INTRODUCTION TO INTERNATIONAL FINANCE MARKETS LAW AND PRACTICE

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INTRODUCTION TO INTERNATIONAL FINANCE MARKETS LAW AND PRACTICE

The international financial markets are the largest markets in the world. International finance has enjoyed massive growth and expansion in recent decades following an earlier period of post-War recovery and reconstruction. The largest companies in the world and governments use these markets on a daily basis to fund their capital and investment needs and working capital programmes. Over US$4tn is moved each day in the international currency markets with the total global financial system being worth in excess of US$180tn.

The international financial markets are made up of a number of separate markets. These principally consist of the Euro-syndicated loan and Eurobond markets with an underlying Euro-dollar deposit or interbank market. The international capital markets include global equity issues and depository receipts as well as international debentures and shorter Medium Term Note (MTN), Euronote and less than one year Commercial Paper programmes. The financial derivatives markets have expanded substantially since the early 1970s with nominal values in excess of $601tn at end 2010. These include the international over-the-counter (OTC) Swap and OTC or exchange traded Futures and Options markets as well as Credit Derivatives and other new product markets such as in the energy and environmental areas. A separate structured finance market had also exploded in size immediately before the financial crisis in 2008-2009, which included such instruments as Collateralised Debt Obligations (CDOs) and Credit Linked Notes (CLNs) as well as Credit Default Swaps (CDSs) in the credit derivatives area.

The operation of these markets raises a number of difficult issues especially in terms of structure and documentation, pricing and disclosure, payment, clearing and settlement. An enormous number of transactions are carried out on a daily basis between a significant number of market counterparties and end-users. All of these interests have to be managed and the stable operation of the markets protected for all users and beneficiaries. International financial markets are, in practice, principally managed on an internal market or self-regulatory basis which is necessary in light of their size and the absence of any global authority capable of overseeing them. While the main market participants are regulated at the domestic level, international contracts themselves are dealt with on a private law basis using standard documentation prepared by various trade bodies or associations which acts as a form of replacement or substitute for formal official regulation.

Recommended Reading William Clarke, *How the City of London Works* (Thompson London 7th ed. 2008); Stephen Valdez and Philip Molyneaux, *An Introduction to Global Financial Markets* (Macmillan, London, 6th ed. 2010); Richard Roberts, *Inside International Finance* (Orion London 1999). On the development of the City of London more generally see also, David Kynaston, *The City of London* (Chatto & Windus London) 4 Volumes.

The main trade bodies include the Loan Market Association (LMA) in the loan area, the International Capital Markets Association (ICMA) in the bond area and the International Swaps and Derivatives Association (ISDA) in the derivatives areas. Each of these organisations has produced several series of standard form agreements and master documents which govern the rights and interests of the parties in these markets and to a significant extent the structure and operation of the markets themselves.

The purpose of this course is to examine the nature, structure and operation of each of the principal markets involved. This includes the international loan and bond market, project finance and securitisation markets and financial derivatives markets. The main standard documentation used is identified in each case. The duties and obligations of each of the parties involved are identified and rights and remedies explained. Stock markets and exchanges are also examined with other more recent forms of alternative investment markets, such as hedge funds, private equity and sovereign wealth funds being referred to. Relevant regulatory provisions are noted where relevant. National practices are outlined where appropriate. Recent developments in the markets are also referred to where this may be of interest.

1. HISTORY OF BANKING AND FINANCE

The history of international finance has been closely associated with the development and evolution of money as well as of trade finance out of which modern merchant and investment banking emerged. The background to money can also be considered with credit and payment as these have always been intimately connected historically. International finance markets have been subject to continuous change and innovation which has included the development of many new forms of financial instruments and more recently new electronic money and funds transfer channels. The key functions of banks and other financial intermediaries have nevertheless remained the same over time. These are essentially based on the provision of deposit (or savings) facilities, loan (or credit), payment (paper based or electronic) as well as investment (bonds and equities) and insurance (and hedging) services.

(1) BANKING

Banking began with the Italian merchant and financial families during the 13th and 14th centuries. The main financial centres were the Italian City states such as Lombardy and Florence, Venice and Genoa and other northern towns. The Italian bankers quickly emerged as the leading money changers, lenders and dealers in early bills of exchange and coins within Europe. The word bank is derived from the Italian *'banco'* or bench on which the early bankers sat to conduct their business. Early coins were referred to as 'florins' (after Florence) with the UK florin not being abolished until the decimalisation of English coinage in 1971. The close connection is still clear with one of the oldest banking streets 'Lombard Street' being named after Lombardy. The oldest private bank in the world is claimed to be the *Monte de Paschi* in Sienna in 1472 with the *Casa de San Giorgio* having been set up in Genoa in 1407 as the first public clearing bank. Italian financiers had a close relationship with British royalty from an early stage. Money was often lent to the British crown generally to finance wars. Defaults were not uncommon such as when Edward III failed to repay outstanding debts to the Bardi and the Peruzzi in Florence in 1345.

(2) INTERNATIONAL FINANCE

International finance generally developed through the great trade fairs that were held in the main mediaeval towns across Europe from the 13th and 14th centuries. While these originated in the northern Italian towns, they subsequently spread to other major European cities including Lyons and Geneva. They then moved north with the growing trade routes into Flanders and the Netherlands, Bruges and Antwerp. Important families included the Fuggers in Augsburg which developed from early wool trading to become the main financiers to the Hapsburg empire. The most common means of payment at such fairs was the ‘bill of exchange’ which was simply a transferable debt instrument drawn by a creditor (the drawer) on his or her debtor (the drawee) with the

debt being directed to be paid to a third party (the beneficiary on the bill). The holder may then further transfer the benefit of the debt before repayment by special (named) or general (open) endorsement and signing with all signatories being liable on the bill subject to recovery against the ultimate drawee. The bill of exchange subsequently emerged as the dominant payment instrument in international finance until the early 20th century.

(3) INTERNATIONAL TRADE AND MERCHANT FINANCE

The most important type of finance instrument apart from the bill of exchange was the promissory note which was simply a written undertaking (promise) to pay an agreed fixed amount by one party to another, either at an agreed time or on demand. Although often used by merchants and tradesmen in their dealings with each other, promissory notes were commonly used as a form of receipt issued by early custodians or goldsmiths. Goldsmiths were often used for custodian purposes for coins and other valuables due to the secure storage facilities maintained. Goldsmiths would then issue receipts which could be traded as early forms of money. Whether paper money originally developed out of the goldsmith's receipts directly or the promissory note is unclear and subject to dispute by historians. Some of the oldest banks in England are nevertheless derived from goldsmiths, such as Coutts Bank, which was set up as a goldsmith bank in 1692.

The first legal tender was issued by the Bank of Sweden in 1661. This had originally been set up as the Bank of Stockholm in 1656 although it had to be closed as a result of significant trading losses which led to its founder being imprisoned. The bank was reopened in 1668 and subsequently renamed the *Riksbank*. The Bank of Amsterdam had been set up in 1609. Other early banking institutions that subsequently developed into national central banks included the Bank of England which was set up by William Patterson, a Scottish merchant, in 1694 to fund the costs of continuing war debts with other European countries.

(4) MERCHANT BANKNG

The earliest type of banking that emerged from merchants and trade fair activities is still referred to as '*merchant banking*.' This includes the financing of trade, mainly through bills of exchange, and then more recently using letters of credit and other trade finance practices as well as raising finance for companies of governments through bond and securities issues and providing other corporate advice and services. A number of the great British and European banking names developed out of such early merchant bank practices including Barings and Rothschild's. '*Commercial banking*' developed out of separate deposit taking activities and the

acceptance of funds from business or individual clients which could then be on-lent in the form of loans and later over-draft or other credit facilities. Such banks emerged during the late 18th and 19th centuries although it was not until the consolidation of the smaller regional banks that took place from the middle of the 19th century and the introduction of limited company liability under the Limited Liability Act 1855 that the large modern commercial banks emerged as dominant market players.

Other more specialised institutions also arose to support trade finance and international trade especially with *Acceptance Houses* and *Discount House*. These are specialist banks that add their credit by accepting (signing or stamping) bills of exchange (trade bills) and other instruments which can then be sold (discounted) through a discount house (with the discount fee being calculated equal to the interest due on the remaining term of the bill before it matures and is paid). The discount houses would also emerge as the specialist counterparties in the UK dealing directly with the Bank of England in the primary Money Market or Discount market. This is the principal market through which the Bank conducts monetary policy which is essentially concerned with managing the volume and cost of credit in circulation within the financial system.

This is distinct from the Secondary Money Markets that developed in the late 1950s and early 1960s which deal in other wholesale financial instruments issued by wholesale issuers. The main secondary markets now consist of the 'Local Authority' bill market, the 'Sterling Certificate of Deposit' (essentially a security representing an underlying deposit) market, the general 'Certificate of Deposit', the 'Inter-Company' market and 'Inter-Bank' market.

(5) INVESTMENT BANKING

Investment banking is an American term which dates from the separation of commercial banking and securities businesses under the Glass Steagall provisions of the Banking Act 1933. This was adopted following the 1929 Stock Market Crash and ensuing Great Depression in the early 1930s and required the division of many large institutions or groups into separate deposit-taking banking and securities or investment firms. The securities business of J P Morgan, for example, was split off with Henry S Morgan and Harold Stanley setting up Morgan Stanley in 1935. A merged Chemical Bank and Chase Manhattan Bank would later acquire J P Morgan & Co in 1996 to create J P Morgan Chase which would, in turn, purchase the fifth largest Wall Street securities firm Bear Stearns in March 2008 for $230 million with the assistance of the Federal Reserve. Investment firms engage in securities trading and market making, underwriting, asset management, corporate advisory work and other activities such as foreign exchange, financial derivatives and commodities trading. The term investment banking is commonly used with merchant banking although merchant banks were strictly British banks specialising in trade finance which could also provide deposit-taking facilities for their clients.

2. INTERNATIONAL FINANCIAL SYSTEM

The international financial system refers to the arrangements for the management of international currencies and payment. This includes informal and formal treaties, agreements and rules of practices that allow currencies to be exchanged and current payments to be made on a cross-border basis. Informal arrangements have always been possible although formal mechanisms generally date from the adoption of the Gold Standard in the 1800s. Exchange rates may either be managed on an automatic basis (using a fixed commodity or floating currency system), an exchange standard regime (with one currency being fixed to a commodity such as gold and all other currencies fixed to the standard currency), multilateral exchange rate management (through policy co-ordination and short-term payment adjustments) or a full monetary union (with a common currency such as in the Euro area which came into effect on 1 January 1999 and with notes and coins being issued on 1 January 2002).

(1) Gold Standard 1816-1933

The Gold Standard was only officially adopted by Britain in 1816 although it had been in operation on a de facto basis for almost a century before. This operated as a fixed commodity system with currencies being tied to a standard weighted measure of gold which had the advantage of controlling inflation and promoting financial stability although this necessarily restricted monetary policy and control of the money supply. The original system was replaced by the Gold Exchange Standard with sterling being fixed to the value of gold and other currencies fixed to sterling until 1914 and outbreak of the World War I. A attempt was made to restore convertibility of gold under the Gold Standard Act 1925 although this was abandoned in September 1931. All gold was nationalised by the Federal Reserve in 1934 under the Gold Reserve Act. While the US dollar had replaced sterling as the main reserve currency from 1914 onwards, any attempt to managed the international currency system was abandoned during the 1930s until this was superseded by a dollar exchange standard from 1944.

(2) Bretton Woods 1944-1973

The new dollar exchange standard was set up by the Allies at the Mount Washington in Bretton Woods, New Hampshire in July 1944 ten months before the end of World War II. This provide for the creation of an alternative reserve system following the financial instability of the inter-war period. Under the Bretton Woods arrangements, the value of the US dollar was fixed to gold and all other currencies fixed to the dollar subject to a formal adjustment mechanism. The system came into effect in March 1947 although full currency convertibility was not restored in Europe until December 1958. Under the arrangements, participating countries could exchange US dollars for gold at any time under a 'Gold Window'.

Convertibility was subsequently suspended on 15 August 1971 following the pressure created by a growing US balance of payments deficit and speculative attacks with President Richard Nixon announcing the closure of the Gold Window in a radio address to the nation. An attempt was made by a specially convened group to design an alternative arrangement under the Committee of Twenty and its *Outline of Reform* document in June 1974 and the earlier Smithsonian Agreement in December 1971 although these efforts were abandoned and currencies allowed to float from 1973. The adoption of a formal international floating exchange rate arrangement was agreed with an amendment to the Articles of Agreement of the International Monetary Fund (IMF)[1] in 1976 and a revised Article IV and enhanced and extended surveillance and conditionality. The Betton Woods Treaty had also provided for the establishment of the IMF and the International Bank for Reconstruction and Development (subsequently part of the World Bank group).[2]

The Bretton Woods conference had also attempted to establish an International Trade Organisation (ITO) although this was not ratified by the US Congress with a separate General Agreement on Tariffs and Trade

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1 http://www.imf.org/

2 http://www.worldbank.org/

(GATT) coming into effect instead. A World Trade Organisation[3] would eventually be set up in 1995 under the Marrakech Agreement which replaced the GATT.

(3) Petro-Dollars and the Debt Crisis 1974-1989

As the price of oil had been denominated in dollars, the OPEC countries introduced significant increases to compensate for the 25% drop in the value of the dollar following the abandonment of the Bretton Woods system. This led to a series of oil price hikes in 1973/74 and 1979 which was aggravated by instability in the Middle East especially with the Yom Kippur War in October 1973. The large amounts of new funds received by the oil exporting countries were then recycled in the form of 'Petrol-dollars' through the main international financial markets including, in particular, the City of London. This resulted in further substantial growth in the late 1970s and especially in the Euro-dollar markets including the syndicated loan and Eurobond sectors.

