

## THE FUTURE OF INTERNATIONAL BANKING AND FINANCIAL LAW AND LAWYERS\*

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This paper makes a medium-term forecast of the future of banking and financial law and lawyers internationally. It expresses the view that the law is essential to societies and that the basic purpose of the law is survival. It explains the rationale of banks as intermediaries for credit, discusses the important role of banking and financial law in the hierarchy of law, shows that there has been a very rapid increase in the size of the law, commencing from 1830 onwards, offers some reasons for the growth of the law and legal risk, such as globalisation and the intensification of regulatory regimes, proposes that there will be a strong demand medium-term for banking and financial lawyers of outstanding competence who can put the world together legally, explains the families of law, discusses various classes of legal risk and explains the high responsibilities undertaken by lawyers in their role in societies.

### I. INTRODUCTION

This paper takes a medium-term view of the future of banking and financial law and lawyers in the world, that is, not in the next few months or next year, but many years hence. It is a prophecy and a forecast, even though the future is obscure and even though, as it has often been said, prophecy is much more difficult than history.

I attempt this prophecy because the law is a universal religion which everybody in the world believes in. It is the foundation of our societies, of our prosperity and our happiness. Lawyers are the guardians of the law. We should therefore be thinking about where law and lawyers are going.

Banking and finance are at the centre of modern economies, because it is banks and others like them who hold the money of the people, the product of their work and labour—and of their hopes and future—and it is banks and capital markets who put this money to work for the benefit of our societies.

This paper is therefore both philosophical and jurisprudential—philosophical because it seeks to find meaning, and jurisprudential because it explores the roots of law.

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## II. WHAT IS THE LAW FOR?

There is one fundamental question which needs to be posed first. What the law is for? This is a question which will be answered emblematically by the parables or allegories expressed in two remarkable paintings and a recent image.

The first painting is the famous allegorical painting by Delacroix “**Liberty leading the people**”, painted in 1830 and hanging in The Louvre in Paris. A half-dressed woman, with flag in hand, leads a throng of people triumphantly through a battlefield of bodies and smoke. The whole of society is represented in this picture—the merchant class, the academics, the military, the peasants and the youth. All of the people in this tumultuous scene are astir and infused with some burning ideal. They are well-armed. A youth has two pistols. The representative of the merchant class, with a big black hat, holds a formidable barrelled gun. Liberty herself clutches a long rifle with the bayonet out. These people intend to get their way for their cause, whatever it is.

In Delacroix’s mind, the liberties she was fighting for were basic political freedoms of democracy, freedom of speech and the like, freedom from despotism and autocracy. You could also say that what she allegorises is freedom from restriction, a universal symbol of our hopes and aspirations.

Some of the most pervasive restrictions in our lives are the restrictions imposed by legal systems, customary law, statutory law, morality translated into mandatory codes. Indeed you could say that the law is entirely a system of restriction, manacling, fettering and tying us down.

The law loses its appeal if it becomes a burden, if it becomes an instrument of oppression, if it manacles and fetters our legitimate freedoms. It is possible to reach a situation where the blue sky is blotted out by the bars and chains of law. A cowering and frightened populace uses the law to snap at each other. A frightened government uses the law to snap at its cowering populace. A frightened government and the cowering populace use the law to snap at foreigners.

The solution to the question of why legal restriction is considered necessary is debated in the extraordinary painting, “**The Raft of Medusa**”, painted by Géricault between 1818 and 1819. It also hangs in The Louvre in Paris, a stupendously huge canvas, in the same hall and on the same side and on the same wall as Delacroix’s picture. It shows a group of people on a huge raft in rough seas, one frantically waving at a ship just on the horizon, others in despair, yet others dead. This is one of the most iconic and powerful pictures ever painted. It really gets to the point—the point of where we are and what we are.

The French frigate the Medusa hit a sandbank off the west coast of Africa, then Senegal but now Mauritania, on 2 July 1816 at 3.00 pm. The terrified passengers and crew built a raft out of parts of the ship. The idea was that the crew would tow the raft with six rowing boats to the nearest coast. Hence nothing was left on the raft to navigate, no oars, no compass, no rudder.

The crew, including the captain, had other ideas. They cut the towropes and disappeared over the horizon. Most of them died on the 300-kilometre walk along the desert coast to St Louis in Senegal. The raft was left to float around helplessly in the scorching mid-summer Saharan sun.

Altogether 147 people got on the raft. There was one woman who was subsequently thrown overboard because she was screaming from a broken leg. When the 147

persons first got on, they were up to their waists in the sea. So they threw away some of the barrels of biscuits and brandy to lighten the load.

They rolled around in the sea for the next 12 days before they were rescued by the brig Argus. Only 15 out of the 147 survived. In fact Géricault has 20 survivors in his picture for the sake of the composition.

The picture portrays the immensity of human nobility, of suffering and courage in the face of adversity. The figures are heroic. Yet the reality was very different. When the rescuing ship arrived, the raft stank. The survivors were crazed. There were bits of human flesh hanging on the makeshift mast to cook in the sun.

Most of those who died on the raft did not die from famine or thirst. They were killed in the fighting for the remaining brandy and biscuits.

So the main question which this picture poses is whether Delacroix's lady with the flag continues to be right in her ideology when we are on the raft. Can we survive with liberty and freedom from law when we are in dire straits? If our banking systems or our corporations are shipwrecked, do we not need iron rules for that situation—to try to avert the disaster and then deal with it toughly when it happens? Does not liberty deserve to be snuffed out when survival is at stake?

Our third image is of the **Chilean mine disaster** in 2010.

On 5 August 2010, 33 miners were deep down in the San José mine in Chile. They had stopped working for lunch in a tiny safety shelter which was 688 metres underground—more than half a kilometre or nearly half a mile. Ten minutes later there was a huge crack and rumbling, a thunderous sound reverberating through the mine.

A massive slab of rock the size of a skyscraper had shed off the mountain, trapping the men below tons of collapsed rocks.

They were down in the mine for 69 days. There were 33 of them. All of them survived.

Yet in the comparable case of the Medusa, only a fraction survived. So what was the difference, apart from the obvious difference of circumstances?

One of the key differences was that the miners, faced with their terrible predicament, made rules. They elected a leader, a captain of the ship. They measured their available food and water and agreed on the rations for each person for each day. They were not university-educated learned types, but they all had an instinct about what had to be done.

So they passed laws, they constituted a makeshift legal system to govern their conduct. There was a captain who was to be in charge, whom they would obey and who would not leave the ship (impossible in any event). They parcelled out the food on an equal basis, a muscular legal principle of the equality of justice. In the face of death, we are all equal.

