BANK OF ENGLAND

Speech

From darkness cometh light? Some early messages from the Fair and Effective Markets Review consultation responses

Speech by

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[1] Check Against Delivery

Introduction

Thank you for the invitation to address you today – it is a pleasure to be here.

Much of the agenda for your conference is strikingly optimistic: developments in renminbi markets; the changing shape of fixed income trading; the new landscape for foreign exchange; the EU Capital Markets Union; and innovative ways to use 'big data' and other analytical techniques. It is good to see the wholesale markets looking forward, seeking out new opportunities, and facing the realities of regulatory and technological change with a sense of purpose and resolve. That dynamism is essential to the prosperity of everyone, and central to financing the global recovery.

And yet these remain dark days for the financial sector in the eyes of the public. Barely a month goes by without some new allegation of manipulation or deception. Repeated attempts to draw a line under the past and move forward have apparently failed. Like the mythic Greek King Sisyphus rolling his boulder up the hill only to see it fall back down again and again, the industry seems locked in an endless cycle of blame and redemption. Restoring public trust must be, and is, a top priority. But it is much, much more than a PR exercise – because trust lies at the very heart of how financial markets operate. Without it, markets cannot function.

The contrast between the bright promise of the future, but an apparent inability to escape the dark burden of the past, was the catalyst for the launch of the Fair and Effective Markets Review[2] by the Chancellor and the Governor of the Bank of England at the Mansion House in London last summer. The aim of the Review, a joint initiative by the Bank of England, the Financial Conduct Authority (FCA) and HM Treasury, is to reinforce confidence in wholesale fixed income, currency and commodity markets – or 'FICC' for short. Sadly, misconduct has stretched well beyond FICC alone in recent years. But anything that impairs the operation of FICC markets affects us all – because these are the markets that determine the borrowing costs of households, companies and governments, set countries' exchange rates, influence the cost of food and raw materials, and help companies manage financial risks associated with investment, production and trade. The reputation of those markets has been laid low by a series of dreadful abuses involving collusion, benchmark manipulation, the structuring of assets designed to undermine the interests of end-investors, deliberate mis-valuation of positions, and abuse of confidential information. That loss in reputation has in turn impaired the effectiveness of these markets, causing intermediaries, investors and other end-users to rein in otherwise desirable levels of risk taking, and diverting huge amounts of management and financial resources. We must put that right.

The Fair and Effective Markets Review is aimed at getting to the bottom of three key questions. First, what were the real root causes of the misconduct seen in recent years? Second, how far have firms and regulators already put in place the changes needed to put things right? And, third, what remains to be done?

[2] For further information on the Review, and copies of its key publications, see http://www.bankofengland.co.uk/markets/Pages/fmreview.aspx

The consultation

To help answer these questions, the Review issued a consultation paper at the end of October, and we have reached out far and wide, both in the UK and overseas. The consultation formally concluded at the end of January, and we have just published getting on for a thousand pages of written responses on the Review's website[3]. Today, I want to give you a flavour of what we have heard. I should stress right up front however that no decisions whatsoever have yet been taken on what the Review will recommend. Those recommendations will be fully independent, and will be set out in June by the Review's Chair, Minouche Shafik of the Bank of England, and Co-Chairs, Charles Roxburgh of HM Treasury and Martin Wheatley of the FCA. Nothing should be read into what I say today about the potential shape of that policy package – it is simply too soon to know.

A particularly welcome aspect of the consultation was the breadth of responses, which came from, amongst others: public interest bodies such as Transparency International, Ofgem and the Law and Ethics in Finance Project; issuers such as GE Capital, EDF and those represented by the Association of Corporate Treasurers; investors responsible for managing public savings, both large and small, from Blackrock to Aberdeen Asset Management and M&G; long-standing and new infrastructure providers, including the London Stock Exchange and TradeWeb; and a broad range of banks and other market intermediaries. As befits markets that are global in scope, substantially more than half of the responses came from overseas organisations, or organisations with a significant international presence. We received a particularly comprehensive response from the Review's Market Practitioner Panel (MPP), chaired by Elizabeth Corley of Allianz Global Investors. AFME and GFMA have also been closely engaged throughout, and published their detailed submission at the end of January.

