BANK OF ENGLAND

Speech

From ‘ethical drift’ to ‘ethical lift’: Reversing the tide of misconduct in global financial markets

Remarks given by

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Introduction

Misconduct in financial markets has existed for as long as commerce has existed. Thousands of years ago, Chinese merchants found ways to hide trading profits through a variety of financial techniques[1]. From the great South Sea bubble in the 1720's to the mis-selling of railway stocks in the mid-1800's through to more recent events such as the collapse of Bank of Credit and Commerce International and the failure of Barings in the mid-90's – we have had a long and inglorious record of rogues, fraudsters and embezzlers in the financial services sector.

But the wave of misconduct which has emerged in the aftermath of the financial crisis suggests that "this time is different." The magnitude of the misconduct fines is indicative of the scale of the problem: since 2009, UK banks have paid almost £35[2] billion in fines and redress costs, roughly equivalent to the private capital they have raised in the same period. The global picture is even more unsettling – the roughly $275[3] billion in legal costs for global banks since 2008 translates into more than $5 trillion[4] of reduced lending capacity to the real economy. Never before has misconduct occurred so systematically, in such a scale and across multiple jurisdictions. Clearly it was not the case of a few bad apples, but something was rotten in the entire barrel.

A combination of factors caused "ethical drift" across the industry where bad behaviour went unchecked, and became progressively more widespread and accepted as the norm. Market structures (such as poorly designed benchmarks, unmanaged conflicts of interest, and possibilities for collusion) presented opportunities for abuse. Systems of governance and control focused on second and third lines of defence that were weaker than highly profitable and powerful trading desks. Weak market discipline, particularly from the buy side, meant that poor market practices were allowed to continue. Remuneration and incentive schemes stressed short term returns over longer term value enhancement. And finally; a culture of impunity was prevalent because of a perception that the likelihood of being caught was low.

Just as multiple forces caused the deterioration of conduct, multiple actions will be required to achieve the kind of "ethical lift" we want to see in the financial markets of the future. As an example, the Fair and Effective Markets Review[5] conducted by the UK authorities concluded that action was needed on various fronts including:

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1 See Sterling Seagrave (1995)
2 Bank of England staff calculations.
3 See European Central Bank Financial Stability Review May 2016. The sample covers the 22 global systemically important banks (G-SIBs) and four non-G-SIBs. Legal costs include damages, fines, settlements and litigation. The analysis relies on data based on regulatory, bank and law firm notices, as well as data obtained from banks' annual reports.
4 Bank of England staff calculations.
5 The Fair and Effective Markets Review: Final Report can be found at: http://www.bankofengland.co.uk/markets/Documents/femrjun15.pdf.

- Measures to ensure individual and collective accountability for misconduct in firms – eliminating the ability of senior management to absolve themselves of any responsibility for bad behaviour on their watch;
- Aligning conduct and incentives so that excessive risk taking and short-term gains do not reap financial rewards;
- Bringing industry together to produce market standards and promote adherence to best practice;
- Tougher punishments for misconduct and making it more difficult for “bad apples” to roll to other firms.

A full progress report on the implementation of these recommendations was published in July 2016.[6] What are some of the broader lessons for other countries from that experience?

‘Hard law’ and ‘Soft Law’

We cannot expect misconduct to never occur in financial markets – history has taught us that there will always be individuals prepared to do the wrong thing if there is a reward. But we can reduce the frequency and severity of misconduct and we can increase the likelihood that it will be detected and punished. Given how quickly financial markets evolve and the practicalities of regulation, this can best be achieved by a combination of ‘hard law’ (legislation and regulation by the official sector), ‘soft law’ (codes and standards defined collectively by market participants), and culture (norms and practices created by firms’ Boards and management).

The authorities obviously have a role to play. Regulators must introduce rules and regulations to enforce minimum standards of conduct, hold individuals to account for their actions, and put in place incentives to promote good conduct. But hard law is not enough. Even in jurisdictions with a preference for ‘hard law’ solutions, issues of interpretation and norms arise. Regulators cannot police every market practice, especially in fast moving markets, nor can they dictate a firm’s culture. However, authorities can use their convening power to bring together market participants to solve collective action problems, set expectations on behalf of broader society about expected behaviours and provide incentives to encourage adherence to voluntary market standards.

