BANK OF ENGLAND

Speech

Rebuilding Trust through the 'FX Global Code': Reasons for optimism

Speech given by

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Good evening, I am delighted to be here at the ACI UK's Square Mile Debate. Tonight, my focus is the work underway to develop a single, global code of conduct for foreign exchange (FX).

But before doing so I cannot not help but advertise the Bank's latest product: the Churchill £5 note that we launched a week ago. It is a technological first for us, made out of polymer, and 'cleaner, safer and stronger' than its paper predecessor. But our unquestioned discretion to replace one version of a £5 note with another relies on a much older concept: trust, trust in our 'promise to pay the bearer…'. And trust, or more specifically, rebuilding trust, is what is at the core of my main subject tonight, the FX global code of conduct (the 'Code').

It is no secret that all has not been well in FX or FICC markets more generally. The nature and scope of misconduct that has come to light in recent years has significantly eroded trust in these markets – not only public trust, but also trust between market participants.

The Fair and Effective Markets Review (2015)[1] extensively documented the root causes of this misconduct. But in short, structural weaknesses, ranging from poorly designed infrastructure through to guidelines about what constituted acceptable market practice that were sometimes poorly understood, presented opportunities for misconduct to occur. And 'ethical drift', whereby a poor culture that prioritised short-term financial gain above all else was perpetuated and normalised, meant that individuals were willing to exploit these opportunities.

All of these features were present in the various episodes of FX misconduct which have come to light. Poor infrastructure was clearly an issue in foreign exchange markets; in particular the manipulation of the 4.00pm fix was facilitated by weaknesses in its design[2]. But, as demonstrated, for example by the misconduct associated with the handling of client stop-loss orders, the breakdown in market practice norms was clearly very important in the FX markets.

The wholesale FX market is one of the most complex markets in the world: it operates 24 hours a day across multiple centres. Participants are diverse: ranging from corporates looking to hedge their trade flows, through to principal trading firms seeking to capitalise on the most transitory of pricing anomalies and, from time to time, central banks seeking to affect the price of their currency. Some of these users access the market directly; others indirectly, for example through the sponsorship of their prime broker. Banks, acting as the key intermediaries, accept market risk when transacting as a principal with some clients while providing agency services for others. Orders are often complex, requiring banks to exercise discretion when executing them. There is no single price – the concept of 'best execution' does not sit as neatly as it does in

[1] http://www.bankofengland.co.uk/markets/Documents/femrjun15.pdf.
[2] http://www.fsb.org/wp-content/uploads/r_140930.pdf - Final Report on Foreign Exchange Benchmarks, Financial Stability Board, 30 September 2014.

other markets. Nor is there a single trading venue, or even single method of trading, with banks and platforms competing for business.

This combination of factors means that the information asymmetries and potential conflicts of interest inherent in all FICC markets are also acute in FX markets. This in turn creates a particular premium on establishing commonly understood and accepted market standards to guide behaviour.

The Global Code initiative launched in May 2015 by the Bank for International Settlements (BIS) Governors, is designed to achieve this. The initiative will establish a single, global code of conduct for the wholesale FX market and has been tasked with developing mechanisms to promote greater adherence[3]. This initiative is now well advanced, with the Phase 1 material published in May 2016[4]. The complete Code will be launched in London in May 2017.

A sceptic might question the prospects for the success of this initiative. After all, this is not the first FX Code – it will supersede a number of existing regional FX Codes, some of which ended up gathering dust in market participants' drawers. So, why will this Code work where others have failed? In a market where information asymmetries have been exploited for selfish motives – what good can a voluntary code of conduct really achieve?

This is a good challenge, and in the end only time will tell if the Code initiative will succeed in minimising future incidents of misconduct. But I want to set out four reasons to be optimistic before discussing the steps that I think market participants will need to take individually and collectively to support future adherence, which is fundamental to the Code's ultimate success, and why I believe it is in their interests to take these steps.