The responses as a whole show widespread support for the consultation's breadth and inclusiveness, its definition of 'Fair and Effective' markets, and its analytical framework. Most respondents – including, crucially, end-users – conclude that FICC markets start in a relatively good place in terms of fairness and effectiveness, and stress the importance of ensuring those markets continue to perform their primary economic functions. At the same time, there is clear recognition of the part that the industry played in past misconduct, and of the importance of its playing a leadership role, jointly with regulators, to put things right. To quote the MPP:

> "…it is self-evident that the abuses which have occurred… were both widespread and totally unacceptable. They happened within a number of firms arising from the actions of individuals whose behaviour was not excusable…" "We … recognise that it is the responsibility of industry participants to work with our regulators to [rebuild and reinforce a trustworthy reputation at the heart of FICC markets, substantial portions of which sit here in the UK]"

[3] Responses to the consultation are here: http://www.bankofengland.co.uk/markets/Pages/femrresponses.aspx

In the rest of this speech, I want to highlight four areas where the responses identified scope for change: first, improved understanding of what ‘acceptable market practice’ means in FICC; second, standards of individual professionalism; third, governance, controls and incentives (‘culture’) within firms; and, fourth, ways for firms to catch misconduct. There are many other issues raised in the consultation document that the Review will have to consider in the coming months – including: the scope of the regulatory perimeter; the types of firm subject to the Senior Managers and Certification Regime (SMCR); whether to strengthen the tools for imposing criminal sanctions; and whether there is any need for further benchmark reform. So you should not conclude that the issues I discuss here today will form the sole basis of the final recommendations in June.

FICC market practices and structures

Perhaps the clearest message to come through the responses was a recognition that the collective understanding of, and adherence to, appropriate standards of market practice has been inadequate in key FICC markets. The MPP’s response identified four reasons for this. First, it felt that codes, regulations and other sources of information across activities, geographies and types of firm were overlapping, contradictory, difficult to navigate and/or not fully consistent. Second, there was limited interpretation of high level principles into practical guidance. Third, firm-led communication and training on codes, policies and procedures was not always sufficiently robust. And, fourth, adherence to standards was not adequately reflected in firms’ incentive and promotion policies or decisions. Although firms had in many cases sought to address these issues in recent years, each had tended to approach the problem in its own way, creating further complexity.

Many of the market practices at issue relate to the operation of the principal-based market making structure that still forms the heart of many parts of FICC. As AFME’s submission states, the market maker model has many strengths, enabling market participants to trade out of positions in less liquid instruments, in size and in a wide variety of market conditions, without excessive price volatility, and at tight spreads. It seems likely that this model will remain a key component of many FICC markets. At the same time, it does give rise to conflicts of interest, reflecting the fact that market makers provide services to counterparties but also, as principals, have a direct interest in the level of market prices. These conflicts have long been understood – but they require effective controls if the benefits of the model are to be delivered without harming the interests of counterparties, or wider market integrity.

Three examples show how structures designed to serve a particular purpose can, if poorly controlled, become subject to abuse. First, the submission-based design of LIBOR, originally introduced to deal with periodic illiquidity in the underlying unsecured interbank market, became vulnerable to deliberately false quoting. Second, the practice of netting off agency trades ahead of the 4pm WMR FX fix, originally undertaken to mitigate unnecessary balance sheet risks, gave unscrupulous traders a tool to manipulate market prices. And, third, the practice of ‘last look’, originally introduced to allow market makers to protect themselves against unexpected market movements or (more recently) attempted high-frequency trading attacks, provides at least the potential – several respondents told us – for abuse, giving market makers time to use the information provided in the trade for their own purposes, or rejecting trades not in their interests. Respondents generally agreed that the Review's consultation document had identified a number of other areas of uncertainty in practice associated with market making, including the use of information, uncertainty over when counterparties are operating in a principal or agency capacity, and the boundaries of acceptable pre-hedging activity[4].

