate on a democratic footing.

### **2.11 OTC Markets and counterparty risk**

- These characteristics can seem abstract. I would like to convince you that they are nothing of the sort.
- As we began by talking about the problems in the securitisation process, I will talk in applied terms about how the exchange model can offer significant advantages to many derivatives products currently traded on the OTC market.

- These derivatives include the mortgage backed securities mentioned earlier, but also many bespoke products structured to allow businesses to carry out hugely complicated financing.
- The big debate in finance is how much of this derivative market can be brought on-exchange, and how much can be cleared through a central counter party - known as a CCP - which acts as an intermediary between the buyer and seller, offering security of settlement to both.
- Certainly, the disciplines of transparency, price discovery and liquidity that a visible market imposes would bring immense benefit, as would the counterparty risk management provided by a CCP.
- When Lehman Brothers defaulted, central counterparties achieved nearly complete resolution of all open, centrally cleared positions within less than 15 trading days. Compare this to the lengthy process of unwinding the OTC positions, which is still ongoing.
- At the moment only 10% of the derivatives market is traded on exchange.
- The transparency of standardisable products could be

significantly enhanced by regulated exchange trading.

## **2.12 Limitations**

- But of course the benefits of the model are not a panacea, and there are many derivatives products for which neither exchange trading nor clearing through a CCP are suitable.
- The CCPs which act as counterparty to both sides of an exchange deal – protecting both against the risk of the other not completing - do so by collecting a margin based on the potential loss in the event of a default.
- For a stock, this might be around 20 per cent; for a bespoke derivative though, it might potentially be as high as 100 per cent of the position.
- Accurately pricing this risk is a significant barrier to central clearing of any non-standardised product. Attempts to make these assets centrally cleared would therefore be very possibly technically unachievable, and certainly have the effect of centralising risk in a vital piece of market infrastructure.

- I would like to offer a warning that this course of action could turn CCPs into a significant source of future systemic risk.
- Clearing houses carry counterparty risks far in excess of the balance sheets of all the banks combined, and do not benefit from guarantees from the state that they would act as lender of last resort in the event of a shock.
- I would ask policy makers to think very carefully about what parts of the OTC market are brought on exchange, and also about how a race to the bottom for CCP margins can be avoided.
- And I believe there is a need for serious thought about whether governments should extend the lender of last resort protection to CCPs
- There is no value to protecting the industry from market forces, and fees should not be subject to the same protection as the risk margins charged.
- But I would warn that it is in no-one's interest for fees or margins to become so low that CCPs cease to be sustainable, or even a potential element for systemic risk transmission.
- We must balance the need for competition with the need to



preserve sustainable and well capitalised CCP institutions.

- Additionally, as with the broader regulation of financial services, we need harmonisation in regulatory structures, funding mechanisms and risk management frameworks for these clearing houses and depositaries.
- The key is to assign the most appropriate trading mechanism for each type of asset.
- Many derivatives are not suitable for exchange trading.
- But for many others, exchange trading would offer the huge and structurally important benefits of transparency, liquidity, neutrality and standardisation.

### **3. Conclusion**

- The process of recovery and recapitalisation from this crisis is not yet over.
  - Nearly \$600 trillion dollars of untransparent OTC products remain in the financial system - ten times the value of the total annual output of the world;
  - Banks remain some distance from their recapitalisation

targets;

- Balanced funding policies are not in place; and
  - Although the savings ratio for the UK is heading back in the right direction, we certainly cannot assume that the era of giant flat screen TVs and 'ninja' loans has passed.
- We will not have repaired our financial system from this crisis until these issues are addressed.
- But preventing a recurrence is the greater challenge. At the beginning I suggested we needed to reconsider the characteristics of the 'good economy'.
- I might suggest profitable, sustainable, ethical, accessible, self-sufficient, and transparent. I'm sure you have some of your own.
- These characteristics don't include the absence of failure. Expansion and contraction of the markets is unavoidable, and to some degree a political rather than economic issue, and I suspect an unsolvable one at that.
- But the peculiar characteristic of excess leverage is to accelerate the effects of failure into a systemic event. If Long Term Capital Management was the last crisis the market itself could afford to

repair, the credit crisis was the last one within the gift of the tax payer.

- And so we must take responsibility for building a new approach to funding business and investment.
- Equity finance and the exchange model stand ready. The transparency, neutrality and liquidity they bring can be the basis of a sustainable financial settlement for us all.
- Thank you very much for listening.

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