Guernsey Financial Services Commission

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How things have changed since 2006

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When looking at the title of the presentation I was given today I couldn't think of anything which took place from an international standard setting perspective in 2006. This didn't seem to be a promising start but it is the fact that nothing did happen in 2006, at least in relative terms, which is the point. It was immediately before the economic and financial crisis. In 2007 the crisis began to show itself with, for example, the first run on a British bank for many years. In 2008 the crisis was in full swing with the failure of Lehmann Brothers in September. For a period there was even concern that the Anglo-Saxon models of capitalism might fail or have to be remodelled.

In order to provide context to show how the supervisory world has changed since 2006 I would like to provide an example of what went wrong. The usual example is Lehmann Brothers but that has been done numerous times before so I shall look instead at Washington Mutual Bank*. At the time of its failure in September 2008 it was the sixth largest deposit taker in the United States. In other words, it was big.

Washington Mutual engaged in high risk lending with liberal underwriting standards and inadequate risk controls. Much of the lending was comprised of sub-prime mortgages. In addition, Washington Mutual and an entity linked to it were engaged in securitising loans to such an extent that Senator Carl Levin was quoted as saying that these two firms dumped "hundreds of billions of dollars of toxic mortgages into the financial system like polluters dumping poison in a river."

By September 2008 the bank had suffered losses, had problems in borrowing and a falling share price. Depositors were withdrawing significant funds. The bank was unable to keep pace with these, i.e. it had liquidity problems, and the bank was closed by the Office of Thrift Supervision, the OTS.

The OTS was the primary supervisor of Washington Mutual. It had concerns about the firm over several years, including repeat findings of problems in a number of areas. However, it did not ensure the bank remediated its shortcomings. The OTS relied on Washington Mutual's system for tracking progress against hundreds of the supervisor's findings. After some years, in March 2008 the OTS took informal enforcement action by requiring Washington Mutual's directors to pass a resolution to ensure that weaknesses in earnings,

asset quality, liquidity and compliance were addressed. We should note that the action was informal rather than formal. The resolution which was passed only addressed liquidity. Additional enforcement action, still informal, was taken by the OTS in September but by then it was too late. As it turns out the informal approach to enforcement went against the OTS's own procedures.

There was a second authority, the Federal Deposit Insurance Corporation, the FDIC, which was responsible for monitoring and assessing Washington Mutual's risk to the Deposit Insurance Fund. Much of 2008 was spent in challenging the OTS's somewhat optimistic risk rating of Washington Mutual. Disagreement between the two bodies as to the right risk rating was resolved a week before the firm's failure. The best that can be said about this is that at least the rating was changed before Washington Mutual's failure.

The FDIC did not itself use enforcement powers because of the significant procedural steps required. There was a written agreement between the FDIC and the OTS. However, the terms of the agreement were circular. In order to use the agreement to obtain fuller access to Washington Mutual and information on the bank's risk profile, the FDIC first needed to justify its use of the agreement by having substantial information on the risk profile – which it did not have. The OTS resisted greater access by the FDIC to Washington Mutual on the basis that it believed the FDIC could and should rely on the work of the OTS. Eventually, access was provided by the OTS but only on a limited basis.

This case has many of the features which changes since 2006 have sought to address. First, Washington Mutual was a bank with poor controls in relation to high risk business. Second, the scale of the business presented a systemic risk. Third, there was inadequate supervision, including lack of cooperation by supervisory authorities.

The overarching strategic response to the crisis came from the G20 countries. Until 2007/2008, the G7 countries had been the prime drivers of global policy but the crisis demonstrated that the wider input and commitment of the G20 was necessary. In addition, it became clear that a number of the countries outside the G7 wanted to join the club and play a part in the response to the crisis. Substantial initiatives were put in train by the governments of the G20, some because of wider political concerns – such as hedge fund regulation – and some inspired by the standard setters and by supervisory bodies.

The G20 acts to a large extent through the Financial Stability Board, the FSB. The existence of the FSB is one of the responses to the crisis. It replaced another body, the Financial Stability Forum, and has enhanced powers compared with the FSF. Its role is to coordinate the work of national finance authorities and international standard setting bodies, and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies in the interest of financial stability. The FSB includes regulators, amongst others, from the G20 and a few jurisdictions outside the G20. The FSB has been particularly active in considering how to reduce risk.

In undertaking its work the FSB spends significant time liaising with the standard setters – the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors, the International Organization of Securities Commissions and the Financial Action Task Force on Money Laundering.

As part of its response to the crisis, the Basel Committee revised its Core Principles in 2012.

