FEMR CONFERENCE
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Regulation, Ethics and Standards in Wholesale Financial Markets

It is a real pleasure to be here this morning and to have the opportunity to talk about why we need to re-think our approach to Standards in wholesale markets and what the FMSB is doing.

First, in case it isn't obvious, I must emphasise that I'm here to speak about the FMSB, in my capacity as its Chair, and not about the Bank of England or the PRA, on whose Board I also sit.

One of the small pleasures of taking up a new post is the (generally) kind and enthusiastic reviews you receive when the news of your appointment is broadcast. But sometimes the critics' judgements are not so kind. So I wasn't too surprised when IFR ran a column under the headline "*FICC Standards Board: another body to clog up the works*":

> "*Has Mark Yallop … just entered the market standards-cum-regulatory equivalent of that inane 'How many people can you fit in a Mini' challenge championed for so long by the equally inane Guinness World Records?*"

and asked some pointed questions:

> *Do Market Standards bodies – the hippies of the new banking ecosystem – really have a place? Do we need august bodies to spout platitudes or offer cute pearls of wisdom that basically tell you to do the right thing? Or to make toothless recommendations to banks about how various sub-segments of the FICC product complex should work; banks that will do just that on their own based on their own needs, business orientations and drive to make profits?*

In my opinion, the FMSB is in fact one of the boldest and most innovative developments in wholesale markets over the past 30 years. That may sound an extreme statement, but I will explain why I think it is fair. The FMSB fills a void left by regulation and addresses persistent, unresolved problems of collective action and unintended consequence that have bedeviled markets as long as I have been working. And it has the potential to make a decisive change in the way the markets on which large parts of the global economy rely work.

But I daresay that IFR voices concerns that others also hold privately. So I'm very glad to have this opportunity to set what the FMSB is attempting to achieve and why I think it is so important. I will try to address two questions:

1. Why do we need Market Standards as well as the rules and laws that govern a clearly heavily regulated industry?
2. What is the FMSB aiming to achieve and how?

The Case for the co-existence of Market Standards and Regulation

There is an oft-repeated, but in my view lazy, view among people who work in financial markets that there is no place for Standards in a well-regulated industry.

This argument runs as follows. Laws and the corpus of regulation make it clear what is allowed and what is not. Following the regulatory rule book is a safe recipe for market participants - indeed the only safe recipe. If the rule book prohibits it then don't do it. If the rule book permits it, or if the rule book doesn't explicitly prohibit it, then it's fair game. Any additional non-statutory "guidance" just muddies the waters and is unhelpful or positively dangerous, not least as it opens the door to the reinterpretation of the rules and law.

With the argument presented in this bald way, perhaps even the hardest-nosed free-marketeer may develop misgivings. But even for extremists the reality is that there are many powerful reasons why the law, and rules and regulation, can't provide all the answers.

It's appropriate that we are in London today. This city is not only the most systemically important financial centre in the world and the epicentre of wholesale financial markets, but also the spiritual home of Standards.

I don't know how you arrived at the hotel today, but I bet that you either passed by or saw one of London's most iconic features – Tower Bridge - with its levered sections of road. The designer of Tower Bridge, Victorian engineer Sir John Wolfe Barry, made his name with this project and the 700,000 tons of concrete, 11,000 tons of steel and twin steam engines used to raise and lower the road sections made it a real wonder of its age. I daresay the grand opening in 1894 was a satisfying moment, since his father had been the architect half a century earlier of the Houses of Parliament.

What is less well known about Barry, but is arguably more wonderful still, is that he was also a passionate pioneer of Standards: 115 years ago, in 1901, he set up the first ever national standards body, now known as the British Standards Institute, here in London.

Numerous other national and international standards bodies have been established across the globe in the century that has passed since then; and it is no exaggeration to say that virtually every aspect of our lives today is touched by private sector-set standards.

By whatever means you travelled to this meeting today; wherever you live and work; wherever and however you spent your vacation this last summer; whenever and wherever you shop; by whatever means you communicate with family, friends, the office and your bank; however your elderly relatives are cared for – and in literally thousands of other ways - you will have, maybe unwittingly, relied on private sector-set standards.

