



BANK OF ENGLAND

Speech

Staying Connected

Speech given by

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I am grateful to Alice Carr, Ankita Mehta and Tim Taylor for their assistance in preparing these remarks.

Thank you Peter (Grauer) for that introduction and for hosting the inaugural Markets Forum.

This incredible Fosters + Partners building connects the Roman Temple of Mithras in its foundations to the glories of St. Paul's in its vista, while pushing the boundaries of sustainable office design.

It is a node in a global network that spins data, information, and capital instantaneously across the planet.

We have been reminded in recent years that networks have the power to divide, as well as connect. And we are here today to continue the process of reconnecting financial markets to the real economy.

Three years ago, in the wake of a series of scandals ranging from mis-selling to manipulation, and following a period when markets had become ever more connected to each other but disconnected from those they serve, the Bank of England, the Financial Conduct Authority and HM Treasury published the recommendations of the Fair and Effective Markets Review (FEMR).¹

FEMR was ground-breaking and ambitious in its recommendations to restore trust in the markets on which we all depend.

At today's event, policymakers and market participants will take stock of the progress in building fair and effective markets. And we will consider how to maintain focus as memories fade and the temptation to turn inwards returns.

We are doing so because we know that everyone has a shared interest in real markets.

Real markets are professional and open.

They are resilient, fair and effective, and they maintain their social license.

Real markets are not ends in themselves but serve the interests of end-users.

Real markets don't just happen. They depend on private actors and public initiatives to ensure the quality of market infrastructure.

That includes 'hard' infrastructure, the plumbing of markets that determines the mechanics of markets; and 'soft' infrastructure, like standards and codes that define how market participants should behave.

Since the crisis, the UK has played a leading role in addressing misconduct in domestic and global markets.

¹ See Fair and Effective Markets Review Final Report, HM Treasury, Bank of England and FCA (June 2015). At: <https://www.bankofengland.co.uk/report/2015/fair-and-effective-markets-review--final-report>

We know that the City has a particular responsibility given London's position as the pre-eminent global financial centre.²

What has been achieved?

So what has been done to re-build the necessary market infrastructures for real markets to thrive?³

In the UK, laws and regulations have been strengthened by, for example, introducing a criminal regime for manipulating benchmarks.

Public authorities know they cannot and should not try to legislate for every circumstance, monitor every transaction, or anticipate every market innovation. As FEMR recognised, while fines and sanctions have roles in deterring misconduct, they will not, on their own, bring about the cultural change needed.

We must move from an excessive reliance on punitive *ex post* fines of firms to greater emphasis on more compelling *ex ante* incentives for individuals, and ultimately a more solid grounding in improved firm culture.

This starts with reducing opportunities for bad behaviour, for example, by overhauling the regulation of key benchmarks in FICC markets.

It requires compensation rules that align risk and reward. In the UK, a significant proportion of variable compensation now must be deferred for a period of seven years.

To address the 'rolling bad apples' problem, mechanisms are now in place here to ensure that when individuals move on their history will be known to those who consider hiring them. Firms will be required to share information on breaches of individual conduct rules, their fitness and propriety assessments and outcomes around subsequent disciplinary proceedings.

These measures are all very constructive but they are not yet sufficient. That's why the Bank of England supports initiatives that ensure firms and their employees take greater responsibility – individually and collectively – for their own conduct.

UK authorities have used their convening powers to encourage market participants to establish standards of market practice that are well understood, widely followed and, crucially, that keep pace with market developments.

Industry has responded. The Banking Standards Board is promoting higher standards of conduct and competence across the UK banking system. The global FICC Market Standards Board (FMSB) is

² 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. And 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 a whole. 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.

³ This is set out in more detail in the FEMR Progress Report being published today at: <https://www.bankofengland.co.uk/markets/fair-and-effective-markets>

establishing readily understood standards for their markets. And the global FX Committees have published the FX Global Code, the first globally consistent code of conduct for FX markets.

But codes are of little use if nobody reads, follows or enforces them.

This is where the UK's Senior Managers Regime (SMR) comes in.⁴

Senior Managers Regime

The SMR gives teeth to voluntary codes by incentivising firms to develop, adopt and embed them. It is very welcome that the FCA is currently consulting on proposals to recognise industry codes publicly under the SMR.

By requiring identification of the most senior decision-makers, the SMR re-establishes the link between seniority and accountability, strengthens individual accountability, and reinforces collective responsibility.

As the SMR starts to bed in, there are encouraging signs that it is making a difference.

For firms, the SMR is clarifying and improving governance, accountability and decision-making. For supervisors, the regime is helping identify weaknesses in governance and accountability, and it is helping them to encourage the necessary changes.

Adoption is spreading. Some international firms are voluntarily adopting elements of the SMR's certification requirements to strengthen their global operations. A number of jurisdictions are applying the principles and features of the SMR.⁵ And elements of the regime are included as examples in the FSB's recently published toolkit on governance frameworks.⁶

While we cannot eliminate misconduct, these measures should reduce its scale and frequency, and they will broaden the sanctions for bad behaviour. All of this will help restore trust in financial markets so that they can work as effectively and efficiently as possible to serve the real economy.

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Today marks an inflection point, when we can celebrate what has been achieved but then look ahead to future challenges.

