

Integrity and the financial centre: some thoughts from the regulator on financial integrity.

An informal summary of a talk by Jean Guill, Director General, Commission de surveillance du secteur financier to The Institute for Global Financial Integrity, Luxembourg, 12th October 2011.

Having looked at the TIGFI web site and looked at the list of speakers and topics in recent months I see that you have covered many of the subjects that I might have spoken about so I will try not to be repetitive in any way.

The need for integrity should be obvious in all business areas but it is particularly important in the financial industry because the financial sector irrigates all business sectors and because the financial industry is based on trust. If trust is lost, for instance because of fraud, the whole financial sector and ultimately the whole economy suffers deeply. An international centre such as Luxembourg - relying on non-resident institutions, depositors and investors - is especially vulnerable on its reputation for integrity and any example of non-ethical behaviour is likely to be magnified enormously by the media, much more so than similar behaviour in a centre with deeper national roots.

What can the regulator do in this respect? Regulating is something different from just controlling or supervising. It of course involves issuing and enforcing authoritative rules but it also implies a guiding and shaping hand, a permanent, corrective and moderating intervention to keep things on track and to ensure the smooth, can I say clockwork, functioning of the financial sector. A regulator is no longer a reactive controller and supervisor but has to take a much more hands on, proactive and preventive stance. It is important also to note that European and international financial institutions expect us to implement and enforce the highest common supervisory and ethical standards. Responsible financial institutions realise that because of the international nature of our business here, a regulatory failure would put the survival of the financial centre at risk.

The regulator has to intervene at the earliest possible stage, when someone wants to establish a financial business here in Luxembourg. We are obliged by law, and this is an essential function of the supervisor, to vet this person and this business before admitting them to Luxembourg. This starts so early and goes so deeply that it goes much beyond what is done in most other business areas. We not only look at the people who want to run the business; we are even obliged to look at the people who own the business to establish whether they are 'fit and proper'. I like this English term as it expresses better than the French legal terms of "honorabilité et expérience". We have to check this not just at the starting phase, as to be 'fit and proper' is something you have to keep up for life. Fitness and propriety are not just a matter of staying out of jail but go much beyond that, especially in the financial sector. They find their most complete expression by a loyal co-operation with the supervisor. Propriety is checked very much in detail and has sometimes led to negative decisions on our part. A clear criterion for us that someone is no longer 'fit and proper' is if he has lied to us or not told us the whole truth. We have prepared at the request of the government a draft bill which

will provide a better structured sanctioning regime and we have included the loss of “fit and proper” status as one distinct reason for either suspending a person or shutting down a business.

One specific area we have been looking into, if for different reasons, is remuneration policy in the financial sector. This is basically a question of whether the remuneration is for taking a risk which subsequently might create a problem for the business. But there is an element here of ensuring that remuneration in the financial sector is not disconnected from ensuring proper behaviour.

We are trying to be more active in the whole area of corporate governance which of course is not just limited to the financial sector. To date the merit goes mainly to initiatives from the private sector, notably the stock exchange and the compliance officers’ association. There are already rules and there will be more in the area of company management. We have a committee working on corporate governance issues and we will have a meeting in the fall to discuss a study commissioned to compare corporate governance rules in Luxembourg with the rest of Europe. It is too early to go into details at the moment but it is definitely a subject I will come back to in the New Year.

It is not just the financial sector that needs to be fit and proper. The regulator himself also has to stick to the rules which is why we have a code of conduct and our decisions are subject to review by the courts.

I have underlined that the financial sector needs to be subject to stricter rules of integrity than most other areas of the economy and I thought I would touch on a few of the areas where more is expected.