Large amounts of the new funds available had been lent by major international banks to emerging market governments to fund domestic infrastructure and other investment projects. The petrol-dollars were accordingly recycled from the oil exporting to the oil importing countries. Following a downturn in global markets in the early 1980s, some countries were unable to continue to service their debt levels with Mexico announcing on 13 August 1982 that it would have to suspend payments. This became known as the 'Third World' Debt Crisis which spread to other Latin American and then Asian countries. Brazil defaulted on 10 November 1982 with 37 other countries following in Latin America, the Caribbean, Africa and Eastern Europe. A total of US$140bn in commercial bank debt had to be rescheduled during the 1980s. The total amount of the debt stock had then increased to US$200bn by the mid-1980s with two major long-term management initiatives being launched by US Treasury Secretary James Baker in October 1985 (based on a sustained growth and balance of payment adjustments package) and by Nicholas F Brady in March 1989 (including the conversion of bank debt into guaranteed 'Brady Bonds').

Mexico's total debt stock had been reduced by 15% and bank debt by 30% under the Baker and Brady plans although further difficulties recurred following political assassinations and economic instability in March and September 1994. The value of peso collapsed by 50% on 10 January 1995 with US$28bn of government bonds (*tesebonos*) being dumped, despite President Ernesto Zedillo promising that there would be no repeat moratorium although a massive private sector and US government supported guarantee package had to be put in place worth almost US$50bn with two further IMF standby facilities of almost US$18bn.

[3] http://www.wto.org/

(4) Asian and Russian Crises 1997-1998

Many Asian economies including Hong Kong, Japan, Singapore, Taiwan, Thailand and the Republic of Korea had enjoyed spectacular growth of over 5% GNP between 1965 and 1990 and over 9% between 1992 and 1995. Difficulties nevertheless remained with the high levels of short-term investment involved, high levels of bank credit, poor loan practices (or 'crony capitalism') and fundamentally weak systems of banking and financial control. The Asian crisis began in Thailand with the collapse in the value of the Thai baht on 2 July 1997 with the government abandoning its peg against the US dollar. Despite an immediate recovery, concerns remained with regard to the strength of the financial system. The crisis quickly spread to Malaysia, Indonesia and The Philippines with average currency depreciations of between 25-33%. The Hong Kong dollar was subject to a speculative attack with the crisis spreading to South Korea and economic damage suffered in Japan. The contagion had spread to Latin America by the end of 1997. Brazil had to protect the real early in 1998 with Russia defaulting on its debt in August 1998.

(5) Credit Crisis 2007-2008

Financial turmoil arose again ten years and one month later with the credit crisis beginning on 9 August 2007. Concerns had arisen with regard to the stability of US sub-prime mortgage market which had been used to support asset-backed securities including collateralised debt obligations (CDOs), large amounts of which had been sold on to off-balance sheet structured investment vehicles (SIVs) or other bank 'conduits'. The CDOs had been highly rated by rating agencies which had not taken into account the possibility of significant levels of default on the underlying mortgages involved as a result of poor or fraudulent sales practices in the unregulated US mortgage market. Significant losses were reported by many major financial institutions with inter-bank markets consequently drying up on 9 August 2007 as banks had to hoard cash rather than on-lend to each other. The US Federal Reserve and other central banks attempted to inject significant amounts of liquidity into the markets during the last quarter of 2007 and early 2008 with only limited effects.

The major UK casualty was the Northern Rock Bank which had a low (28%) deposit cover ratio and was dependent on the mortgage securitisation market for the majority of its funding. With the combined effects of the collapse in the asset-backed securities market and the drying up of credit on the inter-bank markets, Northern Rock was forced to approach the Bank of England for emergency assistance on 14 September 2007.

The Government through the Treasury was forced to make a number of announcements to confirm support for the bank to prevent a further bank run in September 2007. Northern Rock was subsequently taken into public ownership (nationalised) on 17 February 2008 after the Government was unable to agree a private sector solution. A number of official documents have since been issued examining the crisis and its causes and the national, European and international levels, with an increasingly complex series of regulatory responses being produced.

3. INTERNATIONAL FINANCIAL MARKETS

National and international financial systems are made up of a number of specific markets and sub-markets. These are generally divided into the money and capital markets each of which includes a number of separate sub-markets. These may either operate on a formal exchange or off market over-the-counter (OTC) basis. Almost all will be subject to some formal organisation and oversight.

Financial markets carry out a number of essential services including savings, credit, and funding or investment and loss cover or risk management. Risk can be managed either through insurance contracts (including life and non-life or contingent liability insurance) or through specialised instruments, including financial derivatives such as futures, options and swaps or other hybrid products. Organised markets or exchanges more specifically carry out a number of important functions including price discovery or disclosure which permits trading or dealing in relevant securities as well as supporting clearing and settlement and trade and transaction reporting.

One key feature of all of these markets and instruments is that they are based on legally enforceable contracts or claims. This can either be constituted by a debt obligation entered into between a bank (or group of banks) and the customer on a bilateral (or multilateral) basis or in a transferable form of with dedicated security instrument to evidence the debt. While these were traditionally issued in the form of a written security certificate, they have increasingly being issued in a purely electronic form and transferred or traded through electronic systems. This is referred to as the dematerialisation with immobilisation involving the holding of securities through central custodians.

The main types of financial markets that make up any modern economy are reviewed next. This is followed by an examination of the principal types of financial assets or instruments dealt with on these markets.

(1) Money Markets

An initial distinction has to be drawn between the money markets and capital or securities markets. These are the two main set of markets within any financial system.

The money markets generally refer to the wholesale markets in short term bills or paper of up to one year. Relevant instruments include treasury bills, local authority or corporate bills, bankers' drafts (promissory notes issued by banks), certificates of deposit (transferable securities representing underlying deposit amounts) as well as commercial paper (short term marketable unsecured promissory notes) and bankers' acceptances (accepted bills of exchange) or bank deposits. These are considered in further detail in the following section.

The UK money markets are made up of the primary (or discount) market, in which the Bank of England manages the amount of money (credit) in circulation within the financial system as the central bank, and the secondary money markets in which other types of wholesale credits are bought and sold. The Bank of England will generally only deal with a limited number of specialist dealers in the primary market. This is also referred to as the Discount Market as this group was originally restricted to Discount Houses in the City of London, the role and function of which has already discussed. The number of institutions eligible to participate in the primary money market has since been extended with the Bank of England also increasingly using sale and repurchase agreements (repos) to supply funds to banks without the use of the discount market. A repurchase

agreement (RP or repo) provides for the sale and repurchase agreement which involves a cash or spot sale of a security or other asset with a forward repurchase at an agreed price. This effectively operates as a secured loan.

The parallel or secondary money markets consist of a number of separate wholesale markets for the issuance and trading of other types of short-term bills or money market instruments (MMIs). In the UK, these principally consist of the Local Authority market, Finance House market, Inter-Company market, Sterling Inter-bank market and Sterling Certificate of Deposit and Sterling Commercial Paper market. These markets generally emerged at the end of the 1950s following the closure of the earlier Public Works Account which required local authorities to issue bills into the market for the first time. Dealings are unsecured and not supported by the Bank of England and are generally conducted by telephone or on screen basis with no formal trading floor. A number of banks may operate in more than one of these secondary markets.

(2) Capital Markets

Securities or capital markets provide a range of alternative investment and funding mechanisms. The capital markets are made up of a mixture of primary (initial issuance) and secondary (dealing) markets. These principally allow for sovereign or corporate entities to obtain capital through the issuance of transferable debt instruments (principally involving bonds, bills or gilts) that can then be traded on active secondary markets. The investor will receive an interest payment during the term of the instrument with the nominal amount of the issue being repaid in maturity. This is economically the same as a loan except issued in a transferable form. Companies can also raise capital by issuing shares or equity instruments with the holder (shareholder) owning a proportionate interest in the entity and receiving a dividend payment instead of interest.

The issuer of debt or equity will receive funds on the first placement of the security in the primary market. These securities can then be bought or sold on the secondary markets with dealers or investors making a profit (or loss) on the rise and fall in the value of the security. Primary issues and secondary dealing can be carried out either on a formal stock exchange or market or on an off-exchange (OTC) basis. The capital markets more generally also include other direct sources of investment funds, such as through national or international development or industrial banks or investment vehicles or other venture capital providers.

The equity markets consist of the markets for the initial issuance and subsequent purchase and sale of shares in corporate bodies. Equity refers to the equity or share capital of a firm which represents the total value of the company and all of its assets on a going concern basis which corresponds with the total amount subscribed by its members. Warrants and depositary receipts may also be issued. Warrants are transferable certificates that allow

the holder to acquire a specified number of shares or bonds at a future date. Depository receipts are certificates evidencing ownership of an underlying asset such as a share. The certificate acts as a receipt that becomes a fully transferable security independent from the underlying share. These are often used where domestic regulatory restrictions would otherwise prohibit or restrict the sale of the original shares. These include American Depository Receipts (ADRs), that are cleared through the US Depository Trust and Clearing Corporation (DTCC), as well as Global Depository Receipts (GDRs) and some European Depository Receipts (EDRs).

Capital markets generally then provide for the issuance and trading in debt instruments (bonds or gilts), equities, warrants and hybrids as well as depository receipts. Governments principally borrow through debt or bond instruments although these are also commonly issued by large and medium or smaller sized corporate bodies (in which case the instruments are often referred to as debentures). Bonds may either be issued in the local currency or in another currency. The international markets in which large loans or bond issues are denominated in a currency other than the currency of the country of issuance are referred to as the Eurodollar markets.

(3) Eurodollar Markets

The largest international financial markets include the Eurodollar markets which are made up of separate syndicated loan, bond and underlying Eurodeposit or inter-bank markets. These grew significantly with the expansion of cross-border banking and investment business following the restoration of currency convertibility after the Second World War beginning in 1958. Growth of the Eurodollar markets was boosted by the massive influx of 'petro-dollars' following the oil price increases in 1973 and 1979 as well as the more general demand for investment capital by countries and international corporations especially since the early 1970s. While borrowing through the Euroloan markets declined relatively during the 1970s and early 1980s, this was accompanied by a corresponding increase in Eurobond activity which has the advantages of inherent transferability and negotiability which increases liquidity and allows better quality issuers to raise funds at lower margins.

(4) Currency Markets

The currency markets are the wholesale markets for the purchase and sale of foreign exchange on either an immediate (cash) or future (forward) basis. Foreign currency is not strictly money, as it is not legal tender in a particular the local country, and is therefore treated in law as a commodity in the same way as gold or oil. The currency market is reputedly the single largest market in the world with over US$4 trillion being transferred daily. The market is screen based with around 350 participating banks although the majority of transactions are carried through a smaller number of around 50 banks and between 10-12 brokers. Dealer banks provide continuous bid (buy) and ask (sell) prices on minimum contract sizes of US$1m. Brokers act as intermediaries between corporate or retail customers and the main market. Most transactions are inter-bank with a third involving a dealer and another financial institution. The principal financial centres are London, New York and Tokyo with over one-third of the total business being conducted through the City of London.

(5) Financial Derivatives Markets

The financial derivatives markets provide for a number of risk management and investment facilities. These can either be used to hedge specific risks, such as currency and interest rates or increasingly credit risk, or be used for proprietary trading purposes as with other securities. The main instruments involved include exchange and off-exchange futures and options as well as swap contracts. While forwards trading has been available since early times, most of the new more sophisticated instruments only emerged during the early 1970s following the collapse of the Bretton Woods system of managed exchange arrangements between 1971 and 1973. This, in particular, led to the introduction of floating currencies for the first time during the post-War period with associated volatility in foreign exchange and interest rate risks in response to which new derivatives contracts

were created and exchange traded products opened on various exchanges including the Chicago Mercantile Exchange (MERC originally opened in 1898) and Chicago Board of Trade (CBOT established in 1848) which later merged in July 2007 to create the CME Group. The largest derivatives exchange in London is the London International Financial Futures and Options Exchange (LIFFE), which was set up in 1982 and later acquired by Euronext in January2002 and merged with the New York Stock Exchange in April 2007. Eurex was created in 1998 with the merger of Deutsche Terminbörse (DTBe) and the Swiss Options and Financial Futures (SOFFEX).

(6) Gold Market

The gold market provides for the sale and purchase of gold bullion following a daily price 'fixing' in London with physical delivery being managed through other centres such as Zurich. The Gold Market has traditionally been based at Rothschild's in London with the five main members meeting at 10.30am and 3pm to fix the daily price to cover outstanding purchase and sales orders. The market now includes around 11 market-makers and approximately 50 ordinary members of the London Bullion Market Association (LBMA) which was set up in 1987. Members represent the major gold centres including Zurich, Frankfurt, Sydney, Tokyo and New York with the Bank of China also a member.

(7) Commodity and Shipping Markets

Other commodities can be bought and sold on an open outcry or auction basis through various exchanges, salerooms or auctions. This includes oil and metals as well as consumables (such as sugar, cocoa, copper or coffee) and non-consumables (such as fibres and furs). Ships and shipping and airfreight and aircraft are sold through shipping and carriage markets such as the Baltic Exchange in London.[4] The exchange is in St Mary Axe, London beside Norman Foster's Swiss Re Building ('the Gherkin') at 30 St Mary Axe.

(8) Insurance Markets

Insurance markets provide for a range of additional risk management services. These principally either include life (pension) assurance and non-life or other contingent liability cover (including property, business, fire, motor and personal injury insurance). Insurance intermediation allows for the payment of an agreed sum in the event of a contingent or unexpected event. The life or insurance companies receive a one-off, or annual premium, that is invested in the capital markets to create an appropriate capital base to produce an income stream from which

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[4] http://www.balticexchange.com.

payments can be made. This allows governments, businesses and individuals to manage their commercial and financial risks and operations more effectively.

