Mark Carney: Building real markets for the good of the people

Speech by Mr Mark Carney, Governor of the Bank of England and Chairman of the Financial Stability Board, at the Lord Mayor's Banquet for Bankers and Merchants of the City of London at the Mansion House, London, 10 June 2015.

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My Lord Mayor, Lady Mayoress, Chancellor, Ladies and Gentlemen.

Almost 350 years ago, the Great Fire destroyed the City of London and rendered 100,000 people homeless.

It took half a century to rebuild.

The legacy of the Great Fire endures, including such Wren masterpieces as St Paul's and his twenty-five other steeples that survive today within the City's precincts.

But the Fire's legacy is not limited to how the City *looks*, it extends to what the City *does*.

The blaze led Nicholas Barbon to establish the first insurance company, an innovation to fulfil a social need: the sharing of risk.

Public authorities complemented private initiative.

There was a Royal Proclamation that set standards for wider roads and houses built from brick and stone instead of timber.

And Parliament passed the Parish Pump Act to prevent "mischiefs that may happen by fire" by establishing fire brigades and improving water supply.

So that spark in Pudding Lane ignited much more besides the Great Fire itself:

– the provision of liquidity to limit contagion;

– a recognition that clear, well-understood codes contribute to the greater good; and

– a belief that financial markets can solve real world problems.

From the coffee houses that served as meeting places for entrepreneurs and merchants; to the exchanges that supported the trading of financial claims; to a central bank that acted as lender of last resort: a rich infrastructure developed to support markets that served the UK and the world. As it grew into the world's leading economic and trading power, the UK also became its centre of financial capitalism.

By the early 20th century, though no longer the world's largest economy, the UK was still its hub of international finance. It held close to a half of the world's stock of overseas investments and traded one third of all negotiable instruments.

The City has retained its pre-eminence through market innovation. From eurobonds to emerging market debt, credit derivatives and centralised clearing; the City has continually created new financial products and markets to serve the real economy.

Today the City remains the leading global financial centre. The UK is the venue for 40% of foreign exchange trading volume, half of all trades in OTC interest rate derivatives, and more than two-thirds of trading in international bonds. More international banking activity is booked in London than anywhere else, and the UK is host to the world's third largest insurance sector as well as its second largest asset management industry. UK markets matter for global commerce. But above all, our markets matter for our prosperity.

Markets are a major part of the UK economy. 350,000 people are employed in financial services in London alone, and 1 million across the UK as a whole. Across the country, their enterprise contributes £130 billion to our national income and £70 billion to our exports. On current trends, the UK-based non-bank financial system would increase from around six times UK GDP to nearly fifteen times by 2050.

Most fundamentally, our markets serve our real economy.

By financing firms to hire, invest and expand, our markets help drive UK growth.

By opening up cross-border trade and investment, our markets create new opportunities for UK businesses and savers.

By transferring risks to those most willing and able to bear them, our markets help UK households and businesses insure against the unexpected.

Much of this activity depends on fixed income, currency and commodity markets. These FICC markets establish the borrowing costs of households, companies and governments. They set the exchange rates we use when we travel or buy goods from abroad. They determine the costs of our food and raw materials. And they help our companies manage the financial risks they incur when investing, producing and trading.

Markets have become ever more important to people as they bear increasing responsibility for financing their retirements and insuring against risks. The suitability of those decisions will depend heavily on FICC markets. It is therefore vital that they work well. And are seen to do so.

The failures of FICC markets

Though markets can be powerful drivers of prosperity, markets can go wrong.

Left unattended, they are prone to instability, excess and abuse.

Markets without the right standards or infrastructure are like cities without building codes, fire brigades or insurance.

Poor infrastructure allowed the spark of the US subprime crisis to light a powder keg under UK markets, triggering the worst recession in our lifetimes.

– Poor "soft" infrastructure such as codes of conduct that too few read and too many ignored.
– Faulty "hard" infrastructure like interest rate and foreign exchange benchmarks that were quite literally fixed; and
– Weak banks whose light capital and heavy reliance on short-term funding created a tinder box.

Central banks shared in these failings, operating a system of fire insurance whose ambiguity was anything but constructive when global markets were engulfed in flames.

