Guernsey Financial Services Commission

Ten Years in Regulation – Lessons Learnt and Reflections on its Value

Talk to the Guernsey Chamber of Commerce – 15th February 2016

I appreciate that some of you sitting here today, maybe even a majority of you, do not work in the financial services industry and thus may be not as steeped in the regulatory aspects of it as a group of risk officers so I thought it might be helpful to start off by explaining what it is that the Commission is seeking to do today. We work to:-

a) Help keep Guernsey safe in the court of international and European opinion – we spend a lot of energy, working alongside the Channel Island Brussels Office and the States external relations team, explaining to our counterparts in other countries how Guernsey does regulation to internationally expected standards and discussing with them how Guernsey can be regarded as equivalent when, for example, a new European Union Directive is introduced. This is vital because Guernsey is an international, rather than local, financial centre and we can only thrive to the degree that we have access to international markets;

b) Supervise financial service firms to make sure that they are treating their consumers properly and that the firms are not being used to facilitate financial crime;

c) Make sure banks and insurers have enough money to be stable because financial instability causes huge problems for the real economy;

d) Deal with the firms and individuals who have let Guernsey down in terms of the way in which they have behaved, thereby keeping the financial sector safe for law abiding businesses;

e) Develop new policy with industry and government. The international expectations of Guernsey are always evolving and the nature of the business we do changes and so we need to keep the laws fresh to facilitate plausible new business streams.

I am lucky enough to work with a highly committed set of men and women who appreciate that what they do adds value to the largest sector of the Guernsey economy whose tax take supports much other activity in Guernsey.

Those who work in financial regulation are in some ways, a specialist sort of police officer. Sometimes we are facilitating public activity in the same way as the police would at a football match or other public gathering, sometimes we are acting as gatekeepers in the same way as port officers do, sometimes we are supervising, patrolling – keeping the peace, sometimes we are financial detectives trying to work out what is going wrong and what action to take to keep the public safe. I'll touch on some of these aspects over the next few minutes and I hope that in doing so and through my account of some of the highlights of my last ten years in this role, I will be able to give you a flavour of how all of this fits together.

I left the Cabinet Office ten years ago this month and moved to the Financial Services Authority to start managing a team who were supervising stockbrokers, fund managers and Independent Financial Advisor groups. Having worked for the previous three years on reducing regulation (which we called Better Regulation to suit the political hue of the day), it was something of a culture change to find myself actually running a supervisory team focused on uncovering and fixing wrongdoing. Whilst my zeal for less regulation at the Cabinet Office might have been a factor in the FSA's decision to offer me a post, on starting at the FSA I found the freedom from having to work with ministers whose world views were very different from my own, hugely empowering as I studied how one can best inhibit wrongdoing in financial services.

I was fortunate in having a wonderful training ground. My first boss was anything but a passive 9-5 civil servant and, at the imaginatively named Department C, we tended to supervise the medium sized customer facing firms some of whom had serious issues in so much that a number of them (not all I hasten to add) employed significant numbers of staff whose devotion to enriching themselves at the expense of their often credulous customers, had to be seen to be believed.

It was a fascinating and formative time in the 18 months which I passed at the FSA prior to the financial crisis really hitting with fall of Northern Rock in September 2007. I learnt a number of lessons about:-

a) amorality in finance;

b) the economic illiteracy of some of those running quite large firms; and

c) the rewards of conformity in public service;

I am going to focus a little on each of those lessons before turning to some further lessons which I learnt during the financial services crisis.

Amorality in finance

Please note that that I use the words amorality here rather than immorality. To my mind, someone probably has to have a sense of right and wrong in order to behave in an immoral fashion and I'm not sure that everyone I encountered whilst at the sharp end of regulation had a sense of right and wrong. Too often I found firms whose businesses appeared to be built on a culture where, "The Wolf of Wall Street" mentality prevailed - namely - the best thing one could do for ones clients was to transfer their money into your pockets because you would spend it in more amusing ways than them.