This is where industry leadership is vital. An important complement to actions by the official sector are efforts by market participants to create soft law: aspirational standards that are higher than the regulatory minimum and encourage ongoing behavioural change. Market participants are best placed to lead in the development of standards and codes which address real conflicts of interest within a given market place. Such standards are widespread in many professions and are increasingly being used in the financial sector.[7] Adherence to such voluntary standards can be encouraged through peer pressure, transparency, Kitemarking, and

[6] The Fair and Effective Markets Review: Implementation Report is available at: http://www.bankofengland.co.uk/markets/Documents/femr/implementationreport.pdf
[7] See Jay Cullen (2016) and David Rouch (2016).

enhancing business opportunities through compliance. The official sector can also help enhance the effectiveness of soft law by engaging actively with the process and with the organisations that develop standards and industry norms. The Treasury Market Practices Group, sponsored by the Federal Reserve Bank of New York, is a good example of market professionals coming together to supporting the integrity and efficiency of the Treasury, agency debt and agency mortgage backed securities market.

In the remainder of my remarks, I will set out what we have done in the UK to try to reverse the tide of misconduct, focusing on the role of hard law and soft law in shaping conduct and culture in the market as a whole. My colleague James Proudman, the Executive Director for UK Deposit Takers at the Prudential Regulation Authority, will talk later about the role of supervision in influencing conduct at the firm level.

Governance and Accountability

As cases of misconduct were uncovered, too many senior managers pled ignorance about the unethical practices that were taking place on their trading floors. In response, the UK introduced the Senior Managers Regime (SMR)[8], Certification Regime and a set of Conduct Rules[9]. At its heart, the SMR aims to improve governance and culture within financial institutions by ensuring clear allocation of responsibilities and lines of accountability amongst the most senior individuals in firms. The Certification Regime requires firms to assess and certify the fitness and propriety of employees deemed capable of causing 'significant harm to the firm or its customers' every year.

If misconduct does occur, the SMR includes stronger powers for regulators to hold individuals to account. It includes a statutory 'duty of responsibility' that requires all Senior Managers to take reasonable steps to prevent regulatory breaches in areas for which they are responsible. If a regulatory breach does occur, the regulator can impose sanctions on the individual, including financial penalties and suspension. The regime includes two prescribed responsibilities relating to culture - overseeing the development of the firm's culture and ensuring the adoption of the firm's culture in the management of the firm. These prescribed responsibilities would typically be allocated to the Chairman and CEO respectively.

Whilst the purpose of the SMR is to enhance individual accountability, we are also putting greater emphasis on the responsibilities of Boards. We have made clear to firms that we expect Boards to take collective responsibility for establishing strategy, setting the risk appetite, monitoring risk across the business and holding management to account. Boards should also articulate and maintain a culture of risk awareness and ethical behaviour. Collective responsibility and individual accountability can and should complement each other.

[8] The Bank of England has applied the Senior Managers Regime to itself. Further information including the Responsibilities map and allocation of Prescribed Responsibilities can be found at: http://www.bankofengland.co.uk/about/Documents/smr.pdf
[9] Documentation relating to strengthening accountability (including the Senior Managers Regime, Certification Regime, Conduct Rules, Board Responsibilities and Regulatory References) can be found at: http://www.bankofengland.co.uk/pra/Pages/supervision/strengtheningacc/default.aspx

Many of the individuals found guilty of misconduct had moved from firm to firm with no record of their misdeeds shared with future employers. To address this problem of 'rolling bad apples' the UK authorities have put in place a mandated form for regulatory references for key staff. These references will provide prospective employers with more information on the past conduct of staff including internal disciplinary action and any other information relevant to the candidate's fitness and propriety. This initiative will help to prevent the problem of staff with poor conduct records moving from firm to firm based on anodyne references.

Aligning Incentives with Good Conduct

It is now widely recognized that in the lead up to the crisis, bonuses were too closely linked to short-term revenues, with little weight placed on the longer term risks to the firm. These pay structures incentivized excessive individual risk-taking and left shareholders and ultimately tax payers to absorb huge losses and incur misconduct fines when risks crystalized. Moreover, contract theory tells us that high powered incentives work best when outcomes are easily measurable (such as sales targets). But more senior roles involve managing many unquantifiable but very important outcomes – such as reputation and risk culture.

In the United Kingdom, we have taken the following actions to incentivise individuals to consider the longer-term health of the firm:

- Remuneration rules require a substantial portion of bonus rewards to be deferred for up to 7 years for senior managers. This allows for malus (the reduction or cancellation of unpaid bonus awards) and clawback (a contractual agreement whereby the staff member agrees to return paid bonus awards to the firm where risks have subsequently crystallised or instances of individual misconduct have been uncovered).[10] There is evidence that malus is being increasingly used by firms – malus adjustments within major UK banks has more than trebled from c. £100mn in 2010 to c. £300mn in 2014.[11]
- In addition, the Prudential Regulation Authority has made clear that it expects firms to use a balance of both financial and non-financial factors (such as conduct metrics) when determining pay rewards and that financial metrics should be appropriately risk adjusted.

