

Industry Seminar – 22 November 2017

Why we are Regulating, How we are Regulating and How we are Innovating

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We have two star speakers today whose subjects – Making International Regulations and Brexit - I'm sure you'll find thought provoking. Given the overseas flavour of what they are focusing on, I thought I'd focus a little on how we approach our regulatory task within the Bailiwick and what we have been doing over the past year, offering a few reflections whilst highlighting those things which we have done to innovate or facilitate innovation.

Regulation is often complex and there is a danger of not being able to see the wood for the trees. Andrew Bailey recognised this when he moved from being Deputy Governor at the Bank of England to become Chief Executive of the Financial Conduct Authority. There he found a regulatory body with a huge range of legal duties and an almost infinite number of ways of approaching those duties. He sought, with his colleagues, in the absence of much academic literature on financial services regulation, to write a guide to how the Financial Conduct Authority should approach its legal duties.

Slide: Our Regulatory Framework

In Guernsey, Commissioner Hobbs thought it would be very helpful for the Commission to produce a similar document to try to better explain to a lay audience why we do what we do and how we do it, with the added layer of explaining why we won't be able to fix every problem all the time and why, in a democratic context, you wouldn't wish us to be able to do so. He then bent himself to the task and the result of his labours, following a very small amount of editing by the executive and board of the Commission – Our Regulatory Framework – is what you will find around the room alongside its companion, Risk Based Supervision in Guernsey, a document we first published last year explaining our approach to supervision in some detail.

I'd like to start today by précising some key parts of the "Our Regulatory Framework" publication before turning to how we have implemented it in practise in 2017 in the second part of my talk.

Our Regulatory Framework – The Purposes of Regulation

Some free spirits may wonder why there should be any regulation of financial services. Firstly, it should be recognised that regulation pervades much of our lives in the public interest. We want to know the aircraft in which we fly is airworthy and the pilot competent. Likewise that the ferry is seaworthy. We want nuclear power to be safe and the food we eat to be wholesome.

These are obvious. Financial services is less obvious. Some of the same reasoning applies but there is additional reasoning for financial markets.

Slide: The Rationale for Regulation

An overarching reason is so called “information asymmetry”. Few of us are knowledgeable nuclear or food scientists, we must rely on regulation. Equally, few of us can tell whether the bank at which we deposit our savings is solvent now and is likely to be in the future. Many risks in other regulated industries are independent of one another. A pilot makes an error but it does not follow that all pilots will. By contrast, in financial services risks may be systemic: that is a failure in one place can lead to failure in another. The banking crisis of 2008 well illustrates the point. Financial regulation addresses systemic as well as idiosyncratic risk.

A further characteristic of financial services is their potential duration. A long term savings or investment product may have a long period of latency. It may be many years before it is discovered that a serious problem exists. Financial services are also abstract. Many are effectively a promise to pay at some future date. The terms are expressed in a contract the enforceability of which will depend on the standing of the counterparty possibly many years in the future. Economists see this as an aspect of so-called “power asymmetry”. In short this refers to the financial institution being big with strong knowledge of its products while its (retail) customer is small and has less knowledge.

There is also a quite different point to consider. Public bodies can do some things more efficiently than market participants can individually. Either they would be too expensive or legally impossible. These economies of scale can reduce transaction costs. Attaining common standards, enforcing market discipline and keeping out people who are intent on competing unfairly are best achieved centrally.

Whilst regulation can help to address issues such as information asymmetry it is not a solution to all concerns within financial services. Regulation will not help further people’s education and it cannot, alone, address the issues of consumer access and financial inclusion. As a regulator, we may not take action because it is not within the objectives given to us by the States of Guernsey or because the issue to be addressed is a matter of broader public policy, of which financial regulation may only be a small part.