Simply put, the challenge for the Review in this area is as follows. Can such market structures or practices be effectively controlled, by putting in place new conduct standards (or reinforcing existing ones) that credibly outlaw unacceptable behaviour whilst providing sufficient certainty over acceptable behaviour to allow legitimate business to operate effectively? Or is more profound structural change required, either to ban certain practices or to bring about changes in market structures that remove the scope for such abuse? The costs and benefits of these two approaches need careful analysis. Structural change may be highly effective in removing the most virulent abuse – but can be a blunt tool, harming or outlawing forms of business that add substantial value for end users and the wider economy, and creating a whole new set of conduct issues. By contrast, reform to conduct standards relies more heavily for its effectiveness on the willingness of firms and their employees to abide by those standards, but if carried out effectively may allow the continuation of beneficial market outcomes. Of course, the choice between structural or conduct solutions is not necessarily 'either/or'. The reforms to LIBOR and the WMR FX benchmarks, for example, involved both – improving the construction of the indices, and introducing new conduct standards.

In general, respondents argued that the issues identified by the Review were at this stage better dealt with through agreement on new market standards, rather than further regulatory-driven structural change. That was for three main reasons:

- First, there was felt to be considerable scope for market participants and end-users to work with regulators to improve the formulation of acceptable standards of conduct. To that end, the MPP and other respondents advocate the establishment of a body, drawn from across end-users, intermediaries, investors and infrastructure providers, demonstrably independent and respected, to develop Codes and Standards for wholesale FICC markets, act as a focal point for the establishment of recognised best practices that can be translated into practical guidance on trading floors, and provide guidelines and case studies to address specific grey areas of conduct.

- Second, most respondents cautioned against further regulatory intervention at a time when considerable regulatory and technological change was already underway in many FICC markets – reflecting the combined impact of new capital standards, the new transparency and venue provisions in MiFID2 and Dodd-Frank, and the accompanying rapid innovation in electronic trading platforms. Until the effect of these changes can be assessed, further intervention, it was feared, might be based on uncertain evidence and run the risk of perverse or unintended consequences. Interestingly, these

[4] See, for example, Box 7 in: http://www.bankofengland.co.uk/markets/Documents/femr/consultation271014.pdf

views were expressed particularly strongly by some end-users of FICC markets, notably the Association of Corporate Treasurers.

- Third, many respondents also felt that it was unclear whether alternative market structures, for example the sort of electronic, all-to-all, agency based, 'central limit order book' model seen in equity markets, were necessarily more fair and effective. A majority of the MPP, for example, felt that increased use of such a model for <u>liquid</u> instruments could increase fairness and effectiveness. But the reverse was thought likely to be true for <u>larger</u> trades in <u>less liquid</u> instruments, where such platforms were felt to run the risk of creating liquidity illusion, fragment liquidity between rival exchanges, and create technological 'arms races' between systems offering marginal improvements in the ability to exploit latency.

These are clearly major areas of focus for the Review, and the appropriate balance of the final recommendations between structural and conduct measures will require careful reflection. The MPP's response in particular sets out a practical set of proposals for raising and clarifying standards of market practices. But it rightly notes that any approach taken needs to meet a number of objectives: it must command the support of a wide range of key market participants across all parts of the relevant markets, both in the UK and internationally; it must be suitably resourced; it must fit with existing official-sector initiatives such as the global preamble currently being finalised by international FX committees; and it must have more 'bite' than previous initiatives to promulgate codes of conduct. These are important challenges for the months ahead.

Before moving on, I would make two final points:

- First, it was striking how many buy-side and end-user respondents felt it was unrealistic for them to play a significant role in 'policing' market conduct by moving business away from counterparties perceived to have engaged in abuse. Respondents noted that, although tools to enforce such 'market discipline' were available, they could not be a central bulwark against misconduct, reflecting perceived difficulties of 'shopping around', and the need to focus primarily on securing the best possible terms for each transaction. Such mechanisms are however a central plank of the 'caveat emptor' paradigm historically used to argue that wholesale markets should be less heavily regulated. If neither market discipline nor firms' self-discipline can be relied upon to operate more effectively, more intrusive regulation may be the inevitable consequence. Further reflection on this issue is likely to be needed.