On the raft of the Medusa, there were no laws. The captain violated a fundamental law by leaving the ship in priority to the passengers. There were no rules about sharing food. The murderous fighting violated the most basic principles of society.

So that is the answer as to why we have law. We have law in order to survive. Laws create restrictions, to be sure, but the restrictions are created in order to survive. It is that simple. You do not have to read philosophical or metaphysical books on jurisprudence to comprehend something so elementary, so obvious.

These survival laws are not just basic and primitive laws about torture, murder, robbery or war. The laws of survival include laws about money, about banks, about

securities settlements systems, about bankruptcy, about corporations. They include regulatory regimes, all the mighty stacked-up array of our legal systems from top to bottom.

Survival is not just our survival, those of us living now. It is the survival of our children, of their children, of all future generations. It is the survival of us all for long enough to discover what plans the universe has for us and whether we can plan the plans. This is especially so now, when we are like mini-gods with our hands on the levers of the universe and of ourselves, with our hands on some of the crucial equations of cosmology and of our DNA, however infant-like our understanding of the equations may be.

This still leaves the basic questions. What should our laws say? How punishing should it be? How much law should there be? To what degree do we need to restrict ourselves and the entities we create, such as banks?

We still have to resolve the issues of freedom against despotism or you could say, of anarchy against order. We are still left with the question of how much law we should create in order to control risk and threat to our survival. And how much it costs.

### III. WHAT DO BANKS DO?

Our next preliminary question is: what are banks for?

#### A. *Great Inventions*

The history of some of our greatest inventions is comparatively recent, only a few hundred years. Galileo remarkably proposed that our planet earth is going around the sun, not the other way round, a pronouncement which was met with astonishment by some and indignation by many. Galileo died in about the same year that Newton was born—1642. A few decades later, in 1687, Newton published his revolutionary equation which showed that there was a very precise mathematical relationship between mass and gravity, although he was unable to say what gravity was (we are still unable to work this out).

Then, after the stunning inventions of the 18th and 19th centuries, including the steam engine and electricity, we encounter the profound and wholly non-intuitive equation of Einstein that energy is equal to mass times the speed of light squared. Not something you could have dreamed up by the use of common sense. That equation was a pinnacle of human rationality and scientific imagination, a shining symbol of human intellectual advance.

Both Newton and Einstein showed that the cosmos was governed by some fundamental laws of physics. Or so we thought for a time.

#### B. *Money*

Long before these great inventions there was another very great invention. This was the invention of money. Without this money, these tokens, even buying a loaf of bread would not be practical, especially if you were in a hurry. You avoid the need to barter eggs or a sardine or a knitted sock each time.

Money is not just a medium of exchange for buying things. Money connects us to other people who live abroad. It enables people to export and import so that the produce and manufactures of the world can be shared. It forms a vital link between different people and societies.

Money also connects us to our future, once it is transformed into financial assets such as bank deposits, bonds and shares. These financial assets are the ultimate store of our work and labour, the fruits of our efforts, which we can keep for our future, especially when we are old.

It is therefore clear that money is a public utility of enormous importance in people's lives. It is the commons. Because of the importance of money, it engages the rule of law. For example, a government policy of inflation robs savers of their assets. It transfers value from creditors to debtors. Since inflation can ruin those who have saved, typically in the form of pensions, it threatens survival and hence must be subject to the rule of law.

Money is the product of our labour. We convert our work into these tokens. Money is the store of own efforts, our work.

### *C. Money and Banks*

Once money was invented it was necessary to have somewhere safe to put it. Hence the founding of banks. Once there is a means of exchange, then there have to be banks. It is much easier and safer to transfer money from bank account to bank account than to hand over a sackful of notes.

Banks in turn were an ingenious invention. The banks soon found that they could use other people's money by lending it to borrowers. When one switches on the light, the light comes on. It comes on because there is a power station. The power station is often built out of bank money. The bank money derives from the savings of the depositors, that is, the citizens. So it is the citizens' money which makes it possible to switch on the light.

When you are young, you could live in a tent on the mud flats by the river. You could have your dinner by the river, you could wash in the river, and the kids could play in the mud. When you had saved up enough money and were in the autumn of your life, you could buy a chateau on the hill and go and live there instead, for a happy retirement away from the mud.

Alternatively, you could right at the beginning borrow somebody else's money from the banks and buy the chateau on the hill right away. Of course you have to pay back this money because it is somebody else's. But at least you do not have to live in a tent in the mud.

So it is with hospitals, schools, roads, ships, cars, factories, offices, palaces, towns, and all the other creations we have. Credit produces them now rather than later.

Banks are not the only suppliers of credit. The other main form of credit is the bond issue where the lenders are insurance companies, pension funds, banks (again) and mutual funds which purchase the bonds as investors. Insurance companies and pension funds also collect the savings of the citizens in the form of life insurance premiums, for example. In most countries most medium-term credit comes from banks—more than 90% in some countries. In a few countries the debt capital markets provide more credit than the banks, *eg*, the United States of America (US). In the European

Union, the ratio has typically been 60% banks and 40% capital markets, but it varies.

Banks and capital markets are therefore like lakes that gather up the droplets of peoples' savings and their stores of value. They use the water to irrigate the land. You need a large body of water to do this, not just droplets. It is the huge pooling of the results of the work of the people which does this. Much water is wasted. But then many people waste their lives and this is not unreasonable.

If one strips away all the veils of incorporation and all the creative figments of the legal imagination, the real creditor is ultimately the individual who places his or her savings with a bank as a depositor or who pays insurance premiums to an insurance company. There is an ultimate see-through to the individual. In the end it is the individual savers who are the collective lenders to the power station and to the dwellers in the chateau on the hill. It is the citizen who builds the power station to bring power and light, who puts the roof over our heads. It is the product of our work which does these things.

There is no question that this arrangement is ultimately beneficial. The idea that creditors should share their savings with debtors is a good idea. For one thing it gets a roof over our heads.

#### D. *Banks and Disasters*

But like many useful inventions, credit has its dangers. The biggest danger is that in the worst case credit can lead to catastrophic collapses of the whole banking system. That annihilates the savings of creditors and it annihilates the debtors who rely on savings to finance their enterprises. Very few countries escaped a systemic banking crisis over the last 25 years.

Why do these things happen? It is the answer to this which is critical to the underlying impulse for laws which themselves create legal risk.

The question of the mix of the various causes, the proportions in which they contributed to the particular debacle, and also the question of which causes were direct and immediate, which were in the middle distance and which were remote and ancient; all these questions are not so easy and are much disputed.

