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Keynote Speech

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Depending on when you date the outset of the financial crisis, it is now either five or six years since the first recognition of the disruption which was destroying many of the assumptions on which central banking, financial regulation and much of commercial banking had relied. Those assumptions had served us well. The period known to economists as "the great moderation", which was described by Mervyn King as the NICE – non-inflationary consistent expansionary – years and which was in a more homely way characterized by that distinguished CITI banker Bill Rhodes as the Goldilocks era, when not only the porridge but almost everything else was just right, not too hot and not too cold, had seen the world economy grow steadily; inflation was under control in almost all parts of the world; great dangers – two Gulf wars, the largest asset bubble ever, and the largest one day crash in stock prices – had been managed. No wonder that the policy makers thought they had cracked it.

Now, of course, we know better. We know better because we know how far we have fallen. In the UK GDP, despite the recent improvement in our growth performance, still lies below what it was in 2008. Our GDP this year will be about one sixth lower than we expected it to be when in 2008 we extrapolated the trend line from then until 2013. The fiscal position of the UK has deteriorated as government debt has increased from 52 to 90 per cent of GDP. Employment has stood up well, but only at the cost of a decline in labour productivity which will pose long term problems which we are still to face. And I should point out that the UK has not suffered as much as some other countries. If I were to set out the position of Spain, Italy, Ireland or France, the picture in many respects can be painted more bleakly.

Today, I want to consider how we have responded to the challenge posed by this abrupt and huge change: how have the central bankers and the financial regulators redefined what they expect of the financial services which they seek to influence and control? What does this mean for the firms which are subject to their rules and influence? What are the issues still to be resolved?

I will separate the response into two – very large – bundles. The first is a range of prudential issues, the second a range of conduct issues. For each, we need to start by considering what has gone wrong.

Prudential issues: what are we trying to cure?

As the scale of the problems began to become clearer during the slow train wreck which lasted from August 2007 when the first problems emerged – the BNP announcement in France that it could not sensibly value important assets, the run on Northern Rock in the UK – until the actual crash in 2008 as specific large banks had to be saved by massive

government intervention in Europe and the US, the cause of the problems began to be better understood. Let me list some of these:

- There was a growing recognition that we had not understood the scale of leverage in the financial system, nor where the debt in reality lay. The establishment of the Basel 1 capital rules had deflected attention away from simple leverage, for the good reason that we all knew that simple leverage could be and had been manipulated and gamed. The move had been towards greater sophistication which Basel 2 – not yet introduced – would have taken to a new level. It is incidentally one of many myths that Basel 2 was the cause of the bank capital crisis: in fact all were still governed by Basel 1.

- The issue of liquidity, which had from the very start of the Basel Committee's deliberations been consigned to the "too difficult to tackle" category, had been neglected. Insofaras it had been dealt with by banks, their response had been – not stupidly – to move away from retail deposits which could be reclaimed on demand to increased reliance on wholesale deposits for which longer notice periods were required.

- There had been an over reliance on complex mathematical analysis and the insurance value of derivatives. At the time we believed that this sophistication had brought greater stability to the financial system, and was lauded as such, not least by the IMF.

- Valuation of complex instruments was over reliant on the work of the rating agencies, which had been overtrading to an extent which was staggering. The only regulator which claimed to have any regulatory oversight of the rating agencies was the SEC in the US, but all of us – regulators and practitioners – should have been much more aware of this problem, irrespective of our legal responsibilities.

- The systems for compensating consumers in the event of a bank failure had been designed to avoid the problems – only too obvious at the time of the US bail out of the savings and loans – that a generous scheme encouraged moral hazard: people would make deposits in banks with poor credit records and outlooks but offering high interest rates on those deposits safe in the knowledge that they would on failure be repaid in full. The more recent schemes such as that introduced in the UK guarded against this, but did little to guard against a run on the bank.

- The cooperation between national supervisors had not proved adequate to deal with problems that were international, and certain elements of this cooperation, in particular the assumption of the legal right to branch from an authorized bank in one part of the EU to all other member states of the EU, needed to be reviewed.

- Last, there was a belated recognition that the economic and social damage caused by a significant bank failure was such that no government could allow those banks to fail, but that there was no established mechanism to deal with a failing bank. This problem was particularly acute when the bank spanned different countries.

The response

The response to date has dealt with many, but not all, of these. Let me deal with them in the order I have listed them as problems:

(i) Capital: the Basel Committee has been busy, as have individual national or regional regulators. All have been working in the direction of all banks holding more, higher quality, capital, with large banks holding still more capital on top of the norm. Under Basel 3, banks will be required to meet a minimum CET1 ratio of 7%, which rises to a possible 12% when you take into account the additional buffers that will apply to the large banks. On top of this, there has been a reversion to additional use of leverage ratios – the (comparatively) simple measure of assets against equity – as well as risk weighted assets. Regulators have also started to focus on the geographical distribution of that capital, and how this matches the risks country by country, and the on-going work on Recovery and Resolution has pushed firms to think about the amount and location of bail-in eligible debt that they need to hold. This is one – but not the only – example of the increased Balkanisation of regulation that has been a result of the response to the crisis.