Dealing with such people was tricky and some seemed to think you'd fall for platitudes. At one substantial firm we visited somewhere in England we were lectured by the CEO on how the company lived and breathed the ten point plan plastered all over the office on how to Treat Customers Fairly. He hadn't seemed to realise that we might test this thesis over the course of the visit and find, as one so often does, an administrator who informed us that the ten points had come from nowhere and been stuck around the office the day before we arrived with the sole purpose of impressing us.

On another occasion we encountered a particularly unctuous risk officer who seemed to think he'd win our hearts by buying us particularly sticky chocolate puddings for our on-site working lunch and that this would somehow cause us to overlook the fact that the investments undertaken by his firm generally lost his somewhat naive clients up to 90% of their savings whilst delivering vast trading commissions to his colleagues. We did wonder that he thought we would be so easily turned from our purpose. When I was a strategy consultant with my firm paid a lot of money for short assignments, clients used to be very interested in what we had to say because they assumed, given our day rates, that we might have something useful to say. Conversely, when doing what was in some ways a quite similar role of problem diagnosis wearing a regulatory hat, firms often made the mistake of thinking my team dim, perhaps because they believed that anything, "free at the point of use" must be rubbish.

What was noteworthy was the power of self-delusion among the leadership of some firms. They would appear to genuinely believe what they were saying even when, by going down into the bowels of the firm, you could quickly unpick what you were told. In a desire to please the regulator, it was incredible what silly lies some would tell. I remember a comical data protection visit we did to a one firm where we were running through some rather straightforward questions about how the firm kept its physical client files safe. The firm's compliance officer immediately volunteered that he kept them all in his office. We took a note of that and then asked whether the firm vetted the cleaners who went around the office after hours as we were aware that this was one way in which data could be compromised. The compliance officer then asserted that he was so careful about data protection that he let the cleaners clean the rest of the offices whilst locking his own and cleaning it himself. A short conversation with a junior member of staff an hour later and a short walk across the floor to the numerous filing cabinets containing thousands of client files revealed that he had been lying through his teeth. What confirmed my belief in the culture of amorality was the letter the CEO sent me when I raised the issue of his compliance officer having told us a number of lies. I paraphrase a little but I don't exaggerate if I say it read something like, "You shouldn't be too hard on Smith, he always lies when he's under pressure, it's just the way he is." Given the CEO did not regard honest conduct as necessary in his compliance officer, one shudders to think what standards applied to front of house staff.

That is not to say I did not encounter very good financial services firms with a strong ethos of doing their best for their clients however, experience taught me that there were a fair number of bad ones from whom the public needed to be protected given the asymmetries of information which exist when financial services are purchased. It probably made me, a fairly classic supply sider in terms of my economic thinking, far more statist when I saw quite how amoral many firms were, absent any moral ideals to constrain the darker side of human nature. I think the sad conclusion I reached from those experiences is absent the reawakening of something which could be regarded as a shared moral compass for society, caveat emptor should remain the order of the day when dealing with financial services firms. I don't think this is so much of an issue in Guernsey where there is more of a sense of community than in England but my message would be beware of assuming that those you are dealing with share your moral standards and codes of behaviour unless you have good reason to believe that they do.

Economic Illiteracy

I had previously worked for a US strategy house where we used to pride ourselves, Professor Porter being one of our founders, on searching out key success factors which firms could develop or embed to give themselves an edge over the competition who, they appreciated, would eat their breakfast if they didn't stay one step ahead. I rather naively thought that I would be having those sort of strategy discussions with the leaders of the firms I supervised when I went to the FSA. I was therefore shocked to discover at quite significant firms, with employee numbers running well into four figures, that there was no strategic thinking whatsoever as to why they should make money rather than facing competition that would force them to sell at marginal prices as should happen in a well-functioning market economy with any commoditised product. When I tried to ask a question about why they thought their business would work, I was sometimes faced with a reply along the lines of, "Look William, ABC Bank agreed to lend us £20 million last month, who are you to ask us questions about how our business model works, if it is good enough for our bankers, it should be good enough for you and the FSA." Irritatingly, of course, they had a point as formal FSA doctrine at that time said that one could check up that a firm had a strategy-setting process but it strongly discouraged us from asking any questions about the strategy itself. The early frustrating difficulties I had with trying to undertake business model analysis before it became fashionable, have certainly honed my belief that it is one of the most valuable things a regulator can do, and it is one of the things which a firm should find most helpful in its interaction with a regulator. After all, if you hire consultants, they will often seek to borrow your watch and work out what time you would like it to be before telling you what time it is. They want the rollover business after all. Conversely the regulator's staff really don't have any axe to grind. We want your business to be successful because loss-making financial services businesses generally cause us to sleep badly and a firm can therefore expect us to tell them the truth about what we think of its business model, warts and all. For firms without rafts of staff developing group strategy outside Guernsey, the regulator can often provide a really helpful 'thought partnership' during full scope inspection visits, assisting a firm in refining its view of where it is going and how it will make money. That does not mean that it is easy for us to do this. We invest a lot in business model training for our teams – some staff will have an aptitude for it whilst others will find other aspects of regulation easier. Nevertheless, from the perspective of firms, I have had feedback that it is one of the most helpful things they see us doing. We don't believe there is one right business model but the quality of the conversation we can have with a firm around its business model can be helpful for all involved.