Yet we can say that many systemic bank collapses were caused by the insolvency of the sovereign state or by the imprudent political direction of bank loans by governments or by disastrous macro-economic policies, leading to inflation, currency collapses, gyrations in interest rates and money supply, excessive borrowing by governments and the build-up of bubbles which the central bank should have stopped. In other words, most of them were caused by bad governance, defective politics, and populist or imprudent monetary policy. For example, about half the world's states were insolvent at some time over the same period of 25 years—an event which usually bankrupts the banking system and an event which usually starts with government profligacy.

In many cases the flames were fanned by the banks and irresponsible banking. Collapses caused by deliberate bank fraud have been minimal.

In numerous cases, the whole society was in one way or another, directly or indirectly, involved in the failure. If you really wanted to know who was to be blamed, you just had to look in the mirror.

Like many scientific inventions, the crisis emphasised the basic design defect at the heart of the idea of a bank. This is that their deposits are short-term or on demand while most of their loans are medium-term or illiquid and so cannot be sold or collected quickly enough to satisfy a panicky run on the bank—the “maturity mismatch”. At the core of the structure of the bank there is this fault, this fatal instability in the foundation.

The bankruptcy of banks invariably led to an intensification of the regulation of banks, an intensification of the law and an increase in the amount of law.

#### IV. ROLE OF BANKING AND FINANCIAL LAW IN THE HIERARCHY OF LAW

There is a hierarchy of law. We can rank laws according to their importance to survival and power to promote prosperity. The most fundamental and primitive of legal necessities are those which go directly to physical survival, such as laws governing murder, assault and theft. Fundamental law necessities include basic criminal laws, constitutional laws about government and core human rights and laws about family, sex and inheritance.

But there is no question that money and its attendant law are fundamental as a basis of societies in the sense that modern society goes nowhere if it does not have money as a means of payment and store of value. Laws which are also necessary and fundamental include courts and the rule of law, property, contract and taxation. They include laws for companies, banks and insurance. They include laws of accounting and sound money. They include bankruptcy or insolvency laws.

It is sometimes said that lawyers who deal in financial assets are involved with something which is intangible, invisible and therefore sterile. Financial assets include loans, bonds and shares. Unlike other classes of asset, financial assets do not exist without two people, *eg*, a lender and a borrower, a bank and a depositor, a shareholder and a company, a seller and a buyer. The asset does not exist without the people at either end, circling each other with a mixture of suspicion and admiration. So the asset is really the two people. The result is that all of the passions, hopes and fears of the counterparties are built into the asset and it is those emotions which create so many tensions in the room. The fascination of banking and financial laws arises from dealing with the two people. Even though the two people in our field are typically companies, the companies are inhabited by real people. Lawyers with common-sense, rationality and understanding are needed to deal with these emotions and conflicts.

The hierarchy demonstrates a fundamental point. The survival motive of law applies also to money, banks and corporations. These areas of the law are central to our societies. Good law applicable to them improves us all. Bad or excessive law prejudices us all.

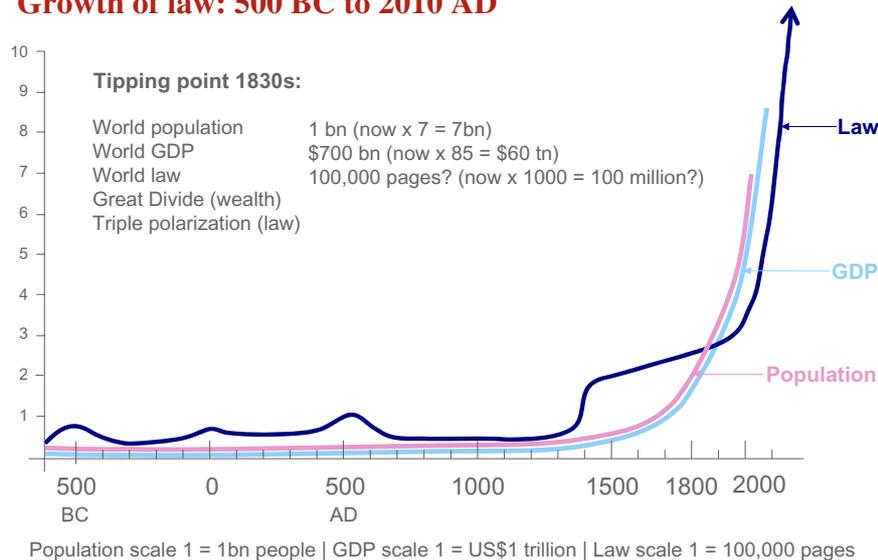
#### V. GROWTH OF LAW

People often talk about the increase of the stress in their lives, the traffic, the congestion, the crowds, the trains and the effort to do simple things. Although they register the increase of general complication, the fact is that the public in general and many lawyers in particular have no idea what a massive upheaval has been going

on if we view the trajectory over a longer term. There has just been a technological revolution. There has also been a legal revolution.

The chart below tentatively tracks the growth of law since 500 BC as against the growth of population and the growth of Gross Domestic Product (GDP).

### Growth of law: 500 BC to 2010 AD



This chart shows that since 500 BC relatively not much happened in the growth of law until around 1830 when the volume of the law took off internationally.

The chart demonstrates a simple correlation (not necessarily a cause). It shows that as population increases, wealth increases and the volume of law increases.

At the tipping point in 1830 the population of the world was around one billion. Now it is seven times as much, at seven billion. World GDP in 1830 was about US\$700 billion. Now it is 85 times as much—at between US\$60 and US\$70 trillion.

It is very hard to calculate how much the law has increased since 1830. We can impressionistically compare the size, for example, of the oldest codes, of religious codes, of Justinian's codification of classical Roman law, of the US Tax Code around 1830. At that stage there was very little company law and minimal regulatory law. Tax codes were short. My chain-saw estimate is that law has increased since then 1,000 times, so there might well be around 100 million pages. It really does not matter if it is 10 million, 50 million or 100 million. It is a lot.

Historians<sup>1</sup> who plot human social development, based on such variables as energy capture, organisational ability, information processing (including writing and printing) and military technology, show that social development grovels along the bottom of the graph until about 1750 and then shoots up in a near vertical line, as in the case of our graph on the growth of law. This provides general support for our graph on the growth of law.

