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Rebuilding Trust in Financial Markets

Remarks by Mark Yallop, Chair of FICC Markets Standards Board

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Good morning. Thank you for this opportunity to speak on a very important topic.

It was 36 degrees at 11.38 Eastern Time in Cape Canaveral on the morning of January 28th, 1986 when NASA pressed the launch button on their latest space shuttle mission.

The shuttle was powered by solid rocket boosters. Each booster was 150 feet long and 12 feet in diameter, manufactured in sections that were joined with the help of several rubber-like O-rings.

Since 1981, evidence had gradually accumulated that the O-rings were vulnerable; by 1985 some rocket boosters were returning from missions with significant damage to the rings.

Initially the engineers were alarmed, but they became convinced with each successful launch that the damage was slight enough and the time of exposure was short enough that the risk was acceptable. Eventually, when it became clear that the damage was a permanent feature of launches without apparent consequence, NASA waived the requirement for back-up, secondary O-rings.

The manufacturers of the booster had specified that the O-rings needed launch temperatures of at least 53 degrees, else they would become brittle and break. But NASA's launches in 1985 nevertheless took place on days with temperatures below this without incident, and by the end of that year the shuttle had been launched a total of 24 times.

Seeing the exceptionally low temperature in January 1986, the booster engineers recommended a delay; but NASA managers elected to make a "management decision," without the engineers, and push ahead with the launch.

As we now know, one O-ring failed almost immediately. Seventy-two seconds after launch a plume from the failed joint cut into the struts holding the booster to the main tank and the booster swiveled free. The flame breached the main tank, which exploded in a ball of flame one second later at an altitude of 46,000 feet. The Challenger shuttle cabin remained intact until it hit the ocean 3 minutes and 58 seconds after launch, killing all on board.

Why does market manipulation happen?

What has this tragedy to do with financial markets?

It illustrates some important facts about how behaviour among well-intentioned people in well-intentioned organisations can evolve. The amount of acceptable O-ring damage went, incrementally, over 5 years from none to complete destruction; the practice of waiving safety measures became normalised; and all the while NASA was actually following its own rules that allowed launch criteria to be waived, thinking "we know what we are doing".

The idea that wrong behaviour can become normalised in organisations, and be the cause of disastrous outcomes, when gradually, in the absence of adverse consequences, the unacceptable becomes acceptable and a blind eye is turned to those doing inappropriate things, is not exclusive to the aerospace industry.

It's one of several ideas that have been used to explain what went wrong in the lead up to and during the global financial crisis.

Take LIBOR manipulation. Derivatives dealing desks are understandably curious about where LIBOR might settle at 11.00 am as this influences the value and risk of their portfolios. Money market traders who also trading short dated swaps are intrigued about where these are priced relative to the cash rates they are trading.

Gradually, over time, curiosity on both sides turns into regular dialogue between junior swap traders and their colleagues on money markets desks. Subliminal messages about the concerns of the derivatives traders start unconsciously to influence the actions of money markets traders and, in turn, their views of where LIBOR should be. All the while, senior management, eager to promote cross-selling to clients, explicitly encourage inter-desk collaboration.

It only requires someone seeking deliberate advantage to spot the opportunity that this situation presents and to set about colluding with and bullying other actors in the market to target LIBOR fixings that suit their positions and profits.

I'm not defending what happened, merely describing a possible history of how it came about.

I am certain that the idea of regularised poor practice - "normalised deviance" as it has been christened - has validity in financial services. But it competes with many other views of what went wrong:

- the "bad apple" theory of lone, corrupt, rogue traders outwitting the system;

- the “rotten barrel” theory of entire organisations gone rogue;

- the “social network” theory that members of a system feel stronger loyalty to other members of their tribe than they do to those for whom they work, and are therefore more likely to break the rules that don’t suit them or their friends;

- the “regulatory arbitrage” theory under which responsibility lies with the increasing reliance in markets on a formal contractual approach to business and the inevitability that people will look to find ways round the legal and regulatory framework within which those contracts operate;

- the “prisoner’s dilemma” theory, whereby those who were aware that bad stuff was happening in markets were trapped by the incentives they faced to maintain the status quo and never able to engage the collective action that was needed with others to make changes; and

- the “conduct void” theory which states that there is a gap in regulation between the high-level principles that the regulators set for the conduct of business and their detailed rulebooks, in which void there is genuine confusion about how to do business, which can in turn lead to poor outcomes for market users.