Lloyds of London is the largest single insurance market in the world through which members operate in groups or syndicates.[5] Lloyds began in a coffee house set up Edward Lloyd in Tower Street around 1688 with a New Lloyd's Coffee House being established in 1769. Lloyds operated out of the Royal Exchange building until it was destroyed by fire in 1838 and then moved to Leadenhall Street in 1928 and Lime Street in 1958. Its prestigious new Richard Rogers building at Number One Lime Street was opened in 1986.

Reinsurance allows issuers of insurance policies to take out separate cover either through Lloyds or through larger insurance companies the event that a claim is made on the underlying policy. This can ever be done on a specific contract (facultative) were general (treaty) basis. The largest reinsurance companies include Munich Re and Hanover Re in Germany, Swiss Re, SCOR in France, General Re and the Reinsurance Group of America in the US and Lloyd's in the UK.

4. FINANCIAL ASSETS AND INSTRUMENTS

The history of finance can also be understood in terms of the development of financial assets, instruments and payment. Financial assets and instruments can be classified in various ways. Payment provides for the transfer of cash or currency directly or for the transfer of funds through a financial intermediary using another payment instrument. Payment instruments were originally developed to avoid the difficulties that arose with the transportation of heavy coin and specie with its possible loss through theft or piracy. The three most important early instruments were promissory notes, bills of exchange and cheques. Each of these is considered further below. Payment can also now be made in an electronic form such as through a debit card (which provides for the direct transfer of funds from one account to another) or credit card (which includes a loan or credit element) or some form of digital money or card (with monetary value having been loaded on and recorded on the card itself).

5 http://www.lloyds.com/

All types of financial rights, assets, instruments or contracts may be dealt with on financial markets. Financial rights include both financial assets (property with an inherent value) and financial claims (payment obligations). Financial assets principally consist of coinage and banknotes along with financial instruments. Financial instruments are strictly chattels (personal property) that embody a payment obligation and principally include negotiable instruments (promissory notes, bills of exchange and cheques) as well as certificates of deposits and bonds. These are referred to as 'documentary intangibles' to payment of money. Specific types of negotiable instruments in the form of cheques include bankers' drafts and traveller's cheques with bankers' acceptances being accepted bills of exchange.

Financial instruments can be distinguished from documents of title to negotiable securities (including shares, bonds or notes) which are bought documentary intangibles. These are again distinct from pure claims or payment obligations (principally loans or advances) and other types of contracts that provide for payment on a contingent or non-contingent basis (including insurance contracts). The total stock of financial assets can also be considered to include gold and foreign exchange, which are strictly commodities of investment assets, and other payment structures, including principally financial derivates and structured finance instruments. All of these may collectively be referred to as financial assets or instruments although the term instruments strictly only applies to documentary intangibles to the payment of money, including principally negotiable instruments.

(1) Coinage and Currency

Legal money can be considered to consist of coinage and bank notes. Wider concepts of money may also include bank accounts or accounts with other financial intermediaries with other forms of electronic or digital money also being available which are considered further below.

(i) Coinage

Metal coinage is still produced under authority of the state for low denomination payments. This is a form of representative money with the coins being stamped and authenticated to show their legal value. These constitute legal tender to the extent provided for under local law. They no longer have intrinsic value as commodities or commodity money as with earlier silver or gold coinage. UK coins are issued under authority of the Royal Mint.

(ii) Banknotes

Banknotes are issued under authority of the monetary sovereignty of the state or sovereign. These are most often issued through the central bank as agent on behalf of the state or sovereign. These are in law negotiable instruments in the of form promissory notes (below) which constitute a promise by the central bank to pay the bearer the sum specified. These formerly operated on a representative basis and were exchangeable for an underlying amount of specie, either in the form of silver or gold. Modern notes are no longer convertible into specie and are issued on a purely fiat or fiduciary basis. These were historically issued by private banks with the notes , me being transferred for less than face value (discounted) depending upon the credit standing of the issuing institution. Issuing powers have since almost exclusively been reserved to the national central bank which acquired monopoly rights. The value of these notes is further confirmed with legislation making them legal tender which means that payment obligations can only be discharged using designated monopoly issued state notes. As these are no longer convertible into or backed by specific gold or other specie, their value depends solely on the credit standing of the issuing central bank and state.

(iii) Foreign Exchange

Foreign exchange or foreign currency is strictly not money and only legal tender in its country of issuance. Outside the country of issuance, it is only a commodity with its value being expressed in terms of its exchange rate volume with other currencies and as agreed by the parties purchasing and selling them at any time.

(iv) Certificates of Deposit (CDs)

Certificates of deposit are receipts evidencing underlying deposits of money (coinage or banknotes) with a bank or other depository institution. These are issued in the form of a transferable certificate which allows them to be separately traded as a security. Certificates of deposit in the UK are issued under special regulations published by the Bank of England.

(v) Account Credits

The most important types of financial claims are claims and loans in the form of account credits advanced by depository institutions, including specifically banks and building societies in the UK, savings and loan institutions in the US and similar entities elsewhere. Such institutions on-lend deposited funds which create new 'bank money' in the form of account credits or transfers with other institutions. This can be considered to amount to the creation of new money (in the form of account balances) through a 'credit multiplier' effect the amount of which is only limited by central bank reserve and regulatory liquidity and capital requirements. This often represents the largest stock of money in any economy. The different types of money available (including coins, notes and credit balances) are reflected in the different monetary aggregates used (such as MO, M1, M2, M3 and M4 and MB).

(2) Credit and Payment

Payment can either be made through the direct transfer of coins or notes or through the indirect issuance of instructions to financial institutions to make payment on the payer's behalf. This has historically principally involved the use of paper instruments with the most common devices being negotiable instruments in the form of promissory notes, bills of exchange and cheques. Payment instructions can now be issued in various ways and monetary amounts transferred through a number of electronic and digital means.

(vi) Promissory Notes

Promissory notes are written undertakings by one party to pay the holder or bearer of the note the amount specified either on demand or on an agreed future date. These constitute one of the three main forms of

negotiable instruments historically with bills of exchange and cheques. These were issued in the UK under the Bills of Exchange Act 1882 with similar legislation in other Commonwealth countries and in the US.

(vii) Bills of Exchange

Bills of exchange are tripartite payment obligations used to settle trade accounts. Historically, one merchant (the drawer) would direct another to whom the first merchant was owed money (the drawee) to make payment to another party (the beneficiary) either on demand or at a future specified time. The English law on bills was codified under the Bills of Exchange Act 1882 which set out the conditions for the legal use and discharge of bills. Bills were the most important means of domestic and cross-border payment for hundreds of years until cheques became more commonly used after World War II and then electronic forms of funds transfer and payment were developed more recently.

(viii) Cheques, Travellers Cheques and Bankers' Drafts

Cheques are specific types of bills of exchange with the payer drawing the bill on his or her bank as payee. Banks generally provide their customers (drawers) with a number of pre-printed bills (cheques) that allows them to make payment to third parties (beneficiaries) by directing the originating bank (as drawee) to make payment on receipt. These were again dealt with under the Bills of Exchange Act 1882 in which a cheque is defined to constitute a bill of exchange drawn on a bank. Extended clearing systems have been set up in most countries to provide for the processing and settlement of payment obligations through cheques in light of their large volume of usage for business and retail purposes. These have become of less importance more recently with the development of debit and credit cards and other electronic forms of payment. A number of countries, including the UK, have announced that they are considering abandoning or restricting the availability of cheques for this reason.

Travellers' cheques are specific types of cheques designed for use on a cross-border basis issued by an entity that will undertake to make payment in a specified currency on receipt.

Bankers' drafts are particular types of cheques issued by banks drawn on themselves. The amounts will have been debited from customer accounts on customer instruction for a fee. The objective is to guarantee payment on the draft with the use of the bank as drawer and drawee which effectively adds the credit standing of the bank to the cheque.

(ix) Bankers' Acceptances

A bankers' acceptance is a bill of exchange that has been signed or stamped by the bank to confirm its acceptance of the obligation to make payment under the bill. This adds the credit of the bank to the bill which effectively makes it as good as cash in practice. The accepted bill can then be sold to another institution, including specifically a discount house, which will pay on the bill less a discount calculated with regard to the interest due on the residual time before payment is obliged to be made on the bill. As has been discussed, bills of exchange in international trade were commonly sent back to London with specialised banks developing as Accepting Houses, to accept bills, which could then be sold to other specialised banks, acting as Discount Houses. International bills of exchange were often issued on standard London terms which were referred to as 'Bills on London' which was a key form of payment instrument in international trade.

Discount houses would later emerge as a small group of specialised banks with which the Bank of England would deal in making funds available in the primary money market. The Bank would purchase instruments issued by the Discount Houses which would put them in funds which could then be on-lent to other banks within the financial system. This was referred to as the Discount Market. This was subsequently extended to include a larger range of institutions beyond the Discount Houses with the Bank of England now generally operating on sale and repurchase (repo) terms. The rate at which the Bank would deal with the Discount Houses (the 'bank rate') would then become the minimum base rate for the financial system with the Houses on-lending to the commercial banks at bank rate plus a margin.

The rate at which banks in London would then lend to each other became known as the London Inter-bank Offered Rate (or LIBOR) which is still set through the British Banker's Association (BBA) with reference to a selected group of banks operating in London.[6] Similar rates have been introduced in other markets which operate on similar terms, such as Euribor.

(x) Electronic and Digital Money

Electronic money generally operates through the passing of payment instructions to move underlying amounts of money, which usually exists in the form of account credits, through electronic means. This can be considered to include debit and credit cards as well as internet or telephonic (mobile phone) account management software. Digital money uses electronic storage devices to hold records of money amounts that have been credited to the device and are then available for onward transmission. In both cases, electronic means are used to hold or transfer existing monetary amounts or values with no new separate types of money being created.

(3) Public Debt

Government or public debt can either be issued in the form of shorter duration instruments for monetary policy purposes or longer term borrowing and debt management. Short-term instruments are usually referred to as bills or notes and longer-term instruments referred to as bonds. Specific types of instruments may also be issued in particular countries such as 'Gilts' in the UK (below).

(xi) Government Bills

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6 http://www.bba.co.uk.

Bills are short-term debt instruments issued on behalf of the finance ministry or government for money market purposes. Treasury bills are issued by the Bank of England in the UK money market. Money market instruments generally have a duration of less than one year with bills generally either being issued for 91 or 182 days. The bills are issued on a tender basis with the issue being underwritten by the Discount Houses.

(xii) Government Bonds and Gilts

Bonds are longer-term debt instruments issued on behalf of the government for debt management purposes. These are transferable debt obligations issued in a security form to allow secondary trading. They generally attract an interest payment which was formerly paid on presentation of a coupon attached to the bond. The bills may alternatively be issued at a discount to their face (par) value with an equivalent amount of interest being paid when the bonds are redeemed at full price. UK bonds are referred to as 'gilt-edged' securities due to the former gold edging on the certificates. These may either be issued for under five years (short deals), 5-10 years (medium) or over 10 years (longs). Issuance is now managed through the Central Gilts Office (CGO). US public debt is either issued in the form of Treasury bills (up to one year), Treasury notes (1-10 years) or Treasury bonds (over 10 years).

Government bond markets are now among the largest in the world due to the size of government deficits which rose substantially following the crisis in financial markets in 2007-2008. This has require that special lending facilities be set up to support particular countries, such as Greece, Ireland and Portugal within the Euro zone, with other countries have to agree special budgets to avoid breaching debt limits, such as the $1.3 trillion ceiling in the US. A Euro 750 billion European Financial Stability Facility (EFSF) and European Financial Stabilisation Mechanism (EFSM) was set up in March 2010 under Article 122 of the EU Treaty[7] to be replaced by a more permanent euro 500 billion European Stability Mechanism (ESM) from 2013.

(4) Corporate Securities

Corporate bodies can raise funds through the issuance of either debt instruments, in the form of bonds or debentures, or various forms of shares or equity instruments.

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7 http://www.efsf.europa.eu.

(xiii) Corporate Bonds and Shares

Corporate securities may either be issued in the form of bonds (debentures) or shares (equity). Corporate bonds or debentures are the same as government bonds and simply constitute payment obligations issued in a transferable form with an interest payment attached or with the bonds being issued at a discount.

Shares constitute a proportionate interest in the equity or share capital of a company. Companies are divided into a specific number of shares (UK) or common stock (US) with shareholders owning a proportionate interest in the company as a whole. Shareholders have a right to receive a dividend payment (rather than interest) and have other associated information, reporting and voting rights over the activities of the executive board and the company as a whole. The nominal share value of the company and its share structure will be set out in its Memorandum of Association. Different types of shares may be issued, such as ordinary shares or preference shares (including participating or non-participating, fixed or variable and cumulative or non-cumulative) and exchangeable or convertible shares.

Bonds and shares may be issued with warrants which entitle the holder to acquire a further specified number of bonds or shares on specific conditions (above).

(xiv) Depository Receipts

Shares may be deposited with a custodian in exchange for a transferable certificate in the form of a depository receipt (above). These are the equivalent of certificates of deposit for money balances. The receipts are fully transferable as independent securities which can avoid sales and distribution restrictions that would otherwise apply to the underlying shares. Depository receipts include American Depository Receipts (ADRs), Global Depository Receipts (GDRs) and European Depository Receipts (EDRs). ADRs can be cleared through the US Depository Trust and Clearing Corporation (DTCC in New York).[8] The DTCC was created in 1999 with the merger of the Depository Trust Company (DTC) and National Securities Clearing Corporation (NSCC).

(5) Risk and Investment Assets

A number of basic as well as more specialist types of instrument have been developed for separate risk management as well as possible investment purposes. The most simple of these is a forward contract which provides for settlement at a subsequent date although other more complex products include financial derivatives and structured finance instruments. Credit derivatives have been developed more recently which provides cover against credit or counterparty before on underlying contracts. Credit derivatives were also commonly used in the structured finance market which created new combination products. Loss can also be managed through the taking our or purchase of insurance cover while other types of assets or commodities, including gold and art, can be used for investment purposes.

