For release on delivery
10:00 a.m. EST
January 20, 2015

"Comments on the Fair and Effective Markets Review"

Remarks by

Jerome H. Powell

Member

Board of Governors of the Federal Reserve System

at

"Making Markets Fair and Effective for All"
Sponsored by The Brookings Institution

Washington, D.C.

January 20, 2015

I want to thank the Brookings Institution for inviting me to comment today on Martin Wheatley's presentation on the Fair and Effective Markets Review (Review). [1] The Review is an ambitious and important initiative. Although London is perhaps the leading center for many fixed-income, currency, and commodities (FICC) markets, these markets are global, and the United States and the largest U.S. firms play key roles in them. So the Review addresses issues that affect our markets as well.

The Review looks to identify further steps that should be taken to restore public confidence in FICC markets in the wake of the depressingly numerous instances of serious misconduct in these markets in recent years. That misconduct has been, and will continue to be, addressed through substantial fines and criminal prosecution of the firms and individuals involved. The Federal Reserve continues to take part in these enforcement actions in cooperation with other U.S. agencies.

The design of the Review is not only to advance the enforcement process, but also to look carefully at markets and firms and ask whether there are structural vulnerabilities or incentives for bad conduct that have not been well addressed by reforms to date. I will offer comments on a few specific areas and discuss some of our parallel efforts here in the United States.

First, as the Review notes, there is a perception that FICC markets and their participants are highly sophisticated and do not need protection. While that may be generally true, the perspective is too narrow, because the importance of these markets extends far beyond the largest participants in them. The market mechanism allocates credit and determines the borrowing costs of households, companies and governments.

[1] The views expressed here are my own and are not necessarily shared by other members of the Federal Reserve Board or the Federal Open Market Committee.

Proper market functioning is really a public good that relies on confidence and trust among market participants and the public. Bad conduct, weak internal firm governance, misaligned incentives, and flawed market structure can all place this trust at risk.

One of the ways we have to influence incentives is through compensation practices at supervised institutions. Many have argued that pre-crisis compensation practices at the largest financial firms allowed or created misaligned incentives. In response, many firms have changed their compensation practices since the crisis to better align incentives between individuals and firms, particularly through enhanced deferral of incentive compensation, with delayed vesting and the possibility of more robust forfeiture in a broader set of circumstances. We have strongly encouraged these reforms in our supervision of these institutions. In my view, the reforms are both essential and generally on target. The U.S. financial regulators, including the Federal Reserve, are also preparing for public comment a proposed new rule on incentive compensation that will codify and strengthen these initiatives.

As the Review notes, greater transparency can also help curb market abuses and strengthen competition. In the United States, we have had over a decade of experience with the Trade Reporting and Compliance Engine (TRACE) in over-the-counter corporate bond, MBS and ABS markets. The Municipal Securities Rulemaking Board provides similar data for municipal bonds. The Dodd-Frank Act also imposed rules requiring greater transparency in over-the-counter derivatives markets through the use of central clearing, trade repositories, and swap execution facilities. Given the issues around OTC derivatives during the recent crisis, these clearly are important initiatives. But despite significant progress, there are still a number of impediments to sharing trade

report data across regulatory agencies and jurisdictions, leaving us with only a piecemeal picture of the overall market rather than the full transparency that we desire.

The issues around foreign exchange (FX) benchmarks serve to illustrate one of the important challenges discussed in the Review--the difficulty of managing the potential conflicts of interest associated with the traditional market-maker model. In FX markets, a wide range of end users seek to guarantee trade execution at the WM Reuters fixing at 4:00 p.m. U.K. time each day. This practice results in dealers having advance information about flows, and at the same time places them at some risk, as they are agreeing to execute these orders at an unknown future price. This advance information can create a perception that dealers are trading ahead of their clients, and it certainly created incentives to attempt to influence the fixing price. The recent Financial Stability Board (FSB) report on foreign exchange benchmarks[2] made a number of recommendations designed to address these issues in this specific market, including use of trading platforms to maximize the netting of fixing orders, encouraging dealers to charge a transparent bid-asked spread or other fee to compensate them for the risk they take, and strengthening dealers' internal systems and controls to better manage potential conflicts of interest.