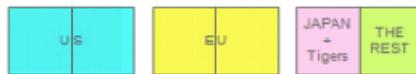
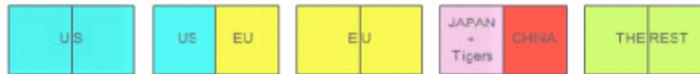
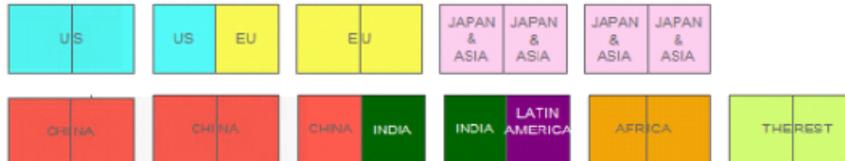
<sup>1</sup> See, for example, Ian Morris, *Why the West rules—for Now* (London: Profile Books, 2010).

## VI. PREDICTIONS FOR THE FUTURE GROWTH OF LAW

Maybe time future contains time past and time present. The arrow of time changes our perspective of the past and also the future.

It is obvious that one cannot predict anything with any degree of confidence, even large trends. You only have to take ten-year slices over the past 100 years to see how ridiculous expectations were at the beginning of each decade. There is just too much noise, too many variables out there to see crucial directions.

Nevertheless, there is one possibility which is worth considering as a rough guess. This is the amount of world GDP in, say, 2030, not very long from now. This is suggested in the chart "GDP football fields".

**GDP FOOTBALL FIELDS (\$10 trillion)****1995****2010****2030**

Each oblong is a football field of US\$10 trillion.

World GDP in 1995 was roughly US\$30 trillion, *ie* three football fields.

In or around 2010 there were five or six football fields of US\$10 trillion each, with China showing marked advances.

By 2030 some economists predict a world GDP of around 12 or 13 football fields or even more. So things are really looking up in terms of more food, more health, more power stations and more hospitals for the peoples of the world.

All this extra GDP is not going to go under the mattress in the form of cash. It is going to go into banks, capital markets and funds and in turn be channelled through to corporations.

If three or five football fields can produce the mayhem of the recent financial crisis, then surely 12 football fields or even more would produce much more money sloshing around in banks and capital markets, more competition between nation states, much more interconnectedness of countries? Surely this could produce more risk? Surely this could point to more red on the map in coming decades?

The fact is that bankruptcy, as the most ruthless of commercial law disciplines, is the great driver of financial and corporate law. If corporations or banks become

bankrupt or are threatened with bankruptcy, the legislator reaches for the legal wand. The result is an emotional and prickly bellicosity in the law. The policy-makers express their indignation in the statute book and in their regulatory codes. Consider the statutory reaction to the collapse of Enron in 2001, consider the massive regulatory regimes installed in the West in reaction to the financial crisis of 2008.

In reaction to the crises, the statute book became excitable and emotional, as if it is picking a quarrel with everyone concerned. The statute book is not the place to express rage or indignation. It is a sacred and holy place. It is a place of reason. It is the place where the people express their moral values.

## VII. LAW AND RISK

The law creates risk. This is because the violation of the law results in some sanction, either a criminal sanction or a civil sanction in the form of damages or some other remedy. But one of the basic objectives of the law is to reduce risk and thereby improve the chances of survival. This collision of objectives is at the heart of the study of legal risk and the future of law and lawyers in this field.

Legal risk can give rise to unexpected and huge losses, that it can lead to criminal penalties, disqualification of senior managers, exclusion from listing or public contracts or can devastate the reputation of a business and result in individuals being ostracised as outcasts and unable to earn their living.

The general counsel of banks will have their own top ten lists of legal nightmares. Those might include a destructive cyber-attack, a rogue trader, a big bribe paid by an employee to a government official, the mis-selling of a bulk financial product, a breach of sanctions or a stupid remark by an employee on twitter. These mishaps for a bank can have dramatic consequences.

But meanwhile, there are other legal risks, insidious legal risks, silent legal risks, creeping up out of the forest, which lead to a steady blood-letting of the profits and assets of the business, which clog up the arteries of the business, which cumulatively drag down the business, risks which arise from the sheer size and incomprehensibility of the law and its arbitrariness.

## VIII. WHY HAS GLOBAL LEGAL RISK INCREASED?

Over recent decades, legal risks have massively intensified around the world. The following are the main reasons:

- As shown, the volume of law has increased hugely. In some countries it is out of control and unmanageable.
- A large part of the increase of risk results from the intensification of regulatory regimes. These regimes, of which there are a great many (more than 30), typically criminalise the ordinary law and can be aggressive.
- Almost all jurisdictions are now part of the world economy in the sense that they have businesses which do business with other countries. Out of just under 200 sovereign states, there are about 320 jurisdictions and almost all of them now participate in world markets. Even Sao Tomé, Chad, and Kyrgyzstan are interested in advancing their economies and are no longer cut off from the rest

of the world. Cambodia has a stock exchange. Only a few countries stand sulkily apart, such as North Korea.

- The law is much more volatile than it has even been and changes rapidly. For example, over the last 15 years, probably more than two-thirds of jurisdictions have made significant changes to their bankruptcy and corporate laws—two of the most fundamental planks of market economies.
- There is great diversity around the world as to how the law is actually applied and the rule of law. For example, the basic law in Congo Kinshasa and Belgium derives from the same roots but the application is very different. One therefore has to cope with a double layer, the written law, or the law in the books, and then how it is applied.
- In addition, there is another layer of law, generated by extraterritorial laws as countries elbow their way through the crowd.
- The legal systems in developed countries are breaking up into tiers, like slicing through the crust of the earth to reveal layers of sand, chalk, granite and gravel. English law is not alone in having at least eight tiers of security interests. England has around 25 insolvency regimes for different classes of entity. Multiply 25 times 320 and you begin to get some very big numbers.

As GDP grows, there are grounds for believing that the situation could get worse, much worse. If it does, then the management of international legal risk for banks will become even more important than it is now, as will the need for lawyers able to deal with these risks.

#### IX. WHY INTERNATIONAL BANKING AND FINANCIAL LAWYERS ARE NEEDED

Exceptional banking and financial lawyers will be needed from now into the future. With the above background in mind, I may briefly summarise some of the reasons, including some of the points I have already made:

- There has been a massive increase in the amount of law and in legal risk for banks and corporations over recent years. The law is the bedrock of our societies and survival.
- Many people forecast a large increase in world GDP in coming decades, mainly in emerging countries. If so this should lead to a huge increase in the volume of transactions and in their value.
- The vast amounts of capital will be placed by the owners who earned it in banks and other corporations. This may well lead to greater prosperity but it is also likely to lead to more crises and bankruptcies, more disputes and more litigation. This could result in more law and hence greater legal risks—a worsening of the legal environment from the point of view of banks and corporates.
- If this happens, the increase in GDP, the increase in transactions and the potential increase in crises would each drive an increase in the number of lawyers globally. They would in particular intensify the demand for international lawyers competent to advise on global risks, who can put the whole picture together and especially in the fields of banking and finance. This could impact on the future size of law firms and in-house legal and compliance departments. The cost of legal

services in this arena of wholesale international law would hinge, amongst other things, on the supply of lawyers able to carry out the above tasks.

