BANK OF ENGLAND

Speech

Making markets fair and effective

Speech given by

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Making Markets Fair and Effective

It is a real pleasure to be giving my first speech as Deputy Governor of the Bank of England at the London School of Economics (LSE). It resonates on so many fronts. The LSE has produced many members of the Monetary Policy Committee, Deputy Governors and indeed Governors of the Bank of England as well as vast numbers of its staff over the years. I was taught macroeconomics at the LSE by Charlie Bean, one of my predecessors at the Bank as well as by my host this evening, Nick Stern, when I did the MSc in economics. And the topic of my speech tonight resonates with the origins of the LSE as an institution that always sought to bring the best of academic thinking to the pressing problems of the day.

As you will no doubt realise by the frequency of misconduct stories in the papers, Fixed Income, Currency and Commodity (or FICC) markets are certainly dealing with pressing problems. The Fair and Effective Markets Review – which I am leading along with my co-chairs, Martin Wheatley from the Financial Conduct Authority and Charles Roxburgh from the Treasury – was set up to restore confidence in the operation of these markets.

We don't want to do this alone. That is why we have launched a consultation document today soliciting the views of anyone with an interest in FICC markets. The consultation is open for three months, and we will issue our final recommendations in June. In the meantime we want to work closely with:

- Market participants – who have the primary responsibility for putting things right. We have enlisted the help of a panel of senior market practitioners to help launch and take forward the Review's final recommendations.
- International policymakers and regulators – because these markets are global in scope, although a significant share of these markets is based in London.
- The academic community – with which we are actively consulting – including the audience here tonight.
- The general public - including companies and households, for whom, I will argue, these markets matter most of all.

In the rest of my speech I would like first to dismiss any notions you may have that Fixed Income, Currency and Commodity markets don't affect your lives. Then I'll talk about what went wrong in these markets and why, including a discussion of some of the markets' key characteristics. I'll then outline some of the changes that are already under way, before finally asking what more needs to be done and outlining some of the questions our Review will be asking.

Why Fixed Income, Currency and Commodity markets matter

I want to start on a personal note. I was born in Egypt but left at a very young age when my family lost everything as a result of nationalisations under the Nasser government. It was a time when many well-intentioned people thought that the state could do a better job of allocating resources and managing economic activity than the market. That view was proven wrong. Perhaps as a result of that experience, I have spent large parts of my professional life thinking about the relationship between the state and the market. The perspective I have reached is that well-functioning markets are the key to prosperity, but that they must operate in ways that are fair and effective to sustain public support and confidence.

By “fair and effective” I mean markets should allow their ultimate end users to invest, fund themselves, and transfer risk in a resilient and predictable way, on the basis of competitive prices. They should offer appropriately open access and transparency. And they should operate according to clear standards of market practice and integrity.

Why should you care about Fixed Income, Currency and Commodity (or FICC) markets? Firstly they are huge. Figure 1 gives you a sense of the scale – the global stock of bonds were worth about $100 trillion in 2013 – bigger than world GDP. So-called “over the counter” derivatives in FICC markets had a market value of around $18 trillion (Figure 2). And the turnover in foreign exchange markets is over $5 trillion on a typical day. That means that the value of trades in a month, in this single market, is roughly equal to the value of all output produced by every worker in the global economy in a year.

These numbers are so big they may make these markets seem somewhat otherworldly to the average person. But in reality they permeate almost all of our economic transactions. Fixed income (or bond) markets matter for our savings and pensions. They matter for the public finances and how much tax we have to pay. They affect the interest we pay on our debts. Currency and commodity markets affect the prices we pay when we go shopping, and the cost of changing money when we go on holiday. FICC markets also affect the ease with which employers can raise finance, which in turn affects their very viability, the level of their investment, and potentially the structure of our economy. Far from being otherworldly, these markets really matter to us all.

The pall of misconduct in Fixed Income Currency and Commodity markets

The shadow of the worst financial crisis in living memory has been significantly lengthened by a series of appalling cases of misconduct in Fixed Income, Currency, Commodity and other markets. Details of these began to emerge relatively late in the crisis, but they have proved surprisingly prevalent and persistent. And they have further eroded the trust of the general public in financial markets. Public outrage is based on the view that the rewards in finance are disproportionate and that the system is rigged. When people read of malpractice in financial markets, of trading profits being claimed through manipulation, collusion or dishonesty, they naturally wonder if they are one of the people who have been wronged.