Markets depend on confidence to work at their best. Economic prosperity depends on market confidence. Regulating financial markets effectively and proportionately enables not just the Bailiwick’s own inhabitants but businesses and individuals internationally to have confidence in the Bailiwick. Where projects are internationally mobile, one aspect of the final location choice will be confidence that the location will be stable and predictable. Proportionate, well-considered, regulation contributes significantly to the stability and predictability that creates confidence.

How Regulation Can Work in a Liberal Democracy

Much regulation is about ensuring that only people and institutions with the right behaviours are allowed to operate in regulated markets. The key tools regulators use are barriers to entry, such as a “fit and proper” test for individuals, and monitoring through the supervision processes that the standards set in rules are met. Those tools will not always work, not least because the public interest is not best served by a “zero failure regime” which would eliminate all risk at the expense of all else.

The Commission supervises over 2,000 licensees of varying scale and complexity. They present a wide range of risks to the public interest and their impact will vary from severe to negligible. Clearly, a systematic approach is required to allocate resources to the management and mitigation of these risks and the International Monetary Fund expects jurisdictions to have such an approach.

Financial services regulation in liberal democracies does not seek to produce an outcome where no institutions ever fail. This is because to do so would result in such intense regulation, both in terms of standards and supervision, that the cost to the customer would be unacceptable both in direct cost terms and through the reduction in choice and availability. In consequence, market participants, including customers, must accept that there is some risk of failure. They should exercise prudence accordingly. If an offer is too good to be true it probably is. For its part, the Commission will endeavour to strike the right balance, given prevailing market conditions, between the customer detriment arising from loss and that arising from lack or loss of choice and affordability.

Many decisions are necessarily taken under varying degrees of uncertainty. More time taken will often make a position clearer but at the expense of action taken too late. Regulators do not have the luxury of infinite time to take the correct decision. The Commission relies on the experience and expertise of its staff to get as many decisions right as possible.

From Theory to Practise

I hope that what I’ve just said will give you some feeling for both why and, in theory, how we approach regulation. I am now going to move from the theoretical foundations to the practical realities of how we have regulated over the past year and what we have found.

Slide: Drivers for Policy Work

During the course of the year, we have fulfilled the role of a broody hen or incubator in a number of policy areas:-

- a) We continue to work on revision of laws. Our scans continue to confirm that the chicks in the revision of laws eggs still have beating hearts and are growing steadily and we hope to have a few of the brood hatch soon with a view to ensuring that all our financial services legislation is aligned, compatible with international standards and somewhat easier to follow;
- b) We also listened to the strong desire of many in industry for pension regulation and, I hope, delivered a reasonably formed pension regime in a little more than six months;

Slide: Policy Projects

- c) We have also been undertaking many other policy projects - the sort of things we must do year in and year out to keep pace with the burden of international regulatory change. We appreciate that these are as burdensome for you to implement as they are for us take forwards and we much appreciate the voluntary help we receive from industry associations and others in our policy development and testing working groups during the policy incubation phases. We hope that this generally enables us to consult on better considered proposals than would otherwise be the case. We appreciate that you will not necessarily like all of them. Believe it or not, we don't like them all either and are perfectly capable of consulting on policy proposals which we might consider, left entirely to our own devices, to be a little bit over the top. That we are consulting on them is almost always because there is an international imperative for us comply and be seen to comply with international expectations in order to maintain our reputation for being a constructive and co-operative member of the international community.
- d) We are also engaged in policy projects designed to create a climate conducive to financial services innovation. Adair Turner famously noted after the 2008 financial crisis that not all innovation is good innovation. In Guernsey we are interested in good quality innovation which helps put the financial services sector on a trajectory of sustainable growth, the sort of innovation which does not leave our enforcement team to pick up the pieces after the design flaws become apparent. In connection with this, in addition to international pensions' regulation over the last 12 months, we have delivered the Private Investment Fund and seen it adopted by innovative local lawyers seeking to provide high value structures to their fund management clients. We have, through the Lending, Credit and Finance (LCF) Consultation, proposed to establish a regulatory structure for lending businesses conducive to lending and equity raising businesses which wish to be properly regulated but which do not want to become banks. We have also used the LCF consultation to invite views on a number of regulatory concepts, namely green funds, regulated electronic customer due diligence providers and electronic agents. Most recently we have consulted on possible insurance solvency reforms as we work to ensure that the