- Notwithstanding the obvious advantages of harmonisation of the law and the commoditisation of transactions in terms of cost, time and efficiency, both harmonisation of law and standardisation of major wholesale transactions seem to be even further away than before. This is so in spite of the ready availability of technological solutions. This situation seems to be the result of the simultaneous impact of a legal revolution so that the technological revolution is either unable to keep up or does not surmount the problems.

It is for lawyers, with their unique knowledge of the theory of law and of its practice, to advise societies on the role of law and to instil the need for measured rationality, justice and fairness.

#### X. UNDERSTANDING THE FAMILIES OF JURISDICTIONS

One of the best ways of getting a grip on a cross-border legal risk is to understand the families of legal jurisdictions throughout the world to establish simplifying patterns.

There are distilled methods of measuring legal risk according to the families of jurisdiction. There are only three major families—the common law jurisdictions, the Napoleonic jurisdictions and the Roman-Germanic jurisdictions. If we reflect necessary sub-divisions, we end up with about eight groups. Nevertheless the groups are completely dominated by the three major groups so that if you understand the fundamental approaches of these three major groups, then you discover the formula, the key, the code, the secret to understanding all of them, including basic legal risks.

Most of the commercial and financial laws of the world's 320 jurisdictions have been based on a few countries in Western Europe. The reason for this is that Western Europe was economically the most dominant region in the world in the period around the 1830s, a dominance which is now being reversed.

The Western European nations concerned transmitted their legal systems by imperialism, emulation or significant influence. On the whole, countries adopting a legal system voluntarily took the latest model, *eg*, most of Latin America, after independence, from France, partly via Spain, in the 19th century, Japan from Germany in the early 20th century, and Turkey from Switzerland in the 1920s. The Russian Civil Code was influenced by the new Dutch Civil Code which happened to be the latest in the early 1990s. People buy the latest car. The result is that now out of the 320 or so jurisdictions, more than 250 draw their inspiration from three fundamental approaches developed originally by three main jurisdictions—England, France and Germany (with others). So an in-depth understanding of those legal systems is the key.

You can understand the basic laws of these jurisdictions so far as their financial and corporate regimes are concerned, as well as other areas of law, by the use of key legal indicators. For example, if a jurisdiction has a universal security interest enforceable privately, then it supports creditors, typically banks, as opposed to debtors—a continuum on a straight line from pro-creditor to pro-debtor. The same technique can be applied to corporate law, *ie* whether, in case of conflict, the law supports management, creditors or shareholders—a triangle of interests. For example, if the law does not impose personal liability on managers for deepening the

insolvency, it is supporting management (as in the case of Delaware), not creditors or shareholders.

The historical classification of the groups of jurisdictions more or less holds good because the original champions had very different ideas about commercial, corporate and financial law. Although the patterns have been fragmented and eroded, the underlying bias still remains. This bias is particularly evident in relation, for example, to bankruptcy law which is the main driver of financial and corporate law.

## XI. THE OUTLOOK FOR EMERGING COUNTRIES

Most of the emerging countries started out with an inherited legal system based in particular on the traditional approaches of England, France or Germany or one of their offshoots. Since decolonisation, mainly in the 20th century, not a great deal happened legally in most of these countries for several decades. But over recent years there have been many calls for the reform of legal systems, especially in order to attract capital for infrastructure. Some countries have already made substantial progress in this direction, *eg*, the Ohada group of 17 sub-Saharan African countries which have adopted a modernised form of French commercial law on a unified basis.

When we examine key indicators of financial law, such as bankruptcy set-off, the scope of security interests and the trust (custodians)—all of which are very important to banks—it is extraordinary how diverse the solutions are in these emerging countries, especially the transition countries which emerged from communism. We see what a great divide there has been between for example, Russia and China in their approach to pro-debtor or pro-creditor protections. For example, Russia, Ukraine and many former Union of Soviet Socialist Republics (USSR) countries are much closer to the original Napoleonic traditional model, whereas China is close to the English common law model in the pro-creditor bias of its written, private and financial law—almost as if it was codifying English law. This should not be a surprise if we consider that England was a developing country when it crystallised its pro-creditor characteristics, and China is a developing country now. In both countries, capital is king, the railways must be built.

One hopes that in any reforms undertaken by emerging countries, they will not make the mistakes the West has made.

## XII. CLASSES OF LEGAL RISK

How you classify legal risks depends upon whether you are a lumpener or a splitter and how finely you divide risks into phyla, genera and species, then sub-species, then sub-sub-species. One could group risks into great fields, such as:

- bankruptcy legal risks;
- regulatory legal risks;
- extraterritorial legal risks;
- contract legal risks;
- litigation risks; and
- rule of law risks.

One may now briefly discuss some of these legal risks, especially those affecting banks.

### XIII. BANKRUPTCY LEGAL RISKS

As mentioned, bankruptcy is the main force behind legal change in credit economies. It is also a major pre-occupation with banks: the main concern of banks is to be repaid their loans. Repayment is blocked by the bankruptcy of the borrower. Most of the non-financial clauses in syndicated bank credit agreements are concerned with monitoring or providing protection against the risk of insolvency. If a large corporation like Enron becomes bankrupt, which it did in 2001, the reaction is to tighten up on corporate governance codes and legal duties regarding financial statements. If banking systems become bankrupt, as they did in 2007-2008, the reaction of the legislature is to introduce more laws, law in profusion.

Insolvency law is the root of commercial and financial law because it obliges the law to choose. There is not enough money to go round and so the law must choose who to pay. The choice cannot be avoided, compromised or fudged. In bankruptcy, commercial law is at its most ruthless. It must decide who is to bear the risk so that there is always a winner and a loser, a victor and a victim. That is why bankruptcy is the most crucial indicator of the attitudes of a legal system in its commercial aspects.

Bankruptcy has a profound effect on normal legal relationships. Bankrupts and their creditors are disqualified from working. Property is seized and sequestered. Assets are expropriated without compensation. Contracts are shattered and their terms interfered with or negated. Security interests are frozen or avoided or debased. The cost of credit is increased or credit—the lifeblood of modern economies—is withdrawn. People lose their jobs and their pensions. The collapse of banks and insurance companies destroys other banks and corporations and destroys the savings of the citizen. The economy of the state itself may be sapped.