Today, tens of thousands of private sector standards sit alongside national and international laws and regulation and determine among other things: safety standards for air pollution, nuclear energy and the transport of live animals; the treatment of waste water in agriculture; sustainable procurement for corporations; the measurement and reporting of greenhouse gasses; the design and energy efficiency of buildings, ships and aircraft; standards in customer complaint handling, staff training and IT privacy and protection; traffic and travel information systems, electronic fee collection on toll roads and automatic vehicle and equipment recognition systems; magnetic ink character recognition, PIN management and security, XML messaging, personal financial planning; and yes, even the design of yacht harbours and care systems for grandma and grandpa.

Everywhere we look, private sector-set standards determine how we live our lives and trade with each other.

And all this started here in London, just up the river from here.

And yet - fewer than 0.5% of the Standards issued by the International Standards Organisation relate to financial services. Indeed, what strikes one most about wholesale financial markets, in comparison with other major industries, is the rarity of private sector market Standards to complement national laws and public sector regulation.

There are a exceptions to this rule, including the US Treasury Market Practitioners Group and the Hedge Fund Standards Board; but across the entire wide spectrum of FICC markets, they are rather few and quite a long way between.

Is there something unique about financial markets which make it unnecessary or inappropriate to develop market standards alongside regulations and law, when this approach is so widely adopted in other spheres?

I think not.

So why do we need Standards in FICC markets?

In fact, those of us who work in the industry know well that public law, rules and regulation all leave a substantial void between the high level, general principles that they set and the actual detail of day to day market practice.

I'm told that if you print out the FCA rule book it will make a 2.5-metre high stack of A4 paper. This stack addresses a multitude of operational requirements, but not how to do a deal.

Despite their voluminous quantity, regulations don't provide practical detailed guidance to practitioners on how to address the myriad challenges that FICC market users face, day to day, in the live market place, for example:

- how should a syndicate desk act in managing the allocation process for a new bond deal fairly, taking into account the views of the issuer? What information might the desk share with potential investors about the state of the book ahead of pricing?
- how might this advice change if the deal is being co-led by several banks acting together?

- how might this advice change if the deal is being co-led by syndicate desks in jurisdictions outside London?
- how should a trader who has sold a barrier option hedge his position as the market approaches the barrier level?
- what actually is the difference between legitimate hedging of barrier risk and market manipulation?
- what safeguards should a firm executing a reference price transaction have so as not to disadvantage its customer?
- how should bidders and those managing bids on behalf of others in a government bond auction act so that demand is accurately portrayed to investors?
- what safeguards should firms offering illiquid corporate bonds to the Bank of England Asset Purchase Facility offer their clients?

I could go on, but I think you get the point.

When a trader asks for advice he or she cannot be told "make sure you treat your customer fairly" or "make sure you act with due skill, care and diligence". These are important – vital – principles: but what he or she needs as well is clear, well-articulated guidance that speaks to their specific market and situation.

In the absence of clear, detailed guidance a multitude of practices develop and, as we know to our cost, sometimes become perverted.

So there is a pressing need for simple, practical, focused measures that can, as rapidly as possible, restore confidence, trust, predictability and transparency to wholesale markets.

Measures that are based on unarguable principles of fairness and transparency.

Measures that are not so proscriptive that they stifle innovation.

Measures that acknowledge the fact that FICC markets are as complex as their real economy drivers, and are specific, targeted and granular.

There is a saying: "to a hammer everything looks like a nail." So, for some regulators and lawmakers the solution to the regulatory void is simple: create more laws and write more regulation.

But if we really want to reduce the risks that we know lie in an inconsistent global regulatory framework for a large scale and highly incentivized industry the answer does not lie in higher mountains of more prescriptive regulation.

So my first point is this: we need something else, alongside and complementing regulation and the letter of the law, to fill the void beyond the regulatory perimeter.

That thing is called Market Standards.

Market Participants' self interest in Standards

The next point I want to make is that these Standards should not need to be inflicted on a reluctant industry by the Bank of England, the FCA or anyone else: market participants have a powerful self-interest to develop new market Standards.

