Guernsey Financial Services Commission

Industry Seminar – 16 November 2016

Banking Supervision and Policy Division Presentation

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Good day

Over the last few years, I have taken up 5 minutes of your time before handing over to Caroline Bradley. However this year with Caroline working in Hong Kong for the Commission, it falls to me to speak to you today for 20 minutes or so.

To help things along, I have included one intentional joke towards the end of this speech at which I will pause. Please try not to laugh therefore more than once during the next 20 minutes.

Slide: Synopsis

But first I shall indicate what I am going to talk about. I am going to start by talking about the theme of the seminar this year – corporate governance. Then I am going to make a fairly novel argument about operational risk, and why you may want to think about this risk type differently than at present. Then I am going to talk about banking trends in Guernsey, then banking policy and supervision and, finally divisional themes.

So let's start with this year; – namely 'the interaction of business culture to regulation'. I am going to do this through examining the composition of bank boards in Guernsey.

In order to make the results as meaningful as possible, I will be comparing the outturn with comparators. I have not been able to find one optimal comparator but instead have been obliged to use several different comparators. None of these comparators is perfect but they are all I could find. I have also used Guernsey insurer boards as another comparator.

Slide: Corporate Governance Caveats

There are caveats. There are 14 bank boards in Guernsey and only 8 comparable insurance boards. These are both small bases from which to make any generalization. Guernsey banks are varied in nature and are subsidiaries of larger groups and therefore subordinate, at least to some extent, to the group board. Incidentally, while there are many studies of corporate governance at the group level discoverable on the internet, there are very few on subsidiary boards; which is surprising as there are inevitably going to be differences between the two.

Nevertheless, I have set out some quantitative data on the following slides.

Slide: Corporate Governance

For the first slide, the general comparator is the FTSE 150 – that is the biggest 150 companies in the FTSE. This is an odd comparator - rather than say the FTSE 100 or 250 – but it is the one used by the only body that provided this data for free on the internet.

Looking at the slide, it seems natural that subsidiary boards will on average be smaller than main boards. That the average board age is somewhere in the 'fifties seems unsurprising. The balance of executives to NEDs in Guernsey also seems uncontroversial.

Slide: Corporate Governance (continued)

Here is the second slide. This chart is taken from the FT and covers all industries. I have however added the results for Guernsey bank subsidiaries and insurers. The former are in line with the norm but the insurers show a marginally younger profile. However the difference is only a few years, so we should not read much into this.

Slide: Corporate Governance (continued)

The third slide uses the most relevant comparator for our Guernsey sample – that is UK financial services companies.

As the note at the bottom of the slide says, women directors make up 21% of FTSE 150 companies. The slide shows that the proportion in UK financial firms is lower at 12.3%; showing that women make up a far lower proportion of boards in finance than in other industries. The Guernsey numbers for both banks and insurers are a little lower than the UK financial services average. However we should not read too much into this as, given the small sample size, a few more, or a few fewer, women would materially affect the outcome. So here Guernsey is broadly in line with the optimal UK comparator, even though the latter shows the finance industry to be out of kilter with the rest of industry. A recent European Banking Authority report[1] suggests that Guernsey and the UK are in line with the general European average.

If the numbers on women are compatible with those in the UK financial services sector, there is a marked divergence in Guernsey in that there are about double the number of NEDs serving on boards serving for more than 9 years in Guernsey than for UK financial firms.

The Financial Reporting Council's Code of Practice considers that a board needs to explain formally as to why a NED on a board serving more than 9 years is still independent. Our approach at the Commission is more subtle and there are several other factors relevant to the composition of a board. However the question of the independence of long-standing directors is primarily one you yourselves will want to consider.

The Commission generally encourages bank boards to contain at least one independent non-group NED. The actual average shown in this slide is higher at two; no doubt to encourage

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[1] Report on the benchmarking of diversity practices (EBA 2016) ,

solidarity. This suggests that group employees are indeed being challenged by non-group influences. This is surely positive.

Slide: Corporate Governance (continued)

Finally, here is the fourth slide. The general comparator in this slide is with the UK financial sector- albeit this is not clearly defined. 'CRO' by the way includes chief compliance officers.

I suspect that, before the financial crisis, the current Guernsey average figure was well in line with the UK norm. However since then, the prominence of the CRO has materially increased in the UK, but not in Guernsey. Whether subsidiary bank boards should have a CRO or not is another question, on which I leave you to ponder.