In fixed income, employees in firms around the world attempted to manipulate Libor, Euribor and other similar measures of short-term borrowing costs in order to benefit themselves or some other part of their firm’s business. In the United States and elsewhere, firms structured the mortgages or other assets used to back securitised assets, or misrepresented the nature of those underlying assets, in ways inconsistent with the interests of end investors. Regulators identified systematic attempts to mis-value and otherwise engage in market misconduct in relation to large scale positions in credit default swaps. In commodities markets, traders were found trying to manipulate physical or derivative prices, including those of gold, oil, lead, platinum, palladium and coffee. And investigations of further cases and criminal actions, in foreign exchange and other markets, remain ongoing.

Some of the cases already brought by colleagues at the Financial Conduct Authority have resulted in the publication of truly shocking evidence about the behaviour by some individuals in these markets. What particularly struck me in reading some of that evidence was how casual their attitude appeared to be towards the abuses they perpetrated. In one example, a trader mentioned to his manager that he had asked a colleague to lower the firm's Yen Libor submission, adding that "every little helps…it's like Tescos." Was the manager concerned? Not a bit of it. "Absolutely, every little helps", he replied.[1] Some individuals seem to have enjoyed a perverse kind of prestige from their involvement in the process. One Libor submitter was told by a grateful trader for whom he had manipulated a submission that his "name will be written in golden letters" should he ever write a book on the business.[2]

As somebody who believes in markets, I find this behaviour outrageous.

How did this happen?

How did this happen? Some academics I have spoken to think that part of the answer may lie in the field of moral psychology.[3] That view suggests that initial transgressions occur because many decisions taken by those in financial markets are done by way of automatic, fast thinking – "System 1" thinking in the language of Nobel Prize winner Daniel Kahneman[4]. For participants to acknowledge that such actions are questionable would in fact require the activation of slower, more effortful "System 2" thinking. The initial transgression may be small, but the culmination of many small transgressions can result in a set of behaviours which would normally be unacceptable becoming the norm, and an undesirable culture becoming ingrained. This is a version of the old proverb that one bad apple spoils the whole barrel.

But the initial argument that it is just the case of "a few bad apples" is no longer credible. Instead it seems that there were deep rooted problems in the nature of FICC markets that resulted in practices that would be unacceptable elsewhere. As the Archbishop of Canterbury put it at a recent panel on ethics and finance at the IMF: "bad business models can corrupt good people." Perhaps there is something also wrong with the barrel?

[1] http://www.fca.org.uk/your-fca/documents/final-notices/2014/lloyds-bank-plc-bank-of-scotland-plc.pdf
[2] http://www.fsa.gov.uk/static/pubs/final/barclays-jun12.pdf
[3] I am particularly grateful to Nicholas C. Barberis for this exposition.
[4] Daniel Kahneman (2011), Thinking Fast and Slow, Macmillan.

The Characteristics of the Fixed Income Currency and Commodity markets

So what are the distinctive characteristics of FICC markets, and how might they have contributed to these problems?

First and foremost, the FICC markets are notable for their heterogeneity. That reflects a key role of many FICC markets in providing bespoke instruments, tailored to meet the needs of investors and issuers. For example, while there are just under 2,500 publicly listed equities in the UK, there are over 11,000 different UK corporate bonds. In the US the disparity is even starker, with more than 36,000 bonds compared with just over 5,000 listed stocks.

To facilitate such heterogeneity, many FICC markets have historically been built around a "market-making" trading model, in which participants trade bilaterally with an intermediary, rather than directly with other investors. For example, in corporate bond markets a market maker will build up an inventory of different corporate bonds when there are net sales from end investors, and run it down when there are net purchases.

An important advantage of the market-making system is that, when it works effectively, it provides investors with continuous two way markets. Government and corporate borrowers can generally be confident that they will be able to borrow at a time, in a currency, and for a duration that suits them. Similarly, investors can feel confident that they will be able to trade smoothly in and out of sometimes large positions without unduly affecting the market price.

The downside of the heterogeneity of many FICC assets is that the market in specific instruments can sometimes be thin, and hence it may be difficult to gauge what a fair price is. Publicly available quotes can be based on a limited number of small transactions, making them more vulnerable to manipulation.