(xv) Forward Contracts

A forward contract is a contract that provides for completion or settlement of a purchase at an agreed subsequent date and price. This is distinct from a spot contract which provides for immediate settlement. Many financial derivatives developed out of simple forward contracts in the agricultural or commodity areas.

(xvi) Financial Futures

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8 http://www.dtcc.com/ .

A future is a form of financial derivative that constitutes an obligation to purchase (or sell) a specified item at an agreed future date and price. These are generally issued in standard terms and dealt with on recognised exchanges. These may also be issued in a purely electronic form. The main futures markets developed in the US following the collapse of the Bretton Woods system of managed currency arrangements and new levels of currency and interest rate risk that arose. Futures developed out of earlier foreign exchange forwards.

(xvii) Financial Options

An option is a financial derivative that provides the right or election to buy (or sell) a specific item at a future agreed date and price. This is effectively a form of a voluntary future with the exercise right being purchased in return for a premium payment. These are again generally issued on standard terms on exchanges although OTC contracts may also be entered into.

(xviii) Swaps

A swap is an exchange of payment obligations between two counterparties. This may either be used for currency payments or interest rate (fixed or floating) payments or be tied to other equity or commodity obligations. Currency swaps involve simple exchanges of agreed currencies. Payments are calculated on the basis of notional amounts which are multiplied by the specified reference rate on each due settlement date.

(xix) Total Return Swaps (TRSs)

A total return swap is a specific type of credit derivative. This provides for the transfer of payment obligations in the event of a specified credit event arising. Payments are then passed through under the TRS contract.

(xx) Credit Default Swaps (CDSs)

A credit default swap is a more sophisticated form of credit derivative with the purchaser buying credit protection in the event of the credit event arising. Payments are then only made on the specified event arising. This acts as a form of credit insurance.

(xxi) Credit Spreads Swap (CSS)

A credit spread swap is a more specialist type of credit derivative that provides for the payment of an amount equal to the difference in the credit spreads involved between the parties, instruments or contracts in the event of the credit event arising.

(xxii) Credit Linked Note (CLNs) and Repackagings

Credit linked notes are specific types of securities that incorporate a credit derivative (usually a CDS) to provide credit protection or support. These are effectively integrated or combined notes and credit derivatives. These emerged out of earlier repackagings that arose where older lending structures, using more traditional instruments such as longer fixed bonds, were restructured using more modern instruments to provide additional funding and repayment flexibility at lower cost with higher ratings and improved investment profiles for institutional investors.

(xxiii) Collateralised Debt Obligations (CDOs)

A collateralised debt obligation (CDO) is a generic term for any type of security made up of a securitised pool of underlying securitised assets. Securitisation arises where an underlying pool of credit assets, such as a number of receivables, credit card or student loans, are transferred to a special purpose vehicle (SPV or Special purpose entity (SPE) or special purpose corporation (SPC) in the US). This is paid for through the issuance of new bonds, notes or commercial paper by the SPV. The underlying credit pool is in this way converted into a new set of securities or capital market instruments. Securitisation developed in the US in the 1970s and was commonly used to transfer bank-based forms of credit to the capital markets which increased liquidity and investor returns.

Structured finance is distinct from securitisation in that it provides for the secondary securitisation, or 're-securitisation', of the income streams from underlying securitisations rather than their original credit assets directly. CDOs are then created by re-securitising the notes, paper or bonds issued by the separate underlying SPVs. Common forms included collateralised mortgage obligations (CMOs), collateralised loan obligations (CLOs) and collateralised equity obligations (CEOs). The ultimate CDO SPV generally issued a number of different types of securities through tranches with different payment and risk profiles which corresponded with the different investment and return needs of institutional investors. Complex structures and documentation issues arise due to the large number of underlying credit pools involved and their separate securitisation and then re-securitisation within the larger CDO structure.

One of the core objectives of structured finance products is to ensure that the various tranches of securities issued by the CDO SPV are highly rated by credit rating agencies (CRAs) to allow them to attract investor interest. This was a key factor in the global financial crisis in that many instruments were incorrectly rated and then downgraded which forced prices to drop even more substantially during the 2007-2009 phase of the financial crisis. Rating errors arose where the CRAs had failed specifically to include sufficient data on possible housing price falls and on correlation effects (where separate markets and prices move in parallel). Complexity and the associated lack of transparency were also important factors which lead to the collapse in confidence in the structured finance market more generally during 2007-2009. While many CDOs only included between 1-3% sub-prime debt and should therefore have fallen in value by a corresponding amount, they had to be marked down by much larger multiples and ultimately to only around 25-35% of their original value or less.

(xxiv) Insurance Policies

Insurance policies are contracts providing for the payment of either lump sums or income streams in the event of defined event arising. These may either be entered into on a contingent (non-life) basis, including car, fire, accidental damage, injury or professional cover insurance, or a non-contingent (life) basis, such as on retirement or death. Policies are purchased in exchange for premia payments made by policy holders on either an initial one-off or continuing regular basis. These funds are invested by the insurance company in other securities and capital market instruments to generate a sufficient return to cover ongoing payment liabilities created. Insurance companies (including pension and life companies) are among the largest institutional investors in the world in

light of the accumulated amount of premia invested in stock markets and exchanges for investment purposes over a large number of years.

(xxv) Gold, Specie and Commodities

Following the abandonment of convertibility of banknotes into gold during the early 20th century, gold is strictly only a commodity now unless it is separately issued in the form of gold coin and included within the definition of legal tender under particular country laws. It can still be considered to constitute an investment asset to the extent that it is held for return purposes as it can hold and increase in value over time. Investment assets may include all possible property items, including gold, oil, minerals or metals and other commodities as well as commercial or residential property, which may be purchased for investment purposes. These are not strictly financial assets as they do not provide for any specific money or payment component although they can be considered to constitute different forms of investment asses or wealth more generally. Wealth comprises all financial and non-financial tangible and intangible property items held by a governmental, corporate entity or private individual. Financial assets only constitute one set or sub-category of tangible and intangible property items or assets more generally.

5. INTERNATIONAL FINANCIAL CENTRES

London has been one of the world's leading international financial centres for centuries with the two other largest centre being New York and Tokyo. While this role was to some extent transferred to New York following World War II, London experienced a remarkable recovery during the 1960s and 1970s and re-established itself as the centre of a number of markets and service areas especially with Eurodollar markets and foreign exchange.

This process was supported by the 'Big Bang' in London in 1986 which transformed London into a leading international securities centre. Many of the largest integrated international banks and investment houses were to set up or conduct their main international business through London. The Big Bang, in particular, provided for the abolition of the earlier distinction between stock brokers (sellers) and stock jobbers (buyers), the dismantling of restrictions on the ownership of Stock Exchange firms by banks (including overseas institutions) and the introduction of price competition through the removal of the earlier fixed commissions in securities trading.

The expansion of both international and domestic financial business has continued since through the 1980s, 1990s and 2000s. London has also expanded to include a new series of significant commercial office

developments especially with the construction of Canary Wharf in the Docklands area and with new investment managers, including hedge funds, moving into the West End of London more recently. The effect of this has been to create three separate 'Cities' with a significant amount investment banking, in particular, now being conducted through Cabot Square and other new developments in Canary Wharf, hedge funds and asset management in the West End and many of the other more traditional financial services still being conducted in the old City around the Bank of England.

(1) International banking

London remains a leading international banking centre undertaking about one-fifth of total cross-border lending. Its revival in the international banking area began in the late 1950s when it became the focus of the rapidly expanding Eurodollar market. The absence of reserve requirements and a sympathetic regulatory system made the City attractive for doing business and especially for US firms with excess dollar funds. A large number of foreign banks quickly came to London to participate in the growing Eurodollar markets either directly or through joint ventures or consortia with other banks. This influx which was, in particular, led by US banks which moved a large part of their international dollar business outside the US through the 1960s and 1970s due to increasingly restrictive regulation at home. These included interest rate ceilings on dollar deposits by banks in the US (under Regulation Q) and high reserve requirements on dollar deposits (under Regulation D). By the mid-1980s, more than 70 US banks were active in London. The City is also the premier location for European and Asian financial institutions and especially Japanese banks during then 1980s and then the Chinese banks in the 1990s and 2000s. Major players still include Citigroup and J P Morgan Chase from the US and Deutsche Bank, Credit Suisse, UBS and Paribas from Europe.

(2) Investment banking

Investment banking services in London were traditionally carried out through independent merchant banks although many of these were acquired by foreign banks in 1980s to allow them to establish a presence in London's investment banking markets. The number of European banks also decided to conduct their investment banking operations through London operations in the City. Many US investment banks and Japanese securities houses also conduct their European operations out of London. These offices provide a full range of investment banking services including the issuing and underwriting of securities, corporate advisory work on mergers and acquisitions, privatisations and restructurings and foreign exchange, financial derivatives and trade finance. Large investment banks in London still include Goldman Sachs, Morgan Stanley, Bank of America Merrill Lynch, J P Morgan, Deutsche Bank, Credit Suisse, UBS and Nomura Securities.

(3) International bonds

Following the first Eurobond issue, which was lead by the London investment bank SG Warburg in 1963 for Autostrade to construct the Italian motorway network, London has been the centre of the Eurobond markets. Around 60% of Eurobond primary market activity, with the raising funds for borrowers through the issue of new bonds, takes place in London with the main transactions being denominated in US dollars, Yen, Euros, Canadian dollars, Sterling and Australian dollars. 70 per cent of all secondary market activity is conducted through London.

(4) Equities

Equity business is principally conducted through the London Stock Exchange which is the world's fourth largest market by equity capitalisation. The LSE has $2,407bn equity market capitalisation only after NYSE Euronext ($11,794bn), Tokyo Stock Exchange ($3,277bn) and NASDAQ ($3,165bn). The LSE provides listing facilities for both domestic UK equities (company shares) and international securities (shares of foreign companies with listings on their domestic market or other foreign exchanges). London is the largest market in terms of foreign

equities with almost 60% of the market in international equities turnover. The LSE began in Jonathan's Coffee House in 1760 when a group of 150 brokers formed a club to buy and sell shares.

Following the Big Bang in 1986, the traditional floor trading (with face-to-face dealing between brokers and market makers on the Stock Exchange floor) was replaced by the screen-based dealing with the 'Stock Exchange Automated Quotations System' (SEAQ) and SEAQ International. While the SEAQ screens provided necessary price information, trading was still conducted between dealers by telephone during the early transitional stages. A new automated screen-based dealing system (called SETS) was introduced in October 1997 which provides for the electronic matching and settlement of all of the main trades dealt with on the exchange. SETs operates on the basis of fully automated order matching system with trades being settled through the London Clearing House (and now LCH Euronext). SEATS Plus (the Stock Exchange Alternative Trading Services) is a separate order matching system for AIM (Alternative Investment Market) shares and remaining official listed shares. Shares can also be dealt with through the Alternative Investment Market (AIM) or the techMARK market

(5) Foreign exchange

With the removal of exchange controls and increased cross-border investments at the end of the 1970s, foreign exchange dealing expanded dramatically in 1980s and 1990s. This was also driven by the continuing growth of international trade and by huge international movements in funds facilitated by the removal of capital restrictions in many parts of the world. Despite the loss of its earlier dominance under the gold standard until the early 1930s, London and re-emerged as the world's largest centre for foreign-exchange trading following the adoption of floating currency regimes after the collapse of the Bretton Woods system of managed currencies in 1971-1973. This is supported by London's central time zone advantage and position in other international wholesale markets.

(6) Financial derivatives

Futures trading has since the early 1970s been dominated by the Chicago Board of Trade (BOT) and the Chicago Mercantile Exchange (MERC) which will merged in 2007 (Section 3(4)). The London International Financial Futures Exchange (LIFFE) was opened for business in September 1982 and has since grown to become Europe's leading futures and options exchange. LIFFE was acquired by Euronext in January 2002 which merged with the New York Stock Exchange in April 2007. LIFFE shifted from its traditional trading 'open-outcry' system to screen based trading in 1998 due to the cost savings generated and with price the

competition from other European rivals and has taken forward a number of other technical and trading innovations since. LIFFE had an initial out of hours electronic trading platform (Automated Pit Trading or PIT) and later introduced LIFFE CONNECT. Euronext LIFFE provides a full range of financial, equity and commodity based derivative contracts including in short-term euro denominated interest rate EURIBOR derivatives. The London Metal Exchange (LME) and the International Petroleum Exchange (IPE) are also based in London which are both recognised investment exchanges to the extent that they deal in commodity related derivatives as well as pure commodity contracts.

(7) Asset management

London is the world's leading financial centre for fund management with the industry being highly concentrated. London's fund management services are principally provided to large institutional clients, including insurance companies and pension funds, rather than private clients as on the European Continent. A number of UK fund managers were acquired during the 1990s and 2000s by overseas firms to benefit from their international asset management expertise. Major firms include Mercury Asset Management (acquired by Merrill Lynch in 1997), the Gartmore Group, the Henderson Group, Schroders, Morgan Grenfell & Co Aberdeen Asset Management and Barclays Wealth.

(8) Gold bullion

London has been the world's leading bullion trading centres since the nineteenth century with the famous London 'fix' (Section 3(6)). Representatives of the world's leading bullion dealing firms meet at Rothschilds merchant bank twice a day to fix the official price for gold which it then used as a global benchmark for gold transactions.

(9) Insurance

London insurance industry is concentrated in the areas of marine, aviation, international reinsurance and large commercial risks most of which are of international nature. Apart from insurance companies, general insurance business is conducted through Lloyd's of London which is still considered to be the largest single insurance market in the world (Section 3(6)). The share capital of Lloyd's has traditionally been provided through its large number of individual members although companies have also been allowed to join recently. Individual members assume unlimited liability for claims relying on their own personal financial resources to support any liabilities that arise. Lloyd's itself does not itself provide insurance for these claims although it does maintain a fund to support syndicates that might otherwise default and consequently damage the reputation of Lloyds.