How to choose between these many factors, personal and environmental, the ones that really caused the problems?

It is meaningless and dangerous to focus on one or other to the exclusion of the rest.

The importance of social networks and the stealthy normalisation of poor practices blunt any sharp distinction between the “bad apple” and the “rotten barrel”.

The behaviour of individuals is never neatly driven solely by their genetic pre-disposition, or by the tempting situations in which they find themselves - as those experiments with Stanford University students in the 1970s showed. There are multiple shades on the behavioural spectrum between the extremes.

And each shade on the personal behavioural spectrum is influenced by external structural factors - the legalistic approach to business, the career and compensation motivations of individuals and gaps in regulation.

The complexity of the mix goes a long way to explaining why market manipulation has been so persistent. Ever since the dawn of modern capital markets, manipulators have been active, a step or two ahead of the authorities. The US Treasury market was subjected to a huge squeeze by insider traders in 1792, just 12 years after Independence.

Abusers were at work in the UK gilt market in 1814 and in the French government bond market in 1834.

Of course, regulators and lawmakers have tried to adapt to, and keep up with, the repeating evidence of market abuse. But it is clear that regulation cannot fix the problem on its own because so many factors far outside the purview of regulation are relevant as well.

The damage to markets: financial penalties and loss of trust

It has been impossible to open a newspaper this summer without finding an article reminding us of the 10^{th} anniversary of the start of the global financial crisis.

The direct cost to the financial services industry, and the wider global economy, of the market manipulation revealed during that crisis and in its aftermath, has been staggering. Over $375 billion has been paid in fines by market participants, 80% of which related to wholesale markets; enough, if it had been retained as capital by the banking system, to support $5 trillion in lending to the real economy.

But many would argue that the real damage done by the manipulation was indirect - to the reputation of banking and markets. That damage was not only huge, but it has been very persistent, its echoes as loud today as the first explosion of anger and frustration was a decade ago.

What can be done about market manipulation?

So how should we address market manipulation? Presented in the way I just have, we face a problem of baffling complexity.

Instead, the challenge needs to be reformulated.

A more useful way to think about the issue is to ask: how can we address the biggest casualty of the crisis – the destruction of trust within the industry, between financial services and the users of markets, and between financial services and society?

Put this way we can see that regulation cannot be the answer.

Good regulation and a sound legal framework are certainly a necessary, but they are definitely not a sufficient, condition for re-establishing trust in markets.

Onora O'Neill, the eminent philosopher, has said that the question for professions that have fallen into disrepute is not "how do we restore trust" but rather "how do we make it easier to judge trustworthiness".

Those who are determined to be untrustworthy will always look for ways to conceal their true purpose; what the rest of us need are the tools to be able to interrogate our counterparts more thoroughly and to place trust intelligently where the evidence shows that this is justified.

So the real challenge today is not for regulators, but for market participants. How do they change the way they operate <u>and</u> make it easier for others to judge their trustworthiness?

Two steps are needed if Baroness O'Neill's challenge is to be answered for wholesale markets.

First, wholesale market participants need to take responsibility themselves for leading the process of fixing problems that have been uncovered - and particularly for demonstrating better outcomes for market users.

To do this they have to be permitted this opportunity by their regulators, and to act in a credible framework; but crucially they have to be seen to be taking the lead, rather than simply to be reacting to regulatory pressure.

Second, those wholesale market participants need to find credible, granular ways to define what will be done differently in future.

These changes need to be genuine, and solid evidence of change needs to be published, so that others can judge whether that change is real.

Of course, neither of these outcomes can simply be legislated or regulated into existence: wholesale market participants have to want them, and make them happen.

One obvious step would be for market participants to break with tradition; work together to create the codes or standards that would fill the "conduct void" and show how business should be conducted; actually to implement those codes or standards; to devise a method for showing the world that business is in fact being conducted in a new way; and to do all this without being instructed at every turn how to act by regulators.

This is what the FICC Market Standards Board (or FMSB) which I Chair, is now doing.

FMSB brings together representative users from all sides of the markets to agree solutions, publish them as Standards, and provide a "trustworthiness gauge" for others' to judge the effectiveness of those Standards.

It is practitioner-led, owned and operated by the major participants in wholesale markets, for the benefit of all wholesale market participants, including both market makers and market users.

It now has a membership of 50 institutions, who 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, 60% of global inter-dealer broker volumes and a very large share of exchange traded volumes.

