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Speech by Duncan Wales, ICAP Group General Counsel, at the Annual General Meeting of the International Capital Market Association (ICMA)

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BACK TO THE FUTURE?

Ladies and gentlemen, colleagues and honoured guests, I am very pleased to be here at ICMA's AGM.

As I pondered what I might say to this august and diverse gathering of policy makers, regulators, and market participants from both buy and sell side, I was reminded that ICMA was established [as the Association of International Bond Dealers] in 1969 – so in its early phase the Association operated in an era that had seen the US embroiled in a protracted and controversial overseas war, there was a stand-off between the West and the Kremlin, proxy conflicts were being waged in the Middle East, there was huge volatility in oil and energy prices, ballooning public debt, a mix of technology, innovation and regulation radically re-shaping financial markets, a Democrat President in the White House with restricted ability to achieve anything, and the UK facing a looming referendum on its membership of what was at the time called the EEC. Does any of that sound familiar?

Certainly the post-crisis world is less certain, more fragmented and capital is more constrained than it was before it. It is a sobering thought that the share prices of some of the largest international banks have reduced to the same levels they were at in the 1990s. So, are we going back to a world without universal banks, with specialists in different market segments, a transatlantic currency split, and with revised forms of securitisation? Will Capital Markets Union create a new Eurobond market? Are we indeed going back to the future?

Despite the familiarities of the past there is one key difference to our current situation: rates were much higher in the 1970s than they are now. Post crisis, rates now are aberrantly and persistently low – with euro yields negative at the shorter end of the curve. Money has therefore become like an entirely un-conflicted FIFA official: surprisingly difficult to get hold of, but not intrinsically worth very much. I am sure I am being unfair! But the pressure on capital is certainly being felt by both lenders and investors. And that, after a period when governments and indeed individuals had borrowed more than ever before.

The financial crisis was global, its origins may have been in US domestic housing, but they managed to contaminate the value of all other assets, and undermine credit in the widest sense. The crisis saw riots and demonstrations on the streets of the world's great cities, and led to the cynicism about the perceived industrial/government complex that inspired the intelligence leaks that so contributed to the collapse of corrupt regimes in the Arab world. Un-elected EU officials walked into the halls of

democratically elected governments, such as the Republic of Ireland, and told them what to do – the Irish have behaved magnificently, and salvaged their economy as a result; the experience between the EU and Greece is, as we know significantly more complex, and the end-game still somewhat uncertain. At the same time we see signs of separatism in some of the major European countries: Spain, which has just had elections; and (distressingly for me as an Anglo-Scot) also in the UK – although I was not sure if it was a high or low point for democracy when the members of the Scottish National Party recently took "selfies" while taking their seats at Westminster. The British still allow their MPs to carry a sword, but have banned selfie-sticks.

In the downturns since the Second World War there was something to recover to – a positive interest rate, and for most of the period a positive yield – the possible exception being the dip caused by the oil crisis of 1972. The economic blips of the late 20th century felt like turbulence – the world's economy, like a lumbering aircraft being buffeted by macro ups and downs. Uncomfortable, but with space to pull out of a dive. This time we are trying to take off from a rough and unpredictable airfield of near-zero rates; we know that taking off is the dangerous part, and there are plenty of opportunities for investors, borrowers and lenders to crash in the process. While we all anticipate that Janet Yellen and the Fed will eventually raise USD rates, the timing and pace of that rise is not clear – the Fed has departed from central bank protocol and made the decision "data dependent", so making what shouldn't really be a surprise still feel rather like it could become a surprise. Despite the end of QE in the US, the Fed now had circa $4 trillion of US Treasury bonds on its balance sheet. The ECB is following suit with its own rather fragmented QE programme, and the BoJ has already bought heavily in to the public debt of Japan. Even the PRC protected itself from the American crisis by increasing domestic debt very substantially from 2010 onwards, and debt more generally in the form of corporate bonds and foreign currency loans, and with a building surge – rather American solutions to the downturn I cannot help thinking, and potentially vulnerable to American-style bubbles? So, while the crisis was the product of globalisation, dramatic increases in public and private borrowing and consumerism, the aftermath is characterised by global fractures: the asymmetries caused by the prospect of a US rate rise, potential US energy independence, a China housing bubble, a more assertive Russia and a future for the Eurozone economy like the recent past of Japan.

