



BANK OF ENGLAND

Speech

Turning back the Tide

Speech given by

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FICC Market Standard Board “Two years on from the Fair and Effective Markets Review”

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It is a pleasure to join the FICC Market Standards Board (FMSB) in reflecting on what's happened in the two years since the Fair and Effective Markets Review (FEMR). This afternoon I would like to assess recent progress in building real markets for the good of the people and discuss the forward agenda for your important work.

Two and a half years ago, FEMR set out a series of ambitious recommendations to restore confidence in Fixed Income, Currency and Commodities (FICC) markets.¹

The FMSB's work is an integral part of the FEMR solution.

Your work matters because UK markets are essential for global commerce.

The City has a special responsibility to address the root causes of misconduct given its pre-eminent position in global markets. The UK accounts for 40% of both global FX volumes and trades in OTC interest rate derivatives, and two-thirds of trading in international bonds. More international banking activity is booked in London than anywhere else.²

Your work matters because the financial sector is an important contributor to UK prosperity.

Finance is one of the largest sectors of the UK economy. Around 400,000 people are employed in financial services in London alone, 1.1 million across the country as whole.³ Their enterprise contributes £115 billion to our national income, £80 billion to our exports and £70 billion to the Exchequer, equivalent to two-thirds of the NHS budget.⁴

Your work matters because finance is not an end in itself; financial markets serve the real economy.

By financing firms that hire, invest and expand, markets drive growth.

By opening up cross border trade and investment, they create new opportunities for businesses and savers.

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

¹ See Fair and Effective Markets Review Final Report, HM Treasury, Bank of England and FCA (June 2015). At: <http://www.bankofengland.co.uk/markets/Pages/fmreview.aspx>

² See BIS Triennial Bank Survey (at <http://www.bis.org/publ/rpfx16fx.pdf>) and BIS OTC data at (https://www.bis.org/statistics/d12_1.pdf) and The City UK "Key facts about the UK as an international financial centre" (November 2016).

³ Workforce jobs and financial services jobs in London (ONS).

⁴ GDP and exports data (ONS), tax revenues from PWC/City of London "Total Tax Contribution of UK Financial Services" and NHS Budget data at: <http://www.nhs.uk/NHSEngland/thenhs/about/Pages/overview.aspx>.

Most fundamentally, your work matters because markets are the best mechanism to drive innovation, productivity, and prosperity.

The Problem

Though markets are generally a force for good, markets can go wrong.

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

Following the global financial crisis, a series of scandals ranging from mis-selling to manipulation undermined trust in banking, in the financial system, and to some degree, in markets themselves.

In FICC markets, misconduct was revealed on a scale that impaired their ability to function fairly and effectively.

The economic consequences have been enormous. Global banks' misconduct costs have exceeded \$320 billion, capital that could otherwise have supported around \$5 trillion of lending to households and businesses.⁵

More worrying still, an industry of the scale, importance and complexity of finance needs social capital as well as economic capital in order to operate, innovate and grow.

Repeated episodes of misconduct have called the social licence of finance into question.

In a system where trust is fundamental, it ought to be of grave concern that only 20% of UK citizens now think that banks are well run, compared to 90% in the 1980s.⁶

The scale of the challenge of restoring trust is thrown into sharp relief by the FMSB's comprehensive review of misconduct over the past two centuries. The history of financial fraud has rhymed all too frequently.

Potential Solutions

In the cycle of scandal, response, integrity, drift, and renewed scandal; potential solutions have oscillated between the extremes of Self Regulation and Total Regulation.

Recent difficulties illustrate the problems with each of these approaches.

⁵ See FSB Chair's letter to G20 Leaders "Building a safer, simpler and fairer financial system" ahead of the Hamburg Summit, (July 2017). Estimates of the impact on lending capacity are Bank of England calculations.

⁶ British Social Attitudes Survey (2013).

By undervaluing the importance of hard and soft infrastructure to the functioning of real markets, light touch regulation led directly to the financial crisis.⁷

Multiple factors contributed to a tide of ethical drift in FICC markets. Market standards were poorly understood, often ignored and always lacked teeth. Too many participants neither felt responsible for the system nor recognised the full impact of their actions. Bad behaviour went unchecked, proliferated and eventually became the norm.

Given the economic and social consequences of the ensuing disaster, it is right that regulators proscribe certain behaviours and set out their high level expectations. Yet, authorities cannot regulate for every circumstance, watch every transaction, or anticipate every market innovation. Total regulation is bound to fail because it promotes a culture of complying with the letter of the law, not its spirit, and because authorities inevitably lag developments in fast-changing markets.

But it doesn't have to be this way.

A more comprehensive and dynamic solution combines public regulation with private standards and then buttresses them with a series of hard incentives which materially increase individual understanding and accountability.

Market standards can be effective if they:

- Articulate clearly the market's collective view of best practice, with worked practical examples to clarify grey areas;
- Are grounded in, and are reinforced by, relevant regulatory frameworks and requirements;
- Are kept current; and
- Are given teeth by incentives that foster adoption and adherence.