Another characteristic of FICC markets is that they tend to be dominated by large professional counterparties. This means that most participants can be assumed to be highly knowledgeable about the products they trade, and capable of making educated investment decisions. As a result these markets have historically tended to work primarily on the principle of *caveat emptor* – or "buyer beware."

In legal terms, *caveat emptor* expresses the basic principle that a buyer of property purchases it at his or her own risk, and that — unless expressly agreed otherwise with the seller — there is no guarantee that the value of that property will not fall. In such circumstances, market participants should invest time and energy in looking after their own interests, voting with their feet when they are poorly treated. Such market discipline has historically always been thought of as a key bulwark against widespread abuse in FICC markets. However, *caveat emptor* has never meant "anything goes", and certainly does not trump the obligation on a firm to act honestly, fairly and professionally.

Change is happening

The structure of these markets is already changing, and recent high profile enforcement actions have brought sharply renewed focus on conduct issues, particularly where they are seen as targeting individuals.

The FCA has a "credible deterrence" enforcement strategy, and recently highlighted its intention to pursue a more proactive approach to wrongdoing in wholesale markets. Since 2010 it has issued 15 final notices for misconduct in FICC markets and imposed more than £700 million in financial penalties. And it isn't just the UK: the most high profile enforcement cases to date, involving the manipulation of short-term interest rate benchmarks, have affected every major financial centre, including London, Singapore, Frankfurt and Tokyo, and have already resulted in global fines totalling nearly £4bn, by authorities in the United States, the United Kingdom and Europe.

Good progress has also been made on the design and regulation of benchmarks. In the United Kingdom, the design and administration of Libor has been overhauled, and a new regulatory regime was introduced in 2013, following the Wheatley Report. In August this year, as its first act, the Fair and Effective Markets Review recommended to HM Treasury that this regime should be extended to cover a further seven major UK-based benchmarks: SONIA, RONIA, the WM/Reuters 4pm London Fix, ISDAFix, the London Gold Fixing, the LMBA Silver Price and the ICE Brent futures contract. The International Organisation of Securities Commissions (IOSCO) has introduced a new set of standards for benchmarks, and the Financial Stability Board (FSB) has produced detailed reports on the priorities for further reform of interest rate and foreign exchange benchmarks.

A number of broader regulatory, market and firm level initiatives are also under way in this area. The second Markets in Financial Instruments Directive (MiFID 2) is expected to have a major impact on the structure of FICC markets across Europe, with new transparency measures expected to transform the way that they function. And the European Market Abuse Regulation (MAR) will greatly extend the coverage of market abuse provisions over FICC markets. Internationally, the programme of derivatives reform led by the G20 will see large sections of the derivatives market moved onto organised venues for the first time. And foreign exchange committees have committed to developing a set of global high-level principles on FX trading.

Closer to home, there have also been a number of initiatives aimed at improving culture and behaviour at a firm and individual level, including the UK Parliamentary Commission on Banking Standards, the Banking Standards Review Council (BSRC), and widespread efforts by individual firms to strengthen internal controls. The introduction of malus, bonus clawback and the Senior Managers and Certification regime in the UK will strengthen accountability as well.

Is it enough?

This range of initiatives should make markets more fair and effective. But we need to make sure that taken together they add up to a comprehensive solution to fix the barrel and to get rid of the bad apples.

A primary aim of our Review is to take stock, and ask whether the extent of regulatory, organisational and technological change since the crisis will be sufficient to ensure FICC markets are fair and effective in the future. Over the next three months, we want to hear from those directly active in those markets, from the companies and households who rely on them, from academics, and from public authorities globally.

Our approach will be explicitly forward looking. And we have no hidden agenda. Where we judge changes that are already under way to regulation, firm-level controls, market structure and technology are sufficient to restore fairness and effectiveness, we will say so. Where we do not, we will make recommendations on the most important priorities for change.

A defining characteristic of our Review is a recognition that improving fairness and effectiveness is a shared responsibility between individuals, firms, the market as a whole and the public authorities. As I said at the outset, we believe that markets – when they work properly – are the best source of dynamism, prosperity and progress. So I expect that a key part of the Review's final recommendations will consist of firm- and market-led initiatives.

With that in mind, we will draw on input from an independent panel of senior market practitioners, chaired by Elizabeth Corley of Allianz Global Investors, and bringing together senior representatives of internationally active market participants and investors, market infrastructure providers, major corporate users of financial markets, and independent members. The final recommendations of the Review will be made by me and my co-chairs with the support of the excellent team we have assembled. But we hope the Panel will help launch and take forward those parts of the final recommendations requiring active market ownership.