Unfair and manipulated markets erode trust. They create uncertainty and chill trading. They impoverish the less-informed, less-capable and smaller market participants. They slow innovation. They reduce liquidity and increase opacity.

Lack of clarity about what standards are expected of participants also creates confusion and hesitancy in markets - which in turn erodes confidence, undermines liquidity, and degrades transparency and predictability.

When participants in markets compete only on conduct standards, everyone loses.

In all these ways – and this is the crucial point - unfair and manipulated markets without Standards have a direct negative impact on the profitability of the firms that participate in them.

Further, given the huge scale and crucial transmission role of FICC markets in the global economy, such markets also have a chilling effect on economic growth.

So I am not here to make a philanthropic appeal or preach a doctrine of loving kindness.

Ethics-free and standards-free markets are less profitable than those with a clear basis of ethical behavior and Standards; they impair economic growth more widely which impoverishes everyone; and market participants have a clear economic incentive to fix the problem.

In my experience, many in wholesale markets have been aware (even if dimly) of these facts long before the manipulation of benchmarks and other problems were revealed in recent years.

But those individuals were caught in a bind: an extreme form of collective action problem in which the short-term rewards, personal and corporate, were so great, and the discount factors on longer term rewards were so punitive, that collaboration with others to change the system was never, or hardly ever, a viable strategy.

The FMSB can help to unlock this collective action problem – and provide a solution to the dilemma that keeps market participants economic prisoners of their situation – by providing commonly agreed, clearly articulated and unambiguous standards for <u>all</u> users of wholesale markets: professional market makers and price takers, issuers and investors, hedgers and speculators, banks, corporations, asset managers and asset owners.

This is why I think the FMSB initiative is such a bold and significant development for wholesale markets: if it succeeds it will shift the basis on which wholesale FICC markets work decisively for the better.

Other reasons to want Market Standards: avoiding unintended consequences and promoting professionalism, competition and efficiency

But there are other problems with relying just on public law and rules and regulation to improve the operation of financial markets.

First, laws and regulation have unintended consequences.

Since I sit on the board of the Prudential Regulation Authority I should make clear that I'm not here to undermine formal regulation. Good regulation has a crucial role to play in wholesale markets; and a great deal has been achieved in the past 8 years.

But there are clear limits to what regulation can achieve, even in principle, that can perhaps best be summarised as follows.

To avoid legal challenge and to be seen to interpret their mandate faithfully, regulators and the Courts have to apply their rules and the law precisely, which in practice means somewhat narrowly; and market participants anticipate this. A narrow application of the law and rules in turn creates incentives for regulatory arbitrage, as participants develop ways to achieve their economic goals in a form that don't offend the law or rule makers – often, an unintended consequence for the regulator.

I know, watching the prudential regulatory process in the UK, and having been a practitioner in markets for 3 decades that such regulatory arbitrage is widespread. Please note that I'm not suggesting that regulatory arbitrage is an offence; but the poor behaviours that it can unintentionally encourage are sometimes a high price for the authorities to pay to achieve their financial and market stability objectives.

The fact is that rules are always open to interpretation; and those who look for clever interpretations and creative loopholes will always find them.

The risks that this pose are far greater in financial services than they are in other industries because of the scale of markets, the corporate and personal incentives to pursue arbitrage, and the social costs of market failure. And also because the speed of circulation of staff in the industry and retirement rates mean that collective memory fades quickly. In some firms there are Managing Directors who can't remember the last time interest rates were above 1%, let alone what caused the collapse of Long Term Capital.

Standards, almost by definition, don't suffer from the unintended consequences problem because they are determined by the market practitioners themselves and therefore designed to eliminate this risk.

The second reason we can't be relying just on regulation and laws is the question of professionalism, knowledge and trust.

Participants in wholesale financial markets have highly asymmetric knowledge; some are considerably better informed about what is going on than others. How this knowledge is acquired by the well-informed, and maintained and acted on, is a key determinant of the professionalism of those market participants.