Of course, similar challenges exist with market-making in other FICC markets. Many firms have taken up these challenges with their own reforms, and their efforts serve to emphasize how complicated these issues can be. Dealers must communicate with other firms, within their own firms and with their clients, and must execute their clients'

[2] http://www.financialstabilityboard.org/2014/09/r_140930/

trades. The challenge is to identify and preserve the legitimate benefits of such communication and trading while safeguarding against improper uses of information. It may be that these challenges can be addressed through coordinated private efforts; for example, through such bodies as the Foreign Exchange Committee and the Treasury Market Practices Group, sponsored by the Federal Reserve Bank of New York. These groups are actively working on industry best practices in their markets and have often played a constructive role on market practices that enhance market functioning. It may also be that further supervisory or regulatory action is needed.

Turning to our work on interest rate benchmark reform, it is worth recalling that, before the scandal broke, the London interbank offered rate (LIBOR) was not regulated. U.K. authorities have now addressed this shortcoming by making both the submission and administration of LIBOR regulated activities. The process by which firms make their LIBOR submissions is now subject to careful monitoring. The new LIBOR administrator, ICE Benchmark Administration, now regulated by the Financial Conduct Authority, is evaluating changes to LIBOR so that it can be based as much as possible on actual arm's-length transactions from a broader base of funding transactions.

With surveillance and penalties in place, and a new administrator, one might be excused for thinking that there is nothing more to be done. In fact, some people *do* think that. That is emphatically not the view of the FSB Official Sector Steering Group that I now co-chair with Martin, which concluded that it is essential to develop one or more risk free (or near risk free) alternatives to LIBOR for use in financial contracts such as interest rate derivatives. The reasons are related to the structure of both LIBOR and the market that underlies it. Unsecured interbank borrowing has been in a secular decline for some

time, and there is a scarcity, or outright absence in longer tenors, of actual transactions that banks can use to estimate their daily submission to LIBOR or that can be used by others to verify those submissions. LIBOR is huge--there are roughly $300 trillion in gross notional contracts that reference it--so the incentives to manipulate it still remain in place. And the structural problems go much further than the incentives for manipulation. Markets need to be fair, effective, and also *safe*. If the publication of LIBOR were to become untenable because the number of transactions that underlie it declined further, then untangling the outstanding LIBOR contracts would entail a legal mess that could endanger our financial stability.

For these reasons, the Federal Reserve has convened a group of the largest global dealers to form the Alternative Reference Rates Committee. We have asked them to work with us in promoting alternatives to U.S. dollar LIBOR that better reflect the current structure of funding markets. As the Review's consultation document notes, issues of this kind are really global in nature; U.S. dollar LIBOR contracts are traded throughout the world, not simply in the United States. For this reason we are working in close consultation with our foreign regulatory counterparts in this endeavor.

One of the reasons that I emphasize structural issues such as the market-maker model or the secular decline in unsecured interbank borrowing is that FICC markets are undergoing rapid changes that seem likely to have far-ranging consequences. Issues that a few years ago concerned equity markets now arise in FICC markets as well. As the consultation document notes, broker-dealers are curtailing some of their market-making activities and their appetite for providing liquidity in response to regulatory changes and their own assessment of the risks and returns of these activities. At the same time, other

players such as mutual funds, exchange traded funds, algorithmic and high-frequency traders, and electronic exchanges are taking more prominent roles. These changes will affect market liquidity and functioning in ways that are difficult to foresee. It is possible that some of these factors played a role in the sharp swing in Treasury yields last October 15, and we are working with other regulators to understand exactly what happened that day and to determine whether there are implications for regulatory or supervisory policy.

The Review raises the right questions in considering the troubling patterns of market abuse, and also in considering the structural changes that we are now seeing. It is important that market participants, end users, and regulators collectively take a step back and consider, as the Review invites us to do, whether the changing structure of FICC markets will result in markets that are fair, effective, and safe.