Bailiwick's firms are as well positioned as possible for free trade in the global insurance market. Not all of the innovative ideas we consult on will necessarily come to fruition but through our Innovation Soundbox we seek to be open to innovative proposals by industry and to work with the proposer to establish how the innovative vehicle could best fit into Bailiwick's regulatory architecture such that consumers are appropriately protected, financial stability safeguarded and the innovation appropriately incubated.

I am not going to talk extensively about Brexit today because I have Deputy Chief Minister Trott here to do that but, before turning away from policy, I will note in passing that, as a Commission, we are burning countless hours working closely with the States and others to position the Bailiwick for a post Brexit world. As we are already outside the EU, much will remain the same and we can, in some sense, claim to be a beacon of stability albeit that the type of trade deals which the UK strikes with the EU (or not) and its future deals with other major economies are important and we are seeking to ensure that you, as our entrepreneurs and industrialists, have good quality access to overseas markets going forwards so that you can exploit the Bailiwick's competitive advantages whilst being incentivised to develop new skill sets to produce new niche products for new markets as the post Brexit trade structures become clearer.

Slide: Authorisations

Turning from policy to practise, our authorisations team have been as busy as usual. We processed, between June last year and July this year, a total of 438 applications and exemptions, including 48 relating to insurance firms and 199 relating to investment firms or funds. Further to this, in the same period, the authorisations team has processed 3,081 appointments and 2,511 resignations, a testament to the liveliness of the jobs market at a senior level within the Bailiwick. We have also dealt, in our capacity as a de facto marriage registrar, scrutinised 58 changes of control. These are often burdensome for us as we take our duties seriously as, more often than is the case with marriages between people, there are often lawful reasons for changes of control not to be granted which need to be properly dealt with to protect consumers and financial stability. We consulted on charging for our change of control services this year because whilst we have a strong public service ethos and accept that some degree of cross subsidy is inevitable in some areas, we simply don't think it fair that those firms which remain happily single for their whole existence should be endlessly paying for the long hours we burn preparing for marriages between firms which appear to us to be anything but monogamous.

We appreciate that when you are transacting with us for statutory purposes you like the process to be as easy and quick as possible. We have continued, throughout this year, using our in-house developers to make improvements to our firm and director facing software so that it is as easy as possible to provide us with the information we need in order to effect a registration or approve an authorisation. I'm delighted with the unsolicited feedback I often receive about the quality of the interaction you have with the human parts of the authorisations team which consistently works hard to ensure that our service level standards are met. The computer based parts of the

authorisations processes will continue to be developed although our quest for artificial intelligence in an on-line portal, sufficient that it charms its users as well as diagnosing and curing itself is, sadly, some way off.

Slide: Supervision – KRIs and Impact Metrics

Supervision continues to take up a great deal of our time and energy across the 4,842 firms, funds and structures we regulate. Whilst I do not intend to take you through all of the detail of our work in this area, I thought I would put up a couple of slides and highlight a few of the statistics so as to offer an idea of the magnitude of our activities in this critical area. We, for examples, dealt with 1,338 Triages (regulatory matters worthy of recording and possible action) and 270 new RMP actions connected with 140 separate risk issues. The slide shows, I hope, the volume and depth of the matters with which we are engaged.

Slide: Supervision – KRIs and Impact Metrics (continued)

Moving on to the next slide, this offers a further breakdown of those statistics – this time by Division. I appreciate these are a little challenging to read if you are towards to back of the hall but all of the slides will be available on the Commission’s website in a few days’ time.