Where firm-led solutions are not enough to improve fairness and effectiveness, targeted interventions by the authorities will also be part of the Review's toolkit.

Where might the solutions lie?

The scope of our consultation is potentially huge. So I want to say a few words about how we will give focus to our work, and to give a sense of the questions we are asking in our consultation document.

The framework we will be using is shown in Figure 3. It divides up areas where the fairness and effectiveness of FICC markets may be deficient into six categories. Three of these relate to the structure of those markets: so-called market microstructure; competition and market discipline; and benchmarks. And three relate to conduct: standards of market practice; firm-level responsibilities, governance and incentives; and surveillance and penalties. Let me say a little more about each in turn.

1. Microstructure

The first category relates to the **microstructure** of FICC markets – covering such things as the arrangements for trading, price transparency, market access and the range of asset types. As I noted earlier, many of the products in these markets are tailored to the specific needs of individual borrowers or investors. Although that may be good news for them, it does mean that quite a number of FICC markets are relatively thin and lack widespread transparency and are hence intrinsically more vulnerable to manipulation. So there may be a tradeoff between the benefits of customisation, and the costs in terms of weaker liquidity and potentially greater vulnerability to abuse.

Regulatory and technological change is already leading to greater standardisation and transparency across many FICC markets. In the consultation document, we ask whether that process should go further, whether through industry-led standardisation, removing barriers to entry for new electronic trading platforms or utilities, or further transparency enhancements to practices such as new issue allocation. Or could imposing standardisation or transparency standards in excess of those already in place harm, rather than enhance, market functioning and risk transfer?   Do practices such as 'internalisation' – where banks match off client orders internally – pose any challenges?

2. Competition and market discipline

The second structural category is **competition and market discipline**. Concentration in some FICC markets is relatively high both amongst intermediaries and amongst the major asset managers, and has risen further since the financial crisis. For example, the top six dealers account for over 60% of the UK interdealer FX market. In some cases, firms have also engaged in horizontal or vertical integration – raising potential conflicts of interest and concerns about information asymmetries. A number of recent misconduct cases have involved attempted collusion, abuse of market power or inadequate management or control of conflicts. The ability of FICC market participants to exercise market discipline against those engaging in misconduct may also have diminished somewhat in recent years.

At the same time, the market maker system has delivered important benefits, including tight pricing and deep and near-continuous liquidity in a wide range of market conditions. That model is now changing, as increased risk aversion and regulatory reforms designed to return the cost of liquidity and capital to more sustainable levels favour more agency-based trading models. The potential diminution of liquidity in some FICC markets has been raised as a concern by many investors and end-users.

This is therefore a finely balanced issue for us to explore. How are competitive conditions likely to change, and what lessons can be learned from other markets, both in the financial sector and more widely? What could be done to strengthen market discipline? Is there sufficient awareness of the scope and nature of the authorities' competition powers? And how best can conflicts of interest intrinsic to specific trading models be managed?

3. Benchmarks

The third category is **benchmarks**. There has already been substantial reform in this area, as I have mentioned, and more is on its way. The question we ask in the consultation document is whether this goes far enough. Could steps be taken to reduce or diversify the reliance of asset managers and other investors on benchmarks? Are there additional changes that could be made to improve their design, construction and governance? What further measures are required to ensure full compliance with IOSCO's standards for better benchmarks? And how can the regulatory framework provide protections to market participants in other jurisdictions in a proportionate way?

We then turn to the three conduct categories. As I mentioned at the outset, every act of misconduct starts with an individual's decision – and that individual should be accountable for that decision. But that decision is also heavily shaped by the environment or "the barrel" that individual works in – by the standards or norms established by regulation, market practice and firm-level expectations; by the extent to which responsibilities are clearly allocated and governed; by the incentives that an individual is given, financial or otherwise; by the perceived probability of being caught; and by the expected penalty if he or she is caught. The recent speeches by Bill Dudley[5] and Dan Tarullo[6] of the US Federal Reserve at a workshop on reforming culture and behaviour in the financial services industry set these issues out very nicely.

