Daniel Mminele: Ethics in finance and financial markets

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, to the South African Chapter of ACI – The Financial Markets Association, Johannesburg, 28 October 2014.

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Introduction

Good evening ladies and gentlemen. Thank you to ACI and Standard Bank for the honour and privilege to address you tonight, for creating an opportunity for us to exchange views, and for ACI members to cultivate their networks of contacts in the industry. As the ACI will be celebrating its sixtieth anniversary next year, it would only be proper to recall some of its important contributions to building a culture of professionalism and best practice in financial markets, especially the foreign exchange market.

As you know, the ACI has over the years taken a leading role in not only bringing finance professionals together to seek ways of addressing the more pressing issues of the day, but also in enhancing the professionalism of its members, assisting in building-up of competence via its training programmes and examinations, and quite importantly, striving for high standards of ethical conduct in the industry. And it is on this latter point that I would like to share some thoughts and impressions today.

Ethics in finance and financial markets has perhaps never been as relevant as it is today, and for that reason, it may not be so much of a surprise that the International Monetary Fund, at its conference on the future of finance during the Annual Meetings earlier this month, scheduled as its first session a two-hour panel discussion on the subject of Ethics and Finance.

The importance of ethics for a sound financial environment

I do not need to highlight to an audience such as this one the importance of ethical behaviour in financial markets, not just from a moral point of view, but equally from a point of view of economic efficiency. In an industry where the conclusion and enforcement of contracts is based on trust – trust from the provider of capital that he is fairly rewarded for the risk of potentially losing some of his assets; trust from the borrower that he is charged a fair price for his access to capital – any breakdown in that confidence can quickly lead to incorrect pricing and in turn, improper allocation of resources. Lack of confidence in the financial system in general typically means rising counterparty risks, and prompts lenders of capital to require a higher risk premium in their investment returns, raising the overall cost of capital in the economy. In similar fashion, fears that some participants in financial transactions may prove to be "rotten apples" would force all others to pay a higher price for access to resources, even if the broad majority behave in a proper manner. In a developing country like South Africa, reluctance to lend, or demand for an elevated risk premium, for fear of fraudulent or information-withholding behaviour, can easily limit the ability of the general public to access credit and, in turn, impede the path to a more balanced and inclusive economic growth framework.

Yet the developments of recent years illustrate the challenges that the industry is facing. The Libor scandal of 2012, when several banks were found guilty of colluding to misprice benchmark rates, illustrates the potential ramifications of unethical behaviour in one segment of the market. Libor is an inter-bank rate, but its role as a benchmark in the pricing of financial derivatives and corporate sector loans means it affects a far broader range of transactions than simply money market ones. Yet the manipulation of Libor was only one example of improper practices. While several global banks were fined for their involvement in the manipulation of the Libor and Euribor reference rates, others ended up paying hefty fines

for infringements as diverse as inadequate underwriting and improper sales practices in the sub-prime mortgage market, material non-disclosure, illegal involvement with counterparties under US sanctions, or illegal credit card practices. Since 2010, two large US banking groups alone ended up paying total fines of US$52 billion and US$36 billion, respectively, while a European banking group paid fines of as much as US$9 billion.

The fines imposed on global banks since 2010 have been the most severe ever applied by US authorities.

Closer to the interests of a professional body like the ACI, the last couple of years have seen the uncovering of several cases of foreign exchange market manipulation, resulting in the dismissal of employees and in criminal prosecutions – potentially larger consequences for the guilty parties than in incidences of interest rate manipulation. The high publicity surrounding these cases has not been without negative impact on the financial industry's reputation with the general public; and it is of concern that surveys of public trust in business and institutions, like the 2014 Edelman Global Trust Survey, continue to place banks as the least trusted of the major business sectors.

Reasons for the drift and corrective measures put in place

A lot has been written about the reasons for this apparent "drift", over the past decade or so in the financial industry's standards. In 2011, already, the US Financial Crisis Inquiry Commission listed several governance issues as key factors behind the global financial crisis, including: failure of accountability and ethics; lowered lending standards; and a lack of regulation of OTC derivatives.[1] Indeed, the increasingly complex nature of financial products transacted between financial counterparties in the run-up to the 2008–09 global financial crisis may have, to some extent, caught both senior executives of companies and their senior risk managers "napping". Or, possibly, the warnings of risk managers may have simply been ignored, with their reports coming low down the list of urgent matters, as the primary focus was on outperforming the competition in generating short-term profits. As long as business was growing and new structured products were bringing in additional customers and raising returns on equity, the risks underlying these products – and the extent to which investors understood that risk – may not have been of sufficient concern to the parties involved.

