Guernsey Financial Services Commission

Industry Seminar – 15 November 2016

The Interaction of Business Culture with Regulation in the Past Decade

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I will start by trying to practise some of that which I will talk about later in relation to management information by giving you my bottom line up front. This is that we all need to be vigilant in guarding against poor corporate governance and poor corporate culture and that there are some practises we may wish to consider to maintain or improve our vigilance. I'll now explain how I arrive at that point considering the interaction of financial services regulation with financial services firms over the last few years.

The Rolling Back of the Tide

The years after the 2008 global financial crisis saw a huge increase in the intensity and scope of prudentially focused regulation. Much of this was understandable and much of this was worthwhile. There were, however, some excesses with zealots pursuing aims other than the greatest happiness of the greatest possible number – something which requires the regulation of the financial services sector so as to permit it to enhance economic life as well as ensuring a reasonable degree of security against systemic financial collapse – sometimes called the macro-prudential dimension.

Recently there have been a number of signs that the Spring tide of prudential regulation has passed its high water mark:-

a) With Delegated Regulation 1016/47, the European Union reduced the capital requirements for insurers operating under Solvency II for investing in qualified infrastructure projects. There is also some consideration being given to whether the risk margins set in Solvency II are excessive in what has become a sustained ultra low interest rate environment;
b) looking beyond the European Union at the work we are undertaking at the International Association of Insurance Supervisors to develop a new International Capital Standard, we have a strong desire to increase the comparability of insurance capital so that comparisons can more easily be made between the performance and security of internationally active insurance firms domiciled in different jurisdictions but we have next to no desire to increase the quantum of capital held against a given risk – our motivations are different from those of the authors of the Basel III banking capital standards a few years ago;

c) turning to Basel III, in terms of banking capital there is increasing recognition that there is a lack of liquidity in some traded markets in times of stress[i] because the capital charges placed on investment banks trading books by Basel III make warehousing stock and market making relatively unattractive businesses for banks to be in given alternative uses for the much increased capital now required. A search for solutions is underway although my sense is that we are some way off an international consensus on what the solution should be, although the FSB's Standing Committee on the Assessment of Vulnerabilities (SCAV) and IOSCO are undertaking analysis looking at the repo market, market stress simulations and the corporate bond markets; and
d) IOSCO (the International Organisation of Securities Commissions) decided not to advance proposals to label the world's largest asset managers as systemic in its decision of 17th June 2015. It has said that priority will now be given to a "broader" study of asset management activities. It is probably fair to regard this as a victory for the industry which lobbied policy makers to treat it differently from other financial services sectors on the basis that it doesn't take risks on its balance sheets in the same way as banks and insurers
e) Finally, Donald Trump being elected as the next president of the United States on a pledge to roll back financial services regulation such as Dodd Frank may presage rather more radical reform although it is difficult to be sure of the direction of any such reform this early into the formation of the new US government.

These moves – even the election of Mr Trump - do not, suddenly invalidate prudential regulation as a concept. Rather they serve to remind us of something which King Athelstan found more than a thousand years ago in the 930s, namely that social ills cannot merely be cured through legislation. He was a very devout man as well as being a noteworthy warrior and administrator who unified the kingdom from Land's End to North of Edinburgh. He found, however, that the laws he passed could not eliminate poverty and secure for all his people enough food to guard against hunger. The recent adaptions to prudential regulations and the associated reduction in prudential ambition serve as a recognition that international policy makers – politicians, central bankers and regulators – have recognised that the problems generated by financial services firms cannot simply be resolved by requiring more capital.

Where Now?

The slight drawing back of the capital tide may indicate that we have arrived at a subtler place in terms of working out how to deal with the very real problems financial services firms continue to generate whilst at the same time allowing them to play a significant role in facilitating the economic activity on which rest our prospects for improving global standards of living.

What is sadly clear is that the financial scandals which adversely affect the public at large, if not the taxpayer directly, have not entirely ceased although I did recently hear a good argument that the PPI misselling scandal had had a very positive impact as the c.£25bn of compensation payments had provided a significant boost to consumer spending in the Sterling Zone –

helicopter money by the back door if you will.

Increased capital, even when abetted by the extraordinary monetary policy maneuverings of the world's major central banks, has not been found to resolve all issues. Indeed it may create some issues with the relatively high capital charges on equity investment perhaps unduly restricting the amount of equity risk capital available to ensure secure balance sheets for businesses in the non-financial services markets. In terms of capital supplied by banks, regulations certainly encourage banks to offer debt rather than equity *although* that international regulation may well create investment opportunities for Guernsey private equity vehicles so we should probably not worry too much about that issue from a purely Bailiwick perspective.