If the bankruptcy law protects one set of creditors of a debtor then other sets of creditors are prejudiced.

The twin competing policies of bankruptcy law are the protection of creditors and the protection of debtors. Insolvency law is preoccupied with the collision of these interests and who to protect. These labels are ambiguous because, for example, the protection of creditors may also incidentally protect debtors as where a universal security granted to a bank leads the bank to postpone insolvency because the bank is safer for longer. Similarly, the protection of debtors may also protect creditors, *eg*, a corporate reorganisation may produce a better return for unsecured creditors than liquidation. Jurisdictions differ fundamentally on who to protect and how.

Bankruptcy risks include the bankruptcy ladder of priorities, where the most important super-priority creditors in practice are those with a set-off on insolvency, those with collateral and those who are beneficiaries under trusts, such as the custodianship of securities. Their claimants escape the insolvency. Other risks include the invalidity of deals on bankruptcy (such as by reason of bankruptcy freezes or stays, the revocation of preferences or freezes on contract terminations) and liability risks on bankruptcy, such as the personal liability of directors and banks for deepening insolvency and the liabilities of a secured creditor, *eg*, for wrongful enforcement or for environmental liabilities.

In addition, a new wave of bank resolution statutes has come into force as a result of the financial crisis of 2008. These nationalise bank bankruptcy law and give the authorities discretions as to the resolution of the bank. While one understands the need for emergency laws in order to protect against systemic risks, the statutes pose a number of questions in relation to the assessment of counterparty legal risks, for example, the problems of doing a credit analysis of a bank if the assets can be cherry-picked and separated from liabilities, and the problem of resolution of international banks where countries may seek to protect their own national creditors and depositors. The discretionary nationalistic free-for-all could worsen the conflicts: international legal conflicts need hard rules, not national discretions.

#### XIV. REGULATORY LEGAL RISKS

Regulatory law differs from ordinary law for three main reasons:

- A **governmental regulator** which is an agent or arm of government, is at the same time the legislator in the sense that it makes rules, the executive, in the sense that it monitors compliance with the rules and a judicial tribunal to punish offences. In other words, many regulatory bodies run contrary to basic constitutional notions of the separation of powers and involve a concentration of power in a single governmental body. For example, in the case of enforcement, the regulator may be acting as both prosecutor and judge in its own cause, a conflicting role which would not be permitted under the ordinary criminal law.
- Regulatory rules are usually extremely **detailed**, prescriptive, intricate and subject to rapid change. By virtue of the legislative power of many regulators, with or without central government control, they tend to use their delegated rule-making powers to the full, so that many regulatory codes are enormous in size and disproportionate.
- The law is **criminalised** in the sense that people can be disqualified from practising their professions in the case of certain violations and offending firms can be faced with very substantial fines. Notwithstanding the criminal nature of the sanctions, the subjects of the law often do not have the protections of the ordinary criminal law, such as the right to silence or the burden of proof beyond reasonable doubt.

The classes of regulation are numerous and widespread. Everywhere one looks, there is a set of regulations enforced by a regulatory authority. Regulation is necessary, but the above challenges to basic rule of law principles require that regulators exercise their powers with restraint and to be mindful of the overriding principles of the rule of law. Regulation is a considerable source of legal risk for banks in their daily operation.

Outside taxation, most developed countries have more than 30 major areas of regulation, vastly exceeding the ordinary law. These include financial regulation, anti-money laundering laws, consumer credit, product liability, food and drug regulation, health and safety regulation, building regulations, regulations governing data protection, regulation of professions and trades, transportation regulation, employee protections, pension regulation, antitrust and competition laws, restrictions on foreign direct investment, exchange controls, environmental regulation, real estate

development controls, regulation of natural resources, sanctions and embargoes, controls on immigration, corporate governance codes and listing rules, shareholding disclosure duties, financial reporting and disclosure rules, landlord and tenant regulation and restrictions on the alien ownership of land. It is now impossible for a single lawyer to grasp all these fields, let alone comprehend the whole world.

## XV. FINANCIAL REGULATION

Financial regulation of banks is vast and intrusive. It multiplied rapidly in the West after the financial crisis in 2007-2008.

Much of the new regulation, apart from the sensible increase in required capital and certain other reforms, seems of marginal significance. This is underlined by the fact that, prior to the financial crisis, you only had to know one simple fact, *ie* that there was a bubble in house prices. You could hardly have had a simpler loan than a home loan and you could have hardly had a simpler cause of financial collapse than a bubble. There was nothing esoteric or arcane or complex about home loans and bubbles. It is hard to understand why policymakers should think that this astonishingly elementary mistake by entire societies should merit anything more than a one-liner: "Watch out next time".

Some of the potential sources of legal risk introduced by financial regulation are (1) inadvertently carrying on **an unauthorised business**; (2) **mis-selling**, *ie* selling a product to a consumer which is unsuitable or too complicated; (3) **violations of conduct of business rules**, *eg*, conflicts of interest or violation of duties of skill and care; (4) **prospectus liability**, including the liability of arrangers or underwriters for negligent mis-statements made by the issuer; (5) **liability for market abuse and frauds**; (6) infringement of **capital and liquidity rules** or large exposures; (7) infringement of rules, such as the US Volcker rule, preventing **proprietary trading** by banks or establishing the ring-fencing of banks; (8) infringing rules about **securitisation**; (9) violation of rules regarding the carrying out of **derivatives** through an affiliate and clearing them through central counterparties; and (10) the infringement of the regulatory regime applying to **hedge funds and private equity funds**.

The regulatory regime internationally is hopelessly intricate and requires large teams of compliance experts to work it out. This situation invites the same underlying debate—how much law do we need to govern banks?

## XVI. EXTRATERRITORIAL LEGAL RISKS

Now that the seven billion people of the world are so tightly squeezed together, their laws burst the riverbanks of their boundaries into other countries. Laws barge outside sovereign states as each national sovereign state elbows its way through the crowd.

The result is that people from one jurisdiction can find themselves arrested or brought before a court in another jurisdiction quite unexpectedly. They can be subject to laws which are completely different from the laws of their own state. They can find themselves subjected to the payment of huge damages claims or fines, obliged to provide all documents and emails to a hostile party in litigation, barred from doing business or extradited to answer criminal charges in a foreign country.

Firms can also be compelled by the law of one country to do something which is a criminal offence in its own country, such as disclosing confidential documents.