The first of these Core Principles states that the promotion of safety and soundness of banks and the banking system is the primary objective for banking supervision. The standards go on to state that it should not be an objective of supervision to prevent banking failures; supervision should aim to reduce the probability and impact of bank failure so that failures occur in an orderly manner. It should be noted that this approach to supervision does not apply only to banking supervision – it holds true for the supervision of other entities as well.

Returning to the Core Principles, in seeking to ensure that failure is orderly, banking supervisors are expected to work with resolution authorities.

Resolution is a hot topic within banking supervisory circles but I suspect not everyone here today will necessarily be up to date on current thinking. One way of getting to grips with what resolution looks like is to outline the tools used in resolving a bank. These include:

- the sale of some or all of the business;
- the temporary transfer of good bank assets to a publically controlled entity - this would be what is called a bridge institution;
- the transfer of poorly performing assets to a separate asset management vehicle;
- the imposition of losses on shareholders and unsecured creditors – these are known as bail-in measures.

The Core Principles acknowledge that supervisors use a risk based approach in which more time and resources are devoted to larger, more complex or riskier banks. Banking supervision also needs to include supervision beyond the level of the individual bank to include supervision on a consolidated or group basis and from a broad financial system perspective.

Supervisors are expected to have crisis preparation and management frameworks, together with an orderly resolution framework. In general, bank supervisors are now expected to be more intrusive and there is a higher threshold within the Principles on satisfying themselves as to whether banks are meeting the required standards.

There is a new Core Principle on corporate governance covering strategic direction, group and organisational structure, control environment, responsibilities of banks' boards and compensation. There is also more emphasis on disclosure and transparency. The supervisor

should determine that banking groups and, where appropriate individual banks, regularly publish accessible and fair information on their financial condition, performance, risk exposures, risk management strategies and corporate governance policies and procedures.

The other main Basel Committee standards are contained in Basel III. Basel III is headlined as strengthening both the quantity and quality of bank capital. It is also aimed at consistency of approaches to establishing what capital is necessary and when, and reliability of bank capital ratios. It is usually forgotten by commentators that Basel III, for the first time, sets international standards on bank liquidity. Lack of liquidity was a key driver in the failure of Washington Mutual and it was by no means an isolated case.

The IAIS issued revised Insurance Core Principles in 2011. I do not intend to dwell in detail on the changes made to the previous Insurance Core Principles but they are broadly analogous to those in the Basel Committee standards with, for example, enhanced provisions on solvency and corporate governance. One aspect which is different, which I do want to touch on, is that the revised Insurance Core Principles contain expectations for the conduct of business by insurance intermediaries. Quantity is not the best yard stick to measure change but, by way of illustrating the scale of change, it takes far longer to consider the implications of the 400 plus pages of the revised Insurance Core Principles compared with the 52 pages of the previous version.

IOSCO too has updated its standards. It has issued eight new Principles and revised others. The new Principles are wide ranging; some of them are similar to those for banks and insurers:

- the regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate;

- the regulator should have or contribute to a process to review the perimeter of regulation regularly;

- the regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed;

- auditors should be subject to adequate levels of oversight;

- auditors should be independent of the issuing entity that they audit;

- credit rating agencies should be subject to adequate levels of oversight. The regulatory system should ensure that credit rating agencies whose ratings are used for regulatory purposes are subject to registration and ongoing supervision;

- other entities that offer investors analytical or evaluative services should be subject to oversight and regulation appropriate to the impact their activities have on the market or the degree to which the regulatory system relies on them;

- regulation should ensure that hedge funds and/or hedge funds managers/advisers are subject to appropriate oversight.

The FATF has also been busy in revising the Recommendations on combating money laundering and the financing of terrorism and weapons proliferation. It has also issued a revised methodology, which will be used to evaluate jurisdictions' compliance with the revised Recommendations. I do not mean to dwell on these at length. The revised methodology pays significantly greater attention to the effectiveness of jurisdictions' AML/CFT frameworks. The key change at the technical level is that one of the Recommendations focuses on a requirement for jurisdictions to have a national risk assessment on money laundering and terrorist financing. This is a new requirement and it is fundamental because it is the foundation on which jurisdictional AML/CFT frameworks should be built. Get this wrong and the AML/CFT framework will be less effective than it should be. It will also have a significant effect on the ratings in any evaluation.

These are not the only changes since 2006 which have affected - and will continue to affect - Guernsey.

The European Union is closer to home, geographically at least. If all three Crown Dependencies are considered together – and they often are – we would comprise a significant and noticeable finance centre on Europe's border. It can be no surprise that the Guernsey authorities need to address responses to the crisis and other changes emerging from the EU.