It is central to the idea of "the professional" that he or she acquires duties and obligations to others as a result of the power bestowed on him or her by his or her greater knowledge. An obligation, that is, to act responsibly and with due care for the interests of others who are less knowledgeable. The one matches the other; and how professionals balance that power with their knowledge defines their professionalism. If power and knowledge are not balanced then trust between buyer and seller, principal and agent, adviser and client - the essence of professionalism - is lost.

That relationship of power and knowledge can be corrupted by individual practitioners in markets; but also by the organizations that employ them.

Individuals, and the organisations they work for, need "guardrails" to safeguard the use of professional knowledge, and the power that that knowledge creates. Market Standards are those guardrails.

The third reason why we need to embrace Standards is the question of efficiency.

Consider the following.

Laws and regulation are (generally) set nationally and have to operate within a defined jurisdiction. As we know, individual countries, politicians and regulators inevitably have differing priorities. Anyone working in a global or international institution who has to wrestle with an inconsistent patchwork of regulation and legal frameworks across the world in order to do business knows this.

By contrast, wholesale financial markets – especially those for fixed income, currencies and commodities – are global and many of the firms working in them are organized and operate globally. It is much easier for Standards, which can be developed and adopted internationally, to address the global nature of wholesale markets than nationally-determined laws and regulation.

Much of regulation – which is concerned with the safety and soundness of firms and the system and the protection of consumers – is by definition only distantly concerned with efficiency. Indeed, many regulators will argue that improving efficiency subverts the more important objective to protect firms, people and the system at large.

Standards by contrast, sitting alongside the legal and regulatory apparatus, are naturally well-placed to promote efficiency. And because they are driven by practitioners who know what works and how it works – and what doesn't work - not by policemen concerned with stopping abuse, Standards have a strong natural bias to efficiency. It is interesting, for example, that the second meeting of the very first national Standards Board that I mentioned earlier – founded in London by Sir John Wolfe Barry – agreed to a reduce the number of London tram gauges from 75 to 5, thereby increasing the interoperability of tram networks, shortening the lead time for producing new rails, reducing costs for tram companies and increasing the markets for tram rail manufacturers.

Today, banks have an urgent need to reduce costs and complexity in their operations. There are many obstacles to doing this, but one of the problems with, for example, creating industry utilities to perform shared tasks more cheaply, is lack of standardization in bank processes. If the work FMSB does accelerates a move towards greater standardization, thereby facilitating process re-engineering and cost cutting, then this will be an important fringe benefit; although it is not our core mission!

Finally, I think its also worth noting that Standards setting bodies are less likely to fall prey to the kind of politicization and other deadlocks that can bedevil the processes for creating new laws and regulation. They can thus be inherently more efficient, and react faster to new developments, than the legal and regulatory processes that they complement.

In summary: Standards are an essential complement to the law and formal regulation

So there you have it.

Financial services generally, and wholesale markets in particular, are unusual in not having embraced Standards as other industries have.

The huge quantities and mobility of capital that can be deployed in financial markets, the corporate profits and scale of the remuneration available to participants and the downside risks to society when things go wrong make it more important for activity in financial services to be guided by behavioural and ethical Standards as well as by the letter of regulation than is the case in many other industries where risks, incentives and the downside are all smaller.

Setting Standards is the only way to anticipate and avoid the unintended consequences of regulatory arbitrage that formal regulation inevitably creates.

Setting standards supports the goals of professionalism and greater efficiency that all firms will endorse. Standards also facilitate competition for those who are innovators.

Naturally, Standards have some cost. Even though Standards acquire their authority by being derived from collective expertise, rather than from the threat of sanctions, they must be supported by a convincing “adoption” or “compliance” framework else they become devalued and ignored. Standard setting bodies need to establish legitimacy of some sort in order to be credible, since they don’t derive power from statute. These and other requirements create some overhead.

But this overhead is very materially lower than the costs of additional regulation or laws that would otherwise take the place of industry-agreed Standards.

FMSB Goals and work Plan

Now for the question of how we make the change that we want to see actually happen.

The UK Fair and Effective Markets Review, which reported in 2015, did an outstanding job of identifying what would make wholesale markets better places to do business.