There are also 15 bank branches In Guernsey. This sector lends itself less easily to a simple quantitative analysis – for example many branch executive committees span different businesses as well as, sometimes, all three Crown Dependencies. However, suffice to say, that we have looked at this sector too and we cannot find a reason to think bank branches diverge too much from bank subsidiaries. The only notable fact is that for bank branches there are several women holding senior compliance posts. Interestingly, the European Banking Authority also noticed a higher representation of women in supervisory as opposed to line management functions.

I started with some caveats, and I will finish this section with some more. I am not suggesting that the average numbers shown here are optimal for your particular firm. This speech is not intended to signal any regulatory direction. All these figures have to be considered in the context of subsidiary boards – a largely unstudied question - and the constraints of the Guernsey employment market.

There is at present a general call for more 'diversity' in boards. This can be interpreted as a somewhat crude call for specific quotas of types of people on boards. However, the word 'diversity' comes from the verb 'divertere' which means 'to cause a change of direction'. This seems a more productive way of thinking about diversity. We want to see on boards people who capable, both technically and through force of character, of causing a change of direction. Gender, longevity, background are all relevant but they are not the key determinants in this.

Nevertheless, I hope that these figures will lead you at least to reflect about ways to think about the composition of your own governing body.

Having considered this year's general theme, I would like to turn to more specific issues firstly to do with operational risk and then with the banking sector in Guernsey.

Slide: Operational Risk

In terms of global trends in banking, I would like now to focus on one risk type in particular – and that is operational risk. As you know, the Basel Committee is due to change the way regulatory capital is assessed for operational risk and you may now be expecting me talk about this. Instead however I would like to focus on a broader, and I think more important, development for this risk category. And, given that most Guernsey banks have quite a lot of operational risk, this may be of interest to you.

The Global Financial Crisis was multi-faceted and led to material losses in the market and the credit space. However it also led to some very large losses around operational risk. Now pigeon-holing losses as due to one type of risk or another is not a particularly meaningful exercise. For example, US mortgage CDO losses were due to a mixture of a failure to measure credit risk together with operational risk failures around transparency and sales practices. Yet it seems undeniable that operational risk mismanagement was at the heart of several types of losses. For example, financial crime fines, libor and fx rigging, PPI, interest-rate sales to businesses, and so on.

I would suggest that these operational losses should lead us to change the way we all think about this risk type. Before the crisis, we used to think about operational risk as, in the first place, being a mostly minor threat; with the exception of rogue trading. For example, the IT system might fail leading to the ATMs going out of action for a day. Or, a bank might have too many cheque frauds. Perhaps BCP processes failed when they were called on. These were worrying events but they were not generally going to threaten the bank.

However, since the crisis, the scale of operational losses – in many cases billions of dollars – has changed the perception of operational risk. In banking terms, a failure to manage operational risk can now be life-threatening to a bank. It may be technology, or the treatment of customers or market behavior or documentation or even cross-border risk management. Another notable feature of these losses is that they have touched several banks at once rather than just one bank. Before the crisis, banks tended to look at say a rogue trading event at one bank only to say to itself that such an event was unlikely to happen to it. In contrast many post-crisis losses have been sectoral.

The ubiquity of these operational losses means that these events have been driven by common factors. Libor/fx rigging fines have been driven by a loss of confidence in the ability of banks to act objectively. Financial crime fines have been driven by society's disappointment that the banks have failed to effectively police the legal perimeter. Rogue trading has been made possible by the increased complexity and speed of trading. And so on.

This trend suggests that operational risk events have become less idiosyncratic than before. Instead, they are triggered by wider trends around society as a whole. Therefore, in the same way that we look for a downward slide in the economy to signal credit loss events; so we should perhaps start to consider wider societal trends as an indicator of changes in the level of operational risk. So we may need to think more as economics or sociologists when considering the next operational risk threat.