The first reason for optimism – and perhaps the most important – is the substance of the Code itself. It will directly address the complexity of the FX market I summarised earlier and, informed by the misconduct of the past, provide guidance where it is necessary. For example, the interim publication established the important principle that 'where the acceptance of an order grants the Principal executing the order some discretion, it should exercise this discretion reasonably, fairly and in such a way that is not designed or intended to disadvantage the Client'. And while acknowledging that pre-hedging may be a legitimate risk management tool it is clear that it should only be undertaken 'in a manner that is not meant to disadvantage the client or disrupt the market'. During Phase 2 of our work programme we will deal with other areas, such as the provision and use of 'last look' and time-stamping that were highlighted by the Fair and Effective Markets Review as areas where market practices in the FX market could be improved.

[3] http://www.bis.org/press/p150511.htm - Guy Debelle of the Reserve Bank of Australia is chairing this work, with Simon Potter of the Federal Reserve Bank of New York leading the work on developing the Code with myself leading the adherence work.
[4] https://www.bis.org/mktc/fxwg/gc_may16.pdf.

And in doing so it strikes the right balance between setting out such high-level principles and providing concrete guidance. Let me illustrate this point summarising how Phase 1 dealt with the vexed issue of information sharing. The May 2016 text sets out, upfront, a broad, overarching principle – 'Market Participants should communicate Market Colour appropriately and without compromising Confidential Information'. And it then sets out in detail, how this principle should be applied to different types of information: for example, 'Client groups, locations and strategies, should be referred to at a level of granularity that does not allow Market Participants to derive the underlying Confidential Information'. This will be augmented in the final Code with stylised examples to demonstrate how this guidance can be applied to practical situations – examples of both effective and ineffective aggregation of information.

Second, we are alive to the importance of keeping the Code up to date. From start to finish the Code will have been completed in just two years. A benefit of this compressed timeline is that the Code should be relevant for today's market when published. And importantly we are committed to developing an appropriate review mechanism so that the Code stays up to date and evolves as the market evolves. Further details will be announced next year, but the new Code will not be allowed to stagnate.

Third, the process for developing the Code is inclusive and, to my knowledge, unprecedented. Its development is very much a partnership between public and private sectors, with broad-based, senior engagement from all types of key market participants. This should help get buy-in for the final product. The Code is for everyone in the FX market – it covers the buy-side, sell-side, non-bank participants, trading platforms and other market infrastructure – and therefore our engagement has necessarily been as diverse. During Phase 2 we are further broadening our engagement to ensure that the voices of all different market participants are heard and taken account of. The contributions made by the more than 40 members of the dedicated Market Participants Group (MPG) – chaired by David Puth from CLS – and on which current ACI President Marshall Bailey also sits – alongside the contributions of the regional FXC members have been invaluable, and involves hundreds of individuals devoting thousands of hours to the cause.

Fourth, the Code is one of a suite of important initiatives which have launched in recent years to improve conduct in FICC markets. Initiatives such as the UK Senior Managers and Certification Regime, soon to be extended beyond banks to all FCA authorised firms, will aim to raise standards of market conduct by strengthening the accountabilities of senior management. This is particularly pertinent for FX given that London accounts for over a third of global FX market turnover. Reforms to remuneration structures will aim to reduce the incentives to cheat for short-term profit. And in the UK the FICC Market Standards Board, created as a direct consequence of the Fair and Effective Markets Review, has been established to champion good conduct across the whole range of FICC markets. These initiatives, combined with a greater focus on conduct, create a supportive environment for the objectives of the Code[5].

[5] There are a number of other important Codes that are being developed in the UK, specifically such as the Securities Lending, Repo and Money Markets Code which is currently being written by a market participant-led joint sub-committee of the Bank's Money Market

These four factors create reasons to be optimistic about the prospects for the Code. But, they are not enough to ensure success. That will require consistent widespread adherence by market participants. The Code will only rebuild trust if it is actively used by market participants to drive a market-wide shift in culture and attitudes – one that embeds behavioural norms that are consistent with both the letter and spirit of the Code.

This type of cultural shift is not something that can be mandated. The official and private sectors will work together to achieve this, but there can be little doubt that change, fundamentally, must come from firms themselves. In my view at least, it is in market participants' individual and collective interest to make that change.

Individually, firms that assimilate the Code fully are likely to benefit, over time, from greater trust in the marketplace, a stronger reputation, and a higher long term franchise value. In a world where competition for market share remains fierce, winning the trust of your clients matters financially.

