

FT Banking Standards Conference

Rebuilding Trustworthiness in Financial Markets

Remarks by Mark Yallop, Chair of FICC Markets Standards Board

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Good afternoon

It is a pleasure to be here with you today.

I'm going to spend the next 10-15 minutes talking about why, for many years, regulators and legislators have struggled to deal with the problem of wholesale financial market manipulation; and some new thinking about how to make a new start on this and to rebuild trust in wholesale markets.

Manipulation of Wholesale Markets: a very brief history and its impact

There are countless lurid tales of market manipulation from:

- the United States in 1792, when the first of the great insider traders of the modern era, whose day job was Assistant Secretary to the US Treasury, was assisted by a group of unscrupulous bankers in an out-of-hours attempt to corner the market in US Treasury bonds; right up to
- Tom Hayes and his co-conspirators in 21st Century London, Tokyo and New Zealand engaged in LIBOR manipulation.

In the past two centuries, there have been many hundreds of cases brought by enforcement authorities globally for wholesale market manipulation and misconduct.

Despite the fact that, during this same period, just in the UK and the US, there have been over 20 major pieces of primary legislation and countless pieces of secondary legislation passed, and tens of thousands of pages of accompanying regulation introduced, to address manipulation and misconduct.

Legal frameworks have adapted and markets and trading techniques have evolved, but misconduct has been extremely resilient.

The financial cost of this is staggering.

In direct terms, 50% of the net profits of UK banks were disgorged in 2015 in fines and other penalties for market abuse of one sort or another. In the past 5 years, banks globally have paid \$375 billion in conduct fines, about 80% of which related to wholesale markets. If that money had been retained as capital it would have supported \$5 trillion in bank lending to the real economy.

Indirectly, manipulation has thrown grit into the wheels of the transmission mechanisms that wholesale FICC markets provide for the global economy, with potentially even greater financial impact.

But rather more seriously, manipulation has done systemic damage to trust in financial services and eroded the social licence that banks and others in the financial system need to operate.

The cost of this damage, in lower revenues, permanently higher costs, higher taxation, market structure changes, higher cost of capital and loss of influence have yet to be calculated.

So, we have to ask the question: if a huge and sustained regulatory and legislative effort has failed to stop repeated examples of misconduct, then what can be done about it?

Why has legislation and regulation failed to stop the problem?

A good legal framework and good conduct regulation are essential pre-requisites for well-functioning, fair and efficient markets.

But even good regulation faces some severe challenges.

It's hard for (largely) jurisdictionally-aligned regulation to control global markets in which liquidity doesn't recognise national borders.

It's hard for regulators to track the pace of new product and market development in global markets, particularly with the rapid development of derivatives and increasing volumes of very high speed business being done electronically.

High level regulations – the guiding principles of the sort that the FCA publishes – have to be set out in such general terms – “act with due skill care and diligence” – that they can't tell those in markets how to act in ambiguous circumstances.

Low level regulations – the rule books that the FCA and others publish – are very operational and don't describe how to resolve tricky conflicts that arise every day in markets.

Consider the very simple case of a new bond issue. Typically, even for a straightforward new issue, there will be five parties involved: the issuer, some investors, the syndicate desk at the lead manager, the secondary trading desk at the lead manager and one or more derivatives banks who will swap the proceeds either for issuer or the investors.

These five all have different economic interests from each other.

The issuer would like the issue priced tight to the reference security while the investor would like it cheap.

The syndicate desk would like it fairly priced to help distribution in the primary market while the secondary desk, with an eye to owning the bonds in 30 days time, would like it cheap.

The swap desk would like the swap priced tight to government bonds while the issuer would like the swap spread wider.

And this is before you consider other conflicts:

- who should get to decide how the bonds being issued will be allocated between different investors? Pro-rata based on potentially inflated demand? Preferentially to those favoured buy-side accounts of the lead manager who pay the lead manager big commissions on other business? Preferentially to the investors that the issuer favours? Some mix of the above?
- how much of what kind of information is it appropriate for the syndicate desk to share with potential investors and other market participants, informally or formally, ahead of the launch of the deal? What caveats should accompany this information?
- how should a reference rate for pricing the deal be determined, given the potential opportunity – virtual certainty even – that the syndicate desk, the secondary desk, the swap desks and the potential investors will all be trading that reference rate as well at the same time that the issue is being priced and distributed?

There is nothing in the FCA or other regulation that tells anyone sitting in any of these five seats how to manage their conflicts of interest.

Between the high-level principles and the low-level rules there exists a “conduct void” in which acceptable market practise is unclear and a multiplicity of behaviours have developed – sometimes slanted to the detriment of market users and in some cases perverted to enrich particular players.

The conduct void, the series of high profile regulatory penalties that we have seen, and the problems I have hinted at with exercising judgement, have combined to create a second problem which I have called “conduct anxiety”: markets become less liquid if participants fear that their actions today will be judged with 20:20 hindsight according to some different set of rules tomorrow, and so simply don’t trade today.