(10) Marine services

International shipping services are principally conducted through the Baltic Exchange which deals with marine insurance, ship broking, ship classification and accounting and other legal and consultancy. The exchange originally operated out of a number of separate coffee houses in London, including the *Jerusalem Coffee House* and the *Virginia and Maryland Coffee House* which later amalgamated. It was originally set up in 1744 wit its name shortened to the *'Baltic'* in 1810 and with *'Baltic Club'* regulations being produced in 1823. It now has around 550 members and operates a number of leading shipping indices. London's involvement with marine services dates from its importance as an international trading centre and with Great Britain being pre-dominantly a shipping nation. This allowed London to develop a leading expertise in maritime law and to act as a centre for other marine services with many of the main ship owning companies or families of the world operating out of London.

6. INTERNATIONAL INVESTMENT BANKING

Financial institutions may generally either operate as commercial banks or investment firms. The essence of commercial banking is the taking in of deposits from the general public and advancing loans or credits although many large commercial banks will now also provide a number of other financial services. Investment banking is principally concerned with raising capital for corporate bodies, governments or other organisations or institutions, market making and trading in securities, managing financial assets for various investors (especially institutional investors and mutual funds) and providing financial advice to private companies and governments. Commercial banking is money market and corporate and retail banking based with investment banking being securities and capital markets based.

The distinction between these two principal types of financial activity is nevertheless not equally maintained in all countries. On Continental Europe, large universal banks can conduct commercial and security related activities from within the same corporate entity. Even in such other countries as the US and UK where separate subsidiaries are commonly used for each type of activity (either for legal reasons or simply as a matter of corporate practice), the distinctions are become increasingly unclear as many cross-sector products and services are developed.

The modern financial environment is now characterised by the emergence of increasingly large complex financial groups which are active in all major areas of financial business at the same time as financial products themselves are dissolving into essentially fungible and substitutable alternative and investment media.

(1) Investment Banking Business

In considering the nature of modern investment banking, the following main types of activities can be identified.

(i) Equity and Debt Underwriting

Investment banks principally assist companies raise capital through the underwriting of issues of new equity or debt (bond) instruments. In acting as an underwriter in the issue of such securities, the investment bank undertakes to ensure that the company will receive the full issue price irrespective of whether the securities are bought by retail or other public investors or are left with the underwriter. The underwriter will receive a fee, commission or discount in return for the commitment to structure, manage and market the issue.

New issues of both debt and equities can either be structured through an initial public offering (IPO) or a private placement with the issue being sold on privately to a smaller group of institutional investors. Other options include Preliminary Prospectus Offerings (provisional price and coupon are set using exploratory documents) and Impact Day Offerings (public announcement of price and coupon with subscription being left open for a particular period.). These new issues are then initially sold to investors through the 'primary market' while the subsequent buying and selling of the securities being conducted in the 'secondary market'.

(ii) Market Making and Trading

Market making involves undertaking to act as a broker or dealer for the purchase and sale of specific securities at all times. This ensures market trading and liquidity in all of the stock covered with the market makers generating profits from the differences in the values that the securities are bought and sold. Trading refers to the more general buying and selling of securities on the secondary market. This can either can be conducted as principal on the bank's own account (proprietary or 'prop desk' trading) or as agent on behalf of one or more clients. Such dealing can then either be conducted on an instruction (execution only) or discretionary basis.

(iii) Asset Management

Most investment banks provide asset management services, often on a discretionary basis, with the aim of generating the maximum return for their clients. The major users of asset management services are institutional investors (especially pension funds and insurance companies) and investment funds (mutual funds, unit trusts and investment trusts) which may either operate on an in-house or independent basis. The fund managers will charge a fee for management of the fund in addition to the broker's commissions charged for each transaction carried out.

(iv) Advisory Services

Investment banks will provide advice to governments on raising funds or to corporations on such matters as mergers and acquisitions, restructuring and privatisation. Corporate restructuring work may involve any major organisational changes or transfers of ownership including management buy-outs (MBIs), management buy-ins (MBIs), share repurchases, asset sales, divestitures, 'spin-offs' and other strategic reviews. With regard to privatisation work, the investment banks may either act as an adviser to the government or the privatised industry or entity on the privatisation and sale strategy to be adopted or on underwriting of the sale of the equities to the public.

(v) Trade Finance

Specialist banking services are traditionally concerned with the trade finance through the provision of bills of exchange for importers and exporters. These may, in particular, involve accepting the bills (adding the bank's credit to the bill through endorsement) or discounting (purchasing the bills less a discount calculated having regard to the outstanding time before payment is due on the bill). Trade finance also includes providing letters of credit or any other form of trade related finance such as forfaiting.

Since the 1980s, investment banks have also become involved in a number of other more specialist areas including, 'project finance' (the arrangement of large and complex financial packages for infrastructure projects such as airports, bridges and power stations), 'structured finance' (the design and implementation of sophisticated and tax efficient financial packages such as securitization), and 'private finance initiatives' (specific arrangements launched by the government in the UK to raise private-sector funds for public-sector capital projects such as schools, hospitals or museums).

(vi) Foreign Exchange and Financial Derivatives

Investment banks will be engaged in foreign exchange trading either for their own account or on behalf of client positions. They are also often key players in the financial derivatives markets in designing and setting-up one-off OTC products or in dealing in OTC or exchange traded products for hedging or speculative purposes and either for their own or client account purposes.

(vii) Prime Brokerage

Many investment banks act as prime brokers on behalf of other financial institutions such as hedge funds. Prime brokerage involves the provision of a range of completion services not involving trade execution directly. Prime brokers are principally responsible for the clearing and settling of executed trades although they may also act as central global custodians on behalf funds as well as provide other margin financing (lending against the collateral of the securities purchased) and stock lending services (providing securities to market counterparties for short periods of time such a for short selling). Prime brokers may provide other research, reporting or reconciliation services.

(viii) Other Activities

Apart from the principal activities discussed above, investment banks may generate income through gold or commodities trading, such as in oil or gas, either directly or through derivatives contracts. Investment banks have often become involved more recently in other activities such as insurance broking, life assurance, leasing, property development and real estate agency. These may be conducted through separate subsidiaries. With these new areas of business and the growing overlap between investment and commercial banking activities, the traditional distinctions between these types of firms are becoming less important.

(2) Development of Investment Banking

In terms of historical development, a number of principal types of investment banks or banking can be identified. These include US investment banks and brokerage houses, British merchant banks, Continental European universal banks and Japanese securities houses. A number of these have already been referred to.

(i) US Investment Banks and Brokerage Houses

The legal separation between commercial banking and investment banking in the United States originated under the Glass-Steagall Act of 1933 (or more specifically the provisions of the Banking Act 1933 sponsored by Congressman Carter Glass and Henry B Steagall). This separation resulted in the creation of a number of leading investment banks such as Morgan Stanley, Lehman Brothers, Kuhn Loeb & Co (acquired by Lehman Brothers in 1977), and Dillon Read (later SBC Warbugh Dillon read and then part of UBS) which dominated during the Wall Street in 1940s and 1950s. The pre-eminence of these firms in the securities underwriting business was then challenged in the 1960s by other leading brokerage houses and newly formed investment banks such as Merrill Lynch, Salomon Brothers and Goldman Sachs.

The abolition of the New York Stock Exchange's fixed brokerage commission rates on 1 May 1975 subsequently led to a number of further amalgamations between brokers and the emergence of a more limited number of large leading firms and set of smaller 'boutique' houses. Since 1980s, the larger Wall Street investment banks attempted to expand their international operations partly due to the further deregulatory eventsin other major financial centres across the world and significant growth in international capital market activity. By the late 1990s, most of the firms had established presences in all of the main financial cities across the world as well as in the leading emerging markets. Further consolidations have also since taken place between the Wall Street investment banks and between the banks and brokerage houses which has allowed a considerably more comprehensive and complementary range of services to be provided.

A two-tier hierarchy has also emerged among the leading US investment banks dominated by a limited number of firms with strong US capital markets and corporate finance operations and large US securities retail capacities as well as extended global operational networks. These were referred to as 'bulge-bracket' firms and the first to be listed on a public 'tombstone' announcement of a major securities issue. The largest Wall Street investment firms before the 200 crisis were (in order of size and influence) Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers and Bear Stearns. Bear Stearns was acquired by JP Morgan Chase in March 2008 and Merrill Lynch by Bank of American on 14 September 2008. Lehman Brothers was forced to file for bankruptcy on 15 September 2008 with Goldman Sachs and Morgan Stanley reregistering as bank holding companies which ended the dominance of Watt Street by powerful independent investment banks.

As the investment banking industry has continued to consolidate again after the financial crisis, the separation between the investment banking and commercial banking has again broken down further as increasingly large complex groups have emerged that have significant presences in both areas. This was specifically facilitated with the adoption of the Financial Services Modernization Act in 1999 (sponsored by Phil Gramm, Jim Leach and Thomas J Bliley) which allowed firms from more than one key financial sector to be owned by new Financial Holding Companies (FHCs). The most notable restructuring that occurred in anticipation of this relaxation of the ownership rules in the US was the merger in 1998 between the international commercial bank Citicorp and Travellers Group owner of Salomon Smith Barney. Continuing consolidation within the US financial industry is expected while the authorities have adopted a number of further re-regulatory measures following the financial crisis and especially with the Dodd Frank Wall Street Reform and Consumer Protection Act of 2010 (renamed after Barney Frank, Chairman of the House Financial Services Committee and Chris Dodd, Chairman of the Senate Banking Committee).

(ii) British Merchant Banks

British merchant banks have historically specialised in trade finance areas including the provision of bills of exchange and letters of credit facilities for merchants engaged in international trade. (Letters of credit allowed merchants to purchase goods abroad using correspondent banks on each side who would exchange the bills of lading (carrying legal title to the goods) for payment on behalf of their clients which ensured quality of the goods and security of payment.) Trade finance developed during the nineteenth and early twentieth centuries at a time when the international trade was denominated in sterling and London was the main centre for

international finance. With the expansion of the international economy in the nineteenth century and an enormous demand for the transfer of capital from European savers to borrowers in the Americas, Asia and elsewhere, the British merchant banks began to offer international bonds into the London capital markets. The main objective of these new securities was to fund overseas governments as well as railway and other large project financing. Early forms of asset management and investment as well as and corporate finance were also developed in the early twentieth century.

Despite of the strength of the British merchant banks during 1960s and early 1970s, they failed to develop a leading position in the expanding Eurobond and Eurocurrency markets in 1970s mainly due to the competition from the larger and more dynamic US investment banks. Their position was also affected by the deregulation of the London Stock Exchange between 1983 and 1986 which permitted the entry of foreign firms into the UK markets by relaxation of the earlier restrictions on ownership of Stock Exchange firms. By the late 1980s, the top of the British merchant banks consisted of a number of leading independent firms including Barings (purchased by ING in 1995 after suffering £827 losses of by Nick Leeson in Singapore), Flemings (sold to Chase Manhattan in 2000), Hambros (sold to Société Generale in 1998), Kleinwort Benson (acquired by RHJ International following a forced disposal by Commerzbank in 2009 which had earlier purchased Dresdner Kleinwort), Morgan Grenfell (bought by Deutsch bank in 1990), NM Rothschild & Sons, Schroders and S G Warburg & Co (acquired by Swiss Bank Corporation in 1995) and divisions of the main UK clearing banks such as Barclays and Royal Bank of Scotland (which acquired NatWest in 2000).

Although a further boom in international investment banking was experienced in the 1990s, the British merchant banks were not able to realise the full potential benefits of this growth. Five of the top independent merchant banks were then acquired by foreign banks and any ambition of competing with the US bulge-bracket firms in the global investment banking market place was abandoned. By the beginning of the 21st century, the UK investment banking industry only comprised three major independent firms with Flemings, Rothschilds and Schroders with Flemings acquired by Chase Manhattan in 2000 (which also merged with JP Morgan & Co in 2000 to create JP Morgan Chase).

(iii) Continental European Universal Banks

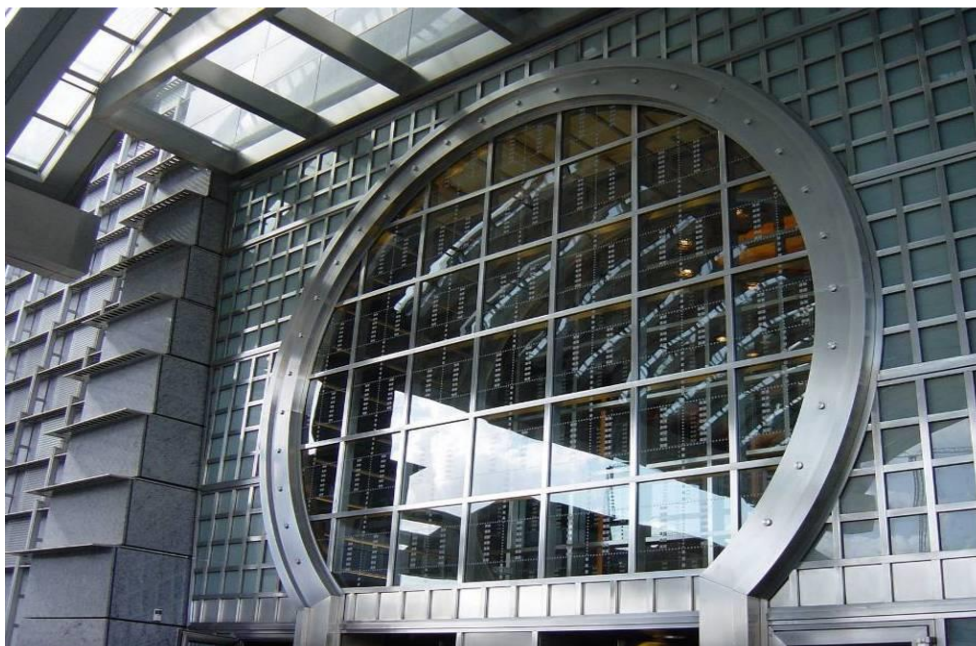
On Continental Europe, the historical practice is that of 'universal banking' which allows commercial and investment banking to be combined with no restrictions being imposed on the conduct of securities business by such institutions. The leading European investment banks now include such large operators as Deutsche Bank, Banque Paribas, Credit Suisse. As one of original developers of international investment banking services, Banque Paribas formed an early alliance with the London merchant bank Warburgs in 1973. Other major continental European banks have also subsequently strengthened their presence in London through the acquisition of British merchant banks taking specific advantage of the relaxation of the ownership rules with the deregulation of the Stock Exchange in 1986.