If we believe that prudential regulation can clearly not resolve all issues to a reasonable degree, we have a number of options:-

a) Firstly, to live with the low regard of the investing public for financial services firms which goes with the diet of greed and malfeasance with which the media feeds the public in relation to financial services;
b) Secondly, to introduce very precise governance regulations in the fashion of the US 2002 Sarbanes Oxley Act in the belief that well drafted regulations covering such things as auditor independence, corporate governance, internal control assessment, and enhanced financial disclosure backed by criminal sanctions could resolve issues such as those exposed by Enron and WorldCom in the US;
c) Or thirdly, find a middle way in which we rely upon the boards of companies to make grown up choices about how to run their businesses whilst taking robust action against those who clearly fail in their duties.

I hope that it will not surprise any of you to know that the Commission does not favour a Guernsey version of Sarbanes Oxley. We don't think that highly prescriptive regulation of the type exhibited in the Sarbanes Oxley implementing provisions is a particularly cost effective way of improving practises. Whilst the increases in auditor independence and CFO accountability for accounts inculcated by Sarbanes Oxley can be commended, the cost of achieving those gains was high and it is noteworthy that the regulations did not effectively inhibit the poor quality decisions and questionable corporate culture that came to light in many US financial institutions in the years after 2008.

Neither does the Commission think that all of us in this hall should simply be content to live with the status quo. The Commission believes that our reputation as a decent place in which people can both save and trade is *vital* to our future prosperity and that we, far less than the United States, can afford to tolerate poor conduct by financial and professional services firms if we are to have a prosperous future. The Panama papers and the damage they have done to the reputations of more than one Caribbean jurisdiction are a salutary reminder, should we need one, of the importance of good conduct and of preserving our Bailiwick's good name.

Given this analysis, the Commission considers that there is work to be done but it is work which

requires not the passing of a particular law (important though having the right laws is to us all) but rather continued and enhanced diligence in our daily activities by all of us in this hall. Lest any of you think that I have simply taken examples of issues in other jurisdictions and extrapolated them to Guernsey without cause, I should offer some examples of the poor conduct and poor corporate culture which the Commission has uncovered over the past year, depressing and unrepresentative although we may find it:-

- Firstly, we have seen a case where an outsourcer falsified some sets of accounts he was preparing on behalf of a regulated firm to meet a deadline. The outsourcer in question was closely associated with the regulated firm and appears to have been working under the illusion that it was better to meet the deadline for the preparation of the accounts than to do the job honestly. There was a breakdown of controls and an inappropriate corporate culture in this instance.
- Secondly, we have seen the executive directors of an investment manager sitting on a fund board and not managing their conflicts of interest appropriately with regard to related party transactions, *apparently* not seeing the difference between their own interests and those of the funds' investors. Thankfully, in this instance following strong steers from the Commission and the support of a non-executive director, conflicts now appear to be being managed more appropriately.
- At the enforcement end of the spectrum, when firms have come under investigation for AML/CTF failings, in our root cause analysis of why the problems arose we have often seen a dominant CEO and/or a culture driven by high profit margins and making a quick buck with a total disregard for any form of meaningful compliance with the law. Whilst we appreciate that taking on complex clients is one of Guernsey's USPs, we have, on occasion, seen issues with high risk clients being taken on without a firm's culture supporting the correspondingly enhanced compliance obligations relating to being on enquiry as to the source of the client's wealth. This behavioural trait can also be associated with favoured introducers of business not being asked for appropriate background checks on those they introduce.
- We have also seen examples of a blame culture within a few weak firms with former senior staff being readily blamed by former colleagues for systemic deficiencies in their compliance controls across client relationships, particularly in relation to serious weaknesses in arrangements for monitoring transactions and activities. Whilst we can readily understand the motivation for trying to deflect attention when the regulator is asking searching questions, the cultural willingness to take responsibility for fixing the messes in question has been noteworthy for its absence.
- Furthermore, we have found examples where the role of risk and compliance officers is denigrated by the board of the firm who set its cultural tone. This can take different forms:-
    - At one level, simply failing to provide any training budget for compliance staff, letting them know they are on their own - to work out how to fail without support;
    - Another example we have seen is impossible amounts of project work being loaded on compliance and risk staff because they aren't the firm's fee earners.

Unsurprisingly this then results in delays building up in compliance work because their day job is sacrificed to meet non-risk centered project tasks.

  - Another way in which boards set the wrong tone is in dismissing the concerns of compliance officers about business the firm wishes to win. For example a compliance officer who raised reputational concerns about a proposal to accept as a client a man with an unsavoury reputation from an African country was overridden by the Board who argued that he had *disguarded* his unsavoury reputationand that there were adequate controls in place. In this instance the Commission went on to identify that the firm's controls were so poor that it had only identified that the unsavoury man had assumed beneficial ownership of a client company four months after it had actually happened... In another case the failure to follow the firm's own policies and procedures stemmed from the Board's failure to do so. A director instigated his firm's procedure in respect of a politically-exposed person by completing a "PEP Assessment Form". The form, quite rightly, posed questions as to any adverse information available about the client. Despite the director being aware of the client's links to fraud and misappropriation of funds, the director signed off the form without further action and continued to service this client in the normal way. This culture was then able to propagate throughout the firm on the basis that if the boss is not doing it – why should I?

