Informal Remarks
On the Occasion of the 50th Anniversary of the Eurobond Market
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When I look back, the first thing that comes to mind are names: John and Nicholas Baring, Michael Von Clemm, Stan Yasakovich, John Craven, Lord Eric Roll, Oscar Lewisohn, Roberto Mendoza, Bob Genillard, David Mulford, Hans-Joerg Rudloff, Pierre Haas, Rainer Gut, Wilfrid Guth, and, of course, the un-named and secretive Belgian dentist, who represented the prototype "everyman" seeking to avoid taxes through holding those marvelous bearer bonds.

I then am reminded of fierce competition. Competition between Amro and ABN, between Swiss Bank Corporation, Credit Suisse and Union Bank. The Swiss had good reason to compete for mandates. Their underwriting commission was higher than the prevailing interest rate. Intense competition between Nomura, Daiwa Yamaichi, Nikko. Between Deutsche Bank and Dresdner. The Deutsche Bank in competing for placements world-wide against CSFB emphasized its tremendous placing power in every place, province, state, city, village and hamlet throughout . . . The Federal Republic of Germany. In those days, Morgan Stanley would only underwrite if they alone were the sole lead manager. Everyone it seemed was prepared to be buried under their own tombstone ads by aggressive pricing if that assured a mandate.

I then thought about risk. How did we handle uncertainty. How did we protect ourselves and our clients? It seemed we had an answer for everything.

- First, we worried about how to hedge against inflation.

  Answer: Short-term bonds or floating rates. But the BundesBank was not happy. They did not like investments which would provide an investment protection against inflation. They were concerned it would remove the political pressures against inflation.

- Then, how to offset currency risk after currencies were "unfixed" in the early 1970s?

Answer: Futures - first to hedge, then to speculate.

- There remained, of course, credit risk. The risk of default.

  Answer: Credit swaps.

- Then how to monetize liabilities when we or clients wanted to stem losses from mistakes or take gains arising from currency or interest rate fluctuations?

  Answer: The Swap Market. The world of liability management came into being. Suffice to note here some rarely publicized details about that first swap transaction between the World Bank and IBM. It took two months to arrange and execute the transaction; it was approved by 180 countries. The BundesBank was very reluctant for it feared that the unfettered use of the Deutsche Mark in swaps would effectively weaken their control over the Deutsche Mark in the exchange markets. Finally, because of fear of the counter-party risk in the swap, the World Bank Board of Executive Directors requested that we ensure the counter-party risk with a private insurance company!

- But it was not all benign. We made mistakes. How did we hide them?

  Answer: Off balance sheet trades or we didn't mark to market. That led to a sense of unreality until recently when auditors, partly from fear of being accomplices, began to mark to market – with vengeance – valuing assets well below their underlying cash flows.

- How to avoid reporting losses?

  Answer: For banks, keep lending to a non-paying borrower so it could pay interest. The principle was straightforward. " A rolling loan gathers no loss."

- How to lend without fear of the capacity of borrowers to repay?

Answer: Securitize. Package the asset. Get rid of it fast. Not to worry about prudential lending.

- How to compete?

  Answer: In the U.S., repeal Glass Steagall. And, develop an asymmetrical compensation system which rewarded success but hardly penalized failure.

- How to avoid disclosure completely.

  Answer: Form a hedge fund.

- How to increase return on capital?

  Answer: Leverage. Or manage other people's money - or both if the client permitted it.

- How to avoid all regulation

  Answer: Hire financial wizards – mathematicians/physicists. The regulators will never figure it out or catch-up. They still haven't.

But despite these wondrous things, risk didn't disappear. It was simply hidden or unreported, or passed on, or securitized, but in a world of increased leverage, risk was to be ignored only at one's peril.

Thirty years ago, I wrote, "You think you are precisely hedged, but the product or the collateral is so esoteric and idiosyncratic that you cannot sell it because there is simply no market for the product. "

And event risk. "A war takes place; an earthquake occurs; a flood of a magnitude not seen in a hundred years washes over the land; a cartel falls apart; oil prices quadruple; tax laws change, and the market in which you had an open position, or even hedged, moves in a magnitude not only unforeseen, but totally outside past models. It always does. The only perfect hedge is in a Japanese garden."