The Bank of England's general approach was consistent with the attitude of FICC markets, which historically relied heavily on informal codes and understandings. That informality was well suited to an earlier age. But as markets innovated and grew, it proved wanting.

Most troubling have been the numerous incidents of misconduct that exploited such informality, undercutting public trust and threatening systemic stability.

This has had direct economic consequences. Mistrust between market participants has raised borrowing costs and reduced credit availability. Falling confidence in market resilience has meant companies have held back productive investments. And uncertainty has meant people have hesitated to move job or home. These effects are not trivial, and they have reduced the dynamism of our economy in the post-crisis years.[1]

Widespread mistrust has also had deeper, indirect costs. Markets are not ends in themselves, but powerful means for prosperity and security for all. As such they need to retain the consent of society – a social licence – to be allowed to operate, innovate and grow. Repeated episodes of misconduct have called that social licence into question.

We have all been let down by these developments. And we all share responsibility for fixing them.

Real markets

I believe everyone in this room would agree: we need real markets for sustainable prosperity.

Not markets that collapse when there is a shock from abroad. Not markets where transactions occur in chat rooms. Not markets where no one appears accountable for anything.

Real markets are professional and open, not informal and clubby. Participants in real markets compete on merit rather than collude online.

Real markets are resilient, fair and effective. They maintain their social licence.

Real markets don't just happen; they depend on the quality of market infrastructure.

Robust market infrastructure is a public good, one in constant danger of under-provision because the best markets innovate continually. This inherent risk can only be managed if all market actors, public and private, recognise their responsibilities for the system as a whole.

The City has a special responsibility given London's pre-eminent position in global markets, which is why it has already brought so many ideas and such energy to advance financial reform.[2]

Financial reform is re-building real markets

Reform is strengthening the resilience of major banks. Their capital requirements have increased ten-fold and their liquid assets are up four-fold. These banks' trading assets are down by a third and intra-bank exposures by two-thirds.

Reform is ending the scourge of Too Big To Fail. The combination of eliminating the implicit public subsidy and increased capitalisation will correct the distortions caused by the structural under-pricing of risk on banks' balance sheets. And by making a further shift to market-based finance inevitable, it is increasing choice and competition – real market forces.

Reform is also improving risk transfer by untangling the complex web of derivatives that meant failures like Lehman triggered chaos; and by creating simple, transparent and comparable securitisation markets.

This reform agenda has increased the effectiveness of FICC markets and reinforced their social licence.

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1 See Haddow, A, Hare, C, Hooley, J and Shakir, T (2013) "Macroeconomic uncertainty: what is it, how can we measure it and why does it matter?", *Bank of England Quarterly Bulletin*, Q2. See also Bloom, N, *et al* (2014), "Really uncertain business cycles", *mimeo*.

2 Examples include the contribution of the private sector to: the development of revised ISDA protocols as part of efforts to tackle Too Big To Fail; improvements in disclosure under the aegis of the Enhanced Disclosure Taskforce; consultation over TLAC proposals; the establishment of the Banking Standards Council; and on-going work to develop the appropriate near-risk free reference rate for sterling markets.

It is frustrating for us all that such major progress risks being overshadowed by misconduct problems.

The fair and effective markets review

We must break the back of these issues, and the *Fair and Effective Markets Review* shows the way forward.

With its publication today, all the main building blocks are now in place for the real markets we need.

I want to pay tribute to my colleagues Charles Roxburgh, Minouche Shafik and Martin Wheatley, who so ably led the Review. And to salute Elizabeth Corley, who so expertly chaired the Review's independent Market Practitioner panel, canvassing and coalescing views from across the industry.

The importance and complexity of their task is illustrated by the multiple root causes of the misconduct in FICC markets. Specifically, the Review identifies:

– Market structures which presented specific opportunities for abuse, such as poor benchmark design, and which more generally were vulnerable to conflicts of interest, collusion, and thin markets;

– Standards of acceptable market practice that were usually poorly understood, often ignored and always lacked teeth;

– Firms' systems of internal governance and control that were incapable of asserting the interests of firms – let alone the wider market – over those of close-knit trading staff;

– Individual incentives that were skewed, with pay packages stressing short-term returns overlong-term value and good conduct;

– And personal accountability that was lacking, with a culture of impunity developing in parts of the market.

