Guernsey Financial Services Commission

Industry Seminar – 6 December 2013

Fiduciary Supervision and Policy Division Presentation: Managing Risks at the Frontier

Audrey Branch, Deputy Director

Many thanks Philip

This is the first opportunity for many of you to meet me and I am looking forward to working with you in the future.

Philip spoke just now about the three RAs –

Risk Appetite, Risk Assessment and Risk Awareness;

and I would like to develop this theme by looking at a case study.

Then I would like to turn to risks in the non-regulated financial services business sector that relate to fiduciary businesses before handing over to Fiona Crocker, who will talk on the topic of pensions.

Some of you here may have an interest in, or connections with, military issues and perhaps, more specifically, an interest in military aviation.

I am sure most of you will be aware of the tragic air accident involving an RAF Nimrod aircraft over Helmand Province Afghanistan in 2006, which resulted in the greatest single loss of life of British service personnel since the Falklands conflict, involving 14 people.

That event was the subject of a Review by the Honourable Sir Charles Haddon-Cave[1].

The Review, which was published in 2009, established that the event was caused by a fuel leak during airborne refuelling, ignited by a hot cross feed pipe. While it was a technical failure another way of looking at this unfortunate event is that it was actually an engineering failure of over 30 years in the making.

My knowledge of military issues is limited to what's on the news so you might be asking why was I keen to read Sir Charles Haddon-Cave's speech[2] in July this year, at the

[1] The Nimrod Review: an independent review into the broader issues surrounding the loss of the RAF Nimrod MR2 aircraft XV230 in Afghanistan in 2006 report http://www.official-documents.gov.uk/document/hc0809/hc10/1025/1025.asp

[2] "Leadership & Culture, Principles & Professionalism, Simplicity & Safety – Lessons from the Nimrod Review" http://www.judiciary.gov.uk/Resources/JCO/Documents/Speeches/ch-c-speech-piper25-190613.pdf

conference remembering the Piper Alpha oil platform tragedy; in which he spoke about the Nimrod incident and his subsequent review.
Why is it relevant to fiduciary businesses?

The reality is, of course, that the key causal issues identified in the Nimrod Review can be carried across any industry. They relate to leadership, culture and priorities within an organisation and its management of risk.

So then……what were the issues that led to the Nimrod accident?

Slide

They included:

- Product design and importantly modifications to design carried out over time;
- A history of operational issues;
- Distractions of change and
- The issues associated with outsourcing.

All of these can be considered in the context of financial services business and let me suggest some common ground with fiduciary business:

Product design – fiduciaries work in the field of financial engineering, developing innovative products and building structures that mitigate risks for their clients.

Product preparation or put another way "manufacturing" – this is the stage where the design of the product is "fitted" to individual clients' requirements.

Questions that arise at this point would include whether the product is appropriate to the client's needs – what is their risk profile now; and when, and how is this going to be reviewed over time. Many fiduciary products are cross-generational and we can refer to the long tail risk of fiduciary business.

What may seem appropriate now may be challenged in future. How has the environment changed? Are your considerations of risks in client structures and relationships documented and retrievable over time?

Operations – my background is in banking supervision and the Basel Committee on Banking Supervision's definition of operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. It includes legal risk with which you will be familiar, but excludes strategic and reputational risk. Industry understands the implications of reputation risk in its business although there is also an implicit read across, of course, to the reputation of the Bailiwick; something of which we all need to be mindful at all times.

To identify your strategic risk, **think about your business model** – what you are doing for economic reward and how you go about achieving it. Revisit and recheck that you are applying the three RAs: -

- Risk Appetite[3] – What is it that your products seeking to address? What is your target market? Who? Where? How?

- Risk Assessment – How do you develop new products? How are new products introduced? What information about new products is presented to the Board of Directors?

- Risk Awareness – what risks are on the horizon - are the products still appropriate over time?

So how did Nimrod XV230 fail?

Well, it was a combination of factors caused by people, by culture, by flaws in systems and controls over time that led to the loss of the Nimrod.

