bruegel

How Fair and Effective are Financial Markets?

Bruegel Event, Brussels, 21.01.15

[Complimentary Materials: Fair and Effictive Financial Markets Review (Bank of England, HM Treasury and Financial Conduct Authority)]

Panel:
Minouche Shafik, *Deputy Governor of the Bank of England*
Olivier Guersent, *Deputy Director General, DG Financial Stability, Financial Services and Capital Markets Union*
Nicolas Veron, *Senior Fellow at Bruegel*

"Misconduct in financial markets has rarely been out of the headlines since the scandal over Libor – the London-based inter-bank lending benchmark – emerged in 2012. More allegations have followed. The market in foreign exchange is only the most recent to come under scrutiny, with regulatory investigations resulting in a number of banks being fined hundreds of millions of euros for attempted manipulation".

Intro

- Financial misconduct by market participants is extremely threatening to financial stability.
- Hence the use of large fines (both personal and at the company-level) against those found to have acted in an improper manner.
- Financial markets are huge: The bond market is approx.. $100 trillion, many multiples of US or Eurozone GDP, and up to $5 trillion's worth of trade in forex markets daily.
- Trust in our financial markets is key. Markets are more important now than they have ever been, and have a huge impact on the behind-the-scenes functioning of our day-to-day lives.

Competition:

- Policy makers are looking to improve the depth and breadth of European financial markets, with the biggest effort taking the form of the capital markets union to improve the volume and efficiency of the capital allocation processes in Europe.
- Key areas going forward will be in the microstructure of individual financial-product markets and in the nature of competition in these markets (structural level)
  - As well as the standardization of issuance and product types available, especially in the fixed income markets (product level)
  - Although some markets can appear concentrated, from a competition theory perspective this is not seen as dominance by monopolies/oligopolies – e.g. 40% of FX trades are done in London, and the top 6 firms account for about 60% of all trades. It may appear highly concentrated (and in need of more competition) however this is still a fairly well functioning market.
    - There are great benefits to having deep capital markets, competition will drive efficiency.

Conduct:

- While we can easily observe the macro-level position of markets, the manipulations happen usually on the micro-level (personal decisions, not firm-level decisions).
    - So while a given financial market may appear to be in a good, functioning state in the aggregate, there may be malpractice taking place on a micro-level, so-called "rogue traders" etc.

    - While the rules are clearly defined from a legal perspective, what this means in practice is not always clear – many grey areas exist. There is a need for a practical guide on conduct in financial markets from the point of view of market participants, not lawyers.

Governance and Incentives:

- In the past a somewhat light-touch approach was seen as appropriate – if a market participant deviates from the accepted norms of behavior, she would cause reputational damage to her firm and herself, thus damaging future prospects.
- This approach seems to have been overpowered by short-termism and the incentive structures that emphasise immediate returns, sometimes at all costs (bonus claw-back of up to 7 years is one mechanism to combat this effect).
- The system needs safeguards against movement of offenders within in the industry to other firms after committing violations.

Concluding remarks:

- European capital markets still have a long way to go compared to the depth of US – euro firms are heavily dependent on bank financing, which can be extremely pro-cyclical and volatile.
- In the US the ratio of bank/market funding is almost reversed.
- Effects of adding more constraints and extra regulation is not clear
    - Net gain or net loss (trade-off between systemic safety and stability vs allocative efficiency/speed) is not clear ex ante.

Q & A session

Why support less individual fines and more at the firm level?

- Legally it can be very costly to pursue individuals who will make strong defense in the courts vs firms who will often not challenge the decision.

- This comes at the cost of signalling the wrong message to the market – that somehow these fines are just another cost of doing business, and that if they commit violations they are absolved by paying the fine.

Event notes by Thomas Walsh,
Research Assistant, Bruegel