A general environment of booming credit growth, at a time when the combination of stable and low inflation together with solid GDP growth led many observers to theorise about a structural decline in macroeconomic and market risk, probably added to overall complacency, together with what is now regarded as the lax underwriting standards of the time, and the insufficient capital requirements imposed on banks.

The changing nature of the financial business may also have contributed to the problem. In the debate on ethics and finance hosted by the IMF on 12 October, which I referred to earlier, Bank of England Governor Mark Carney spoke of how finance, over time, became much more transactional rather than relational – in a word, the growing number of intermediaries tended to break the connection between the original service provider and the end-customer, which had earlier formed the basis of trust-building in the industry. Furthermore, as the number of intermediaries grew, so did the size of financial companies through the wave of mergers and acquisitions that followed the deregulation of the 1980s, resulting in what some have described as a "dilution of culture" in many institutions. An institution spanning many businesses, countries and continents, as per the "financial supermarket" model that increasingly prevailed from the mid-1990s, made the creation of a common culture and set of values difficult. In many instances, companies began operating "in silos" and even senior staff often lacked sufficient knowledge of the different businesses

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[1] See Report of the US Financial Crisis Inquiry Commission, January 2011.

in which they were involved. Finally, one cannot ignore the issue of incentives in the financial industry, especially the system of employee compensation, which at some stage heavily rewarded sales volume and short-term profits at the expense of risk awareness and longer-term prudential analysis.

There is no doubt that regulatory authorities and financial institutions alike have become more aware of the need for correcting the excesses of the past. Back in 2010, the Seoul Summit of the G-20 committed to "*core elements of a new financial regulatory framework (…) as well as measures to better regulate and effectively resolve systemically important financial institutions, complemented by more effective oversight and supervision*." This included the endorsement of Basel III rules on banking supervision, which, among others, raised the quality and quantity of bank capital and liquidity, and constrained the build-up of leverage and maturity mismatches. Separately, since the global financial crisis, several pieces of legislation have strengthened prudential regulation and supervision of the industry. In the United States, for instance, the Dodd-Frank Wall Street Reform and Consumer Protection Act gave regulatory agencies increased powers of oversight towards systemically important institutions, while incorporating stricter rules on executive compensation and corporate governance. The Volcker Rule, introduced as an amendment to the Act, was specifically aimed at shielding bank customers from risky behaviour by banks, by seeking separation of retail banking from investment banking and proprietary trading activities.

At the same time, financial institutions have themselves taken steps to avoid a repeat of past crises, including a comprehensive review of their corporate culture and practices, with greater emphasis on the need to prioritize customer service. A September 2013 survey of 382 respondents from Europe, Asia-pacific and North America by the Economist Intelligence Unit showed that nearly all of the respondents felt that ethical conduct was just as important as financial success to their firm, and that 67 per cent had taken steps to make staff more aware of the importance of ethical conduct. Furthermore, 63 per cent had introduced or strengthened a formal code for ethical conduct, and 43 per cent had introduced financial or career incentives for respecting that code of conduct.[2]

Another approach followed by financial institutions was to hire high profile corporate governance specialists that have knowledge of compliance issues in order to transform their institutions, and help them to quickly step up to the required standards of compliance and conduct. If there is one area in which banks are not cutting costs, it is in the area of risk management and compliance. This is a positive step insofar as it brings governance closer to the coal face; however, there are also concerns that these actions, if not undertaken properly, can weaken the enforcement institutions by creating a false sense security, and achieve little more than increasing salaries for compliance officers.

Limits to what regulation can achieve

With the ambitious efforts on the part of regulators to up their game as well, specialist skills have also been recruited from the markets into official institutions. Yet the extent to which regulators can enforce more ethical standards in the industry, and avoid a repeat of the excesses that contributed to the global financial crisis, may have its limitations. The first problem resides with the ability of regulations to envisage all possible infringements. In a world where financial innovation has been moving fast, and new and more sophisticated products continue to be developed, there is always the risk that unethical market participants remain one step ahead of regulatory authorities, in the same way as unethical athletes and sport physicians attempt to be one step ahead of anti-doping agencies. And indeed, new transgressions in the recent past have been committed after the promulgation of legislation

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[2] See "A Crisis of Culture: Valuing Ethics and Knowledge in Financial Services", a report from the Economist Intelligence Unit, 2013.

aimed at curbing improper practices – providing evidence that legislation will not completely prevent the occurrence of improper or fraudulent behaviour.