And operational risk. **"**Back-office systems, yours or someone else's, fall apart; credit monitoring systems break down; documentation is flawed; recording mistakes are made -- the computer program doesn't yet cover that kind of transaction. It never does. After all, who pays attention to the back office. It's not a revenue producer."

I summed up my concerns and those of my colleagues and friends some 30 years ago this way:

"Senior managers are rarely as informed as traders, and legislation is not likely to make them so. Typically, senior management is usually unaware of the technical operations of financial engineering. Worse, they are often afraid to ask, out of concern of admitting to their lack of mastery over the subject matters, and I think we also must admit to the fact that there is a good deal of underlying hostility to financial superstars, mathematicians, physicists. . . Management is not trained in the intricacies of convexity or volatility. As a result, reports are inadequate, supervision thin."

The result was – is – inevitable. Barings, Orange County, Daiwa, Sumitomo, Long Term Credit, Lehman, Salomon Brothers, Merrill Lynch, Enron, J.P. Morgan.

Sigmund Freud, not Sigmund Warburg, would have a blast.

- He would have explained financial engineering as denial – the pretense that we are doing one thing when we really mean to do something else – we are not speculating, only hedging;

- the relationship between the client and its banker he would describe as reliance on a father figure;

- the use of accounting conventions – the absence of reality testing or magical thinking.
- the work environment – an example of the pleasure/pain principle – current pleasure for future pain, let someone else pick up the pieces - later;
- doubling our bets in response to mistake is counter phobic behavior;
- termination therapy is what happens when the CFO gets caught;
- transference – how the trader seeks to shift responsibility to his or her superior when the string runs out;
- leveraging is bulimia;
- dynamic hedging is desensitizing;
- "I really prefer clearance and back-office work," – anal compulsive;
- "I relied on the risk manager" is but an interpretation of dreams
- and, the ultimate in narcissism, "I am the market."

Now, other than therapy, we might admit to some basic “characteristics” of our profession. Most of you and I are of a different generation, but we are really the same.

We respond to peer pressure. We want to patent that magic zero coupon bond with a perpetual maturity so we need pay neither interest nor principal. We want to capture rewards quickly and visibly so we can look good if we can't be good. We deny responsibility. We <u>never</u> measure or report opportunities lost. We rely on sympathetic accounting conventions. We design performance measures to cover-up error. They are called benchmarks. We make decisions based on: Will we be found out? Discovered? Identified as the wrongdoer? Do we really want to have to explain this stuff to someone who spent his or her life in sales or marketing? Leverage is fun. That’s who we were. That is who we are.

But I cannot leave you on such a down note because, despite everything I have said, the people in this room, our predecessors and those who follow, have changed and will change the world. Very simply, you permitted capital, in all of its ordinary and arcane forms, to be available to the private sector, to governments and to multinational institutions. You were bridges to success, you created access, you were the catalyst for globalization and while you did not invent cross border financing – you honed it, polished it, adjusted it, made it fit the circumstances and the demands of investors. The result, for which you deserve enormous credit?:

- Less infant mortality
- Fewer mothers have died in childbirth
- 300 million people have moved into the Middle-Class in China
- Fewer 12-year old girls work knee-deep in rice fields
- Caloric intake is up 50% in less developed countries
- There is less starvation
- People live longer
- The average age in India has increased by 20 years
- Children are now going to school all over the world in numbers unimaginable even 30 years ago
- There is now electricity, roads, ports, education, dams, water, food, awareness of what is going on in the world in places which wallowed in poverty for a thousand years
- In short, people now have hope. They see their lives and the lives of their children getting better and better

Yes, you and your successors created the instruments which facilitated that economic growth. Yes, a building will collapse in Bangladesh. One thousand die. Yes, storms will ravage the earth in response to our neglect of the environment. Yes, my country has un-necessarily and foolishly

fueled much hostility and violence. But the fact remains there is less violence prompted by a sense of no hope. And that is to your credit. No, it is not likely you will be remembered by name in a hundred years – that kind of immortality – but a little girl from Bangladesh, as yet unborn, one day will have dinner here returning from her studies at Cambridge or Oxford and she will one day do wondrous things. That will bring you a different kind of immortality.