Where was the leadership team in all of this?

The Nimrod Report referred to the need for commitment to safety and risk at the top.

It is the Board's responsibility to establish and maintain the culture of a firm, in other words the "tone at the top".

The Commission's interaction with fiduciary licensees over time sometimes highlights issues around leadership, culture and control of risks, in other words corporate governance.

Board cohesion – the Board should be working together, not independently of each other, having the ability and taking the opportunity to make appropriate, constructive challenge at Board meetings.

Governance structure – setting clearly defined roles and responsibilities, establishing appropriate committees of the Board.

Defined risk appetite – communicated throughout the business so that the Board, your staff (and your regulator) understand the parameters within which the Board regards it as acceptable to develop business opportunities. If you don't communicate your risk appetite to your staff, they won't know what the boundaries for business are.

Risk assessment and mitigation – this is not "the job" of the compliance function.
Mitigating client related risks should be the responsibility of client facing staff as they are best placed to understand the risks relating to their client. A positive compliance function provides the business with a backstop to ensure that product design, product preparation, operations, changes and any outsourcing is working effectively, according to the firm's business model and that the risk framework remains within its risk appetite and is fully risk

[3] The Financial Stability Board, a G20 group body published papers on risk appetite and risk culture on 18 November 2013. Whilst these are primarily aimed at systemically important firms, they provide some useful guidance. http://www.financialstabilityboard.org/press/pr_131118.htm

assessed; and with an awareness of changes to risk. Hence a top down and bottom up approach to risk assessment and risk mitigation. That is risk sensible.

Management information – The Board has ultimate responsibility for risk, but this should be supported by a risk framework that places executive responsibility for risk where it lies. Just because a Board received a report from its compliance team does not necessarily absolve others from any consideration of risk. What is the quality of information about risk being placed before your Board of Directors? Does the information truly reflect risks and risk mitigation? Where are the gaps and how do you propose to close them off? Have you ever conducted a whole business risk assessment and Are you alert to **changes** that affect the risks in your business?

Here's an example:

In 2008 the Non-Regulated Financial Services Businesses (Bailiwick of Guernsey) Law was introduced. The purpose of the Law was to bring non-regulated financial services businesses into the AML framework. In other words, a new frontier.

The Law encompasses a diverse group of businesses from local lenders and bureaux de change to payment processing operations.

So how does this Law affect fiduciary businesses?

Our experience suggests that there is a risk that these financial services businesses may not have been identified in your client base. Fiduciary businesses could therefore be at risk of providing services to businesses that are operating in breach of the Law, because of a failure to recognise the business activity related risks.

Again, we come back to product design, preparation, and operations. You may need to consider unbundling the risks in your company services offering to clients, set out what the companies you provide services to are doing **"by way of business"**, which for the non-regulated sector is "whether or not carried on for profit"[4].

You may be providing company formation services, registered offices, director services, and company administration services to a company that is, or should be registered with the Commission and regulated for compliance with the Handbook on Countering Financial Crime and Terrorist Financing.

This brings with it the responsibility for that company itself to comply with the Handbook; conduct a business risk assessment; appoint an MLRO; and conduct customer risk assessments and so on…

Separately, the Handbook requires financial services businesses (here the fiduciary business)

to carry out **enhanced due diligence** on a business relationship which amounts to a financial services business.

[4] The Registration of Non-Regulated Financial Services (Bailiwick of Guernsey) Law 2008,s.42

or facilitates financial services business[5] (here, the non-regulated financial services business), that is regard them as high risk relationships.

By looking carefully at what risks you have identified in your company services offering to clients and whether they have changed over time will enable you to identify any new risks or changes in existing risks and manage them effectively going forward.

Thank you for listening;

I will now hand over to Fiona Crocker who is going to speak about pensions

[5] The Criminal Justice (Proceeds of Crime) (Bailiwick of Guernsey) Regulations 2007, Reg 5(1)(b)(ii)