- We also see examples of trustee and company service provider board representatives of administered entities failing to communicate properly with external directors of those same administered entities.

Many of our firms recognise the value of an empowered and well-resourced compliance function that can provide guidance to the Board as they traverse the regulatory landscape. Sadly some do not.

What goes wrong?

If these examples go to show that we, as a jurisdiction, are not immune from the sorts of issues which occur in financial services firms in other jurisdictions, I will overlay the raw facts of the cases with a little analysis which I hope may be helpful, at least for the vast majority of firms where poor practise is not the intended key success factor of the business.

The first thing to say is that in our experience bad things happen for all sorts of reasons. They are often not the result of some great pre-planned conspiracy. We may, when we read about them, draw up some sort of comfort blanket around ourselves and reflect that something like that could *never* happen to a firm with which *we* were involved. We often see fundamentally decent people who, through force of circumstance, find themselves in a difficult place and fail to do quite the right thing, often with significant adverse consequences for themselves and others.

Other issues we see as we look at our hard cases relate to a lack of modesty and experience.

What we see too often in Guernsey is previously successful people asked to do something outside their comfort zone which promises to be profitable. What then happens is that they can fail to ask, for quite understandable reasons, appropriately searching questions of their potential counter-parties and end up in a relationship which becomes something other than that which they probably originally intended *but* from which they feel unable to extricate themselves. Whilst I'm probably as guilty as anyone in this hall of believing that with a little exertion you can mug up a subject well enough in a couple of weeks to be something approaching competent on it, I'm modest enough to realise, that for me at least, it depends on the subject in question. Too often in Guernsey we see a local industry practitioner who has got themselves into something about which they know nothing which is clearly beyond his or her abilities to manage appropriately. As a result of this a poor corporate culture with poor standards of governance can materialise with all the problems these things tend to bring.

How can we make things better?

At the Commission we have been working to make things better by providing c.20 fairly informal education sessions in 2016 to offer officers and directors of firms the chance to interact with us to discuss how to sensibly comply with the different aspects of the law in order to run a good quality business. The feedback on these education sessions is positive and we intend to continue holding more of them because helping people plan to avoid possible problems, people being willing, is generally much more efficient that letting them happen and then seeking to resolve them.

Turning to things which we as directors can do, I think we can seek to understand the business model. If we do not understand how our firm or putative new enterprise makes its money or is going to make its money and the risks which it must take, we should probably not be comfortable being involved in it. This is not about our becoming unduly risk adverse, it is about us being aware of the risks which we are taking and being comfortable that they are likely to be worthwhile. If we are running a high risk enterprise we need to understand how and what has to work for it to be profitable, what the warning signs will be that the business is not working out as we had hoped and what we will do in such circumstances to try to ensure a soft landing of some description.

I also think we need to make sure that our processes are actually being used. I am not a great fan of embedding best practises because I fully appreciate, especially in smaller businesses, the latest best practise fashion can well be the enemy of good practise - if it is so complex that having been nicely written up ready to be parroted during the next regulatory visit it is then left on a shelf to gather dust because it is just too complicated and time consuming to apply in everyday life. I'd suggest we need to make sure that we have good processes and that they are actually being applied properly. It is surely better to have a workable risk set up which is good than have a theoretically best practice set up which is actually misunderstood or ignored leaving you and others without the information you require to manage or to help others manage organisational risks appropriately. I've found, as I'm sure many of you have, that one quick way in which a director can check is to consider for himself or herself a major decision his or her firm has taken

and then to discuss with the risk officer or similar how that decision actually interacted with the organisation's processes – was it as laid down in the book or did the decision strangely bypass half the processes because of "exceptional circumstances." If we find a decision did bypass most of our processes we may have cause to worry.

It can also be helpful to consider how much our fellow directors are going to challenge us and how we react when it happens. We need to consider their natural tendencies, whether they are our intellectual equals and how dependent they are upon our goodwill for their continued financial wellbeing. These are all facets of how much challenge we are likely to receive from them. If we find ourselves in a place where we do not think that our decision making is likely to be subject to any intellectually credible challenge, we should probably consider whether our governance structure is actually working as we would wish and whether it is helping to keep us safe from harm. If we find ourselves in the position of being a director who feels under pressure not to challenge, we probably need to consider whether we are comfortable finding ourselves in that position and whether there are techniques we can use such as, for example, explicit black hatting in discussion groups to create a safe space to say some of the things we would like to say were the power dynamics not as they are. In a specifically Guernsey context there is also the issue of boards which only have one non executive director (NED). This can sometimes create situations which are both lonely and difficult for that NED and the best solution can sometimes be an additional NED although I appreciate this is often an expensive solution for a smaller firm.