All these factors contributed to an ethical drift. Unethical behaviour went unchecked, proliferated and eventually became the norm. Too many participants neither felt responsible for the system nor recognised the full impact of their actions. For too many, the City stopped at its gates, though its influence extended far beyond.

A good start has been made in addressing these deficiencies.

The design and regulation of key FICC benchmarks has been overhauled and transparency in FICC markets is being enhanced. Compensation rules have, in the main, been transformed to align better risk and reward.

From next year, senior managers of banks and insurers will be held directly accountable for failures in their areas of responsibility. And the best firms are improving the "tone from the top", launching conduct training and revamping control structures.

But major gaps remain.

These are evidenced by enforcement actions which continue to appear with depressing frequency. These sanctions, while necessary, aren't the solution, not least since the $150 billion of fines levied on global banks translates into more than $3 trillion of reduced lending capacity to the real economy.

We need a better balance between individual and firm accountability. But who should be accountable? Against which standards? And with what consequences?

In these regards, I welcome the Review's recommendations that:

First, ***individuals*** must be held to account. Doing so requires new, common standards, cast in clear language; better training and qualifications for FICC personnel; and mechanisms to ensure that when individuals are fired, their history will be known to those who consider hiring them.

Second, ***firms*** must take greater responsibility for the system by improving the quality, clarity and market-wide understanding of FICC trading practices. I welcome the industry's leadership in drawing up plans for a new *FICC Market Standards Board*. The Board's mandate will be to establish readily understandable standards, keep them up-to-date with market developments, and promote adherence to them. Crucially, the Board will be dynamic, and will monitor and address areas of uncertainty in specific trading practices.

This is a major opportunity for the industry to establish common standards of market practice that are well understood, widely followed and, crucially, that keep pace with markets. If firms and their staff fail to take this opportunity, more restrictive regulation is inevitable.

To give these measures teeth, key elements of the Senior Managers Regime should be extended to all firms active in wholesale FICC markets, including dealers and asset managers. That means all senior managers would have clearly defined responsibilities and would be answerable for training, certifying and monitoring the material risk takers they supervise. The FCA should oversee compliance, redeploying resources to focus on Senior Persons. In turn, these individuals would be on the hook for promoting compliance within their organisations. Incentives will be aligned.

For the best in the industry, this won't be new. This is just how you run your business. But for others, who free ride on your reputations: the Age of Irresponsibility is over.

Third, ***regulators*** should extend the coverage of market abuse regulation to include every major fixed income and currency market. And criminal sanctions should be updated, with market abuse rules similarly extended and maximum prison terms lengthened.

Finally we need ***global*** standards for global markets. I welcome the FICC Markets Standards Board's intent to be as global as possible in its membership and influence. All major Central Banks and market participants have begun working on developing a new single Global Code for FX. I would encourage IOSCO to consider complementing these efforts with a similar initiative to cover FICC markets as a whole when they meet in London next week. The FSB will engage with these processes and work to improve the alignment between remuneration and conduct risk across the globe.

The Bank of England's role

All must play a role in building real markets, including the Bank of England.

Although the Bank does not regulate conduct or markets per se, it has responsibilities for, and powers over, the stability of the UK's financial system as a whole.

In the run-up to the crisis, the Bank's contribution to the effectiveness of markets fell short in three respects. In all cases, the Bank is now responding.

First, the Bank's framework for providing liquidity was shown to have lagged behind market developments. Once under pressure, the Bank could neither stabilise overnight rates nor support the banking system. Fortunately, in the jaws of the crisis, the Bank innovated rapidly and admirably to avoid a collapse of the system.

Those lessons are now embedded in a new, comprehensive framework for the Bank's sterling market operations. We have expanded the range of eligible collateral, and will lend to many more counterparties, at much longer maturities. The Bank also stands ready to act as a market maker of last resort.

Constructive Ambiguity has been replaced by Open for Business.

Second, like many others, the Bank neither identified the scale of risks in the system nor spotted the gaps in the regulatory architecture.