Slide: Supervision – RMP Actions

My colleagues will talk in greater detail tomorrow about particular risk areas where we have concerns but, to give you some idea of our key areas of concern, if I look at the types of RMPs we were writing as of June this year, Governance tops the table (something which the Chairman will discuss later) having just overtaken financial crime as our most frequently occurring unacceptable risk area. Conduct risk remains an area of concern though it is markedly less prominent than at the same period last year whilst firms running inappropriate operational risks have become a more prominent feature of our supervisory assessments. I thought it might be helpful to give you a flavour of some of the underlying issues at some of the firms we inspect rather than just talking about them at a high level. I must, however caveat what I’m saying in as much as I’m talking about issues which arise which require mitigation by us at some of the firms we visit. From that, it certainly and thankfully does not follow that the bulk or even a lot of financial services companies in Guernsey have the issues I am about to highlight. Nevertheless, I hope it is helpful to give you some flavour of the sorts of things which are currently concerning us.

Key **governance** issues which we have encountered include:-

- a) A huge variation in a firm’s understanding of its own risk appetite throughout the firm – a real case of the left hand not communicating with the right hand. Clearly this can have unfortunate consequences;

- b) Weak non-executive directors and a general lack of independent challenge in the boardroom;
- c) Inappropriate direction of the legal entity board by Group. Clearly we might expect the Group Board to offer a steer as to the direction a Guernsey subsidiary should take but when Group issues instructions in a fashion which goes against the board's duty to comply with local law, that becomes troubling;
- d) On the funds side we have seen too often a failure to either acknowledge or appropriately manage conflicts of interest. We certainly don't live in a pious world where conflicts of interest magically don't exist but we do expect boards to understand when they exist and to manage them properly. Another issue we see in connection with some funds is a failure to oversee underlying assets appropriately;
- e) In the fiduciary area we occasionally find businesses which simply don't understand the structures which they are administering. We generally find people or corporates being directors of things they don't understand troubling although, fortunately, this is not one of our more common findings. When they fail to understand that several of the businesses they are administering are, in their own right, financial services businesses requiring regulatory permissions to operate legally, our concerns are perhaps exacerbated.
- f) And then, we have seen firms where boards have clearly taken the wrong decisions for customers to meet a short term financial need of the regulated entity. This clearly isn't good and neither is the failure of the governing parts of the firm to ensure appropriate financial crime and conduct standards are applied. It is to these I will now turn.

Under **conduct risk** we have seen issues connected with:-

- a) Firms failing to undertake reasonable compliance checks when transferring in customers from another firm;
- b) A failure to properly safeguard the interests of underlying pension fund beneficiaries;
- c) Poor advice to new clients; and
- c) Palpably poor investment choices. Here we are not talking about investment managers which have simply failed to buy what, with the benefit of hindsight, turned out to be the best performing shares but rather making investment choices which were simply not aligned with a customer's interests or risk appetite.

Under **financial crime risk** we see a number of issues repeated at a number of firms:-

- a) Firstly, we see too many poor quality business risk assessments (BRAs) which appear to have been ordered from someone to put on a shelf rather than being created by the firm to actually reflect the types of customers a firm has and the risks they present. To pick a hypothetical example, having a BRA written around Guernsey resident customers is probably inappropriate if the bulk of your client base is Eastern European or Middle Eastern;
- b) Sometimes allied to poor business risk assessments is poor customer due diligence, another key financial crime issue which we uncover too often in the firms we visit. We have come across cases where as many as 90% of the files we reviewed had incorrect or absent CDD information. In other cases we have come across firms which seem to operate as if the AML/CFT handbook did not exist whilst overdue risk reviews on established customers can also be troubling.
- d) We also come across poor compliance monitoring programmes, inappropriate reliance on those introducing a client to a firm - not to mention relying on memory rather than written records within the firm as to the source of clients' wealth.

What we find particularly concerning, **turning again to governance risk**, is when these issues have arisen as a result of a poor compliance culture at all levels or because of a failure to act on a Risk Mitigation Programme action we gave a firm following a previous risk assessment visit.

