Guernsey Financial Services Commission

Managing the crisis and the aftermath

William Mason, Director-General of the Guernsey Financial Services Commission, was at the heart of the British and Irish regulatory response to the international financial crisis. Here he gives his first-hand account and his thoughts about the impact of the crisis for Guernsey and further afield

When I was interviewed in late 2005 by one of the directors of the Financial Services Authority, he asked me what I thought the big risks were in finance. I said that I thought lending and house price growth were out of control and that I saw the failure of banks as being the biggest risk. He laughed and said that he didn't think I understood all aspects of financial services regulation but that I could still have a job.

When the Northern Rock story broke I thought of that interview and how difficult it is to persuade someone to take you seriously when you are challenging the often scantily clad assumptions behind conventional thinking.

I led an investment firm supervision team at the time the crisis broke and I can remember seeing the queues forming at Northern Rock branches and listening to a lot of nonsense being talked about how people were irrational to queue to get their money out. As things stood at that time, if you had a penny over £2,000 in Northern Rock it was quite rational for you to queue and if you had a few tens of thousands, it was imperative given the limitations of the guarantee system in place then.

As part of the quality control processes for inspection visits we had panels made up of senior supervisors and risk experts at the Financial Services Authority which reviewed the findings of supervisors following inspection visits. I'd chaired one of those for a building society a few months before the crisis broke. I'd asked some awkward questions about ABC Building Society and generally been difficult because I didn't think the supervisory team had taken the prudential risks seriously. (This was at a time in the Financial Services Authority when the "Treating Customers Fairly" initiative trumped all else and, frankly, life was a little tricky as a supervisor if you happened to believe that some firms were pretty good at treating customers well and that there were other things to worry about such as firms' business models.)

Eventually, my boss tapped me on the shoulder and asked me politely if I might like to stop being quite so awkward about ABC Building Society because Mr X down the corridor had developed a model which suggested it was pretty impossible for any British building society to go bust so please could I get back in line and busy myself with fixing a few more dodgy stockbrokers. Being a dutiful sort who was quite keen not to have the senior management team put him at the bottom of the pile at the end year appraisals, I did what I was told.

The danger of group think

I tell this story, not because I was particularly unusual in asking awkward questions at the FSA but because it shows how dangerous group thinking is and how difficult it is, even when the evidence is in front of you, to influence the direction of an organisation from what was, at best, a middle ranking position. I had had similar issues when, (as a former strategy consultant), I used to challenge the business models of some firms I supervised. I was told by both the firms we supervised and then by my own management that all we were allowed to do as regulators was check that the firm had a process for setting strategy. We were not allowed to challenge that strategy because strategy was for the senior financiers sitting in private sector board rooms paid 10 times as much as us. This was, after all, the era in which a some of my fellow regulators were going along with the bizarre proposition that one wasn't allowed to interview directors of firms but merely to have conversations with them because interviewing might sound overly aggressive to the firms we were regulating !

I highlight this background because I think it led, when the crisis broke in late 2007, to some senior managers in the FSA recalling that my earlier rejection of the Orwellian Newspeak so redolent of the New Labour era, might mean I would not be shy about asking bankers potentially useful questions without fear or favour.

This led to my team leaving our investment firms to their own devices for some time to trail around the British Isles examining the liquidity of small banks in a very short and sharp fashion so that the Executive Committee of the FSA and hence HM Treasury could have some assurance as to which of these banks would actually be able to limp into 2008 in a solvent fashion. People who had spent 18 months training to seek out investment advisors who were defrauding old ladies suddenly had to learn all about this strange concept called bank liquidity and how to assess it. Our esprit d'corps rose markedly on our round Britain train trip – we'd worked out how we could check up on a bank's solvency through a half-day visit and there were a lot banks to get around before Christmas. We had a sense that we were doing something important.

As we worked into 2008, the initial burst of adrenalin faded and it became a long slog as we, unshackled for the first time, really started to discover just how complacent had been the assumptions of the leaderships of so many credit institutions.

I can remember the Financial Services Authority's green police wailing loudly that we were not meeting targets for reducing the use of paper and retorting quite sharply that that was likely to be because we were working three times as hard as we had before the crisis.

I can remember being given quite a large firm's accounts on a Friday, prepping with them over the weekend and then on a Monday morning interrogating members of the board as to how they understood their situation and discovering that they had nearly no concept of risk being related to return. The level of ignorance about basic economic and business concepts which we discovered in financial services boardrooms was pretty unbelievable as were, compared with what would have been politically possible for us only a few months previously, the radical changes we required them to implement to restore some semblance of financial stability.

The GFSC's Chairman has remarked before now that the credit institutions in London generally did OK because they had enough contact with other City actors to keep the directors real. I think there is truth in that and certainly the leaders of a number of regional firms we

encountered had a very full sense of their own importance and did not appear to have had to deal with anyone challenging their thinking in years.
Back at the FSA, the directors of the FSA became so worried about the risk of burnout amongst the supervisory managers – my cadre – that we were all forced to go and have a session with a specialist FSA doctor about how to manage the stress of managing the crisis. In its own way it was quite cathartic as we stood by the coffee machine falling about laughing because the only actionable thing the doctors had suggested which we could actually do was to drink green tea - given the pressures we were under the recommended long lunch break whilst sitting outside in the sun with no Blackberry wasn't quite going to happen.