An Early Assessment of the FMSB's work

So how is the FMSB doing in establishing common standards of market practice that are well understood, widely followed dynamically relevant?

The FMSB is already making an important contribution.

⁷ "Hard infrastructure" refers to the way in which markets are organised. "Soft infrastructure" refers to the standards and norms, including regulation, market standards and codes, by which markets operate.

Drawing on the expertise of its members, the FMSB has finalised standards that codify best practice with respect to: reference price transactions, commodity binary options, and new bond issues. A standard on risk management transactions for new bond issues is nearly final, and an earlier draft standard on FX stop-loss orders has been absorbed into the FX Global Code.

In each case, potential conflicts of interest are mapped to high-level principles designed to mitigate them. For reference price transactions, emphasis is placed on transparency with clients on mechanics and potential conflicts, and on mitigating the risk that the wider transactions of dealers could be market moving. The draft standard on risk management for new bond issuances sets out principles to mitigate risks around selection and formation of reference rates.

The FMSB's Statements of Good Practice, such as for surveillance of FX markets, provide more detailed guidance and worked examples to help set expectations.

The FMSB is also scanning the horizon for future misconduct risks, including through its innovative behavioural cluster analysis. Rightly, given rapid changes in underlying market structure, this process has prioritised work on vulnerabilities arising from fast automated markets.

Will These Standards and Codes Make a Difference?

We know from history that codes are of little use if nobody reads, follows or enforces them.

Why should the FMSB's efforts be expected to help reverse the tide of ethical drift? Indeed, given the long history of misconduct, aren't such efforts akin to King Canute rebuking the waves?⁸

I'm more optimistic that the tide will turn because the FMSB is part of a much broader effort by UK authorities and market participants. Together, we have created a comprehensive and mutually reinforcing set of measures that strengthen the hard and soft market infrastructure.

The resulting incentives give FMSB standards moral force and practical consequence.

First, in the FMSB's core work, the best in the market are taking responsibility for identifying and codifying best practice, in a way that complements and reinforces existing regulation. The FMSB now convenes senior participants from fifty global issuers, underwriters, asset managers, exchanges, custodians and investment banks. The breadth and engagement of the membership gives its standards credibility and creates peer pressure within the industry to promote adherence.

⁸ Canute, King of Denmark, England and Norway, 995-1035, reputedly set his throne by the sea shore and commanded the incoming tide to halt and not wet his feet and robes. Yet "continuing to rise as usual [the tide] dashed over his feet and legs without respect to his royal person. Then the king leapt backwards, saying: 'Let all men know how empty and worthless is the power of kings, for there is none worthy of the name, but He whom heaven, earth, and sea obey by eternal laws.'

Second, peer pressure within firms should reinforce standards and, more generally, the commitment to real markets.

Most banks have codes of ethics or business principles. These are necessary but not sufficient not least because it isn't reasonable to expect every trader to absorb their meaning or to translate them readily into live situations. But it is reasonable to expect them to use FMSB guidance to help recognise the differences between a real market and a rigged one. And it is essential that business cultures encourage everyone to call out market abuse when it occurs.

Third, buy-side pressure for proper behaviour is made easier by clear, practical standards. This is formalised in the example of the FX Global Code, where major central banks including the Bank of England, have confirmed that they intend to adhere to the principles of the Code, and that they also expect the same of their regular FX counterparties.⁹ Similarly, the Bank of England will adhere to the UK Money Markets Code and Precious Metals Code and will expect the same of its market counterparties.

Fourth, the combination of new arrangements for compensation, the expectations of the Senior Managers Regime (SMR), regulation and market standards are mutually reinforcing. In the UK, a significant proportion of the variable compensation of key decision-makers must now be deferred for a period of seven years to ensure it can be clawed back over the time scales it generally takes for conduct issues to come to light.

The SMR gives teeth to voluntary codes by incentivising firms to develop, adopt and embed them.

By requiring identification of the most senior decision-makers of banks, insurers and major investment firms, and setting requirements on them, the SMR re-establishes the link between seniority and accountability, strengthens individual accountability, and reinforces collective responsibility.

Senior Managers can now be held individually accountable if they fail to take reasonable steps (including training or proper oversight) to prevent or stop regulatory breaches in their areas of responsibility.

The SMR prescribes individual responsibilities – typically to the Chair and CEO respectively – for developing and embedding a firm's culture, alongside a collective responsibility for the Board.

And under the related Certification Regime, firms must also annually assess and certify the fitness and propriety of a wide range of risk-taking employees.

To help meet all of these expectations, Senior Managers can draw on market standards in order to explain and promote good practice, assess their risk-takers, and build a strong culture.

⁹ See the BIS Press Release on the FX Global Code, available at: <https://www.bis.org/press/p170525.htm>.

There are encouraging signs that the SMR is already beginning to make a difference.

For firms, it is clarifying and improving governance, accountability and decision-making processes. Senior Managers are increasingly focusing on building cultures of risk awareness, openness and ethical behaviour. In the words of one chair “responsibility for culture has moved to the top of my agenda.”¹⁰

For supervisors, the regime is helping identify weaknesses in governance and accountability, and to assess the fitness and propriety of senior managers and others in positions of responsibility, and whether the firm has an appropriate culture, and is encouraging the necessary changes.