In the Western world, regulation also has a strong hand in all this. If one is to look at the last letter from the Chairman of the FSB (Mark Carney) to the G20 in November, providing an update on the progress of the original 2009 Pittsburgh agenda for regulatory reform, an annex notes that the only areas in which new rules have been universally introduced are transaction reporting to regulators and capital rules. So the first thing regulators have done is to make capital more expensive, and to reduce its volume and velocity through the system: entirely logical given the over exuberance and over-lending that led to the crisis. But even in the depressed rates environment, the reduction of capital has led to less depth and consistent commitment to secondary markets – whether the mini-flash crash in US Treasuries of 15 Oct 2014 or the Bund volatility and gapping liquidity we have witnessed since May, it is likely that these experiences will become more frequent, even in what should be the more liquid government bond markets. The further roll out of capital and collateral measures will directly target market makers' balance sheets, and it seems that the risk of volatile

shocks and gapping secondary market liquidity is only likely to amplify. However, we haven't felt the full impact of these rules yet – and may not until rates in some major currencies begin to rise.

The other factor is that central banks have become both the lender and investor of first (rather than last) resort. The economies of the western world have become "self-licking lollipops", where governments issued debt on the assumption that central banks would take up the supply. And if we think about the scale of public debt held by central banks, there is the problem of how to circulate it back into the financial system – with regulators very sceptical about repo as a technique, and capital charges applied to it, we could face the problem of insufficient circulating collateral – so that cash cannot move without collateral, and another liquidity hiatus is created despite there being plenty of cash.

Initiatives like MiFID II, with its emphasis on pre-trade transparency, may also have implications well beyond what its authors envisaged as a result of the evolving economic reality – it is of course essential for investors to have fair and timely valuation data, but it is counterproductive to expose the large range of debt instruments to real-time risk for market makers and indeed investors. The notion of "best execution" should be re-introduced to the ideology of MiFID transparency calibration, with the emphasis on the rather old-fashioned idea of "chances of trading success". It will be more unhelpful to have such high degrees of transparency that transparency itself becomes meaningless due to the destruction of liquidity. If anything the crisis was the result of a lack of transparency in valuation methodology, not in trading. If capital remains too constrained, if commitment becomes too fragile and inconsistent and chances of trading success decline, it will be counterproductive for all concerned.

So what are the solutions? And how can ICMA and its members, with their perspectives and experience in the capital markets contribute to them?

Capital has to be centralised and deployed more efficiently. For the large banks, this is a process that is already on-going, and future efficiency will be increasingly technology enabled. I fully expect a Nobel Prize for economics to go to the modeller of a genuinely three dimensional risk surface in due course. In the interim, financing seems destined to be more fragmented, with some specialist finance providers and smaller banks taking up the space left by the larger international banks. Central banks need to release investible bonds back into the system, and banks need to fulfil their social function and provide liquidity and transparent investment opportunities to their clients. Perhaps that means reducing the capital burden for dealers in public debt, and unencumbering repo in the same. Investors who have inventory in corporate bonds need to be provided with the means of identifying opportunities of trading – via better technology and greater standardisation in bonds if that can be achieved for liquid issues. However, solutions cannot be created under a one-size-fits-all structure. Markets need space to innovate, and authorities need to allow for different models of connecting investors and liquidity providers, not just all-to-all exchange-style transparency. Trading systems today need to adapt to the realities of economic circumstances and investor choice, which encompass anything from public central limit order book platforms to individually-tailored price streams, crossing networks and intelligent search engines.

Policy makers and regulators have achieved a lot but must not be static – the FICC markets are driven by real economy, by real demographics and real politics, public debt and the cost of money. Our collective sight must be clear on what the priorities are in protecting investors, borrowers and lenders. Risk at 0.5% is not the same as risk with rates at even 2%. The real economy is the thing that will cause the next crisis – the over extension of credit, incorrect risk assumptions and un-noticed concentrations and correlations.

So as we stray back to the future, it must be with a mind to real risk, the healthy circulation of capital, appropriate and constructive levels of transparency, verification and market opportunity, and with a well-developed sense of danger.

No one element of the system can make this work; it will have to involve governments, central banks, regulators, the buy side, and the sell side. Debate must be constructive, evidence-led and collaborative. Between us we have opportunities to collectivise data and create warning indicators, and we must be prepared to act on them. Novel technology, which might include distributed ledger models (such as the Blockchain, where there is an opportunity to replace bilateral confirmation with constant multilateral consensus confirmation) and near real-time risk measurement and mitigation should help us all in this. In an ideal world, we would also aim for truly international solutions to avoid the increasing fragmentation we have witnessed in FICC markets and indeed their regulation in recent times. And ICMA, with its mandate and diversity of participants, should be one of the strong voices in all of that.