The territorial trespass is not an intrusion on sovereignty if all or most societies agree on the policy and the policy is sensible. For example, it is hard to disagree that a prohibition on the payment of bribes to public officials should be a universal legal policy so that extraterritoriality should not be an issue in that case. The problem arises if societies legitimately do not agree on the general policy of the law or do not agree on the degree of criminal protections of the accused or do not agree on the proportionality of penalties or the like.

Notwithstanding that some laws may indeed represent a reasonable consensus or are justifiable, the presence of increasing extraterritoriality can increase tensions between nations and lead to distrust and resentment.

A simple example is where a bank in Beijing sells a US dollar bond to a bank in Singapore. This routine transaction could infringe US extraterritorial laws, such as (1) laws prohibiting the Singapore bank from engaging in **proprietary trading**; (2) US **sanctions legislation**, *eg*, against Iran if the Singapore bank is buying for a fund which includes Iranian residents; (3) US **insider trading** rules; and (4) rules requiring the Singapore bank to make a tax disclosure to the US tax authorities. A routine high volume transaction can become a legal minefield, requiring complex due diligence.

#### XVII. CONTRACT LEGAL RISKS

The whole fabric of financial law is based on contract. Contracts are webs of invisible but potent nets and chains of rights and obligations. The main contracts in banking and finance are loan agreements, deposit agreements, security agreements, derivatives, bonds and guarantees but there are an enormous number of others.

It is quite hard for a major financial contract between companies to be initially invalid. As regards powers, most commercial jurisdictions have protective doctrines whereby a contract with an ordinary corporation is not usually invalidated because of lack of power. The special parties to watch include municipalities, insurance companies, international organisations formed by treaty and trustees of a trust. The special transactions to watch are guarantees and derivatives.

Other areas of risk for banks, depending on the jurisdiction, include (1) the fact that heads of terms intended to be non-binding are deemed to be a contract because of the conduct of the parties; (2) good faith or “merits of the case” doctrines which upset predictability (which is essential for contracts involving very large amounts); (3) the unenforceability of loan accelerations and terminations of loan contracts especially on bankruptcy; (4) the efficacy of exclusion clauses; and (5) the risks of misrepresentation.

The choice of the governing law of a contract and the submission to the jurisdiction of suitable courts can help to mitigate some of these risks.

#### XVIII. LITIGATION RISKS

The commencement of litigation is generally a sign that all else has failed. The uncertainties of litigation, plus the stress and costs involved, make litigation extremely

unattractive for business parties. The costs of a major piece of litigation can be enormous, in excess of US\$100 million in some cases.

Typical examples of private litigation claims involving banks include (1) claims for mis-selling financial products without adequate disclosure of the risk; (2) underwriter liability for an offering circular; (3) involvement in fraud by an employee or bank customer, such as bribery, insider dealing or money laundering; (4) wrong financial statements; and (5) regulatory enforcement.

My predictions as to the increase in GDP, especially in emerging countries, would seem to point to more and larger transactions and hence to more disputes.

In some countries, the litigation system is designed to encourage private enforcement with the result that the citizens are extremely litigious and the litigation is aggressive. In most US states, for example, the litigation rules are extremely favourable to plaintiffs. These rules include (1) huge punitive damages for civil claims; (2) jury trials—US juries are said to sometimes favour the small against the big; (3) elected judges in some states; (4) no award of costs against a losing plaintiff; (5) contingent fees dependent on success; (6) class actions; (7) an apparently unrestrained ability for plaintiffs to make any allegations that they like of fraud and dishonesty against a defendant, not substantiated by facts, in the hope that the defendant will be abused and harassed into giving up and settling the case out of court; and (8) an exorbitantly wide discovery of documents worldwide, so that a plaintiff can conduct a fishing expedition to see if there is anything which looks bad and which might influence a jury, such as a silly email by an employee—discovery can involve millions of documents.

The effect of the rule that there is often no award of costs against a losing complainant and that fees are contingent and dependent on success means that a complainant has no cost risk and the scales are weighted in his or her favour.

#### XIX. RULE OF LAW RISKS

A rating of legal risk should measure two aspects separately. These are:

- The written or black letter law or what the law says—law on the books.
- How the law is applied and what the legal environment is like in practice, *ie* the legal infrastructure of a jurisdiction, how the government behave, and adherence to the rule of law.

For example, as regards legal infrastructure, the basic law in Congo-Kinshasa and Belgium derives from the same roots, but the application is very different. There are many similarities between the written legal systems of, say, Malawi and England, or Brazil and Portugal or Turkey and Switzerland, but there are significant differences in doing business in these countries so far as the application of the law is concerned.

One of the main objects of a legal rating is to endeavour to measure what the differences are. If we were to measure black letter law and legal infrastructure or the rule of law together, we would just get a noise or a blur.

Legal infrastructure and rule of law risks include such things as expropriations, governmental or judicial corruption, very inefficient courts, high crime levels and a lack of personal security, civil war or terrorism, political killings, arbitrary arrests,

a lack of independence of the judiciary, political instability, excessive government borrowing, inflation and the abusive exercise of power.

Banks, as depositories of the people's wealth and as lenders, are highly exposed to these risks. Banks are often a target, simply because they hold the cash wealth of the nation.

## XX. THE ROLE OF LAWYERS

The differences between jurisdictions in the number of lawyers practicing per jurisdiction raise some fascinating and intriguing questions, and the extent to which the number of lawyers is related to an increase in volume and the riskiness of law.

If we extrapolate from a sample of countries representing rich, medium-wealth and low-wealth jurisdictions, it would seem that there may be between five million and seven million licenced and active legal practitioners in the world, *ie* not far from one lawyer per thousand people. If, however, we estimate figures for particular jurisdictions, there are some quite colossal discrepancies. For example, the ratio in the United States is about one lawyer per 265 people, with Brazil close behind with one per 326. Canada has one per 390 and New Zealand has also one per 390. The usual figure for rich jurisdictions is somewhere between these ratios and one per 600 or so—Spain, one lawyer per 394; United Kingdom, one per 401; Italy, one per 480; and Germany, one per 590. But in France the ratio appears to be around one per 1,000 and in Sweden, the ratio seems much higher, perhaps one per 2,000. The Singapore ratio is perhaps one per 1200, excluding foreign lawyers.

The ratios in Latin American jurisdictions are much higher than in other middle-income countries, for example, one lawyer per 550 in Argentina. This compares with around one per 1,300 in Turkey, one per 1,700 in Poland and one per 2,600 in Russia.

Amongst poor countries, one can expect from one lawyer per 3,000 up to one per 10,000 or so. For example, in Kenya the ratio is one per 6,000, and in Nigeria one per 3,700.