The rewards of Conformity in Public Service

I thought I'd share, briefly, one other lesson I learnt prior to the financial crisis, namely how difficult it is to create a culture in the public sector where original thinking and risk taking is rewarded. I don't come from a particularly conformist background and I was always brought up to ask the curious question, no matter if it be slightly awkward. What I have realised over the years is that mine was a moderately unusual upbringing and that habits of conformity are instilled into a lot of bright and well educated people throughout their time in education and in the workforce. They are happy to sway with the dictates of fashion and they have little desire to ask awkward questions.

To offer two examples, I can remember being lectured by a supervisor from another division at the FSA a couple of months before the financial crisis hit, when the political pressure on FSA staff to be nice to industry was intense. She told me that I was entirely out of order to talk about "interviewing" firms because the proper term was "meeting" – this was because one would not wish to convey the impression that we were going to ask a firm any difficult questions.

I further remember a very bright and driven boss taking me aside after I'd chaired an internal quality assurance panel on a medium sized credit institution and asking me to back off from asking questions about whether ABC firm was properly capitalised because Mr Jones, a supervisory colleague across the floor, had built a model which proved that no firm of ABC's type could ever fail. My intellectual assault on such an outrageously flawed piece of received wisdom cut the ice with her as she could see through poor logic as well as me, but her political advice to me was to "back off or you'll damage your prospects".

This leads me to pose the question as to how one encourages people to be constructively questioning and sufficiently radical to ensure that you are challenging established verities. Such work, especially in the regulatory sphere, can be very valuable but it often means holding unfashionable and uncomfortable positions. There has been much recent talk of "sandboxes" in the FinTech space but I think something about which we all might reflect, and about which I don't pretend to have a polished answer, is what use would a sandbox – a safe zone for radical thought and ideas – be to us within our own organisations and how could we create one?

The financial services crisis, or crises in my case, as I did the global one in the UK and then arrived at the Central Bank of Ireland two weeks ahead of the IMF to do the Euro crisis - taught me or reinforced a number of further lessons in addition to confirming those I have already discussed:-

- The dynamics of analysis paralysis;
- The art of the possible;
- The importance of good governance;
- The importance of sound business models; and

- The inadequacy of accounting provisioning.

As a regulator, it is often quite hard to work out when to act, especially when dealing with prudential regulatory issues which tend to be less cut and dried than consumer detriment and financial crime issues. You are often dealing with lots of very bright people who always prided themselves on getting top marks at school and university by knowing everything on the syllabus. Trying to ask them to recommend actions on the basis of imperfect information is difficult. The observation, “Good report, what shall we do now?” is often met with the response, “More analysis because we don’t know everything yet.”