- Second, it will be important to ensure that whatever standards are put in place are sufficiently comprehensive and robust to deal with the changing structure of FICC markets. Two recent events – the volatility in international bond markets on 15 October 2014, and the way in which FX market structures responded to the exceptional adjustment to the Swiss Franc in mid-January this year – have particularly attracted the attention of policymakers. One hypothesis is that these events showed the impact of a progressive reduction in liquidity in FICC markets. But another is that they showed that FICC markets are increasingly demonstrating the sorts of more complex dynamics previously thought to be more typically associated with equity and other heavily 'electronified' markets with a more diverse range of participants. Further work is required on these issues – but increasingly FICC market standards will need to be suitable for both voice-based and electronic-based contexts.

Individual standards of professionalism

Once proper standards of behaviour have been defined, it is clearly important to have tools to ensure that individuals behave according to those standards. In this area, respondents focused on two areas: first, the scope for professional FICC market qualifications; and, second, the scope for a register to record individuals' conduct track record.

The issue of qualifications has already been extensively considered by, amongst other bodies, the Parliamentary Commission for Banking Standards, and the Banking Standards Review Council. Some respondents to the Review highlighted challenges posed by the highly varied nature of FICC markets, and the difficulty of inculcating behavioural standards (as opposed to technical knowledge) through desk-, screen- or classroom based testing. Others, however, in particular the British Bankers Association, argued strongly in favour of a professional qualification as a means of acquiring a 'licence to trade', subject to developing suitable cross-border arrangements.

One of the most common concerns voiced by respondents was the need for effective mechanisms to prevent staff with a questionable conduct record moving freely between firms without full disclosure of their professional history. Legal constraints on recording contested or potentially prejudicial personal information pose one challenge to this approach – as, more recently in the UK, does the shift to the SMCR, which aims to shift responsibility for conduct back from the authorities towards the senior leadership of financial firms. But there is a strong desire to find a way to make progress in this area, not merely in the UK, but globally: similar points have been raised by President Bill Dudley of the New York Federal Reserve,[5] and in the Reserve Bank of Australia's submission to the Review.

'Culture' within firms

The third key theme I wanted to highlight in the responses was the role played by firms' internal governance, accountability and incentive structures in recent abuses. There was widespread agreement amongst respondents that deficiencies in these areas played an important role in past abuse – and while much had been done to address those gaps, there remained further to go to ensure that 'best practices' become 'normal industry practice'. In its response, Transparency International reported US research suggesting that, as recently as 2013, nearly a third of financial services professionals believed they might need to engage in unethical or illegal activity in order to be successful. That is an astonishing statistic. One could only guess at

[5] See: http://www.newyorkfed.org/newsevents/speeches/2014/dud141020a.html

the consequences for society if, for example, a third of medical professionals considered unethical activity to be a necessary route to the top.

Yet, despite this common agreement on the cause, there is much less agreement on the solution: ie on 'what good looks like'. Part of this is a logical problem: 'culture' is very firm-specific. Yet, as one commentator put it recently, "'if you don't define 'culture', it's hard to enforce it; if you do, it's going to be gamed."[6] Those responses which do attempt a definition pull out the following high level priorities:

- **Improving Board level oversight of conduct risks**, including the careful use of suitable, well-chosen metrics. The importance of this is increased by the extremely limited number of non-executives on global bank Boards with direct FICC market experience.

- **Engaging key management staff** – in particular the so-called 'first line of defence'. There are currently few clear definitions of the responsibilities of such roles – though the SMCR will substantially increase the focus on this area.

- **Embedding conduct in a wide range of Human Resources processes**, including remuneration, recruitment, employee induction, performance evaluation, promotion and training. During its consultation period, the Review was also asked by the Chancellor to examine how remuneration structures might need to evolve to support sounder risk taking – a topic highlighted by Mark Carney and Bill Dudley in recent months[7].

- **Improving firms' ability to draw out the lessons of past failures for other parts of the business**, including those in other 'silos'. The incidence of some recent enforcement cases suggests there is considerably further to go in this area.

Respondents report that a key challenge in this area is how to make such changes stick, particularly if they come up against conflicting business objectives. At a minimum, respondents suggested giving any new codes and standards body a role in promulgating best practice.

