4th International Initiatives in Behavioural Financial Regulation and Policy

Pandemic Shocks, Financial Institutions, Markets and Behaviours

Virtual Seminar: December 15th, 2020

New Rules for the New Normal

Remarks by Mark Yallop, FICC Markets Standards Board Chair

It is a cliché to say that the public health crisis, and the economic fallout, created by the pandemic have brought unprecedented challenges this year. Even after a successful roll-out of an effective vaccine, when that happens, Covid will have changed much about life for almost everyone, almost everywhere.

New rules will be needed for the new normal.

The human cost of the pandemic has been so great that it feels callous to be discussing the, by comparison, trivial challenges for policy makers thinking about new rules.

But the sacrifices made by so many demand that the obvious policy weaknesses exposed by the pandemic do get addressed, at the same time that we celebrate the policy successes that the pandemic has confirmed.

Covid has forcibly reminded us of many limitations of conventional economic thinking. To pick just two examples:

- Economic models that rely on the actions of “rational” agents and take no account of behavioural factors are virtually useless in the face of “unknown unknowns”, even if they seem to work in “normally random” times. Every day over the past nine months we have seen how individuals, worried about infection or angry about social restrictions, a have made personal decisions that have been just as important to health and economic outcomes as government policy; and

- Models calibrated to the tails of the "old normal" distribution can seriously underestimate the tails of the "new normal": mortality rates in this pandemic are (so far) about one percent of those in the last comparable global event, the Spanish Flu, but GDP losses are up to twice as large as seen a century ago.

And the pandemic has created other policy problems too. Again to pick just two examples:

- Monetary policy needs working transmission mechanisms to be effective: an open economy and functioning markets. Even the most expansionary policies can't expand economies that have been shut-down; and

- We are learning that it is easy to create government support mechanisms, much harder to withdraw them. How to avoid a crippling long-term overhang of unserviceable debt, and how to re-capitalise those enterprises that have a viable future are urgent policy dilemmas for all governments.

But Covid has also demonstrated the power of preparation.

A decade ago, policy makers realised that key financial institutions needed to be resilient to ontological risk. Raising "going concern" capital and liquidity standards, central clearing of derivatives and securities, new bank resolution and insolvency regimes, bail-in debt and solvent wind-down programmes have all gone a long way to address this deficiency, and have made financial <u>institutions</u> hugely safer, even if that work is not yet fully complete.

This is why financial institutions are now in a position to play a central role in supporting corporations, institutions and individuals to navigate their own way through the crisis, rather than themselves needing to be rescued, as happened in the last crisis.

But financial market functioning remains exposed to ontological risk: and where the completely unexpected overwhelms market mechanisms, as happened earlier this year in even the largest government bond, repo financing and money markets, then we must still rely on government or central bank interventions to restore liquidity.

The government "put", and with it moral hazard, is alive and well, in financial markets.

It is an interesting question whether markets can be organised in a way that is completely resilient to "black swan" events and no longer dependent on a liquidity provider of last resort. The fragility of markets in these extreme events is caused by the multiplication of liquidity across complex chains of intermediaries in markets. In good times liquidity passes smoothly along these chains; in a crisis, pulling liquidity in one part of the market can create a "domino effect", accelerating progressively larger shortages of liquidity down the chain, and extreme responses in pricing and availability of liquidity; in the final case, freezing markets altogether.

Better understanding these chains and how they operate might allow regulators to redesign market structure so as to reduce or eliminate the "government put" in markets.

Such changes would be great "new rules for the new normal", if they could be introduced at an acceptable cost.

But my hope is that the pandemic is the stimulus for faster progress on an altogether different kind of "new rule".

As the last crisis revealed, fair and effective wholesale markets underpin fair and effective financial services and products for, and the economic prosperity of, all the ultimate end-users of finance: corporations, institutions and individual borrowers, investors and insurance policy holders.

The trust that these end users place in markets to provide services fairly and effectively, and in governments to "backstop" market failures, is the basis for the social licence to operate that the providers of financial services need.