We may also wish to think about the quality of the management information we receive or produce. If our board committees and the board itself are to be effective, they need to receive appropriate management information. Stories abound of risk-adverse risk professionals who appear to think they are doing their job by providing part-time non-executive directors with hundreds of pages of reading on regulatory risks before each board meeting. When I'm given such accounts I'm reminded of Pascal's famous remark, "I have only made this letter longer because I have not had the time to make it shorter[1]." As a non-executive director chairing the Audit and Risk Committee of IAIS I often find myself reflecting on whether my committee is being provided with appropriate information to allow it to undertake its scrutiny function in an appropriate fashion. I certainly see it as part of my role to secure sufficiently pertinent material and sufficiently clear agendas to allow my committee to do its job to the best of its ability. Contemporary British Army doctrine outlines the personal and organisational skills needed to distil essential information in high tempo environments where time is a premium. Good Staff Officers learn swiftly not to waste the precious time of a busy superior officer with excessive detail and a 'BLUF' culture – 'Bottom Line Up Front' prevails. I think it's helpful for us to regularly and consciously consider whether that which we receive to help us do our jobs is good enough.

Thinking about how outsourcing is managed can also be worthwhile as highlighted earlier.

[1] Blaise Pascal, *Letter 16, Provincial Letters* (1657)

Almost all organisations outsource aspects of their operations. Henry Ford may have found it most efficient to buy railroads and ships in the early 20th Century to increase the efficiency of his production[2] but since then most organisations have massively increased outsourcing in the quest for cost savings and a focus on value creating core competencies in the last twenty years. We may wish to ask ourselves how the processes and culture we have established within our own organisations translate to the outsourced service providers and, further, what happens if the outsourced service providers fail in some fashion.

Then there is reward. Working out the right reward structures is generally tricky. Many other jurisdictions now have specific national or supranational regulations on reward structures. Not all of them are perfect and many of us may legitimately regard some of them as over the top. Nevertheless, that does not mean that we can ignore the incentives which our teams have and, depending on the type of organisation we are running, we may wish to question whether their incentives are spread over a long enough timescale to match the timescale of the risks they maybe taking for investors.

Whistle blowing, like remuneration, is a tricky area. If we wish to be in a position where we are fully aware of the risks our organisation faces, *what* incentives and safeguards can we create to ensure that a potential whistle-blower will have a quiet word with us or with one of our trusted colleagues when he or she first feels uneasy? The alternative, for a regulated firm at least, that the potential whistle-blower waits until a problem is much bigger and then gets so desperate that he or she comes to the Commission or Law Enforcement to talk about poor behaviour is, probably not the mechanism you would choose to become aware of a problem in your organisation. All too often it is well known within a firm that someone who puts up his or her hand about a real risk is saying goodbye to his or her future employment with that organisation. I think we might ask ourselves whether that is really a sign of a healthy culture.

Finally a point which I often like to consider from various angles is how we tolerate eccentricity. By this I mean thinking about how we react and deal with those who don't quite fit into the organisation's culture. I don't mean how we deal with the lazy or those who are just not educationally suited but rather those who have a tendency to ask awkward questions in awkward ways at awkward times. Do we look for swift ways to manage them out of the organisation, send them on coaching courses designed to achieve the politically acceptable equivalent of a lobotomy or do we value them because, like the canary in the mine, they can occasionally keep our organisation safe by treading where others fear to tread?

Summary

So to summarise. What I have endeavoured to do over the last half hour is to explain how the regulatory canvass is changing as many policy makers come to appreciate the sensible bounds of prudential regulation and its limitations. I have then considered the difficult issue of poor

[2] See Henry Ford's New York Times Obituary for details of how this worked https://www.nytimes.com/learning/general/onthisday/bday/0730.html

corporate governance and culture and how it may arise before offering some thoughts on some of the techniques which we may like to employ to guard ourselves against it and its consequences.

My core message today is that whilst not quite as certain as death and taxes, poor corporate governance and culture can afflict us all, even in Guernsey, at *any* stage of our professional lives. We should not think that we are inoculated against these issues. The Commission does not believe in mammoth sized prescriptive rule books as the solution but we all need to be vigilant and willing to act to counter poor culture when we find it. In that way we can collectively help preserve and enhance the Bailiwick's reputation whilst securing our long term future.

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[i] see p.2 Financial Stability Board paper on Market Liquidity Developments – 11th July 2016. Ref SC/2016/04 REV