Finally, for this part of my talk at least, I will turn to **operational risk** where we are seeing a number of issues which may bear future consideration:-

- a) Too often we see poor pricing processes for assets, perhaps allied to a failure to safeguard assets appropriately;
- b) The above issue can also be combined with poor documentation and control over outsourcing;
- c) We see staff who do not understand the processes they are meant to be following. A key here is that there must be a focus on implementing processes properly not just writing them; and
- d) Allied to this is the alternative operational risk which arises if firms try to do too much too quickly. This tends to manifest itself in a firm running too many change projects simultaneously with non-optimal outcomes for all of them and insufficient staff to execute any project well. This is particularly troubling in the IT area where poor implementation of new operating software can lead to damaging systems failures.

The good news is that we haven't yet found any of the above issues at more than c. 95% of the entities to whom we issue licences. That said, those of you in the room whom we have yet to inspect may find it helpful to assure yourselves that your firms would pass muster when assessed by us or someone else for their vulnerability to the above issues.

Fortunately most of those we supervise, those of you in this room, are self-starters, interested in continuing professional development so I wanted to take a few moments today to outline a logical development of something we have already been doing informally, to help put you and your teams in a position where we can help you to self-assess your own understanding of the regulatory laws so you don't need to worry as much about supervisory visits.

Slide: Assisting regulatory Self-Assurance

I mentioned in my talk this time last year that we had held over twenty educational events for industry, to help those who wanted to follow the law understand better what they could do to ensure that they were following the law. We have been continuing these education focused outreach activities and I wanted today, to outline how we are going to evolve these sessions a little further going forwards - to help you or those of your teams who attend - to derive maximum value from them. From now onwards you should find that:-

- a) We will normally aim to state at the beginning of an educational session what outcomes, in terms of knowledge acquisition, should be achieved by those attending by the end of the session;
- b) All educational sessions which we run for the financial services sector ask you to reflect on how you are doing in comparison with that which we have been talking about at the end of the session; and
- c) We will generally provide those attending with a themed self-assurance help sheet or questionnaire at the end of the session which the person attending will be able to take back to his or her office and discuss with colleagues.

We hope that through these innovations we can help those of you who wish to ensure that your firms obey the law to further develop whatever self-assurance practises you already have in place. We want to provide an environment where it becomes normal practise for those returning from a knowledge-sharing session with the Commission, to discuss what they have learnt with colleagues and reflect with those colleagues on what they need to do to assure themselves that they are meeting their legal requirements in an appropriate fashion.

To be clear, we do not intend to start asking you to return the self-assessment questionnaires to us. If we do that I fear our educational sessions will suddenly become markedly less popular. Nor, as a matter of general practise, are we going to start asking you to take a test on what you have learnt on an individual basis before you leave one of our sessions, although in the spirit of

encouraging pedagogical diversity amongst my colleagues, I certainly don't rule out there being group question and answer sessions during the course of an event.

No-one should think that, because a member of his or her team is dutiful in attending our education sessions that we won't come and visit his or her firm. We are not seeking to encourage self-assurance as an alternative to formal supervision but as a complement to it. Some firms are very good at reflecting internally on how good is their adherence to the law and then working without prompting to fill possible gaps. Such self-awareness and empowered internal discussion comes less easily to some organisations which we visit. We would like to see more firms become good at it so that we have to uncover fewer serious issues during our inspections.

Various models of self-assurance are used already by a number of non-financial UK regulators to good effect. We hope you will find the version we are gradually implementing helpful in your endeavours to develop your businesses in a proper and profitable fashion.

Slide: Enforcement – a necessity

Having spoken about what we have been doing and plan to do for firms which are working hard to obey the law and maintain the high standards which form an important part of the Bailiwick's competitive proposition, it is proper to complete my coverage of our practise by talking about our enforcement division which takes over when our supervisors discover a problem with a firm where an amicable resolution would be difficult or inappropriate given the nature of the discovery.