Financial market participants enjoy freedom to pursue their business in proportion to the trust they inspire by acting in trustworthy ways.

For reasons we are all familiar with, trust cannot be defined or delivered merely by adherence to laws or regulation.

Economic crises, if they expose financial sector greed and market manipulation, which in turn demonstrate un-trustworthiness, destroy trust and tear up the social licence.

This is why the behaviours of those in financial markets are so critical to prosperity: and why FMSB is on such an important quest.

Even before the pandemic, the need to codify market practices that demonstrated trustworthiness, reinforced trust and strengthened the social licence, was clear. The pandemic has only made this more urgent - not because it has exposed manipulation or malpractice, or because financial services companies have failed to rise to the challenge (in fact they have very much done so) - but rather because of the urgent need for speedy economic recovery. One critical pre-condition for rapid economic growth is that people and corporations trust financial services providers and markets.

Developing a comprehensive set of standards that lay out how business should be done in markets - beyond the limits of regulation and the law - is one of the most valuable things we could do to rebuild trust and support economic growth.

And if this can be done, these standards really would be valuable new rules for the new order.

I am optimistic about the future. Grave as the public health and economic challenges may be, there is much to celebrate in:

- the adaptability shown in the lightning-quick adoption of new technology, and new ways of working;
- the resilience shown in the operational response of financial services firms; and
- the "wartime" spirit evoked by the response of individuals to the pandemic.

But I think we should go further, and use the challenges of Covid as a trigger to accelerate overdue change in the workplace, in areas such as employee relations and well-being; diversity; resource allocation; and the advancement of broader stakeholder interests alongside the financial returns to shareholders.

As a trigger to create new rules for the new normal, not just in business practices, but in business purpose.

The most startling revelation for financial services of the past nine months has been how effective remote working arrangements have been, despite the universal assumption beforehand that mass out-of-office working could occur only in large, dedicated business recovery or continuity sites. Mass work-from-home has enabled not only excellent customer service but also business volumes up to 4-5 times usual levels.

Of course we don't know if mass work-from-home will endure. But if it does, then there are risks to consider as well as benefits.

Among them, genuinely new risks: unsuitable or shared remote working spaces, psychological pressures to return to office environments, fragmentation of corporate culture and difficulties in delivering training.

As well as other risks that are exacerbated by remote working: for example identifying and handling inside information, as the nature of inside information changes in the context of the pandemic.

But focussing on individual risks ignores the root of the problem.

How business is conducted is not just determined by the control environment but also by the culture of organisations.

Of course firms need systematic controls, designed so far as possible to prevent misconduct happening in the first place, as well as detective controls to catch misconduct when it does occur. Rules-based controls have their place. But overly formulaic controls can lead to staff not exercising judgement where that is required; and excessive focus on systems and controls can disempower individuals, and potentially result in poorer outcomes where judgement is needed.

Firms also need to select and develop the right kind of people, provide them with the high quality guidance and training, opportunities to develop sound judgement when simple rules don't provide clear answers, and a clear sense of their own purpose in the financial system.

Individual staff members who feel enfranchised within their firm, understand their purpose, the "social licence" that their firms enjoy, and are willing to talk about how potential conflicts of interest should be addressed are more likely to develop better judgement and deliver fairer and more effective outcomes for their customers. It may be that a more diverse workforce is better equipped to address novel challenges, can apply better judgement and will underpin fairer and more effective outcomes than more uniform staffing.

A revolution has been underway in financial markets for some time, to deliver a more robust framework that sets out fairer and more effective outcomes for market users, based on a genuine sense of purpose, demonstrates trustworthiness, builds trust and provides a stronger foundation for economic growth and prosperity.

This framework should be the "new rules" for financial markets.

The need for this revolution is intensified, not diminished, by the pandemic. The new ways of working that we have all had to adopt should be a "call to arms" for greater attention to the way that purpose, culture and competence underpin business conduct.

I am optimistic that the makers of markets will rise to this challenge.

Thank you ladies and gentlemen for your attention.