FIXED INCOME LEADERS CONFERENCE

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FICC Markets Standards Board: bringing buy-side and sell-side together to promote Standards in Wholesale Markets

The $5 trillion opportunity

Thank you for the opportunity to talk to you this morning. I should make it clear at the outset that I am speaking as Chair of the FICC Markets Standards Board and not on behalf of the Bank of England or the PRA on whose board I also sit.

No-one here needs reminding of the gigantic damage caused to individual institutions, and the reputation of the financial services industry as a whole, by the Conduct failures revealed in the past few years.

The fines imposed, and the cost of the remediation work that went with them – which is not just financial - are not only a problem for the short-term profits of a few banks.

They are hindering the recapitalisation of the banking system, and contributing to a long-term “investability” problem for banks.

But they are also throwing grit in the wheels of global wholesale markets, reducing trading volumes and increasing the cost of trading.

And that is a problem for us all here in this room: investors and infrastructure providers, just as much as banks and high frequency market makers.

Further, given the still huge scale and transmission role of FICC markets in the global economy, the cleanup of misconduct is a problem for economic growth and society at large.

Minouche Shafik, Deputy Governor at the Bank of England has recently estimated that if those conduct fines had instead been retained as capital, they would have supported more than $5 trillion in lending to the real economy.

Misconduct is easy to describe when you see it. But actually stopping it before it happens is not so simple. That is a complex, global problem – changing the course of tens of thousands of individual judgements and actions taken every day in multiple organisations.

I believe that the path that most regulators are taking, and the way in which banks are responding to regulatory messages, well-intentioned though they all are, will not give us the answer we need.

But there is good news! In the UK we have the beginning of a genuinely new and exciting way to address conduct risk, and the collateral damage it causes. I want to tell you what this is and enlist your support so that we don't allow this $5 trillion opportunity to slip out of our grasp.

Statement of the Problem

So let's start with the numbers.

The industry has paid away, or provided for, Conduct fines and costs of $375 billion in the past 5 years.

Eighty per cent of this - or $300 billion - was driven by wholesale market activity.

Alongside the gigantic fines for US mortgage mis-selling, the $10 billion in fines for each of the FX and LIBOR problems seem almost insignificant. But these FX fines wiped out a whole year's revenues – or probably 2-3 entire years of net profits – for the entire global spot FX industry. Put another way, the fines were equivalent to 5 years of 15% annual, compound, margin compression.

And then there are the huge, multi-billion-dollar remediation and on-going infrastructure and control costs.

But despite the gargantuan size of these numbers, the main impact on the industry of the misconduct problems and the regulatory reaction and resulting clean-up is not the direct financial cost.

No: the lasting, and corrosive, impact is on confidence and firms' willingness to take conduct risk in execution.

The problem is simple: if you worry that your actions today may be reviewed and unpicked by market regulators in the future – perhaps with the benefit of 20:20 hindsight and by different standards, and that you and your firm may be sanctioned under those standards – then you lose your appetite to trade today.

To offset that fear, regulation would have to be much more descriptive and much more prescriptive than anything we see today; and I don't think this is desirable on many grounds.

Of course, misconduct costs have hit the industry at a time when it also faces other, huge challenges.

Capital requirements are rising. Market structure is changing. Electronic execution, greater transparency, margining of OTC products and central clearing are all fundamentally changing the FICC landscape

Liquidity in wholesale markets is falling. Trading volumes are falling. And revenues from wholesale markets activities are falling, fast: by $50 billion per annum over the last 5 years alone.

I am not here as an apologist for the banking industry: when market participants compete only on conduct standards, everyone loses. Greater transparency, more appropriate amounts of capital to support risk and new market entrants are all long over-due.

But the dampening effect that these regulatory measures were intended to have on the wilder excesses of wholesale markets is being amplified in an unintended and harmful way by "conduct anxiety".

And both market participants, and the wider economy that depends on FICC markets, suffer when this anxiety reaches the levels it now has.

The existing regulatory approach doesn't work

So why isn't regulation not solving this problem? And, more important, what can we do about it?

Simply put, existing regulatory models fall into two camps: principles-based and rules-based.

Both these camps struggle to address the causes of Conduct failure.

On the one hand, the high level "principles" approach does not guide specific market practice at a granular enough level to show market participants what is acceptable behaviour in real life situations.

But neither on the other hand does the multiplicity of low-level, complex operational rules that the "rule book" approach takes show market participants how to transact or how to behave.

There is a "void" between high level principles and low level rules which urgently needs to be filled with better guidance for market participants if Conduct problems are really to be fixed.

In the UK, 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 it doesn't tell you how to do a deal.

Nowhere do these rules 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 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?

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

When a trader asks for advice he or she can't 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 at that moment 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 not so proscriptive that they stifle innovation; and that acknowledge the fact that FICC markets are as nuanced and complex as their real economy drivers.