Firm-level surveillance

The final topic I want to highlight from the responses is the issue of how to detect misconduct in FICC and other wholesale markets at an early stage – one of the most challenging practical problems in recent years. It is sometimes claimed that this is primarily the responsibility of the regulator, particularly as data reporting obligations increase. But that is clearly untrue. Firms have primary responsibility for their own conduct – and regulators can never hope to be as close to the behaviour of frontline staff as their own employers are, or

[6] Matt Levine, Bloomberg View, 2 February 2015: http://www.bloombergview.com/articles/2015-02-02/levine-on-wall-street-culture-and-retaliation
[7] The Chancellor's letter is at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/377192/CX_MC_201114.pdf. Governor Carney's speech is at: http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech775.pdf. President Dudley's remarks are in the speech referenced in footnote 5.

have the same array of tools for affecting behaviour. Although regulatory enforcement is a vital backstop against the most egregious behaviour, many respondents accepted that firms also needed to do more to catch, and act upon, unacceptable activity at an earlier stage.

The responses identify a number of ways in which this might be done. The first is to strengthen the surveillance responsibilities of those closest to the front line: heads of trading or business. As I noted earlier, the SMCR should concentrate minds in this area. The second is to recognise that second-line surveillance resources should be focused, not just on ensuring regulatory compliance, but on detecting misconduct wherever it might arise, including in less heavily-regulated markets. The third is for firms to support a more effective culture of challenge. The response from Public Concern at Work notes that only 66% of financial services whistleblowers raise their concerns internally at the first attempt, falling to 35% a second time. That compares to 91% and 73% in other sectors. Earlier this week, the PRA and FCA announced a consultation on measures to strengthen whistleblowing provisions.

Finally, respondents report that many firms have begun to explore the use of ‘big data’ techniques to identify potential misconduct by their own employees. These techniques, which are in large part at a relatively early stage of development, draw together traditional trade monitoring systems with electronic surveillance of communications and other measures of behaviour. There are many challenges in implementing such systems, including cost, patchy data feeds, overly simplistic matching patterns, and the problem of multiple ‘false positives’ – and they are clearly no substitute for effective front office supervision. But a number of responses identified scope for further cross-industry work to explore areas of common concern and potential solutions.

Conclusion

I have covered only four topics here today – but the submissions to the Review raise many more. They will all be considered between now and the Review’s final recommendations in June. As I said at the start, it is too soon to say what those final recommendations will be. But they will be guided by the three key principles set out in the consultation document:

- First, the Review’s work is predicated on the belief that markets, where they work fairly and effectively, are the best source of dynamism, prosperity and progress. The people best placed to achieve that are those who work in those markets every day. Where feasible, therefore, the Review is seeking to catalyse credible and effective market-led processes. The constructive responses to the consultation are therefore encouraging. At the same time, the Review will form its final recommendations independently, and in full recognition that targeted regulatory interventions are also part of its toolkit, subject to having regard to the impact of any measures on the efficiency, competitiveness and growth-generating potential of the financial services sector and the cost of regulatory resources.

- Second, the Review recognises that FICC markets are global in scope. With that in mind, we have engaged in extensive outreach to international partners during the consultation period. The Financial Stability Board[8] has signalled its intention to consider reforms to reduce the likelihood of misconduct, including by: assessing reforms to risk governance, compensation structures and benchmarks; and considering ways to improve market structure, standards of practice and incentives for good conduct in financial markets. And the International Organisation of Securities Commissions has begun to discuss what role it might play in the global dimensions of the Review's work[9].

- Third, the Review recognises that its recommendations must be sensitive to the varied ways in which different FICC markets operate. There is no intention to impose a 'one size fits all' solution.

At the start of my remarks I drew a contrast between the 'light' of the new opportunities facing FICC markets – the topic of much of your conference agenda today – and the 'dark' of the legacy of misconduct that we are still working through. In most Hollywood films, it is light that triumphs. I hope that, working together, we can do the same.

Thank you

[8] See http://www.financialstabilityboard.org/wp-content/uploads/FSB-Chair-letter-to-G20-February-2015.pdf
[9] See http://www.iosco.org/news/pdf/IOSCONEWS366.pdf