That Report listed a number of imperatives for "fair" and "efficient" markets. They need to:

- have clear standards of market practice;
- provide transparency and predictability for market users;
- offer competitive pricing and open access for market participants;
- ensure competition between participants on the basis of merit;
- only entertain participants who behave with integrity;
- provide robust trading and post trade infrastructure;
- enable proper allocation of capital and risk by participants.

The FMSB was set up to improve the quality, clarity and market-wide understanding of FICC trading practices and help our industry to raise standards of conduct in wholesale FICC markets, and make markets fairer and more effective.

It is practitioner-led and practical; owned and operated by the major participants in wholesale markets, for the wholesale market. It is independent of regulators but complements their work.

The organisation is now just one year old, but has achieved a lot in that brief period.

It has a membership of 36 institutions, most of them global, representing all sides of the wholesale markets: sell side, UK and international commercial and investment banks; buy side, real money asset managers and hedge funds; corporations; exchanges and OTC trading venues; custodians and other market infrastructure providers.

The FMSB also has the enthusiastic and active support of the UK authorities – the Bank of England, HM Treasury and the Financial Conduct Authority and is developing relationships with other Standards Boards and overseas authorities. Mark Carney and Minouche Shafik both spoke at recent FMSB events.

It has a well-established and active Board and Advisory Council populated by Chief Executives and Chairmen, Investment Bank CEOs and Global Business Heads. Both bodies therefore have the highest level of commitment from our member firms.

The legitimacy of the FMSB is critical to its success: in my view this legitimacy derives not primarily from its backing by the authorities but from the breadth and inclusiveness of its membership base, the seniority of the people from member firms who sit on its Board and Advisory Council, and the authority of the market practitioners who make up its technical Working Groups.

Seven Working Groups of senior market practitioners are responsible for producing Standards and Statements of Best Practice that will fill the "void" that I mentioned earlier. Decisions about where to focus attention are made by reference to a 'horizon scan' prioritization of 'grey areas' and emerging problems in wholesale markets, as well as data on historic problems that have already been encountered. Two Standards have already been published in draft form; and a further Standard and two Best Practice Statements are currently in production. These cover topics as wide ranging as the trading of barrier options, surveillance of FICC markets and training of FICC professionals at member firms.

We have an ambitious programme over the next 3 years to:

- extend our membership;
- assist members with adoption of the Standards we produce throughout their businesses;
- accelerate the production of further Standards that cover all contentious areas of wholesale market practice; and
- promote international adoption of the Standards where they are relevant in other wholesale market centres - we already have strong interest in the work of FMSB from Canada, Australia and South Africa

Toothless standards are ineffective - and the FMSB is explicitly not a policing organization. But we will report publicly each year on the rate of adoption of FMSB Standards. I expect that market forces will play an important positive role in fostering adoption of Standards as market users – Central Banks, asset managers and corporations - demand to transact according to the new Standards. And regulators will also be pushing for adoption; here in the UK the FCA has stated that it will use FMSB Standards in its implementation of the Senior Managers Regime. Overseas we will work with relevant local authorities to promote the adoption of FMSB Standards that are tuned to local market needs and regulation.

One of the reasons the FMSB has been successful thus far is that it is focused: the FMSB is not preaching about culture; it is not engaging in any industry lobbying; it is not concerned with any aspect of financial services or markets outside the wholesale world of FICC. It is not seeking to replace regulation or interpose itself between firms and their regulators.

But it is concerned with markets globally, not just here in the UK. We will work with and share ideas and Standards with any other body that is willing to do so. In due course I would like to see FMSB Standards discussed and adopted worldwide wherever they can help to illuminate best practice and fair and efficient markets, resting alongside and complementing local rules and regulation, and fostering confidence and high standards of trading among all market participants, fulfilling the ambitious expectations originally placed in them by the Bank of England and others.

People often throw around "once in a lifetime" language about events that are in reality quite unremarkable. The FMSB has so far adopted a low profile, which I think has been appropriate. But in my view the FMSB is the unremarkable-sounding event that will really be a "once in a generation" change for wholesale markets and the financial services industry more generally. In my view it was brave of the UK authorities to support this initiative. I hope you in turn can help us grasp the opportunity we have been given and support the FMSB team in delivering its vision.

Ladies and Gentlemen, thank you for your attention.