Let me give you an example. It may be that, due to low interest rates, the equity markets are currently in a price bubble. Eventually the bubble will burst. At that point, some wealthy clients will claim that they were miss-sold equity-related products by their wealth-management bank. Banks will resist this but, unless their documentation is sound, they will be vulnerable. So, seeing this economic trend, the action for banks might be – check your advice documentation process now or suffer later. There are other examples of this type of thinking. For example, equity release for an ageing and possibly impoverished population, the mismanagement of power supplies in the UK leading to business shut-downs or increased sectoral exposure to cyber-crime due to

global technology changes. No doubt you could come up with some examples of your own. The point is that this is the sort of wider thinking about operational risk that banks now need to engage in. I am sorry if I have gone on too long about all this, but I think that somewhere here is an important point for Guernsey banks, given that their collective operational risk – broadly defined - massively exceeds any other risk type.

Slide: Banking Trends in Guernsey

I'd now like to focus on the current health of the banking sector in Guernsey.

Now it is undeniable that business remains tough. Among the main reasons for this are:

- A fall in cross-border global trade and financial flows
- A more autarchic global regulatory environment and
- Low global interest rates

And, until one or more or more of these factors changes, times in Guernsey will not get appreciably better for banks.

In my own mind, the Guernsey banking sector is akin to a small but well-built ship. It has met the biggest financial crisis of our lifetimes and inevitably has found the going heavy. For the immediate future, the adverse winds are still blowing. However, the ship will still be sea-worthy and then ready to move forward again once the storm has eventually died down

In the meantime, the best role for the Commission is to help ensure that the ship is up-to-date. We do this by being good regulatory citizens – attending supervisory colleges, applying Basel III, undertaking risk-based supervision and so on. The Commission has also gone out of its way to explain the Guernsey regulatory regime to several UK deposit-takers. Just in case they might want to set up a bank here. And we have internally considered our own risk appetite for new banks with particular reference to the BRICS; so that we are prepared if we get an application for these areas. The Commission has also reviewed Chinese banks through its Hong Kong office. So be assured the Commission is not hiding Guernsey's light under a bushel.

The Commission also stands ready to discuss the possibility of a new home-grown bank. I think there would be challenges around such a bank in respect for example of size and profitability, but the Commission's door is always open for discussion.

Slide: Banking Policy and Supervision

Turning now to domestic policy, on Basel III, this year we finished implementing the new requirements around the quality and quantity of capital. We are now Basel III complaint for capital – something we can feel happy about.

This year we have also been consulting on the new liquidity rules. I want to linger on these awhile because I think it shows how we as a Commission work.

Up until recently, the Basel Committee had no specific liquidity rules – although it did have broad motherhood-and apple pie guidelines. After the Global Financial Crisis, the Committee agreed that, with the benefit of hindsight, this was mistake and issued specific rules.

We, as the Commission, feel obligated to implement these rules – they after all the collective wisdom of the G20. So we started off by considering them along with our colleagues in the other CDs. The CD regulators realized that the Basel rules, if applied without change, would in effect outlaw up-streaming. Although many CD subsidiaries have changed their up-streaming business model, we as regulators still believed that, subject to proper controls, the up-streaming model remained valid in the particular circumstances of small IFCs. So, we all decided to amend the Basel rules to allow up-streaming subject to several safeguards.

We also felt that the Basel Committee had not undertaken a behavioral analysis of deposits from fiduciaries. So we decided to take our own view, although, oddly enough, the European Commission did something similar too.

Before issuing a consultative paper, the Commission undertook an impact study to see how Guernsey banks would be affected by the new Basel rules. We also took to heart what the Basel Committee said about its own rules – namely that banks should have their own bespoke liquidity policies and that these should be stress-tested. For good measure, we have also decided to include our old liquidity rules in pillar two because we think there is no one way of considering liquidity.

I will stop here. By the now the point should be clear. At the Commission we are committed to implementing Basel rules – and we do so, as many of here know, without granting ad hoc get-of-jail cards for individual exceptions. We also do so reasonably soon after their implementation in, for example, the UK. But we will also tweak these rules when we think it right, and we will introduce the rules only after some thought and only after we have prepared and worked with the local industry.

Having said all this, some of you may therefore be a little disappointed to hear that, liquidity aside, we look set for breather in 2017 as Basel III has not quite yet issued all its new credit and operational risk weightings.

Nevertheless, the Commission will continue in 2017 to work with interested parties on the continued implications of UK ring-fencing for Guernsey and on the potential establishment of a resolution authority in the Bailiwick. Although both developments only envisage a largely hypothetical risk, both will continue to keep us busy.