The second issue is one of finding the optimal degree of regulation. While the events of the past decade have clearly demonstrated the limits of "light touch" regulation and reliance on the market's ability to self-regulate, there may equally be a risk that too much regulation will stifle financial innovation, result in elevated compliance costs that will be passed through to the end-customer, and limit the willingness of institutions to provide funding to all but the most creditworthy borrowers. Furthermore, "top-down" regulation brought about by international bodies like, for example, the G-20, may not be appropriately tailored to all jurisdictions in which they would apply. It would be undesirable, for instance, for regulations initiated in response to developments witnessed in the world's largest economies to end up stifling financial development in an emerging country like South Africa. A push for elevated regulation may also easily break the fragile consensus achieved by most countries in the aftermath of the global financial crisis: In recent weeks, for instance, the Bank of England's Prudential Regulation Authority has expressed strong reservations about EU proposals on the role of bonuses on bankers' remuneration.

At the same time, acknowledgement by financial institutions of the need to encourage more ethical behaviour by their staff is no guarantee that practices will indeed change. Speaking last week to a workshop on reforming culture in the financial industry, Federal Reserve Bank of New York President, Bill Dudley, stressed that supervisors will need to see evidence of measures taken yielding results in the form, among others, of more open and routine escalation of issues, reduced frequency of unchecked problems, and improved image of institutions with the general public.[3] What remains of concern is that not everybody is convinced that tougher standards are in their own best interest: For example, the Economist Intelligence Unit's survey of financial industry participants, which I cited earlier, also found that 53 per cent of respondents felt that career progression at their firm would be difficult without being flexible on ethical standards, and that only 37 per cent thought that better ethics would mean better financial results for their institutions.

Such continued shortfalls emphasise not just the need for stronger and more effective self-regulation in the industry, but also the role that professional bodies like the ACI can and should play in areas like the development of conduct rules for its members, and in educating finance professionals to better understand the complexity of today's financial world and the risks emanating from that complexity. In adapting to these needs, the ACI Model Code is being developed as an online exam (separate module) that can be incorporated into individual bank and institution compliance processes. The Code will be updated annually and staff will keep current with the Model Code by completing the exams annually to ensure compliance and adherence to the etiquette of the market rules of engagements.

On the regulatory front, the ECB has been given the lead role in work to strengthen codes of conduct for currency markets. Work on new standards were top of the agenda at a meeting of regulators in Sydney in May 2014, which brought together eight central bank committees charged with keeping tabs on the currency market. The meeting followed suspensions or firing of more than 40 dealers following claims that senior bankers used client order information improperly to manipulate prices.

The ACI has already proven its ability to contribute at the highest level to the new regulatory process: In recent months, for example, the ACI has been leading the solution agenda for the European Central Bank, the Reserve Bank of Australia and the Bank of Canada, who have

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[3] See "Enhancing financial stability by improving culture in the financial services industry", Remarks by William C. Dudley, President of the Federal Reserve Bank of New York, at the workshop on "Reforming Culture and Behaviour in the Financial Services Industry", Federal Reserve Bank of New York, New York City, 20 October 2014.

all signed up to the Model Code it has developed. The New York Federal Reserve and Bank of England both have their own set of rules, but an agreement on the new principles could tie all closer together.

On the particular point of US policy enforcement, it may be worth noting that the Securities and Exchange Commission (SEC), in an attempt to stamp out unethical and unlawful behaviour, has been providing huge incentives for whistle-blowers by giving them record-breaking rewards for successful prosecutions of untoward behaviour. Is this indicative of weakness or, in instances, even a failure of the self-regulation model? Would bodies like the ACI have improved the situation by being more proactive? Whatever the case maybe, there is a need to step up, probably in both self-regulation and actual regulation of market participants in order to bring fairness to the market place. Bodies like the ACI have no doubt a big role in delivering to this objective, with the recent engagement by ACI around the FSB Benchmark Consultative Document being a good example.

South Africa's experience – looking for a pro-active approach

Before I conclude, allow me to provide some detail about South Africa's efforts in trying to keep ahead of the pack when it comes to entrenching and maintaining ethical market conduct, and also highlight the current and envisaged role and contribution of the ACI in this regard.