There seem to be around one million lawyers in India, roughly the same number in the United States, but India has nearly four times the population of the United States so the ratio is quite a high ratio of one per 1,200 or so, compared to one per 265 in the US.

By contrast, the ratio in China seems to be about one per 14,000 with a total of 110,000 lawyers (up from 200 over the last 20 years), but this may be a large underestimate.

In a country like Indonesia the ratio appears to be about one per 10,000. Compare this to Tunisia (one per 1,350) and Philippines (one per 2,400).

Apart from cultural considerations, there is a clear correlation between the degree of economic development and the number of lawyers, that is, the richer the country, the greater is the number of lawyers. This may in turn be influenced by the fact that richer countries tend to have more complicated laws especially in the fields of regulation and the like, laws which are the product of the welfare state which tends to flow over into protective regulation, such as financial regulation, health and safety rules or consumer credit protections. Richer countries will have more and larger

banks and corporates, therefore more transactions that have to be documented and therefore more disputes.

At any rate, if there is anything in our predictions about the increase in GDP over the coming two decades, then this would seem to point to an increase in the number of lawyers worldwide as currently poor countries get richer. At the simplest level, there are more commercial deals and more arguments about those deals. The larger amounts justify the use of lawyers in the deal or the recourse to expensive litigation. In addition, excessive regulatory or other statutes lead to a demand for lawyers who have to interpret these statutes and help resolve conflicts driven by the aggressive legal framework. Every time something goes wrong, it is the population at large who clamour for more laws to punish the villains. The politicians respond to this righteous indignation by promising legal vengeance.

There are many conclusions which one might debate. Some are worth mentioning here.

The first issue is about the future size of law firms and of the legal and compliance departments of international banks and corporates. If we continue to inflate our legal systems as we are doing now, and if there is an increase in worldwide wealth and hence the volume and complexity of transactions, then this may point to the fact that international law firms and in-house legal departments are currently too small to cope with the risks, as well as the transactions.

If the US or Brazil model is followed, then wealth expansion, coupled with population and wealth growth, over the next two decades might result in an increase of the number of global lawyers from the estimated current 6 million to 12 to 15 million, give or take a few million.

A second conclusion would be that countries which are now in the emerging bracket and which therefore have less extensive legal systems than are found in developed countries should consider whether they should adopt the legal policies of the West or should resist enlarging their legal systems in the way that the West has done. The legal and compliance costs in the West of complying with regulation of dubious worth and with legal risks are considered unjustifiable.

As to whether legal costs, which are currently very high, will come down or go up will depend on a large number of factors, including the supply of lawyers, the width of their education and the attitude to risk of the business community which uses legal services.

## XXI. A LARGER PERSPECTIVE

It is worth standing back and examining the general role of lawyers so as to achieve a proper perspective.

As mentioned, the law is the one universal secular religion which everybody believes in, although people may differ, and usually do, about the scope and content of the codes of this religion. Unlike many other religions, belief in the law, the role of law and the rule of law, does not require a belief in the supernatural. You can believe in other supernatural religions in parallel. This religion does not require a showing of commitment to the codes in the form of rituals or attendance at churches or temples or in the form of other outward marks of identity. This religion is not regional or local but is universal. Because much law appears to be driven by emotion, and because its

enforcement is sometimes pugnacious and bellicose, it is one of the primary tasks of lawyers to instil rationality, common-sense and a measured coolness, as well as tolerance.

The law has its sects and its cults. It has heretics and fanatics. Some of its priests are venal and corrupt. But on the whole its adherents, namely the entire population of the earth, want it to work.

If law is a form of restriction on the freedom of human conduct, the rationale is that restrictions are necessary for survival, that is, if we indeed are to continue our existence here on the earth, then we need prescriptive codes of behaviour which limit our propensity to anarchy and savagery. One of the most fundamental questions is how much law should there be and how punitive it should be. Should we be fettered and chained, and why?

In the modern world these prescriptive codes go far beyond basic human rights and freedom from arbitrary despotism, slavery and torture. Companies, banks and capital markets are artificial creatures of the legal imagination, no less fictional than dreams, but still extraordinarily potent and marvellously inventive as engines of economic growth, of technology and enterprise. These were the invention of lawyers, as were constitutions, the criminal law and the rest of the legal edifice. Overall, the lawyers' contribution has been fundamental in promoting the most primitive objective of preserving the species and building creative and ingenious structures to do it, including in the fields of productive enterprise, banking and finance.

It is remarkable to observe that, in their many fruitful debates about the underpinnings of economic growth, economists, from a profession which has done so much to shed light on our societies, have come around to view that what really matters are "institutions". By this the economists mean not just cultural but legal institutions. They also refer to "contracts and property rights" as being crucial in enhancing economic potential, *ie* the rule of law.

It is often said that economists are primarily interested in function, usefulness, utilitarianism, efficiency and in the weighing of costs and benefits in terms of money. By contrast, it may be said that lawyers, by their training, are more inclined to consider morality, justice, individual freedom and the rule of law. That may well be true. But it is considered that morality is the most functional and utilitarian of all disciplines because it is about survival.

There seems little doubt that much of the incomprehensibility and size of the law at present is driven by emotions. Many of the laws which we have, particularly the most excessive laws, are not the products of rationality or scientific and enlightened debate or of a measured coolness or of careful empirical work. There are more, far more, risks of a legal sort than there need to be.

The heroes of economists include Adam Smith, Karl Marx, David Ricardo, John Maynard Keynes and Milton Friedman. You could add others, such as Friedrich A Hayek. They are all fairly recent and indeed economics is a recent discipline in terms of the larger scale of history.

Who then are the heroes of the lawyers? Tentatively, respondents might mention Grotius or Justinian or some well-known judge. In fact, the first lawyers were of much, much more ancient heritage. Some of them are the man on the mountain with his ten bullet points (Moses), Siddhartha Gautama, the founder of Buddhism, who died about 483 BC, Confucius, who died about 479 BC, Jesus Christ, who died

around 30 AD, Mahomet, the founder of Islam, who died in 632 AD and Socrates, who died about 399 BC. These individuals were amongst the first people to introduce legal codes which were fundamentally about survival.

The larger role of lawyers is therefore clear. They are very close to peoples' emotions, they are close to meticulous detail, they are close to morality as the bedrock of survival. They are not priests or rabbis or imams or brahmins or religious leaders, but they are the true inheritors of the first lawyers who were these things and who did write commandments and moral codes about the principles of survival. Since those ancient times, legal codes have far exceeded religious codes in their scope and detail. It is these legal codes, including those in the banking and financial law arena, which express our values and the moral order. And it is lawyers who must be the ultimate guardians of the moral order.