<u>Supervision</u>

Our routine supervisory work in Guernsey continued to take two forms in 2016. The first is thematic and the other firm-based.

This year we have undertaken one thematic that affects banks. This has been around the degree of accuracy with which banks complete their regulatory returns. We chose this topic in the wake of a critical report from the JFSC on this subject on Jersey banks. Whilst the odd honest mistake is understandable, we expect banks to have in place effective systems and controls, together with

high-level sign-off procedures, such that senior bank management can be confident that the returns are accurate. It may well be that a bank does not run itself according to the regulatory returns but instead uses more risk-sensitive approaches. This is fine. However, the regulator needs to be sure that the returns he sees are accurate. This thematic is still in progress but I would urge you to take action in the event that the eventual report is negative.

In terms of firm-based supervision, the Commission has continued with its routine supervision of banks through PRISM. There have been no particular surprises or themes in 2015. However, when issues emerge, it has often been around the following three areas:

1. *Governance* – Problems here usually emerge at banks due to poor management at the very top level.

2. *Outsourcing* – The problem here is often around intra-group issues where Guernsey management has to accept a sub-optimal solution.

3. *People* – There is a limited pool of skilled people in Guernsey and this means that it can take some time to get the right people.

So what of 2017? In terms of the future, I will stick my neck out and highlight areas where I think we may and may not have trouble.

Let us take potential banana skins first. It will not surprise you in the least that I think cyber-crime is a growing and major threat. This is particularly for private banks that hold significant amount of data about their private clients. I will I know be preaching to the converted when I say that the utmost due diligence needs to be taken in this area.

The second banana skin is potential miss-selling. This is not because I think this is prevalent in Guernsey. It is because I think that your controls to prove that it is not taking place need to be as tight as possible. And I am not 100% convinced that they are.

The third and final banana skin is also unoriginal – and that is the mitigation of financial crime across banking groups. My sense is that we are now moving into a world where many countries simply will not accept that banks that materially fail in this area should continue to be licensed. I do not think for one moment that this is the case, but we do not want a Guernsey bank to be the one that fails within a wider banking group.

I have given you my banana skins for 2017. I realize resources are limited so I think it also right to stick my neck out and tell you where I have fewer concerns.

For example, Guernsey banks have always lent into the central London residential market and do so with low LTVs and usually using collateral. Lending into the London commercial market is more risky but the exposure from Guernsey banks is limited. Guernsey banks have a very low risk appetite for lower-grade inter-bank or sovereign exposure. Parental exposure is unlikely to be a sectorial issue in the near future saving a repeat of 2008, although this is not to discount the possibility of individual problems.

So there you have my forecast. No doubt somebody today is making a note and this time next year will stand up and tell me how wrong I was.

Slide: Divisional Themes

Finally, with apologies for being inward-looking, I would like to say something about the division.

Although consisting of only 16 people, it covers several areas, namely the prudential supervision of banks and insurance companies, the supervision of insurance intermediaries and managers, and conduct issues generally. It also covers both line supervision and policy. No doubt, given this diversity, we lose something in terms of specialization. On the other hand, there are also numerous gains to be had in terms of cross-sectorial thinking and simply being joined-up. As companies give way to branches, I suspect that conduct of business issues will become more prominent.

One are that we are still working on is multi-licence supervision. For example a Guernsey bank might well have a POI licence and a sister trust company in Guernsey. We take a portfolio approach to bank supervision but that does not mean that we supervise the fund and fiduciary licensees in the division. This means that we have to liaise internally to ensure that we have a joined-up approach to each bank. I think we are getting better at this but we do not always succeed. An added complication for the Channel Islands is that bank group can be spread out across two jurisdictions. I can think of no easy solution to this; other than abolishing the JFSC. Just in case you missed it, that was my intentional joke and no offence to the JFSC!

In 2016, the division hosted a week–long visit from the Central Bank of the Seychelles and provided technical support around banking supervision to the financial regulator in Nevis on behalf of, and funded, by the Commonwealth.

Slide: Summary

In this talk, I have looked at aspects of corporate governance for Guernsey banks. I have then considered operational risk and issues relating specially to the Guernsey banking sector, including policy. I have then talked about some local supervisory issues and the division.

I hope that you have found this interesting.

If you have any questions on this speech, I am sure that either Liam or Martin will be delighted to answer them, as will I.