By the late 1980s and early 1990s, European banks had expanded their securities activities across the Continent and into Asia with the deregulation of the continental bourses and the opening up of the Tokyo Stock Exchange. In spite of this, most European banks experienced great difficulty in establishing any significant presence on Wall Street with only four major banks being able to develop any substantial expertise in the US, Credit Suisse, UBS, Deutsche Bank and Schroders.

(iv) Japanese Securities Houses

A strict legal separation of commercial and investment banking was also adopted in Japan on a US model after the Second World War. The domestic business was then dominated by the 'Big Four' securities firms of Nomura, Daiwa Securities, Nikko (later Nikko Cordial under Citigroup) and Yamaichi Securities (later closed down in 1999). Japanese securities houses were able to expand substantially in the 1980s especially with the growing use of the capital markets by corporate borrowers. They had also secured become highly successful in

London and New York until a turn around in economic conditions in the 1990s led to the collapse of several large securities houses including Yamaichi. Financial crisis and scandals as well as a stagnant deflationary economy have subsequently restricted any substantial expansion of the Japanese securities industry until recently.



(3) International Investment Banking and the Financial Crisis

International investment banking had grown substantially immediately before the global financial crisis. This had been referred to as being a period of ‘Great Moderation’ or ‘Great Stability’. Investment banking had become a global business with the cross-border and complex nature of modern international capital market activity. Margins had earlier become increasingly tighter and business more competitive although the massive levels in global liquidity that arose especially with the recycling of Asian surplus assets lead to huge expansion in activity. This had been particularly noticeable in a number of specialist also market sectors including structured finance, with the growth in the use of CDSs, CDOs and CLNs and other structured products. This expansion ended with the contraction in global interbank credits which began in summer 2007 and led to the closure of many structured finance markets. Bear Stearns had to be purchased by JP Morgan Chase in February 2008 with Bank of America acquiring Merrill Lynch in September 2008 following the closure of Lehman Brothers 15 September 2008 (above). As noted, the other two largest Wall Street investment firms, Goldman Sachs and Morgan Stanley, were forced to be registered as bank holding companies to obtain Federal discount window lending facilities. This led to the demise of international investment banking as an independent sector with most of this activity now been carried on within universal banks or larger banking and financial groups.

7. INTERNATIONAL COMMERCIAL BANKING

Commercial banks principally provide savings or deposit facilities from which they advance loans and credit to government, corporate entities or smaller and medium sized businesses and households or individuals. These activities tend to be more country based as the banks are dependent on underlying deposit volumes or access to local money markets. Most commercial banks will fund their activities with a proportion of wholesale lending of between 20 and 35%. Many of the institutions that suffered the most difficulties during the global financial crisis, such as Northern Rock and RBS, had considerably larger dependent on short-term wholesale borrowing. Commercial banking can nevertheless still be profitable even on a cross-border basis. Commercial banks

manage their payment systems which includes providing cross-border payment facilities for clients in addition to other lending, investment or insurance sales services.

(1) Banking and Banks

Apart from the core activities of deposit taking and loan making, commercial banks may also offer a broad range of other financial services, dependent on legislation or tradition of different jurisdictions, at both retail and wholesale levels. Retail banking aims at servicing the general public and small businesses, while wholesale banking is mainly conducted in inter-bank market, with a relatively small number of high-value transactions involved.

The range of activities commercial banks may conduct varies from country to country. In some countries, such as US and UK, commercial banks are, either legally or traditionally, separated from investment banks or merchant banks, whose business is mainly concerned with securities underwriting and other related activities. Other countries, especially those in European continent, maintain the pattern of universal banks, which can conduct not only deposit taking and lending, but also securities underwriting as well as a wide range of other activities, such as insurance, asset management and corporate advisory services, etc. Despite of this difference, universal banking is increasingly becoming the international norm, following the deregulation activities and relaxation or removal of legal barriers to it.

(2) International Banking

International banking, which means servicing the international requirements of clients such as importers, exporters, or foreign travellers at home and abroad, was originally conducted by commercial banks through establishing ‘correspondent’ relationships with a set of banks overseas. As correspondents, the banks act as each other’s local agent. This form of correspondent relationship still remains one option for banks nowadays that envisages the international operation. With the international economy more integrating, however, commercial banks have established their own presence in overseas markets, that is, multinational banking, which takes a variety of forms, including subsidiary (a separate legal entity), branch (wholly owned by parent banks), agency (similar to branch, but not able to accept local deposits), representative office (as a point of contact only), or consortium bank (jointly owned by several banks).

(3) Development of International Banking

International banking expanded quickly scope and scale during the 1960s with the overseas expansion of many banking groups especially from the US. The large US banks wish to support their domestic corporate clients and multilateral corporations through the provision of a wide range of services through the establishment of overseas branches and subsidiaries. Many large US banks also moved to London to become involved in the expanding Eurodollar markets. International lending continued to grow during the 1970s and early 1980s with the recycling of funds from oil exporting countries and the rise in borrowing by Western and emerging market economies. An over commitment in these markets led to the international debt crisis beginning in 1982 lead to a slowdown in lending activity following the organised rescheduling or re-structurings that had to take place many under the Paris Club or Rome Club. European and Japanese banks were also closely involved in the expansion of the Eurodollar markets and were subsequently followed by the largest Chinese banks which became among the largest operators in the world.

(4) International Commercial Bank Activities

International commercial banks were mainly engaged in trade finance, currency trading and foreign lending. historically. They were closely involved in the growing Eurodollar market activities which developed in 1960s and 1970s, including specifically syndicated lending and interbank transactions. Commercial banks are the always been dominant players in the international project finance market which has provided funding for many

large infrastructure projects across the world. Since 1980s and 1990s, they have also developed a number of further services and innovative products involving alternative sources of financing, global money market operations, global custody and global private banking and wealth management.

(5) International Banking Regulation

Banking has traditionally been more tightly regulated than most other industries due to its key role to the economy as a whole. Growing concern with regard to the stability of the international financial system has led to a number of multilateral initiatives being taken forward since the early 1970s and 1980s. Most of this work in the banking area has been taken forward by the Basel Committee on Banking Supervision which was established at the offices of the Bank for International Settlements (BIS) in Basel, Switzerland in 1974. The Basel Committee has produced a number of papers in the supervisory and regulatory areas. These have included its international capital standards originally developed under its first Capital Accord in 1988 (Basel I) has extended in 2004 (Basel II) and then further amended in 2010 (Basel III). The Committee has also issued a number of sets of regulatory principles in core areas following the global financial crisis including on bank governance, remuneration, cross-border resolution, supervisory college supervision and wider macro-prudential oversight.

The Committee had originally worked on and agreeing a series of principles governing the supervision of internationally active banks on a cross-border basis. These provided for the allocation of supervisory functions between the parent and host authorities and for the exchange of information, co-operation and coordination procedures between all of the separate sets of national authorities involved. These were initially set out in a 1975 First Concordat following the crises with Franklin National in the US and Bankhaus Herstatt in Germany in summer 1974. A Revised Concordat was produced in 1983 after the closure of Banco Ambrosiano and disagreement between the Italian and Luxembourg authorities as to its supervision. A separate Information Supplement was issued in 1990 and strengthened Minimum Standards in 1992 after the closure of BCCI. A further Report on the Implementation of the Minimum Standards was produced in 1996.

Bank capital has traditionally always been dealt with at the national or country level. Capital provides a buffer against losses which protects the solvency of banks and their individual stability as well as the stability of the markets as a whole which could otherwise be damaged through depositor ‘runs’ or contagion. Following expansion of international banking during the 1960s and 1970s, the authorities recognised that capital levels had

fallen to historic lows especially following the Third World debt crisis in the early 1980s. This had been referred to in a number of statements by the Basel Committee.

While it had not been possible to agree common standards and the Committee level initially, the US and UK authorities produced a Bilateral Capital Accord in 1986 which was presented to the Committee for consideration with the threat of applying the new rules in New York and London in the absence of further global common standards. The Committee subsequently produced a first Capital Accord in July 1988, which established the minimum 8% of capital to risk adjusted assets ratio which became the de facto global base level.

A separate set of standards for capital for securities activities of international banks was agreed under a Market Risk Amendment in 1996. The Basel Committee had attempted to work with the International Organisation for Securities Commissions (IOSCO) although this had failed and the Committee proceeded to produce its own standards generally following the EU provisions set out in the Capital Adequacy Directive (CAD) which was adopted with the Investment Services Directive (ISD) in 1993. The Basel I capital requirements for banks were implemented in the EU under the Own Finds Directive (OFD) and Solvency Ratio Directive (SRD) in 1989, with their Second Banking Directive (SBD) in 1989. All of these provisions were subsequently consolidated in the Banking Consolidation Directive (BCD) 2000 which was revised (recast) in 2006 under a separate Capital Requirements Directive (CRD) to give effect to Basel II. This will be further amended to implement Basel III under a further CRD within the EU June 2011.

While Basel I was accepted as a common principal global standard for capital adequacy, it was strongly criticised from an early stage for its simplicity and for failing to take into account many of the underlying risks that banks were assuming and to keep up with financial innovation in the markets. The committee had also been unable to retain any common global liquidity standards. The original Basel I measures will extended under Basel II to include three mutually reinforcing pillars with a minimum capital requirement (pillar 1), a formal supervisory review process (pillar 2) and strengthened market discipline through market disclosure (pillar 3).

Basel II pillar 1 retains the original definition of regulatory capital with the minimum required ratio of 8% of all this is made more risk sensitive by using the ratings provided for government and corporate borrowers by internationally recognised Credit Rating Agencies (CRAs). Larger banks may alternatively use their own internal grades of risk or order were ratings under either a Foundation or Advanced Internal Ratings Based (IRB) approach subject to strict rules. The requirements for capital for securities activities in the trading book are retained in pillar 1 with a new operational risk charge also being provided for.

Pillar 2 of Basel II provides for a formal supervisory oversight procedure to confirm that banks have established necessary systems to identify, measure, monitor and control the overall risks they face and maintain capital accordingly. National authorities must ensure that banks are able to assess their capital adequacy positions relative to their overall risks and take appropriate actions in response to those assessments where they are found to be inadequate. A range of remedial actions may be applied to banks were the thing to do so, such as strengthening risk management, improving internal controls, or increasing regulatory capital requirements.

Pillar 3 support or complements pillars 1 and 2 by strengthening market discipline market discipline through the disclosure of mandatory and supplemental information by banks on their capital positions. This is intended to allow market participants to assess key aspects about a particular bank's risk profile and level of capitalization and capital support.

The Basel Committee consulted on the revision of its Basel II requirements during 2008-2209 following a global financial crisis, with a final set of Basel III amendments being produced and agreed in December 2010. It is principally operate by increasing cord minimum tier one capital (essentially paid-up share capital and retained earnings) from 2% (a quarter of 8%) to 4 1/2 % with an additional 'Conservation Buffer' of 2 ½ % which takes core tier 1capital to 7%. This is to be supported by a further discretionary 'Counter-cyclical Buffer' of between 1-2 1/2% by national authorities in times of expanding 'boom' market conditions to allow banks to build up the

capital reserves in the event of a downturn in the markets. This is to be further supported by a further 'Systemic Risk Buffer' of between 1-2% for the largest banking group's to reflect their additional systemic risk and potential liability to the national support.

The Committee has agreed a separate set of common global requirements for liquidity with a Liquidity Cover Ratio (LCR) and Net Stable Funding Ratio (NSFR) with an additional leverage ratio of 3% of core tier 1 capital. These then supplement the strengthened capital measures within a new set of short-term funding liquidity requirements and a total debt ceiling under the then new leverage requirement. The leverage position of a number of banks and investment firms immediately before the crisis had risen to over 40% which was strongly criticised as this made their continued viability particularly difficult in the event of the significant trading losses suffered unstructured products and with the loss of funding in the interbank credit markets.

These financial reserve requirements have also been further supplemented by a series of principles being produced by the Basel Committee in such areas as bank governance, remuneration, cross-border resolution, the establishment of a supervisory college for all large banking groups (made up of official representatives from all of the countries they operate in) and the conduct of wider full financial macroprudential oversight to identify any build of risk across the financial system or economy as a whole.

8. INTERNATIONAL FINANCE MARKETS

The rest of the course examines the nature and structure of the principal international finance markets and the main documentation used. This includes the international loan finance (Euroloan) market, international bond (Eurobond) market as well as the international project finance, securitisation and financial derivatives markets. The course will also consider the structure and operation of the principal international stock markets and exchanges as well as the operation of some of the main Alternative Investment Markets including hedge funds, private equity and sovereign wealth funds.

A large number of different types of financial transactions exist although a number of common elements arise in each case. These can be considered in terms of finance structure (nature of funding), documentation, parties (and rights and duties), party liability (and limitation and exclusion of liability) and remedy. The three most commonly used sources of funding are loans (personal debt obligations between a creditor, or group of creditors, and borrower), debt securities (transferrable debt obligations issued in the form of a paper or electronic form) and financial derivatives (payment obligations tied to other reference assets or prices).