The trouble with that approach is, of course, by the time you know everything the bank will have failed ten years ago and you might as well not have bothered learning everything given the lack of value you have delivered to society. This issue, of analysis paralysis, is a real one which regulators have to confront and deal with effectively if we are not to repeat the mistakes of the past. Some very good prudential analysts are always likely to be risk adverse but there are some things which one can do to help make sure that the regulator is able to adapt – for example, giving air cover to our staff to do difficult things albeit with proper controls in place to quality assure their output, rotating prudentially focused staff onto teams more used to taking action so they don’t become stuck in an ivory tower unable to contemplate acting when the need arises, and having good business model analysis with triggers to prompt high level discussion about when a firm is changing from being on a recovery track to a wind down track. I like to think that the regulators of my generation are unlikely to be afraid to act because we have been seared with the consequences of not having acted enough last time. Thus I would hope that one of the most significant benefits which the Commission can help deliver to the Bailiwick, is macro-economic stability, in terms of holding the practical experience of how to act to prevent the catastrophic failure of significant banks and insurers.

This leads to another observation I want to make about the financial crisis - the art of the possible. I was blessed at the time the crisis hit to find myself leading a team of optimists. I don’t mean that there were optimistic about the economic outlook – because they really weren’t, but they were optimistic about their own abilities, hardened through frequent conflict with some of the worst firms in the financial services sector. Whilst none of us was probably a prudential specialist as the crisis started, we were far more comfortable than many in operating in a place where there was no audited user manual telling you what to do. This meant that we were able to grab things such as year end liquidity risk assessments for small banks - doing field work around the country with conclusions written up in the evenings on a lot of firms in the space of two weeks. Others were, at this time, slightly less functional because their orderly routine had been swept aside by events. I am a great fan of orderly routine but a key lesson I took away from it is the value of having a team who are optimistic and confident enough to deal with crises. I don’t know how well that translates into the business world but at the Commission we try to add value by making sure we have a balance between staff who enjoy the day to day routine and those who will enjoy dealing with a crisis. For prudential regulators, generally unappreciated in the fat years, a financial crisis provides the opportunity to repay their salaries a hundredfold in terms of value delivered to the economy. We really hope you never have to see our prudential skills deployed in a crisis but we try to keep them honed for that snowy day when they are likely be most useful.

The Importance of Good Governance and Sound Business Models

I won't repeat what I've already said today about the importance of sound business models but it is worth noting the importance of good governance. I don't mean by this, the importance of having committees with the precisely right names with a very specific set of linkages. Rather what I mean is that it is important to have boards where people are both able and willing to ask searching questions about the organisations they oversee, where management information highlights issues rather than seeking to disguise them in business speak gobbledygook or worse. More than that, boards have a role in setting the cultural tone for the firm. If the board is intellectually incurious and content to accept half truths in a vaguely hopeful sort of way then it is unlikely that the staff of the firm will be seekers after truth and the culture of the firm is likely to suffer. I have spoken on other occasions on the importance of morality in business and I won't digress into that involved subject today. Suffice it to say that if the board does not set a cultural tone which is open to discussing difficult issues then it is unlikely that staff will be encouraged to behave in an enquiring and upright fashion. In the new world order, a marked lack of uprightness may well lead to eye watering regulatory fines as opposed to being the relatively one way bet it was perhaps perceived as being a few years back.

The inadequacy of accounting provisioning

Finally, it is worth noting how difficult it is sometimes to do your job, as a firm employee or as a regulator, when one set of standards legally prevents you from understanding the underlying facts. Throughout the financial crisis accounting standards, having been tweaked to inhibit profit smoothing, inhibited the prudent recognition of likely losses by banks[1]. This meant that for both staff inside the bank and the regulator, knowledge of how desperate the situation was becoming, in terms of defaulting loans, was hidden from view for far too long. It is a well known that armies generally train to fight the last war. It is certainly the case that the accounting standards banks were forced to use as they approached the financial crisis did not aid understanding of the risks in the sector – perhaps a lesson to us all that it is often necessary to get a wider sense of what it happening rather than relying on a single set of numbers as a source of truth – yet another reason for regulators to continue to undertake high quality business model analysis.

Slide 4 – More Recent Lessons

More recently, since I've come to Guernsey, I've had time to reflect on some other points:-

[1] "During the financial crisis, the delayed recognition of credit losses on loans (and other financial instruments) was identified as a weakness in existing accounting standards. As part of IFRS 9 the IASB has introduced a new, expected loss impairment model that will require more timely recognition of expected credit losses. Specifically, the new Standard requires entities to account for expected credit losses from when financial instruments are first recognised and it lowers the threshold for recognition of full lifetime expected losses" IFRS Website.