FMSB is tackling head-on the lack of clear guidance about how business should be conducted on a practical day-to-day level by producing Standards

Standards or codes have important advantages for addressing the problems seen in wholesale markets.

Standards are less prone to suffer the "unintended consequences" problem – of creating incentives to arbitrage the rules - that arise with formal laws and regulations.

Standards reinforce professionalism by reminding professionals how they must use the superior, asymmetric knowledge that they possess.

Standards can be calibrated to the express level of principle - or detail - that market participants seek when trying to navigate the "conduct void".

Standards can more easily reflect the international nature of global markets than nationally determined legislation and regulation.

By enlisting all participants, and empowering market users to play a larger role in determining how markets operate, FMSB aims to re-establish market discipline and encourage a move away from continual reliance on regulation to provide answers to questions that regulation is often not well equipped, or should not be dealing, with.

What aspects of markets should we be concerned about for the future?

People often ask us what concerns us about the future in markets, and what issues we must focus on now to underscore fairness and effectiveness for tomorrow. So before concluding, let me touch on three areas that we think are genuinely problematic.

First, "conduct anxiety".

We know that one intended consequence of regulation after the crisis was that tougher prudential and conduct rules would prick the bubble of speculative trading activity, particularly by tax-payer insured banks.

But there is anecdotal evidence that the reductions in trading activity, and in market liquidity over the past 8 years, have exceeded what was intended in the regulatory clampdown after the 2008 crisis, and that which would be expected as a logical result of the tougher prudential capital and liquidity rules.

Conduct anxiety is one important explanation of this observation. When institutions come to fear that their actions today may be reinterpreted in future with 20/20 hindsight, then they often conclude that it is just more prudent not to trade today.

Unfortunately, the poorer liquidity that results hurts market users and makes markets less effective. The cost of this to market users in the real economy needs more thought.

Second, market fragmentation.

Lawmakers and regulators across the key financial market jurisdictions have taken a variety of paths, at different speeds, following the global financial crisis, with policy imperatives sometimes trumping a thorough analysis of foreseeable, undesirable market consequences.

Some of these regulatory initiatives have fragmented liquidity, increased the costs and impaired the effectiveness of markets for end users.

US regulation, for example, has fragmented swap market liquidity, both domestically in the US and internationally between the US and Europe, to the detriment of all.

As Chris Giancarlo, the newly appointed Chairman of the CFTC has said: "*Flawed and ill-suited swaps market regulation arbitrarily increases the cost of risk management, repels global capital, diminishes trading liquidity and stymies the legitimate use of derivatives causing the economy as a whole to suffer*".

Third, the "electronification" of markets.

Electronic trading received a major boost in the past 10 years from the G20 regulatory reforms and it has delivered benefits, including improved transparency and auditability.

But electronic trading does not eliminate market abuse and misconduct - these cannot simply be "coded out" - and it can create new types of vulnerability for FICC market users, for example:

- The commercial incentives and rebate structures for liquidity providers, and the platform rules about who can see market indications of interest, bids/offers and executed orders are often complex, normally invisible to market users and can impact pricing and liquidity for users - often in ways they don't understand;

- The rules that match bids and offers in the order book can favour certain types of trader - often the faster ones - and create opportunities for electronic versions of the flash orders, spoofing, manipulation of closing market prices and other abusive techniques that are seen in traditional voice markets;

- Electronic markets proliferate new order types which can, for example, allow conditionality in the execution of an order, facilitate follow-on trading after an order has been filled, permit queue jumping in some circumstances, or shield larger overall orders from lit markets - all of which impact on market users in ways that are not clear to many market users;

- The electronic "dark pools" in which selected participants trade with other privileged participants outside the glare of public "lit" markets fragment liquidity to the disadvantage some types of market user.

Conclusion

The evidence shows that misconduct has been a repeating problem over a long time.

Experience shows that it has complex root causes.

Logic tells us that regulation cannot be the answer.

But lack of clear guidance about how business should be conducted is without question one major contributor. The FMSB initiative has the capability to solve that problem and be a decisive step on the journey to rebuild trust in markets.

It will be a tragedy the unintended consequences of regulatory reform shrink global markets and the access for end users to those pools of liquidity.

Equally, it will be a tragedy if this opportunity for reform by the private sector slips through our hands - not least because the likely regulatory reaction is ever more prescriptive formal regulation, the wheels of global fixed income markets grinding ever more slowly and continuing damage, not just to trust but to the wider economy.

Ladies and gentlemen, thank you for your attention.