A correspondingly large number of different types of contracts and documents may be used. Most of these contain certain common terms governing financial provisions (amount or advance, draw down, term or duration,

interest and repayment), obligations or conditions (principally with conditions precedent, representations and covenants) and remedies (events of default, termination and recovery). Almost all finance contracts are based on these core provisions. Standard documentation is often prepared by industry trade associations such as the Loan Market Association (LMA), International Capital Markets Association (ICMA) and International Swaps and Derivatives Association (ISDA) which is adjusted as necessary to reflect a particular deal.

The most complex transactions with the most documents (or 'deliverables') to be prepared are usually project finance (due to the tied construction element), acquisition finance (with the takeover or merger of companies) and structured finance (incorporating large numbers of underlying securitised and re-securitised transactions).

Finance contracts may either be conducted on a formal stock market or exchange or off-exchange which is commonly referred to as over-the-counter (OTC). International lending and domestic loan, mortgage or other credit transactions are generally OTC due to the personal nature of the debt obligations created. Capital market financing, principally through longer term bonds, medium floating rate notes (MTNs) and shorter duration commercial paper (less than one year) instruments can either be OTC or on-exchange. Many bonds and notes are listed on stock markets to increase the range of potential investors, including in particular institutional investors, such as pension funds, unit trusts and other professional asset managers, due to restrictions on the types of assets they may otherwise hold. Even where securities and derivatives transactions are carried out OTC, there has been an increasing trend to use central trade repositories and central counter parties (CCPs) for transactional reporting and clearing purposes. CCPs became of particular importance following the global financial crisis during 2007-2009 with calls for OTC derivatives contracts to be centrally cleared.

(1) Euro Loans

The international loan market emerged in London after the Second World War with the influx of US dollars. This became known as the 'Eurodollar' market as the currency of the debt was separated from the local currency of issuance which was sterling in London. There had been international financial markets during the 19th century in major cities such as London, Paris and Berlin although the debt was always denominated in local currencies. The Eurodollar markets expanded quickly following the restoration of international currency convertibility in 1958 and the need for governments and large international companies to borrow on the international markets.

The following more specific sets of issues may be considered with regard to Euroloans although all of this is considered in further detail during the course:

(i) Loan Structures

A loan is created through a borrower entering into a personal debt obligation with a specific bank or group of banks in larger transactions (referred to as a syndicate). This may either be for a fixed duration (a term loan) or revolving basis (a corporate credit line or individual overdraft). The main financial terms are concerned with the amount of the advance (the principal), draw down (initial single amount or separate tranches), term or duration (fixed or adustable), interest (fixed or floating) and repayment (again single amount or in tranches or through amortisation over a period). Loan contracts generally used a single document based on a term loan agreement (although this may be relatively lengthy) with supporting security instruments or guarantees with any transfer instruments usually being incorporated as an appendix to the loan agreement. .

(ii) Loan Facilities

A simple term loan arrangement can be used as the basis for a number of different types of lending facilities. These include large international single bank or syndicated lending (Euro loans), Multi-Currency Facilities (with draw down in different foreign currencies), revolving credit facilities (RCFs), credit lines (up to agreed limits), property finance (secured on commercial or residential property), project finance (secured on project assets and repaid from project income), asset finance (with title retention or security over other large assets such as aircraft

or ships), acquisition finance (to facilitate a corporate acquisition, merger or restructuring) and subordinated finance (with the borrowing being postponed to other priority creditors).

(iii) Issue Procedure

The issuance procedure for a term loan is relatively simple. Where a group of banks is involved, an arranging bank is appointed to solicit interest and negotiate the loan documentation. The borrower issues a Mandate Letter in appointing the arranging bank with the core financial provisions being set out in a Term Sheet. A longer Information Memorandum is prepared which explains the borrower's business and management and financial conditions and the purpose of the advance. The draft loan agreement is prepared and circulated for comment. Conditions precedent documents are collected and the loan agreement signed after which the borrower will be able to draw down the funds. Separate commitment, management and agency fees are charged.

(iv) Loan Syndication

Where large sums are to be advanced, banks will form a syndicate to divide and allocate the risk. The principal risk that arises is with regard to credit risk which is the risk of counter party default with the borrower not paying interest during term nor repayment of principal on maturity. The loan agreement includes provisions governing the relations between the banks who will generally act on a principal basis with only limited functions being delegated to the agent bank who managers the distribution and collection of payments after the loan amounts have been advanced. The general principles governing the relations between the syndicate members may be summarised in terms of severality (independence), proportionality (shared lending amounts), equality (shared receipts), democracy (limited majority rights) and limited delegated agency function (with the agent bank's functions generally consisting of payment, receipt, banking, notification and limited default duties).

(v) Documentation

A term loan is based on the loan agreement. While a single document is involved, this can be substantial as it has to set out the conditions under which the amounts are to be advanced and protect the interests of all of the lending banks until full repayment. Term loans include, as noted, all of the key financial terms (amount, draw down, duration, interest and repayment), conditions (obligations) and events of default (remedies).

The conditions generally consist of the Conditions Precedent, Representations and Warranties and Covenants. Conditions precedent are generally corporate and constitutional in nature and involve providing copies of all relevant company documentation, board resolutions, country confirmations, security and legal opinions. Representations and Warranties ('Reps and Ws') specify the conditions under which the advance is to be made

and generally consist of a series of legal and financial or commercial confirmations with regard to the status of the borrower (and any connected companies) and its legal capacity to act and the validity of the transactions entered into. The Covenants ('Covs') are continuing obligations to be complied with following draw down until repayment which are generally concerned with providing information to the banks and protecting the financial condition of the borrower or other group companies.

A series of events of default will be specified, including non-repayment, breach of financial or non-financial covenants, misrepresentation, cross-default on other debts, insolvency, commencement of creditor processes, loss of control, illegality, repudiation or other material adverse change (referred to as the 'MAC' clause). Contractual default remedies principally consist of suspension, cancellation of subsequent draw downs, demand for repayment, acceleration and termination. Lenders may be able to use other remedies including netting and set-off, appropriation of amounts across accounts, combination of amounts in different accounts and enforcement of security and guarantees. Where the borrower is in breach but able to continue to make some payments, some form of rescheduling or restructuring of the debt may be agreed without prejudice to any other rights of the lending banks.

(2) Euro Bonds

A parallel Eurobond market quickly emerged in which the debt was issued in a transferable security based form rather than simply exist as a bilateral debt obligation between the banks and borrower. The has substantial advantages in terms of tradability, increased liquidity and lower borrowing spreads for higher credit standing counterparties. The international loan market had generally fallen by around a quarter by the beginning of the 1980s with the bond market expanding by an equivalent amount. Both the loan and bond markets are supported by an underlying Eurodollar deposit, or inter-bank, market within which funds were transferred between the banks on a wholesale basis.

The number of currencies involved in the Eurobond market has expanded substantially from an early stage to include sterling, Japanese yen, previously deutschemarks and French and Swiss francs and later Euros. The history of the Eurobond market has also been one of the production of shorter duration instruments that can be rolled over on a continuous basis. Early more traditional bonds may have been from between 20-50 years, which were followed by shorter Medium Term Notes (MTNs) of between 5 and 15 years and then shorter Euronotes (of less than one year). While these have to be re-issued, or rolled over, more regularly, this allows the borrower to benefit from flexibility in terms of the total amount of debt outstanding at any one point. Shorter commercial paper can also be used for borrowings of up to one year with the difference between commercial paper and Euro notes being that the banks are not committed to purchase the paper from the issuer which has to rely on market uptake.

The following more specific issues may be considered with regard to Eurobonds although all of this is considered in further detail during the course:

(i) Bond Structures

Debt or bond finance consists of the issuance of transferrable debt securities by governments or companies which provide for both the payment of a dividend amount (biannually or annually) and repayment of the value of the bond on maturity or redemption. The principal financial terms are again then amount, dividend and repayment or redemption. As the debt is issued in a tradable form, the issuer government or country decides such issues as amount, currency and duration initially with different classes of bonds being issued as necessary over time. Each class of bonds may lack the same contractual flexibility as under a loan agreement although this can be replicated by issuing different types of bonds, in different amounts and on different terms at different times. The general advantage of bonds is that their transferability can create additional market liquidity although the amount the issuer will have to pay through dividend will be determined by market conditions. Higher standing governments or higher quality companies can obtain funds more cheaply on the bond markets with less quality issuers having to either pay higher dividends or rely on the banking markets.

(ii) Bond Facilities

Debt or bond instruments may be issued in a number of forms. This includes long, fixed duration and interest rate bonds, or Eurobonds of between 15/20 and 40/50 years. Eurobonds are transferrable debt securities denominated in a currency other than that of the issuer's home country. While bonds generally provide for a fixed dividend, Floating Rate Notes (FRNs) can be used to pay variable interest rates which are usually calculated with regard to the London Interbank Offered Rate (LIBOR) managed by the British Bankers Association (BBA). Variations include floor, drop lock, double drop lock, cap, collar and inverse FRNs. Perpetual notes may be issued without a fixed redemption date. Bonds and notes can be issued with warrants attached to allow the holder to acquire additional bonds or notes on predetermined terms. Equity linked and convertible bonds may also be issued.

Euro medium term notes (MTNs) are unsecured debt instruments for between nine months and 15 years. Euro commercial paper (ECP) or sterling commercial paper (SCP) consists of unlisted short dated debt for one year or less. Multi-Option Funding Facilities (MOFFs) combine a number of facilities including possibly long bonds or more likely MTNs with ECP, or SCP, and short term advances, swing line facilities (overdrafts) and possibly bankers' acceptances (accepted bills of exchange) or certificates of deposit (securities evidencing an underlying deposit of funds with a bank).

(iii) Parties and Documentation

Debt instruments are issued by the issuer who may be a government or corporate borrower with the bonds, notes or paper being purchased by end investors. A Lead or Managing Bank is appointed to manage the issue with the securities being sold by a Selling Group or through an Underwriting syndicate which guarantees purchase and on-sale. A Trustee will be appointed in large issues to represent the interests of bondholders. A Paying Agent is appointed to manage the payment of dividends and redemptions during the duration of the issuance. A separate Fiscal Agent is appointed where there is no trustee with the fiscal agent holding payments due to investors on trust on their behalf.

(iv) Issuance Procedure and Listing

The Lead Manager will receive the Mandate Letter from the issuer and prepare draft documentation including a Prospectus to solicit investor interest. The Prospectus is the equivalent of the Information Memorandum under a lending transaction and can also act as the Listing Particulars where the bonds are to be offered to the general public or traded on a specific stock market of exchange.

In terms of procedure, a public announcement of the proposed issuance was traditionally made on the launch date with an invitation telex, fax or email being sent out to selling group members and underwriters. A

Subscription Agreement is generally signed around 14 days after the launch date with a final closing seven days later. Bonds may be dealt with on a 'grey market' between the launch and listing subject to local market stabilisation rules which would otherwise prohibit such dealings. Eurobonds have generally been issued in the form of a single Global Note on the closing which is held by one of two major custodians, Euroclear in Brussels (formerly Cedel) and Clearstream in Luxembourg. The Global Note is replaced by definitive notes following their production which are again held with the custodian and transfers effected through account entries. Most modern issues are now managed on an electronic, or dematerialised form, with no single global or definitive notes being used.

Where bonds are to be sold to the general public, they have to comply with local listing requirements. These are now set out in Europe under the EU Transparency Directive and Prospectus Directive with the Financial Services Authority (FSA) acting as the Listing Authority in the UK. The bonds and prospectus must comply with relevant requirements. They will also have to comply with separate rules for admission to trading on a particular stock market or exchange. They will then be admitted both to listing and to trading on the specific market. Listing is desirable to allow the bonds to be sold to a wider group of potential investors including principally institutional entities, unit trusts and other professional investment managers.

(v) Liability

Financial institutions and, in particular, the Arranging Bank under a syndicated loan or Lead or Managing Bank under a Eurobond issuance, have to take care not to mislead other members of the lending syndicate or potential investors. This may become relevant where the borrower or issuing company becomes unable to pay and defaults with other syndicate banks or external investors looking to other financial institutions for recovery. Various heads of potential liability may arise including under Common Law misrepresentation, statutory misrepresentation or deceit, agency liability, breach of fiduciary duty and potentially separate regulatory liability. Finance documentation attempts to reduce the risk of loss partly by incorporating a range of 'limited duty' clauses (which define contractual and other duties of care narrowly) or 'limited liability' clauses (which either exclude liability or reduce loss through set-off, estoppel, indemnity or possibly contribution or contributory negligence). Exclusion clauses are nevertheless subject to statutory control under the Unfair Contract Terms Act 1977 which imposes a general reasonableness test with consumer contracts being dealt with under the Unfair Terms and Consumer Contracts Regulations 1999 (SI 1999/2083). This is an important part of documentation drafting and negotiation especially in light of a number of recent high profile cases involving large value actions after borrowers or issuing companies defaulted.

(3) Project Finance

Major construction projects are generally managed through some form of project finance with the funding being repaid principally from the income stream generated by the project on a non-recourse, or more commonly, limited recourse basis. This can be achieved through the establishment of a special purpose company or vehicle (SPV) to manage the project with the funding being made available to the SPV either through an international term loan or bond, note or paper programme. As repayment is dependent on the viability of the project, the credit providers will take security over all the assets involved, including income streams, bank accounts and insurance policies, with other additional credit support also commonly being provided such as through guarantees, performance bonds or insurance. The principal advantages are the debt separation and sponsor insulation that arise from the limited recourse nature of the financing. A number of additional risks nevertheless arise that have to be managed through considerably more complex documentation which has to be negotiated with all of the larger number of parties involved.