Internationally, the Financial Stability Board is taking action to improve the alignment between remuneration and conduct risk[12] and (during 2017) will consult on:

- Supplementary guidance on the use of compensation tools to address misconduct, and
- Recommendations for consistent national reporting and collection of data on the use of compensation tools.

[10] Documentation relating to remunerations rules can be found at: http://www.bankofengland.co.uk/pra/Pages/supervision/activities/remuneration.aspx
[11] See the Bank of England Quarterly Bulletin 2015 Q4, Volume 55 No. 4, page 328, Chart 6.
[12] See 'Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards: Fourth Progress Report' at http://www.fsb.org/wp-content/uploads/FSB-Fourth-progress-report-on-compensation-practices.pdf

Taken together, these reforms will further strengthen the alignment between risk and reward, and ensure greater accountability for risk management failings over a longer timeframe.

Complementing "Hard Law" with "Soft Law"

The authorities can implement rules and regulations, but they can also play a broader role by promoting good behaviour. The Fixed Income, Currency and Commodity (FICC) markets are covered by a patchwork of poorly understood codes of conduct and market practices. To address this, the Fair and Effective Markets Review recommended the creation of a FICC Markets Standards Board (FMSB)[13], with a mandate to:

- To improve the quality, clarity and market-wide understanding of wholesale FICC trading practices;
- Produce guidelines, standards and other materials to promote good conduct; and,
- Undertake horizon scanning by periodically reviewing wholesale FICC markets for emerging risks.

The FMSB has already made significant progress in engaging a wide range of market participants, which is a testament to the leadership of Elizabeth Corley as interim Chair and Mark Yallop who took over as Chairman in July.

- Over 50 firms have signed up including 17 G-SIBs, some of the largest asset managers in the world, and many corporates and treasurers who are major users of FICC markets.
- The FMSB has published draft guidance on 'Reference Price Transactions in Fixed Income Rates Markets' and 'Binary Options in Commodities Markets' that members must adhere to on a comply or explain basis; and
- Other jurisdictions are starting to take note – the Australian Financial Markets Associations' members have agreed to implement the FMSB's standards and the South African Reserve Bank has been in touch about setting up its own FMSB equivalent. Many global banks are telling us they intend to apply these standards to all their operations. The internationalization of these market standards is critical for creating a level playing field and preventing "ethical drift" across different jurisdictions. It is also vital for sustaining public support for open and global financial markets.

The FMSB is not self-regulation. The laws and regulations governing conduct apply and will continue to be enforced. But the official sector has an important role to play in supporting such market-led initiatives, helping to solve coordination problems and enabling the private sector to come together to raise standards and share best practice.

An excellent example of this approach is the development of a single global foreign exchange code being written through a partnership between 16 central banks and market participants in both advanced and

[13] Further information on the FMSB, its membership and draft guidance can be found at: http://www.fmsb.com/

emerging economies.[14] This will be the first time that the approximately $5 trillion per day foreign exchange market will be governed by a single code of conduct. Sections of the global foreign exchange code covering ethics, information sharing, execution, confirmation and settlement, including an update on how adherence to the code will be promoted, was released in May 2016. The full text of the code, including additional sections on governance, risk management and compliance, is on track for publication in May 2017.

The nature of conduct risks will of course evolve over time and the official sector needs to stay on the front foot. The UK authorities have announced a work programme to scan the horizon for potential market or private sector co-ordination failures that may be damaging the fairness or effectiveness of FICC markets.[15] The authorities will seek to catalyse reforms to insure that market structures that are vulnerable to manipulation and misconduct do not develop over time.

Conclusion

The examples above show how the UK has put in place a set of reforms to improve standards and ethics in financial markets. We have not tried to regulate culture, but we have used a combination of hard law and soft law to raise expectations and norms. It will take time to move from 'ethical drift' to 'ethical lift'. Better regulation is part of the solution, but so is a more effective partnership between the official and private sectors to improve market practices and conduct norms.

[14] The FX Global Code: May 2016 Update can be found at: https://www.bis.org/mktc/fxwg/gc_may16.pdf
[15] See FEMR Implementation Report at: http://www.bankofengland.co.uk/markets/Documents/femr/implementationreport.pdf

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