Ireland

After the crisis I moved to Ireland to do the Euro crisis with the Central Bank of Ireland, a different sort of experience which ended up being much darker because, without the Bank of England to ride to the rescue with free money for all – essentially the solution Alistair Darling and Mervyn King eventually implemented – the people of the Irish Republic really suffered through the long drawn out Troika programme. For anyone who ever says quantitative easing was wrong on ideological grounds, I say look at the suffering and distress not having it in the Irish Republic caused, to a large degree because EU monetary policy was – at that time – being set to suit the interests of continental countries rather than those on the periphery like the Irish.

Reflecting on the last decade

Looking back over the last 10 years and all the changes we have made at an international level, some problems may be said to have been fixed whilst others have probably been created as a result of the fixes.

On balance, I think Basel III (the new capital standard for banks) is a good thing and, when fully implemented, is likely to create a much safer global banking system without doing that much damage to the ability of banks to provide finance to private individuals and the non-financial economy.

I am much less certain that the move to make most derivative contracts clear through central counterparties (CCPs) rather than with bilaterally (over the counter) was very clever. If Lehman Brothers was a nightmare to resolve, just consider how difficult it would be to resolve a CCP – a trading hub.

I worry that in our attempts to stop banks being too big to fail we may well have created another class of financial services firm which is much too big to fail which might, in extremis, require a taxpayer bailout. Thankfully, there are no CCPs in Guernsey.

In terms of other types of regulation, the financial crisis showed the dangers of having a lot of assets off the book but effectively part of a banking group – hence the disquiet over so-called "shadow banking". That clearly needed to be resolved but I became concerned when some countries, apparently for reasons of national self-interest, promoted the notion that properly regulated large investment funds are somehow dangerous shadow banking. I don't think the empirical evidence supports the view that they are dangerous in the same way as the legal vehicles closely associated with banks holding assets which, were they declared, would have put those banks in breach of their capital ratios and am wary of moves to try to regulate investment firms in a similar fashion to banks.

I am similarly wary of moves to track every transaction so that macro-prudential specialists can issue orders from central banks instructing firms what to do about certain risk exposures on an economy wide perspective. At school and university I studied why communist central planning didn't work and I worry that what is now being developed is merely a variation of that and is likely to be similarly unsuccessful.

There is also emerging evidence that the capital requirements around trading are now so high that market liquidity in areas such as foreign exchange is sub-optimal. This could result in it being much more difficult to exchange currencies in a time of market stress without paying very high spreads. This is clearly undesirable.

Bureaucratic burden

Over a range of areas, there is a perception that regulation has gone too far and it is certainly the case that the balance isn't quite right if the boards of firms are finding they have to spend much more time on regulatory compliance than on growing the business and innovating to stay competitive.

I particularly worry about bureaucratic administrative requirements which can become value free make work exercises. One of the reasons for the lack of productivity growth in the UK may perhaps be because of the growth in such requirements.

I appreciate that these are sometimes needed to achieve the policy outcomes you desire but I still think, as the Better Regulation Task Force argued 13 years ago in *Regulation – Less is More, a report to the Prime Minister* - that there should be clever ways of achieving a desired policy outcome than carpet-bombing people with forms. Hopefully FinTech can help mitigate some of these issues in the future, particularly around the costly anti-money laundering paper trail.

Brexit

I suspect that the somewhat muted reaction from the City to the decision by Mrs May - as set out in her proposal to the EU from Chequers - that HM Government will not seek access to the EU Single Market for UK financial services firms is a result of the perception of a number of City actors that the European Commission regulated excessively without a good enough evidence base when M. Barnier was in charge of financial services.

Indeed, it is possible to argue that the result of the Brexit referendum might have been different if so many wealthy and powerful individuals in the City had not been so fed up with the weight of new financial services regulations from the EU, regulations which were clearly not optimised to suit the UK and its entrepreneurial financial services culture.

Guernsey's Position

Guernsey's position on new regulatory developments, as per the recent commitments made by the States of Guernsey to the House of Commons Treasury Select Committee on 12th June 2018, is that it will "adhere to international standards as they emerge and evolve." I, along with my colleagues at the GFSC, sit on some of the international committees from which these standards emerge. There we work to try and make sure that the standards seek to focus on the policy outcomes which need to be achieved rather than merely imposing further bureaucracy of both firms and regulators.

Sometimes we succeed, sometimes we fail or cannot be in the room when the standards are made. Once the standards are made, because of the nature of Guernsey's financial services sector as an export hub, Guernsey tends to need to implement them to maintain its access to overseas markets, although we can try to work with the States and industry to implement them in a sensible and proportionate manner, taking into account the specialisms of Guernsey's IFC.

I hope that, going forward, we can work to ensure that well-implemented international standards continue to mitigate the risk of a major crisis whilst being flexible enough to allow for innovative and small firms as they will encourage the finance necessary for prosperity whilst challenging the oligopolistic practises which tend to work against citizens interests.

William Mason
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