The following more specific issues may be considered with regard to project finance:

(i) Structure

Project finance involves the provision of funding for a discrete, single purpose investment on a non, or limited recourse, basis with repayment principally being serviced through the income generated under the project. The five key elements of the transaction then involve the SPV and project concession, limited recourse financing, extended project cycle, full risk assessment and allocation and confirmation of contractual integrity and validity. The SPV obtains the initial project concession and manages the project, receiving all income and making appropriate repayments to the creditors. The transaction is limited recourse with repayment being made through the income streams generated and without separate recovery against the sponsors or project contractors. As repayment is made from the income streams produced, there is an extended project cycle which continues either until repayment has been made in full of all funds advanced or the project is no longer viable. A large number of separate risks can arise, including with regard to construction, operational, financial, legal and regulatory and political and other matters. The objective of the documentation used is to ensure that all of these risks are fully assessed and allocated between the parties involves. Contractual integrity is concerned with confirming that the rights and duties of all of the parties under all of the documentation are consistent and work effectively together.

(ii) Advantage and Disadvantage

A number of project finance advantages can be identified in using this form of limited recourse financing. These principally include funding and debt separation, sponsor insulation, off-balance sheet financing, project separation and independent credit assessment, improved credit standing and ratings, higher project security, other taxation, legal and regulatory advantages, covenant compliance, available investment and expertise, maximum leverage, political risk mitigation and successful project completion. A number of limitations and disadvantages may also arise which have to be managed, including with regard to project complexity, documentation complexity, possible negotiation delay and higher cost, project length and continuing service costs, commitment, insurance and credit support costs and higher overall costs and lending commitment. All of these limitations and potential costs can nevertheless be reflected through the contract pricing, which is dependent on the initial credit assessment, and though the final documentation entered into. All relevant risks can be fully identified and managed through well drafted legal documentation.

(iii) Parties

A large number of contracts have to be entered into with the construction of major infrastructure projects or with the manufacturing and production of specific large value assets, such as aeroplanes or ships. This necessarily involves a number of further parties are involved in addition to the core borrower, in the form of the project vehicle or SPV, and lenders. Other parties include the sponsors, shareholders and private equity contributors, the

host government providing the relevant concession, the project banks, project contractor, project manager and operator, project suppliers and purchasers (off-takers), project advisors and other experts, project insurers, possible involvement by multilateral or development banks, export credit agencies and other project parties. The interests, rights and duties of all of these parties have to be properly reflected in the documentation entered into.

(iv) Documentation

A large number of documents are required in light of the complexity of the underlying construction or production processes and large number of parties involved. Five principal sets of documentation (deliverables) have to be prepared with regard to initial sponsor documentation (project or pre-development agreements, joint venture agreement, shareholders' agreement, sponsor/shareholder support agreement and credit support documents), original project company documentation (memorandum and articles of association, declaration of trust and separate administration agreement where appropriate), project documentation (concession, feasibility study and information memorandum, construction contract, equipment supply contracts, operating and maintenance contracts, supply and purchasing agreements and advisory and expert agreements), financial documentation (project loan agreement, security issue or lease finance agreement, interest rate and currency derivatives, direct agreements and collateral warranties and inter-creditor agreement) and security, insurance and credit support (including security agreement, credit support guarantees, insurances, third party rights and modifications and inter-creditor agreements).

(v) Negotiation

A series of specific additional legal or negotiation issues arise in project finance transactions. These include managing all of the relevant project risks, recourse, viability and financial ratios, risk management and project accounts, risk allocation and distribution, guarantees, credit support and insurance and risk cover. All of this will be examined in further detail in the relevant part of the course.

(4) Securitisation

The international securitisation markets provide a link between the banking or credit markets and capital markets. Pools of credit instruments, such as trade receivables, commercial or residential mortgages and corporate, car or student loans, can be sold to a special purpose vehicle (SPV) which pays for the pool by issuing new bonds, notes or paper. This takes the credit asset pool off the balance sheet of the originating bank and transfers it to the SPV which allows the bank to receive additional funds for further lending purposes. The bank will nevertheless often continue to manage the assets with this function having been re-delegated by the SPV back to the bank in return for a service fee. Additional credit support may also be provided through over-

collateralisation (transferring excess assets as security), credit lines or insurance. Synthetic securitisation structures may also be set up using financial derivatives (and principally credit default swaps or CDSs) to create the same economic effects as an assignment without a legal transfer of the assets from the bank to the SPV.

The following more specific issues may be considered with regard to securitisation:

(i) Structure

Securitisation is based on asset transfer, SPV funding, servicing and profit extraction, collateral provision and credit enhancement. It operates through the transfer of the asset pool from the 'originator' bank to the SPV principally through equitable assignment (under s136 of the Law of Property Act 1926). The assets are effectively sold to the SPV with the SPV paying for them by issuing new bonds, notes or short term commercial paper. The originator acts as servicing agent to manage the underlying debts in return for a fee with other forms of profit extraction being used. The SPV grants security over the whole of the asset pool either through fixed or floating charges with collateral being taken over all of the other contracts, insurance policies and moneys held in bank accounts or investments. Additional credit enhancement may also be provided, such as through over-collateralisation, guarantees, originator support, subordinated debt, additional credit enhancement may be provided to ensure that the securities issued by the SPV are AAA.

(ii) Advantage

The advantages of securitisation can be summarised in terms of new capital asset, high grade debt, income stream, improved payment profile and portfolio diversification, asset matching, off-balance sheet treatment, tax relief, capital allowance, credit protection, bankruptcy remoteness and last resort funding.

(iii) Parties

The parties to a securitisation may include the SPV, originator, servicer or servicing agent (to manage the collection of interest payments and repayments), investors, security trustee, financial guarantors, liquidity provider, funding manager, investment management, swap counter party and guarantor, arranger (investment bank responsible for setting up the structure) and credit rating agencies.

(iv) Documentation

Various sets of documents have to be prepared in connection with the establishment of the SPV, transfer agreements, funding agreements, enhancement and a security trust deed. SPV enhancements include a Memorandum and Articles of Association, Declaration of Trust in respect of the SPV share, administration

agreement, board resolutions and company registration forms. Funding agreements may include, depending upon the financing structure adopted, a loan or syndicated agreement, prospectus or offering circular, subscription agreement, agency agreement, trustee agreement and derivatives master agreement using common ISDA formats. Enhancement may also require subordinated loan agreement, financial guarantees, letters of credit, surety bonds, interest rate caps or swaps, tranching arrangements, account pool policy and possible reserve fund policy.

(v) Negotiation

A number of other negotiation issues arise in practice. These may relate to the nature of the assignment and transfer of the assets to ensure that there is a 'true sale' and no court 're-characterisation' (or re-classification) of the transaction. The securitisation cannot work economically if there has been no effective legal transfer of assets. Courts have re-characterised transactions where they have amounted to a deceit or sham or the rights and obligations created do not reflect the stated nature and purpose of the contract (*re George Inglefield Ltd* [1993] Ch1 CA; and *Welsh Development Agency v Export Finance Co Ltd* [1992] BCC 270). The SPV must also be bankruptcy remote from the originator. Cash flows on the underlying receivables or other assets may have to be matched with the SPV funding commitment. The originator will look for adequate profit extraction, such as through servicing fees, subordinated debt, dividends and a receivables trust or sale. Other issues include ensuring sufficient enhancement and collateral (above) to secure an adequate ratings (above) as well as realising the most effective accountancy, taxation and capital adequacy treatment. Any securities offering by the SPV have to comply with relevant UK, EU and US laws and regulations.

(5) Financial Derivatives

While forward contracts have always been available throughout history, which provide for contract settlement at a subsequent agreed date, modern financial derivatives instruments principally arose during the early 1970s due to the currency and interest rate instability created after the collapse of the Bretton Woods system of managed currency arrangements. This led to the creation of early currency and interest rate swaps (exchange contracts) with later exchange traded futures and traded and OTC options.

A wide range of products have since been developed tied to a whole range of financial assets, indices and commodities, including most recently energy and the weather. These can either be used for risk cover (or hedging) purposes or for investment (or speculation). Derivatives may be dealt with on a formal exchange or OTC. Early forms of standard documentation were produced by the International Swaps and Derivatives Association (formerly the International Swaps Dealers Association) which has since produced various forms of

master agreements (with long and short form confirmations), common definitions, bridge documents and protocols (for multilateral amendment).

Specific regulatory concerns arise with regard to the lack of transparency in the OTC market, high levels of concentration and the potential ability for derivatives speculation to affect the prices of underlying assets or commodities. Much of this has been dealt with following the global financial crisis by requiring increased disclosure and transparency especially through trade repositories, increased capital and liquidity cover and with clearing and settlement being conducted through formal central counterparties (CCPs).

The following more specific issues may be considered with regard to financial derivatives:

(i) Market Structure

The most commonly used financial derivatives are futures, options and swaps. A future provides for the purchase (or sale) of an item at a future agreed time and price. An option provides for the right, or election, to purchase (or sell) the item at a future agreed time and price. While they involve a forward element, they are distinct from other private forward contracts which are non-transferable, non-traded, have no exchange cash or collateral margin calls, do not used customised documentation and have no central counter parties (CCPs) or trade repositories. A swap provides for the exchange of financial obligations most commonly including currencies or interest rates (fixed for floating or floating for fixed).

The most recent development within the derivatives market has been the emergence of credit derivatives which provide different forms of credit risk or counter party default cover. These principally consist of credit default swaps (CDSs) although other forms of total return swaps (TRSs) or credit spread swaps (CSSs) may be used. Credit derivatives are often incorporated into larger ad hoc or standard financial arrangements which create structured products, such as credit linked notes (CLNs). A collateralised debt obligation (CDO) is not a financial derivative as such but a re-securitisation of the income streams from a number of underlying securitised products (above).

(ii) Advantages and Disadvantages

Financial derivatives provide end-users with additional risk coverage or certainty, lower borrowing costs, higher returns, improved debt management and additional choice and election which can improve production, growth or other innovation. Financial intermediaries benefit through improved risk cover and management, additional liquidity, higher earnings, improved portfolio management and enhanced client service and increased customer loyalty with derivatives also allowing further financial innovation such as through the construction of structured products (above).

Certain market disadvantages also arise with the speed of risk transfer, higher concentration levels, product complexity, possible underlying asset price distortion and a lack of market transparency, especially in the OTC market. Other issues may arise with regard to reduced regulation of ‘outliers’ (higher risk institutions), leverage, liquidity collapses, cross-border exposures, alteration on settlement risk as well as legal risk and increased inter and intra-sector loss transfer, contagion and collapse. A number of initiatives have since been taken to attempt to increase disclosure and transparency and to strengthen transaction clearing and settlement.

(iii) ISDA and Standard Documentation

Exchange traded derivatives use pre-prepared standard contracts on each of the markets involved, such as on the London International Financial and Futures Exchange (LIFFE). OTC contracts use standard documentation prepared by ISDA, such as its most commonly used 2002 Master Agreement. Earlier standard documents included those prepared by the British Bankers Association with its BBA Interest Rate Swap document (BBAIRS). All of these contain standard terms and conditions, including definitions, conditions precedent,

representations and warranties, covenants, events of default and termination procedures. ISDA parties enter into the standard master agreements to govern their relations with confirmations being entered into in connection with each contract. Long confirmations can be used with full terms although short form confirmations are also available which incorporate standard product Definitions. Any adjustments or elective clauses under the master documentation are dealt with in Schedules. The use of such standard documentation across the market creates the form of proxy or surrogate regulation in the absence of formal statutory regulation.

(iv) Financial Crisis

Financial derivatives were a factor in the global financial crisis during 2008-2009 although they were not the direct or immediate principal causes. Credit default swaps (CDSs) were used in synthetic CDOs (re-securitisations without assignment of the underlying securities) although later synthetic CDO collapses were attributable to the design of the specific products constructed rather than the use of CDSs within these larger structures as such. AIG had to be supported by the US authorities due to the high levels of concentration that it amassed in the CDS market rather than due to defects within the CDS contracts themselves. There were other operational and settlement delays, a general lack of transparency especially with regard to loss allocation, all of which aggravated a larger collapse in confidence.

Financial derivatives were one factor in a larger chain of complex events although only one factor. The principal causes of the crisis can be more accurately summarised in terms of poor credit assessment in the US subprime market, aggressive re-securitisation and product complexity, mispricing of debt by credit rating agencies, retention of ‘super senior’ CDO tranches (uncovered non-securitised amounts) by firms and a lack of effective market supervision and support as the crisis unfolded.

(v) Financial Regulation

While derivatives contracts specifically are not subject to direct regulation but governed by exchange or trade standard documentation, almost all intermediaries will be authorised persons and subject to the laws and regulation of their home territory. A number of measures have also been strengthened following the recent financial crises. Firms have been subject to improved risk management, higher capital and liquidity levels, enhanced margin cover requirements, improved governance and increased supervisory disclosure. Customers and end-users can be protected through higher disclosure and warning requirements, cancellation (‘cooling-off’) periods, segregation of cash and asset obligations, deposit protection and outright prohibitions in appropriate cases. Derivatives markets more generally have been strengthened through the development of increased reporting and transparency especially through trade repositories, central clearing through CCPs, firm RRPs and official SRR and substantially improved domestic and cross-border crisis management procedures.

MODULE CLOSE

The purpose of this paper has been to review of the background to the main international financial markets and the structure and operation of the principal markets in. The different types of financial assets and instruments traded on the markets have been identified.

The role and function of the main international financial centres and the nature of global investment banking and commercial banking have been reviewed. Reference has also been made to some of the principal sets of standard market documentation that are used to govern the rights and duties of parties dealing in these markets.

The principal markets and documentation are considered in further detail in subsequent classes.

We very much hope that you have found this introduction useful and instructive. Additional online reading and external reading lists are provided on QMplus although this is strictly voluntary.

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INTRODUCTION TO INTERNATIONAL FINANCE LAW AND PRACTICE

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