4. Standards of market practice

We start with **standards or norms of market practice**. On one view, the existing regulatory provisions and voluntary codes – and there are many of the latter – provide a sufficient guide to expectations of market practice. If that is the case, the main priority should be enforcement actions against those who are in breach, and a parallel process of ensuring that all FICC market participants understand the implications of those provisions. The Review explores a number of ideas for deepening that education process and encouraging more of Kahneman's "System 2" type thinking.

A further question is whether there is a need to supplement existing rules and codes with more specific market-wide guidance or rules on acceptable market practice on a global basis for global markets. The regulatory perimeter is being extended in Europe, and codes covering foreign exchange markets are being

[5] http://www.newyorkfed.org/newsevents/speeches/2014/dud141020a.html
[6] http://www.federalreserve.gov/newsevents/speech/tarullo20141020a.htm

updated. Market participants have nevertheless identified a range of market practices to the Review where they believe further guidance would be helpful.

Put another way, is there more that we need to do to embed acceptable behaviours into participants' rapid reaction "System 1" responses to situations of conflict? How can codes of conduct be given real 'teeth', whilst also remaining consistent with the many different national regulatory regimes and voluntary codes already in place? How can it be customised to the individual conditions in specific markets? How can it be couched in language that traders can immediately understand? And could it be owned by the industry – or does it ultimately need to be embedded in regulation, if necessary through an extension of the regulatory perimeter?

5. Responsibility, governance and incentives

The penultimate category in the table looks at how firms can ensure that standards, once set, are adhered to – through appropriate internal **responsibility, governance and incentive** mechanisms. It is clear that, in the run-up to the crisis, some firms active in FICC markets had allowed the culture on their trading floors to get out of control, combining weak controls with incentives focused heavily on short-term revenue performance. In such structures, focus on maintaining a firm's reputation – normally a bulwark against misconduct – became heavily diluted, with some traders feeling greater loyalty to their desk or peers in the market than to their firm.

A lot has happened in this field since the crisis. The better alignment of incentives has been a key plank of the reform agenda. In the UK, we are looking to introduce strong new accountability measures through the proposed Senior Managers and Certification regime, and new powers to defer payment of bonuses, or where necessary even claw them back. Several banks have already moved to withhold bonuses or cut bonus pools as the result of recent misconduct cases affecting their firms. Such moves make it more likely that individuals will ultimately face the long-term consequences of their choices.

But looking more broadly, the risk is that, as memories of recent enforcement cases fade, bad practices may re-emerge. Some say that may already be happening. We want to ask what more can be done to hardwire sounder approaches, including improved measures for appraising performance, promotion and advancement of individuals; better safeguards against inappropriate staff moves; ways to strengthen the role of boards in the governance of FICC activities; and ways to strengthen the role of front line managers, the so-called first line of defence.

6. Surveillance and penalties

However successful we may be in introducing stronger standards, and incentivising people to follow them, attempted misconduct will still occur. So the Review also wants to consider whether more needs to be done to **monitor for, and where it is found punish, misconduct**. Firms should be at the frontline of these efforts. Underdeveloped monitoring systems and poor procedures for dealing with internal misconduct undoubtedly played a role in recent years. Though approaches to these issues have since improved, the Review is keen to identify examples of best practice, and ways in which the authorities can catalyse further progress. Questions we raise include the scope for stronger firm-level whistleblowing regimes, the role for electronic surveillance tools, penalties imposed by firms for staff breaching internal guidelines (and ways to publicise such cases), and the extent to which firms can punish poor behaviour by other firms by shifting business and reporting such behaviour to the authorities.

Conclusion

Let me come to a conclusion.

We are slowly emerging from the worst economic crisis in living memory. Much has been done to strengthen the financial system since then: banks hold much more capital, they have more effective liquidity support, major progress has been made on ending Too Big To Fail on the global stage, and in the UK we have transformed the way that we regulate banks and how we set policy to deliver financial stability.

But some of the benefits of these advances are being offset by a long tail of outrageous conduct cases. These are like salt rubbed into the wounds to public confidence in financial markets. This is in no one's interest. Many leaders in the financial industry and the majority of those who work in these markets are ashamed of this bad behaviour and want to find a way to put it comprehensively behind them. The fines alone have been sufficiently large to require substantial reshaping of firms' businesses.