The spirit and intention behind FEMR is that continual focus is required because markets continually evolve.

⁴ The Government has legislated to extend the SM&CR to all other FSMA authorised financial services firms. As a first step, the Government will extend the Regime to insurance firms from 10 December 2018 and will confirm when the Regime will be extended to firms regulated solely by the FCA in due course.

⁵ The Hong Kong Securities and Futures Commission implemented a Manager in Charge Regime (MICR); the Australian Parliament has recently passed legislation establishing a Bank Executive Accountability Regime (BEAR); and the Monetary Authority of Singapore has published Proposed Guidelines on Individual Accountability and Conduct

⁶ The FSB Report on Strengthening Governance Frameworks to Mitigate Misconduct Risk can be found here: <http://www.fsb.org/wp-content/uploads/P200418.pdf>

That's why the Bank and the FCA are taking a proactive, forward-looking approach to identifying vulnerabilities in hard and soft market infrastructure. We see this as core to our institutional responsibilities. Indeed, the Bank has made catalysing structural reforms in financial markets, such as the new risk-free benchmarks that I'll turn to in a moment, one of its core strategic goals.

But the authorities cannot future-proof alone. We rely on industry to help us scan the landscape for emerging risks and to help determine ways to mitigate them.

We are encouraged by your efforts. In particular, the FMSB is undertaking horizon scanning for future misconduct risks through its innovative behaviour cluster analysis; and the Global Foreign Exchange Committee, which is responsible for keeping the FX Global Code 'alive', has already identified areas of further work on spot FX market practices.⁷

With the leaders of the industry here, we hope that today's discussions will identify emerging risks and challenges, and explore how we can all work together to address potential vulnerabilities as we continue to build real markets for the good the people of the UK and beyond.

In this spirit, before concluding, I want to briefly touch on one of the biggest challenges facing us right now – the transition to Risk Free Rates.

The move to new Risk Free Rates

Libor is a prime example of critical hard (market) infrastructure that has not kept up with market developments. Libor is meant to measure the short-term unsecured funding costs of banks. But the reality is that, since the financial crisis, Libor really has become the rate at which banks don't lend to each other.

Bank funding markets have changed enormously. Banks no longer take sufficient short-term wholesale deposits to form the basis for a robust transaction-based Libor benchmark.

As a result Libor is overly reliant on expert judgement rather than actual transactions. And global markets remain overly reliant on Libor, a benchmark that may not exist beyond 2021. That reliance is neither desirable nor sustainable.

That's why authorities internationally have worked with market participants to identify alternative benchmarks based on actual transactions. These are overnight rates – a relatively pure read on risk-free rates in each economy.

In sterling, the market has chosen SONIA, a benchmark now administered by the Bank of England. In April we implemented reforms to SONIA that boosted the volume of transactions captured by a factor of three to £50bn per day.

⁷ These areas are: the role that 'cover and deal' and similar trading models play in the FX market; how market participants adjust their pricing on E-Trading Platforms and when trading by voice; and, disclosures regarding last look practices.

The focus now is on transition. Market participants in every sector and market that use Libor now need to come together to identify and resolve issues, change business practices, and adopt alternative benchmarks. In sterling, over 90 institutions, including banks, law firms, corporates, asset managers, trade associations and infrastructure firms, are directly involved in this effort supported by the Bank and FCA.

Transition to SONIA will bring a number of benefits.

Market participants can have the confidence that SONIA faithfully represents conditions in a deep underlying market.

They can also be assured that SONIA's design is robust to future changes in money markets because, if necessary, SONIA's data inputs can evolve.

Near risk-free rates like SONIA are a better reflection of the general level of interest rates than Libor – which is affected by fluctuations in the perceived credit quality of banks (as well as other technical factors as seen recently). Interest payments for benchmark users should be less volatile as a result, especially in times of stress, and products referencing SONIA should provide a better hedge for duration risk.

Over time the private sector will develop a wider range of products referencing SONIA. Futures contracts have already been created. We can expect Floating Rate Notes and loans referencing SONIA to follow. The end point should be an ecosystem for interest rate markets which has an altogether healthier foundation than at present.

Developing the infrastructure around the near risk-free benchmarks globally, and assisting market participants in dealing with legacy Libor portfolios, is a significant opportunity for innovation. Firms here in London are well placed to take advantage.

As mentioned, international authorities are working closely together, and I know Bill Dudley is going to pick up the baton and talk more about the transition to risk-free rates from a US perspective.

It is an immense pleasure to introduce Bill.

It is an honour that he is here at this Markets Forum to give his last keynote speech as President of the New York Federal Reserve. And it is appropriate given his deep commitment to fighting misconduct and improving standards of behaviour in the institutions we regulate and supervise. Bill had the wisdom to appreciate quickly how cultural and ethical issues lay at the heart of the global financial crisis, and he has been a consistent and strong voice in arguing for what needs to be done to improve individual behaviour, firm culture, and industry ethics.

On behalf everyone, I would like to thank you Bill for your many, invaluable contributions throughout this exceptional period for financial markets and the global economy.

On a personal note, I will greatly miss your deep technical expertise, open-mindedness, wisdom, good humour and friendship. Today isn't really goodbye but au revoir.

Because, whether it is the financial system or as colleagues, we know the future will be better if we stay connected.