It is tempting to see regulation – more, and tighter, controls on markets - as the solution to the problems revealed in recent years. But the evidence of recurring problems suggests that it hasn’t had this effect so far.

Rather, I believe it is more realistic to see formal regulation as a necessary, but not sufficient, condition for well-functioning, fair and effective markets.

To deliver fair and effective markets we need a different approach: an extra dimension.

This missing dimension is a set of commonly agreed Standards which provide practical guidance on how conflicts that arise every day, in every wholesale market trading centre worldwide, should be handled so as to ensure the best outcomes for market users.

How can we deal with the problem? The role of FMSB

The FICC Markets Standards Board was established in late 2015 to provide a global platform for creating such Standards.

It brings together issuers and investors; corporates and banks, hedge funds and non-bank liquidity providers; asset managers and exchanges, brokers and clearing houses from all key wholesale markets globally.

Today we have 50 Members who collectively represent 85% of sell-side activity in wholesale FICC markets globally, \$10 trillion of global assets in the asset management industry, \$100 trillion of global assets in the custody industry, over \$100 billion of annual new issuance volume in the global debt markets, over 50% of all FICC trading

globally in the inter-dealer broker markets and over 60% of European exchange traded and post trade activity in wholesale markets.

Such a group of interested parties has never before been assembled – for any purpose, let alone to address market failure.

Our mission is very simple: to identify the grey areas where wholesale market practise is unclear, formal regulation can't help and market users are vulnerable – and to develop and publish Standards which lay out exactly how markets should function in these areas in order to deliver the best outcomes for all users.

We are a private sector body, practitioner-led, and practical; owned and operated by the major participants in wholesale markets, for the wholesale market.

We are focussed only on Standards production. We are not a regulator or a self-regulator, we have no enforcement powers, we are not a lobbying firm, trade association or advisor. We are not seeking to replace regulation or interpose ourselves between firms and their regulators. We are not trying to dictate or to measure culture in markets – though what we are doing will have I believe a profound impact on market culture over time.

We provide a forum for collective action to address problems that have in truth existed for some time but which is very hard, or impossible, for a single actor – or even group of actors - to address.

And all our Members undertake to adopt our Standards when they join FMSB, and evidence in a public statement each year that they are actually doing so and have allocated resources to make this happen.

London is the most systemically important, multi-currency trading location for wholesale FICC markets and is the logical place to develop such Standards. But we are developing international, and generally global, not just UK Standards.

The authorities have taken a bold step by allowing the industry a chance to take responsibility themselves for leading the process of fixing the problems that have been uncovered - and for demonstrating better outcomes for market users.

Over time our members will define in clear, granular ways, what will be done differently in future in markets.

And by publishing these Standards and the evidence that they are being followed, so that others can judge whether change is real, I believe we can take a profound and important step along the road to demonstrating trustworthiness – and in due course helping to rebuild the trust in markets that has been lost this last decade.

What is FMSB actually doing?

Last year we published 5 pieces of work covering an eclectic range of topics:

- binary options in the commodity markets;
- reference price transactions in rates markets;
- the new issue process for European capital markets;
- surveillance techniques for FX markets;
- training programmes for FICC staff.

Earlier this year we completed an analysis that scoped the range of conduct problems in wholesale FICC markets and identified a field of about 75 issues that need to be clarified.

These range from big, broad, strategic questions which affect all markets such as:

- how the protocols for electronic market order books should operate;
- the definition of the role of “agents” and “principals” in markets and how these differ;
- the dissemination of confidential “market colour” information to other market participants;

to highly specific questions relevant only to a single market, such as how government bond auctions should be conducted, or the right to a “last look” exercised by a market maker in foreign exchange.

We are now working on Standards relating to:

- risk management techniques for new issues;
- auction processes in government bond markets;
- information barriers in primary capital markets;
- confidential information sharing across secondary FICC markets;
- front office supervision of trading businesses;
- monitoring of e-communications and the use of lexicons;
- suspicious transaction monitoring in FICC markets
- governance of algo trading engines;
- commonly occurring abusing trading practises in FICC markets.

I expect that we will publish about 10-12 Standards this year that will collectively address about half the 75 issues that I mentioned earlier. Next year and in 2019 we will attempt to address at least half of the rest and create a comprehensive and coherent set of foundations to guide day today practice in wholesale markets.

Three things are fundamentally different about the FMSB from anything that has been tried before: it is a private sector body empowered by the authorities to take charge of improving user outcomes; it includes members from all sides of the industry; and it has a clear adherence mechanism.

These three facts give the FMSB a chance to succeed where previous initiatives have failed to get traction. And for these reasons, I am very confident we will be successful.

Indeed, 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, while I am very confident of success, the stakes are also very high.

Ladies and Gentlemen, thank you for your attention. I look forward to any questions that you may have.