Between July last year and June this year the supervisory divisions made nine referrals to enforcement. Not all of these related to regulated firms, some related to people illegally conducting financial services activity outside the regulated perimeter. The overall number of cases supervisory directors referred to enforcement remains small compared with the c. 190 RMP actions open at the end of June which seek to deal with material issues at regulated firms using more collaborative techniques.

Callum McVean will talk later today about the particulars of the cases we have seen and on which we can currently speak but I wished to use this talk to reiterate a few key messages about our use of enforcement which bear repeating:-

- a) We are not and do not wish to be an enforcement-led regulator. Every enforcement case the Enforcement Division takes on has to be referred to it by a director or deputy director in a supervisory division. The supervisory directors only make referrals where matters are serious or where there has been "repeat offending".
- b) We have no desire to take petty matters to enforcement and our enforcement team is stretched carrying out investigations into the serious matters which have been referred. When the NHS was set up, the notion was popular that there was a finite

quantity of ill health which, once treated, would mean that everyone was healthy and that healthcare costs fell. As we all know c.70 years on it didn't quite work out like that. Similarly I know that some of my colleagues hoped that, having dealt with a residue of poor quality individuals and firms, the work of the enforcement team would tail off. Having now supervised firms for nearly 12 years, I always thought that view was at the far end of the optimistic spectrum and our experience over the past four years is that as our supervisory teams become more focused and more capable they are better at finding the serious wrongdoing which requires referrals to enforcement. Much though I would like to paint a picture of a time when we don't need to enforce, I don't think that is realistic anytime soon. Rather I fear there will always be a residue of unscrupulous individuals seeking to exploit and thereby harm customers, investors and/or Guernsey and that we will need to continue to work hard to keep them in check. Access to other people's money can create an environment, unfortunately, where people who would otherwise lead relatively blameless existences, choose to do the wrong thing.

- c) We will listen to well-argued cases even once a firm or an individual has been referred to enforcement. Sometimes we discover things are not as bad as the supervisor feared when the referral was made and the firm or individual is taken out of the enforcement process. We obviously try and avoid cases which are not serious going to enforcement but the analytical rigour and depth of an enforcement investigation can bring facts to light which cause us to change our minds. There is no target for the Enforcement Division to take a certain percentage of referrals through to a formal sanction and when we learn matters are not as serious as we feared we happily discontinue cases.
- d) We do not and will not run away from well-resourced legal teams. I am not pretending that we don't find fighting someone who can command a string of Queen's Counsel a trifle challenging at times but we have a strong in-house litigation team and a strong investigation team and we will be guided by the evidence - not the size of the firm or the power of the individuals running it. When we do find, over the course of an investigation, evidence of individuals seeking to escape justice through use of their connections, we will generally regard that as an aggravating factor, to be taken into account when determining what sanction is appropriate.
- e) In terms of feedback you have given us on our public statements, we will try to make them as full as reasonably possible so that the learning value of them is maximised. This is part of our efforts to help you with self-assurance.

I think my final message on enforcement is that you should be reassured that the Commission has an effective enforcement team. Without it, those of you in this room, who seek to conduct business properly and honourably would risk being undercut by those without scruples who, even if they failed to directly damage the businesses you run, would damage it through

undermining the reputation of the Bailiwick as a good place in which to do business.

Slide: Why we Regulate and How we Regulate and Innovate

I hope that what I have said today has given you some idea of why the Commission regulates, the issues with which it is engaged and some understanding of how we are approaching those issues. In all the areas in which we operate, we seek to add value for the Bailiwick. We will continue to seek to work with the States and the industry to help develop useful innovations. We will continue to work to help the Bailiwick be sensibly compliant with international standards with as good an access to overseas markets as possible. We will also continue to develop our authorisations, supervision and education activity and we will continue to use our enforcement team to help create an environment in which the good, skilled and hardworking can prosper with the reckless and the wrongdoers facing justice.

We will do this in an environment informed by both Brexit and the ongoing development of global standards, things upon which our subsequent speakers will dwell.