(ii) Liquidity: liquidity is now receiving the attention it should, both in terms of amount and the quality of that liquidity The UK banks and building societies have been asked to hold significantly increased liquid asset buffers since 2010 (when the FSA implemented its new liquidity regime), and shortly there will be an international liquidity standard in force with the implementation of the Liquidity Coverage Ratio (LCR), which was developed to promote the short-term resilience of the liquidity risk profile of banks. Again, not just the quantity but the location of the liquidity is being looked at, particularly in reference to Recovery and Resolution planning.

(iii) Financial compensation schemes have been revised to rebalance the danger of moral hazard against the need to ensure that there is some better means of convincing retail bank depositors that they will not lose their money. This – like many other aspects of the response to the crisis – is very much work in progress, and policy is being determined as much by the immediate and specific response to whatever crisis is the panic of the day (most recently Cyprus banks) as it is by a coherent policy. There is no established policy here yet.

(iv) The reaction to the problems of how national supervisors and authorities should have cooperated better has been to take policy in two – largely opposite – directions. The first response has been to endeavour in a number of ways to improve international cooperation. Creating larger blocs, most notable by the initiative to create a Eurozone system of large bank supervision by the ECB, with the prospect of a wider banking union and eventually a wider financial compensation scheme; work between the US FDIC and the Bank of England on a bank resolution scheme; and a beefed up Financial Stability Board under Mark Carney's chairmanship are all examples of attempts to improve cooperation. But the second response has been to move to take greater national powers, essentially to make sure that in a crisis a country's taxpayers are not left holding the baby of compensation for the failure of banks they did not regulate – as the UK and Dutch taxpayers were at least temporarily forced to do in relation to the

Icelandic banks. Hence the national aspects of capital and liquidity requirements to which I referred earlier.

(v) Too big to fail: the last response I want to describe is the response to how to reduce the impact of bank failure: how to remove institutions from the TBTF category, where the response has been to require banks to develop Recovery and Resolution Programmes (RRPs) to make it easier to close them down without disruption, and to overhaul individual country's arrangements for the orderly winding up of a bank. Incidentally, it is one of a number of unintended consequences of the crisis that the effort to save failing banks by allowing them to be taken over by better managed and better capitalized rivals has resulted in more very large banks. The TBTF problem has become bigger, not smaller.

Anyone who has been following closely what I have been saying will have noticed that there are problems for which I have suggested no response. We have made little progress on the detailed mathematical underpinning of risk analysis – and even less progress on the underlying problem which is sociological rather than mathematical or econometric of how we connect a (younger) generation of hot shot analysts with an (older) generation of decision makers who do not understand the analytic underpinning of the decisions they are called upon to make. And – for all the failure by the rating agencies – we have moved to a world which in all sorts of important ways relies on the ratings of countries, institutions and instruments more than ever. Since it is truth almost universally accepted – which may or may not be true – that the rating agencies and their ratings were the villain of the crisis, this is ironic.

Conduct issues: what went wrong?

The conduct issues thrown up by the financial crisis were very different from the prudential issues, and I am tempted to say were unconnected to the financial crisis, in the sense that they could have occurred at any time. Essentially there are two major categories here. The first is the growing recognition that there had been a series of instances where the direct treatment of retail customers was clearly improper or inadequate: the bank overdraft charges levied by banks, the PPI services offered to customers, or the complex products sold to small and medium sized enterprises (defined by EU law as retail customers) are the obvious examples. The second are the scandals in the wholesale space – the established scandal of LIBOR fixing, and the emerging but not yet answered questions about manipulation in the FX market. On both the retail and the wholesale side there have been huge question marks raised about the integrity of banking conduct.

The response

The response to these issues has been both specific and – more importantly for all of us here concerned with any aspect of providing financial services to the retail market – general.

The specific has taken the form of a series of actions designed to punish those who have transgressed and to provide compensation for those who have been the victims. The punishments have included action against individuals to remove them from their positions or to prosecute them for criminal offence; and against firms to require them both to pay

substantial fines and to pay even more substantial compensation. I do not believe there was any bank board in the UK which believed ten years ago that the cost of conduct mistakes was going to cost British banks between 20 and 30 billion sterling over that period – but that is the scale of the remedy that has been exacted.

More important than the specific response has been the general response: a new concentration on conduct issues as a subject deserving full attention in themselves which is reflected in institutional arrangements, most notably the establishment of the FCA in the UK and of the FSCB in the US; a new determination to hold senior individuals responsible within financial firms for their actions or for those things they fail to do; and a quite fundamental redefinition of the essential concepts governing the relationships between those providing and those using retail financial services.