I am confident we can find a way forward. I recall the story of when the Queen visited the LSE in November 2008 and asked the gathered assembly of eminent economists why had nobody noticed that a crisis was on its way? The reply came in the form of a letter from the British Academy[7]. Their bottom line was that the crisis was caused by "a failure of the collective imagination of many bright people, both in this country and internationally to understand the risks to the system as a whole." This is a moment when we need collective imagination – to imagine financial markets that are fair and effective and work in the interests of all of us.

[7] http://www.britac.ac.uk/templates/asset-relay.cfm?frmAssetFileID=8285

Figure 1: Global financial assets

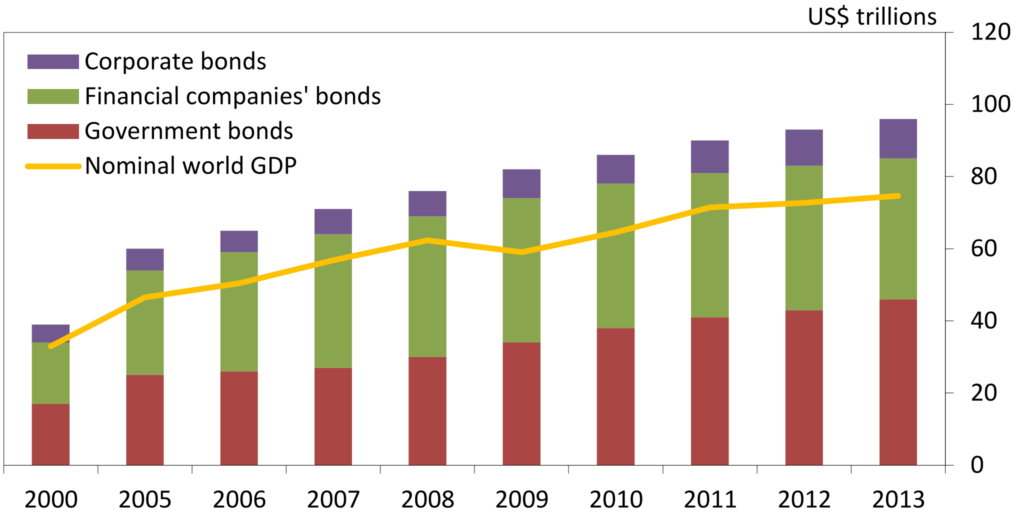

Figure 2: Market value of FICC derivatives contracts

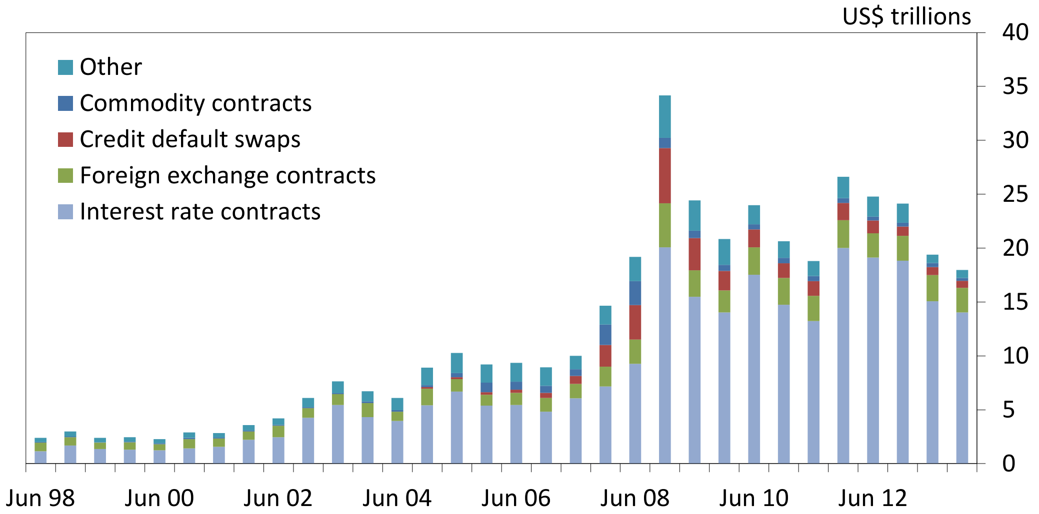

Figure 3: The Review Framework

	Potential source of vulnerability	Possible responses by			
		Markets	Firms	Individuals	Regulators/ Legislators
Structure	Market microstructure				
	Competition and market discipline				
	Benchmarks				
Conduct	Standards of market practice				
	Responsibilities, governance and incentives				
	Surveillance and penalties				