Collectively, if standards of behaviour throughout the market are higher, it is easier for any one firm to maintain its own high standards and avoid getting embroiled in a 'race to the bottom'; all firms can then benefit from a reduction in future regulatory and legal risk. Moreover, enduring adherence to the Code's higher standards of behaviour will likely lead to improved functioning of the market as a whole: if widely followed, the Code should facilitate more effective and consistently appropriate information sharing than has been the case. An efficient and effective market can make a positive impact on everyone's bottom line – leading to better volumes, fewer disputes and better outcomes for all market participants.

So the question for market participants is - how can you, collectively and individually, make use of the Code to realise these benefits? There are three key elements that need to be in place: First, the Code needs to be embedded in firms' practices: training and education will be important here. Second, firms should have the right policies and procedures in place to ensure that they are able to monitor how successfully they have embedded the Code. The text of the Code itself provides some practical suggestions but ultimately firms will need to consider what the appropriate framework is for their business and level of activity in the FX market. Third, firms should be able to demonstrate publicly that their behaviour and practices in the FX market are in line with the Code's principles. The widespread use of a common public attestation could be a powerful tool in this respect. It would provide a strong signal of a firm's commitment to following good practices and help focus the mind of the firm's senior management who would be asked to sign the attestation.

Embedding, monitoring and demonstrating adherence requires concrete action. The central banks are leading the way, both by demonstrating their own commitment to the Code and by setting incentives for others to follow. BIS central banks have announced their intention to embed the finalised Code within their

Liaison Committee (MMLC) and Securities Lending and Repo Committee (SLRC); and the Precious Metals Code being produced by the LBMA. These parallel initiatives will both benefit from and contribute to this supportive environment.

own practices – with the expectation that their FX counterparties will do likewise. We are also working towards establishing a link between a firm's formal commitment to adhere to the Code and membership of regional FXCs (the London FXJSC in our case). In this context, we have been developing an attestation form, which could be adopted more widely, and could be viewed as a public good. Given the breadth of FXC membership – there are over 200 FXC members within the 8 major regional FXCs, representing the buy-side, sell-side, infrastructure, associations and others – the potential importance of this link should not be underestimated.

Our actions as central banks, however, can only be a part of the broader picture. The market itself needs to consider how to engage with the Code both collectively and individually. The process has already started at a collective level. David Puth's MPG has recently created a dedicated sub-group to consider market-based methods to support the Code. I am sure the MPG group will reach out to industry associations, like the ACI, about the potential to develop common education modules, provide training and seminars or facilitating workshops to deepen knowledge of the Code. We will share thinking about the use of attestations with the MPG team, and I am confident that they will identify a number of market-based initiatives to support adherence. One idea the group is exploring, which is not without challenges but could be developed through time, is the creation of an industry kite-mark, which firms would be awarded if their public attestation to the Code was buttressed by a threshold amount of independent assurance work.

Individually, firms, and particularly senior management, should start considering the steps they will take to support the Code. Over and above questions about policies and procedures and training modules the key question senior management should be asking is how can they set a strong positive tone and ensure that their firm's incentives and promotion policies are aligned with responsible engagement in the market and the long-term reputation of the firm? Part of this conversation will involve a discussion on how firms can monitor their adherence to the Code, reward good behaviour and penalise bad behaviour. In the UK, senior managers may find it helpful to consider this work in conjunction with their responsibilities under the Senior Managers and Certification Regime.

When the final Code is released in May 2017 it will no doubt be subject to much scrutiny. Sceptics will look for clear commitments from firms to adhere to the Code. Central banks are playing their part in catalysing those commitments, but what will really count is the response of market participants. Words alone will not be enough and I encourage you all to ensure you respond positively and quickly. The Code should not be seen as, and indeed it is not created to be, a tick-box exercise. The Code is not written primarily for compliance departments but for all the FX market – including front, middle and back office and senior management who should want to adhere. It is a tool for rebuilding trust and standards.

If the new Churchill £5 is 'cleaner, safer and stronger' than its predecessor, then I hope the global Code initiative will lead to an FX market that is 'cleaner' and 'safer' for its users because it has a 'stronger' impact on behaviours than its forefathers.