It is with two of these general changes that I want to dwell for the good reason that they are likely to impact – possibly painfully – on all here today.

The first is the issue of personal responsibility. There is a new assertiveness on the part of the UK regulators, both PRA and FCA, in their judgments about personal responsibility. It manifests itself in the greater demands both make when assessing individuals for their suitability for senior roles in financial firms, where there are both higher initial standards and a new emphasis on continuing assessment; it appears in the proposal from the Banking Commission of criminal liability of bank directors in banks which have to be rescued with public funds if they are shown to have been acting far below reasonable expectations of a person in that position and liable for decisions leading to failure of the bank ; it is clear in the day to day supervision of all financial institutions where the examination of the detailed ways in which directors discharge their responsibilities is much more intense.

The second is even more fundamental. The FCA in the UK is in the process of redefining what it expects of any firm which provides retail financial services. The past basis has emphasized the fair treatment of customers, a foundation stone of which was the provision to the prospective customer of information that was agreed to be fair, clear and not misleading. The future position will be very different. The FCA has made clear that it does not believe in a world of information asymmetry between sophisticated provider and unsophisticated consumer that information, however fair, clear and not misleading, is a sufficient basis. It has made clear that it will seek to take on board the complexities of behavioural economics rather than rely on more classic economics. It has made explicit that the concept of caveat emptor cannot be relied upon as a defence against an accusation of improper selling. Instead it will rely on wider concepts of fairness, the parameters of which are still to be defined. The brave new world in which all financial firms are operating is a much more dangerous world, both personally and corporately.

What does this mean for Guernsey?

Let me turn to what this means for Guernsey and for those who do business here. Let me be highly selective.

I'll start with the host of our proceedings, the Guernsey authority. As part of the recognition that too much reliance has been placed in the crisis on non-home regulators, I think the

Guernsey Authority, like all non-home regulators (and I would say particularly, whether fairly or unfairly, smaller authorities which can be in any way categorized as off shore authorities) will face increased challenge by the home regulators in terms of both competence and independence. Competence is not only a question of the technical ability of the staff of an authority, where the successful implementation of a sensible risk based regime is likely to be the foundation. It is also a question of resources and political independence. It will therefore be essential, if the Guernsey authority is to maintain its standing, that it should be able to demonstrate that it has sufficient resources to discharge its responsibilities, and independence from political influence.

Second there are the many people here who are authorized under the present PRA and FCA regimes in the UK. For all of you, there will be quite profound changes, whose outline, although they are not to be defined until a further consultation paper next January, can already be discerned. I am not here concerned with the changes to the authorization processes, to cope with the administration of dealing with two, rather than a single, authorities. Rather it is what is the new reality. Here I would highlight the following important dimensions of the probable new regime:

- Approval will not simply be a spot test at the moment of entry to an approved person status, but will be subject to continuing assessment over the life of an appointment;

- There will be much greater emphasis on defining responsibilities and ascribing them to named individuals. There has been a mounting impatience on the part of the authorities and of the Parliamentary Commission on Banking Standards with the failure to nail individuals for the errors that have been committed by financial institutions, and a desire to identify personal direct responsibility. Hence expect a greater attention required of definition of responsibilities, the time span for which these responsibilities were held (and when handed over) and personal attestation as to the effectiveness of remedial actions and controls. Action will be taken against individuals, not institutions – and as a consequence being a director or manager of a financial institution will become more dangerous to the individual.

Third, for all those who face the retail market, there is a need to recognize that the demands made upon them to demonstrate fair treatment of customers has assumed a new dimension, and few of the safe havens which in the past it was believed could be relied upon are still secure.

21 Fourth, and last in my highly selective list, there is the pressure which will come from the increased efforts to establish better coordination between national regulators, one of whose manifestations has been continuing pressures towards ever greater transparency of tax and ownership data, and the sharing of this information between authorities. You have already seen this in respect of the provision of information on interest payments made here to nationals of other countries. The same pressures will occur in relation to questions of ownership, and in particular in relation to trusts. Questions of identification of "real" ownership, the sharing of information with other authorities and the public disclosure of ownership will become of increasing importance. For all the Channel Islands, this will demand changes.

Conclusion

I have sketched some of the changes already made in the regulatory framework, both prudential and consumer protection, to respond to the many and various failures which were identified in the previous set of arrangements. The scale of these changes should not surprise us. After all the scale of the failure was great. Nor should we be surprised that many of the changes which are underway are still not completed. After all, these questions are difficult, and the previous answers – which were thought for an extended period to be correct – took a decade or more to bring together. Finding a new paradigm will take as long. In the meantime, we should all recognize that we are in a time of unprecedented change; that keeping abreast of that change is an essential task of any of us responsible for financial services; and that to believe - for us as for our customers -that past performance is a guide to the future will be a great mistake.