- Regulatory Independence, despite its limitations, as an anchor for a secure law abiding society; and
- Where we are with global regulation - two steps forwards, one steps back?

Regulatory Independence and the Rule of Law

When I moved from the Cabinet Office to the FSA I found it rather nice that a minister was not constantly trying to tell us how to do our job, something which was an operational hazard in Whitehall, although not one which would overly trouble many disciples of Sir Humphrey. There is always likely to be some interplay between government and regulator when it comes to financial services policy making in a well-functioning polity. One side will represent some approximation of the democratic will of the people whilst the other will have a certain amount of experience of what works and what doesn't work to bring to the table, not to mention knowledge of international expectations if ones polity is to access the global market. Hopefully together with input from other groups such as industry and civil society, sensible policy in the national interest may be advanced.

Regulatory independence becomes much more critical when it comes to how a regulator operates. As the IMF noted in a paper authored by a number of its senior staff, "Political interference in financial sector regulation and supervision contributed to the depth and magnitude of nearly all of the financial crises of past decade.[2]" As they point out, "independence for financial regulatory agencies matters for financial stability for many of the same reasons that central bank independence matters. An independent regulator can ensure that the rules of the regulatory game are applied consistently and objectively over time. ... In contrast, when politicians become directly involved in enforcing regulations, they may be influenced by other considerations in making their decisions, which then take on an ad hoc quality.[3]" Irrespective of jurisdiction, there is always a strong argument for a regulator to have its own apolitical board and strong safeguards on its operational independence, such that the rule of law can always be applied without fear or favour. Having a regulator which bases its actions on the law rather than on the need to humour partisan supporters is vitally important if the rule of law is to be sustained.

I am conscious that this then raises Juvenal's question, *Quis custodiet ipsos custodes* although its fascination for some escapes me as it may be simply answered. The answer in Guernsey lies, of course, in the Commissioners – a body of men and women who are unusual in terms of the depth of their background in financial services businesses. It is for them to oversee the administration of the regulatory laws in a fair and impartial fashion, acting as a buffer between populist views and the application of law. Clearly, if they are not seen to be fulfilling their governance role then the States does not reappoint them at the end of their term of office. If the States does not like the law they are administering then it has the right to change the law in which case the Commission will administer a different law. In addition, there is an external audit of Commission finances by a States appointed auditor, as well as the States holding the

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[2] *Financial Regulators Need Independence* by Udaibir S. Das, Marc Quintyn, and Michael W. Taylor published in *Finance & Development*, a Quarterly Magazine of the IMF Vol 39, No. 4

[3] Ibid

Commission to account via debates on its annual report and financial statements. Furthermore, in terms of the Commission's most potent powers, it is of course accountable to the Royal Court for their application in a reasonable and proportionate manner via the appeals process connected with any enforcement decisions the Commission may take. In a modern democratic polity these are a fairly reasonable set of controls which juxtapose operational independence with several sets of checks and balances. In the same way that the Royal Court gives assurance of fair treatment under the law in a criminal matter, the Commission aims to do the same in the financial regulatory space, thereby offering Guernsey the opportunity to maintain its IFC in the face of much overseas scrutiny.

Two steps forwards, one step back?

I've tried to extract a few points from my last decade which I thought might be of interest. None of this is to pretend that we, as regulators have all of the right answers. I have not discussed the trade-offs which are so clearly emerging as Basel III and Solvency II are implemented between having high capital standards for market makers and market liquidity or the trade-off between low risk insurance and long term capital investment. Nor have I touched upon the issues of 'too big to fail' which we seem to have simply diverted from giant banks into market central counterparties. It does sometimes feel as a regulator, as I suspect it does in other walks of life, as if you only take two steps forward to take one and a half back. All I will say at this juncture is that, at the Commission, we seek to appreciate human nature and to work with the grain rather than against it, to try and ensure that justice is administered fairly and proportionately and that the Bailiwick and its people are safeguarded from the worst of the all too frequent financial crime, customer detriment and financial instability we see around the globe.