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 formal regulation encourages regulatory arbitrage - and that arbitrage creates unintended, and potentially harmful, consequences.

Formal regulation can end up "telling people what to think" - and thereby undermine exactly the core principles of professionalism, good judgement and individual responsibility which need to be bolstered in the industry, not undercut.

Without a very high degree of international consistency, formal regulation will move risk to less regulated jurisdictions, thereby undermining systemic stability.

Formal regulation can only be framed by reference to past experience and current market practice, and inevitably struggles to reflect evolving changes in market behaviour and the pace of innovation in markets.

So I believe this: Conduct regulators are well-intentioned people trying hard to grapple with the multiple failures that they see recurring in many jurisdictions. Equally, banks are sincere in their efforts to respond to the conduct challenges set by their regulators.

But the mechanism that they both are relying on – formal regulation – cannot fill the void, is not agile enough, perpetuates an ethos of regulatory arbitrage, and relies on an improbable degree of international regulatory collaboration to be effective.

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.

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.

A solution to the problem: the FICC Markets Standards Board

In London we are running a bold initiative to create these standards and fill the regulatory void; and we are achieving some early success.

It is called the FICC Markets Standards Board, or FMSB.

The FMSB was set up in 2015 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, thereby, make wholesale markets fairer and more effective.

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

In our first year we have achieved a quite a lot.

We have a membership of 38 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.

Our members account for more than 80% of all sell-side activity in wholesale markets, over $10 trillion in assets under management, over $100 trillion in custody and administration assets, over $100 billion in corporate new issue volumes in the past year, 45% of global inter-dealer broker volumes and a very large share of exchange traded volumes.

We have the enthusiastic and active support of the UK authorities – the Bank of England, HM Treasury and the Financial Conduct Authority - in particular from Mark Carney and Minouche Shafik. And we are building relationships and support from other Standards Boards and overseas authorities.

Our Board is made up of the most senior people in our industry: Chief Executives and Chairmen, Investment Bank CEOs and Global Business Heads. This is not a talking shop.

We have already published several Standards and other guidance on Conduct in markets covering topics as wide-ranging as the trading of barrier options, surveillance of FICC markets, the Eurobond new issue process and training of FICC professionals at member firms. All our members have committed to using these Standards in their businesses starting next year.

But there is much more to do. We have an ambitious programme over the next 3 years to:

- extend our membership;
- accelerate the production of further Standards that cover all contentious areas of wholesale market practice;
- promote international adoption of the Standards where they are relevant in other wholesale market centres; and
- assist our members and the markets more widely with the adoption of our Standards.

While misconduct surfaces in many guises, the fundamental root causes of misconduct are relatively few. We have scoped out the market landscape and believe that there are

about 40-50 issues that need to be covered by FICC Standards or guidelines, ranging – as examples - from the impact of technology on market conduct, to the handling of market order flow information and client confidentiality, to what constitutes acceptable "market colour". We aim to have addressed a significant number of these areas in the next 24 months.

We are not a policing organization, but we will report publicly each year on the rate of adoption of FMSB Standards so it will be transparent how far adoption by our Members has progressed and how the "void" is being filled.

Market forces will play an important role in fostering adoption of Standards by other market users – as Central Banks, asset managers and corporations demand to transact according to the new Standards. But I think some regulators will also be pushing for adoption; in the UK the FCA has stated that it will use FMSB Standards in its implementation of the new Senior Managers Regime. Overseas we will work with local authorities to promote the adoption of FMSB Standards that are tuned to local market needs and regulation; and several jurisdictions have already asked us to work with them.

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

Of course, misconduct does not recognize jurisdictional boundaries; and history shows that problems recur again and again in identical or very similar form over time and across geographies.

So we are concerned with markets globally, not just 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.

As I have emphasized, the FMSB is a private sector initiative: our industry, attempting to forge the best remedy for what went wrong, not relying on regulators to tell it what to do. If there was a bit more of this, we might have much less regulation. But we shouldn't kid ourselves that regulators will just stand by if we fail to do a proper job: if credible, and effective, Standards are not developed, and soon, then regulators will fill the void in their own way.

So the stakes are high; very high.

It will be a tragedy if the real lessons of a $5 trillion shock are not learnt and our wholesale businesses fail to build the stronger foundations that global markets need; but an equally big tragedy if the wrong lessons are learnt, the regulatory void is filled with ever-more prescriptive formal regulation, and the wheels of global fixed income markets grind ever more slowly, gradually throttled in a regulatory noose.

To make our initiative work I need to enlist the support of many of you in the room today. I hope that you can join us to grasp the opportunity we have been given to make sure that this moment isn't wasted.

Ladies and Gentlemen, thank you for your attention.