For quite a while, the local chapter of ACI has been engaged in consultations with the Financial Services Board to ensure that the current regulatory exams are adequate for ACI accreditation. The process is has not been finalised yet, however, the Financial Services Board has embarked on an initiative to get this done as soon as possible. Through its participation in the Foreign Exchange subcommittee of the Financial Markets Liaison Group (FMLG), the ACI played a constructive role in ensuring that we could complete the project around the South African Rand Fixing page, which is now being published on the JSE website. Publishing it on third-party systems such as Bloomberg and Reuters is still work in progress. Although the JSE currently maintains the governance around the fixing, and given that the rand fixing is such a critical issue in the domestic market, market participants on various occasions have expressed the urgent need for a Code of Conduct for Rand Fixing participants. At the June 2014 FMLG meeting, it was proposed that the ACI Model Code could be used for this purpose, but further work is required to establish whether the Model Code in its current form would fully meet the requirements of the domestic market.

I would therefore like to acknowledge and convey my appreciation the ACI's participation in the substructures of FMLG and its involvement in efforts to improve the functioning of the South African financial markets. We look forward to continuing to work with the ACI, and the FMLG can certainly leverage off the ACI's global linkages as part of our efforts to make the foreign exchange and money markets safer, more liquid and more transparent.

Another much applauded effort by the ACI is the extension of its coverage to the settlements area by providing customized learning programmes. The more competent these officers are, the greater their effectiveness in the implementation of the segregation of duty principle. The SARB has taken advantage of the training provided by arranging such training in-house for our own staff.

South Africa's escape (by an large) of the financial crisis should not leave room for complacency, and it is with this awareness that the South African Reserve Bank is engaging in an ongoing dialogue with the financial industry in order to "batten down the hatches" and contribute to the review and enhancement of codes of conduct for the different markets, and to generally ensure that our markets meet best practice standards.

It is also within this context that we announced yesterday that the SARB and the Financial Services Board will conduct a review of foreign exchange trading operations of authorised dealers. This review is intended to confirm and, where appropriate, strengthen the level of

adherence to best practices in foreign exchange dealing, minimise the risk of manipulating benchmarks and sharing confidential client information, so as to enhance the transparency, efficiency and integrity of the foreign exchange market. As indicated earlier, regulators in a number of jurisdictions have been investigating banking institutions over various improper practices. We have no evidence of widespread malpractices in the South African foreign exchange market, nor are we dealing with any specific allegations, but felt that given the broad-based nature of investigations in other jurisdictions, which also involve trading in emerging market currencies, it would be prudent to obtain comfort that foreign exchange trading practices are in line with best practice.

Conclusion

In conclusion, while a lot of work remains to be done, it is nonetheless very encouraging to note that key steps have been taken by regulators and financial institutions alike to tighten behavioural standards in the industry. It is equally encouraging that South Africa, while largely sheltered from the global financial crisis, is embarking on measures to limit the risk of such crises occurring locally in the future, including strengthening market conduct regulations as part of the move to a twin peaks system of regulation. Nonetheless, the future evolution of the financial industry will bring new challenges for regulators and professional bodies alike. I will only mention a few potential examples here. Much has been written, for instance, about the growing role of non-bank institutions in financial intermediation, and indeed, one potential consequence of stricter regulation of banks may be to shift a greater share of transactions towards the non-bank sector. Extending codes of good behaviour and governance to a broader swathe of financial market players will be a continuing task for regulators and professional bodies.

Another example is the changing world of information technology, and how it can bring new players into the financial system. Will internet and cellular telephony companies become the major providers of financial services in the next twenty years, as more people complete financial transactions on their mobile phones? Similarly, will the main centres of financial transactions migrate towards regions and countries which up to now, like China and India, have been held back by the low liquidity of their markets and the existence of capital controls, even though their share in the world economy has been growing fast? It is too early to answer, but these may be just examples of new, non-bank institutions and new major financial centres that will over time, play a larger role in global financial transactions. As such, they will have to join in the endorsement of codes of good practice, if the industry and indeed the world economy are to continue on the path to greater and safer prosperity.

I therefore encourage the ACI to keep up the good work, to continue building your organisation and being a constructive partner in the continuous effort of building a professional culture that is characterised by adherence to the highest standards of ethical conduct.

Thank you.