Following the Chancellor's reforms in the last Parliament, the Bank now has statutory responsibility to protect and enhance the stability of the UK's financial system, and is working as One Bank to do so. The FPC and the PRA have catalysed a series of actions that influence market resilience including stress tests of banks and hedge funds, system-wide capital actions, and new tools like the leverage ratio and minimum repo haircuts.[3]

Third, the Bank's arcane governance blurred the Bank's accountability and, by extension, weakened the social licence of markets.

Before my arrival, the Bank's governance was reshaped. The Bank's board of directors, Court, has been strengthened. Its external members now have formal powers to observe the meetings of the Bank's policy committees and to commission reviews into the Bank's performance.[4]

I welcome the Government's intention to introduce legislation further strengthening the governance and accountability of the Bank.

The Bank will continue to modernise its operations. Following the Grabiner report, the Bank has focused its Market Intelligence programme, strengthened procedures, improved training and overhauled compliance. And the Bank is introducing today a new code of conduct. The Bank expects its senior management to meet the highest standards of professional conduct. As one example, the Bank will apply the core principles of the Senior Managers Regimes to its own senior staff, including the Governor. This is in addition to existing obligations and scrutiny from Court, Parliament, the media and the general public.

And the Bank will continue to reinforce its commitment to openness and transparency. Minutes of Court meetings are now published with minimal delay. The Monetary Policy Committee will publish transcripts of its deliberations with an appropriate lag. Whenever there are difficult issues, outside reviews of the Bank's performance will be conducted, publicly released and acted upon.

Looking ahead

The Bank welcomes such scrutiny of our activities, including open debate about the cumulative impact of reform on the functioning of markets.

In particular, while the core of the system has been made more resilient, the combination of new prudential requirements on dealers and structural changes in markets has reduced market depth and increased potential volatility. This process likely has further to run, particularly as the normalisation of global monetary conditions edges closer. Firms and regulators should be alert to these developments, including their consequences for investment funds that offer daily liquidity while investing in securities that only appear liquid.

To be clear, more expensive liquidity is a price well worth paying for making the core of the system more robust. Removing public subsidies is absolutely necessary for real markets to exist. Volatility characterises such real markets and much of the pre-crisis market making capacity among dealers was ephemeral. However, the possibility of sharp, unpredictable changes in market liquidity poses a clear risk to financial stability, particularly when some

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3 See, inter alia, the Record of the FPC meeting held on 20th November 2013, which summarises the outcome of joint work with the FCA on "snap-back" risk; Bank of England (2014), "Stress testing the UK banking system: 2014 results", December; Bank of England (2014), "The Financial Policy Committee's review of the leverage ratio", October.

4 Including from a new independent evaluation office that reports directly to the non-executive Chairman.

market participants take liquidity for granted and crowd into trades in anticipation of central bank action.

The Bank is keenly alert to such risks. The FPC and the FSB are currently analysing these issues and welcome perspectives on whether the market, regulation or both should adjust for the good of the system.

Conclusion

With the main building blocks of reform in place, now is the time to take stock.

It's vital that we – public authorities and private market participants – work together to reverse the tide of ethical drift. This cannot be a one-off exercise. We need continuous engagement so that market infrastructure keeps pace with market innovation.

That's why the Bank is announcing that it will hold an Open Forum this Autumn which will bring together all stakeholders in FICC markets. Our goal is to discuss the prospects for market functioning, where regulations might overlap or conflict, and whether enough has been done to build the real markets the UK deserves.

To prompt an open discussion, we are publishing a detailed paper which reviews these issues and draws out such questions.[5]

Everyone has an interest in the future of financial markets, so I would strongly encourage you to engage with our Open Forum process online and at the conference itself. An Open and Accountable Bank welcomes your input.

Our response to recent failings should be as ambitious as those of our predecessors to the Great Fire: renewed prosperity built on private markets and public market infrastructure.

Let our legacy be the earthly equivalent of Wren's ethereal genius, real markets so that the City can do what it does best: transact and innovate for the good of the people of the United Kingdom and the world.

Thank you.

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5 See http://www.bankofengland.co.uk/markets/Pages/openforum.aspx.