In the first instance, consistent or widespread shortcomings would have consequences for compensation. More persistent failings could increase the capital that must be set aside for operational risks, and in the extreme, could influence our judgements regarding the fitness and propriety of senior managers.

Over time, market codes may become more firmly embedded still, something on which the FCA is currently consulting.¹¹

The Way Forward

The mutually reinforcing relationship between the regulatory framework and market good practice should help the FMSB, and other market standard-setters, maintain their ambition and momentum even once memories of post-crisis misconduct fade.

It could sharpen collective incentives to address, more conclusively, outstanding ambiguities that act as obstacles to real markets. And it should help mitigate emerging vulnerabilities.

The Bank of England encourages the FMSB to consider where additional guidance and worked examples could buttress its existing standards, to guard against the risk that certain principles mean different things to different parties.

The City’s special responsibility, given its pre-eminent position in global markets, is why it has brought so many ideas and such energy to advance reforms to address the misconduct risk that has plagued global markets.

¹⁰ See page 16, Financial Reporting Council (FRC), “Corporate Culture and the Role of Boards: Report of observations”, July 2016.

¹¹ In light of its responsibilities for conduct and market integrity, the FCA is consulting on an approach under which it would formalise that in supervising to, and enforcing, SMR rules for unregulated markets and activities, it would consider whether firms and individuals are meeting “proper standards of market conduct” with reference to “recognised” industry codes. See FCA CP17/37 available at: <https://www.fca.org.uk/publications/consultation-papers/cp17-37-consultation-paper-industry-codes-conduct-and-discussion-paper>

These efforts have helped set the international agenda, with many of the themes identified in FEMR are finding support more broadly, particularly in the work of the Financial Stability Board (FSB).

The FSB's misconduct action plan, presented to the G20 Leaders' Summit in July 2017, includes:

- (i) Developing new global standards of conduct in fixed income, commodities and currency markets, of the sort that the FMSB has championed, as well the FX global code, in which UK-based authorities and market participants played an important role;
- (ii) Direct measures to strengthen financial institution governance and compensation structures to align better risk and reward, including developing governance toolkits, which will address individual accountability, firms' risk culture, and the risk of 'rolling bad apples', (all of which are in place in the UK); and
- (iii) Reform of major financial benchmarks arrangements to reduce the risks of their manipulation.

I would like to say a few words about this final strand before concluding.

The goal of this work is to restore confidence in the integrity of key interest rate benchmarks globally. Reforms to the governance of Libor – which is vital hard infrastructure in UK markets and for many borrowers in the real economy – have gone a long way to meeting this objective. That is the good news. The bad news is that it has become increasingly clear that we cannot rely on Libor in the long term.

Libor is meant to measure banks' short-term unsecured funding costs. But the reality is that bank funding markets have changed, and banks no longer take enough wholesale term deposits to form the basis for a robust transaction-based benchmark.

As we have pointed out in the past, the result is that Libor is overly reliant on expert judgement rather than actual transactions. That situation is neither desirable nor sustainable.

There is also a risk that panel banks might withdraw from Libor and precipitate its collapse, which raises obvious financial stability concerns.

So there is a clear need for the authorities and market participants, across every sector, to come together, and transition to alternative benchmarks.

Under the auspices of the FSB, authorities in the UK, US, Japan and Switzerland have worked with market participants to identify alternative benchmarks. In the UK, the market-led Working Group on Sterling Risk Free Rates recently confirmed SONIA as its preferred alternative to Sterling Libor.¹²

Market participants in every sector and market that uses Libor now need to come together to identify and resolve issues, change business practices, and adopt alternative benchmarks.

To support the next phase of this work, the Bank and FCA are today announcing that from January, the Sterling Risk Free Rate Working Group will have a new mandate and wider representation from across the market. Its key objective will be to pursue a broad-based transition from Libor to SONIA by 2021. Buy side firms, issuers, infrastructure firms and trade associations will be brought into the Group alongside banks and broker-dealers.

We are under no illusions about the complexity of the task. Libor is embedded throughout the financial system in derivatives, loans, bonds and commercial contracts.¹³

The Bank and FCA are committed to supporting UK market participants as they prepare for the transition.

Reasserting London's Leadership of Real Markets

To conclude, two years on from FEMR, by working together, we are making enormous progress.

We are moving from markets that collapse when there is a shock from abroad to markets that are resilient.

From markets where transactions occur in chat rooms to markets that are professional and open.

From markets where few were accountable for anything to markets where everyone is responsible for their actions.

The FMSB is playing an essential role in this transformation.

When your standards are combined with more robust regulatory requirements, new compensation arrangements and the Senior Managers Regime, we are achieving what Canute could not.

The tide of misconduct is going out, revealing the real markets working for the good of the people of the United Kingdom and the world.

¹² To facilitate a smooth transition, the FCA has coordinated panel banks to support Libor until the end of 2021.

¹³ See the Record of the September FPC meeting at <http://www.bankofengland.co.uk/publications/Pages/Records/fpc/2017/record1710.aspx>