I cannot remember Guernsey having to seek equivalence with or otherwise deal with any EU legislation in the 1990s. Since then we have had to introduce legislation or other measures on alternative investment fund management, auditor regulation, data protection, insider dealing, tax and wire transfers in order to take account of developments in the EU.

There is more than one feature of these developments which is relevant to Guernsey. Changes in regulation and supervision as a result of the crisis are linked to a natural desire within the EU for third countries which wish to undertake business in the EU to meet EU standards. There is an increasing number of EU initiatives which include third country provisions. At the least, these provisions need to be monitored. In other cases we need seek changes to EU standards at the draft stage and, depending on the outcome, to enact legislation or other measures here.

There is an avalanche of EU activity which must be monitored. This work includes banking supervision, bank resolution, shadow banking, SEPA, AML/CFT, European Long Term Investment Funds, AIFMD, MiFID 2, pensions, Solvency II, insurance mediation, insurer resolution, data protection and tax. Of these initiatives, the one with the greatest potential impact on Guernsey is MiFID 2. The draft directive contains language which, if introduced in its current form, would require investment firms providing services to retail customers in

the EU to establish a branch operation in a Member State and be subject to certain provisions in the directive. This provision would of course apply to Guernsey firms providing services in the UK.

It is increasing recognition of the EU's influence and the need to identify and address that influence in a more rounded way that led to the establishment of the Channel Islands Brussels Office. CIBO is Guernsey's eyes and ears in Brussels.

In addition, the Commission has been paying increasing amounts of attention to bodies in the EU with quasi-supervisory or supervisory powers.

These bodies include the European Banking Authority, the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority. These three Authorities were established in 2011 as part of the EU's response to the crisis.

The legislation governing these Authorities makes it clear that the crisis exposed shortcomings in nationally-based supervision. There was no mechanism for national supervisors to arrive at the best possible supervisory decisions for financial institutions and groups active in more than one Member State. The crisis exposed poor supervisory cooperation and information exchange; an absence of trust in some areas between national supervisors; a need for complicated arrangements to take account of national supervisory requirements; and inconsistent interpretation of EU-wide legislation.

In order to address these issues, it was envisaged that national supervisors would remain responsible for day-to-day supervision, while the Authorities would be given powers to issue EU-wide regulatory technical standards. The European Commission endorses the standards to give them binding legal effect. The Authorities are also be able to issue guidance and, in some circumstances, recommendations to national supervisors. It is possible, in very limited circumstances, for an Authority to issue a decision to individual financial institutions.

The Commission monitors and engages with the Authorities. The most notable example of this is the significant time spent liaising with ESMA in relation to the cooperation agreements signed between the Commission and Member State supervisors as part of our response to ensuring that Guernsey is well positioned to address the alternative investment fund management directive.

However, even since 2011 there have been sweeping changes in relation to banks. In less than a year's time, the European Central Bank, the ECB, will be the prudential supervisory authority for 128 banks in the euro area. It will therefore be the supervisor of banks with operations in Guernsey. The Commission is very mindful of the importance of building a relationship with the ECB.
Responses to initiatives by the UK Government are also part of the Commission's ongoing work. The most obvious example of this is the UK Government's desire to establish a framework for banks with retail customers, which is ring fenced from what are colloquially

described as casino banks or the casino operations of banks. The Commission is significantly involved in Guernsey's response to this initiative, not least to ascertain whether Guernsey branches of UK clearing banks might be included within the ring fence.

The UK has also been very active in the G8 on matters relevant to the Commission. As part of the international drive for transparency the G8, with strong input from the UK, has launched an initiative on transparency in relation to the beneficial ownership and control of legal persons and legal arrangements. The States of Guernsey has issued an action plan in response to the initiative. It is quite difficult to have a discussion in Guernsey on beneficial ownership without including anti-money laundering standards in relation to entities supervised by the Commission. As a consequence, the Commission is liaising with the States of Guernsey in its work on taking forward the action plan.

As you can see, although I have barely scratched the surface, there is a huge amount of international activity which the Commission and other authorities need to monitor and address. This is a vastly different world to the one of ten years ago where the pace of change was slower. The Commission has to spend far more time on policy matters now than before the crisis. We work closely with others, including the States of Guernsey. Our aim is to be on the front foot in relation to changes to international supervisory standards and standards affecting supervision, and to do the best we can for the Bailiwick. It is not enough to do half a job - only our best is good enough.

*This text on Washington Mutual Bank has largely been inspired by and uses language from the US Offices of Inspector General April 2010 Evaluation of Federal Regulatory Oversight of Washington Mutual Bank.