A businessman is by definition on the other side of the table from his customer and seeks to do the best for himself, but in the financial sector professionals are expected to put themselves in the place of the customer and to be loyal to them, taking the interest of the customer to heart and where necessary selling competitors’ products if they better suit the customer. This is justified by the legislator on the basis that the customer is usually at a disadvantage to the financial company which knows more about its products and their risks. The legislator has required that the guiding hand of the regulator should intervene in the area of consumer and investor protection which is a very wide field. Although we are not liable for an individual’s loss, we are there to protect him against malpractice and possibly also against his own folly. This concern is not new and shows up in MiFID of course, the regulation on prospectuses, key investor information documents, transparency laws, the rules governing UCITS and payment services and regulations on consumer credit. Financial professionals have had to get used to a very special approach which almost goes against nature from a business perspective. Lord Rothschild was reputed to have made a fortune because he knew the outcome of the Battle of Waterloo before the others. I suppose that now-a-days he would be put in jail for insider trading and market abuse. So you see some changes in perspective in the financial sector have been wrought through legislation and we are living in a different world from what was considered to be acceptable behaviour only a few decades ago.

The financial crisis has laid bare a certain amount of misselling of financial products which was easily covered in boom times. The sellers were of course motivated by their profit and bonuses. The buyers were very much driven by their own greed and they would never admit that they had not understood the risk they were taking on. No wonder then that consumer protection and product

vetting are very much to the forefront of politicians' concerns and they have been added specifically to the mission of the new European supervisory authorities. This is one aspect of integrity and loyalty to the customer that the new European authorities will be judged upon in about three years' time when the Commission and the Parliament will look at their efficiency. This also means for us that together with the industry and stakeholders from the consumer side we will have to go very much beyond what we are mainly doing now in responding to complaints and go very much into the area of financial education, consumer information and product control or even banning?

Another area on which you have had a presentation recently is money laundering where the financial sector has to act as the long arm of the law enforcement authorities. I remember when we had the first law on money laundering - restricted at the time to drug trafficking - the general complaint from bankers was that this was not a banker's job. It is now accepted that keeping the financial sector clean by making an effort to make sure that it is not being used and abused by those who wish to do illegal business is important for the health and reputation of the financial sector. Anti-money laundering implies you need to know your customer quite well, and it extends into the areas of bribery, corruption and even tax evasion.

Sometimes you wonder if some activities should be considered to be more ethical than others. Investing in development aid, microfinance, environmental protection might be candidates for such a labelling, with production of weapons at the other end of the range. But what about nuclear energy for instance? Drawing lines between what should be encouraged and what might even be forbidden should be left to the legislator rather than to financial professionals.

Nevertheless there are many other interesting tracks to follow, to take into account what is ultimately a social responsibility and ethical awareness in financing some things rather than others. I just mention the interest taken in Islamic finance which is based very much on ethical values. I would dare to say they are not different from the values that we also know; for instance through keeping the link between taking the risk and earning an income which is something that has been lost in some other financial operations in the past few years.

Has the crisis changed our views on integrity? I would just make two remarks on this. As mentioned, 'fit and proper' is very much about being honest. But I would also like to say that the crisis has underlined that other elements of character - beyond just being honest - have also been shown to be very important from the point of view of ethics and integrity; in a crisis you need the necessary character of soundness, the necessary responsible behaviour not to panic when things get tough, not to run away from difficult decisions, to keep a steady hand to get through the crisis. Patience is required because the aftermath of a crisis is a long-time effort.

Ethical considerations are not a luxury which we can afford when things are fine but they are even more important in difficult times because they underlie the whole integrity of the financial system. I do not talk so much about Luxembourg here but globally, the financial sector comes under heavy criticism from those who say that it has become disconnected from the real economy. It is important that the financial sector shows its integrity in being at the service of the whole economy. I believe that this is the noblest collective social responsibility that the financial sector can provide.

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Q and A

Q. In the past few years the banking industry has gone through improvements to the regulation of banking, but what about shadow banking?

A. The supervisory authorities prefer not to use the term “shadow banking” as it does not reflect the reality of that phenomenon. But that does not detract from the relevance of your question. As banks have more difficulties to provide sufficient credit to the economy, other channels and institutions fulfil that role to a greater extent. This has come very much to the forefront of the authorities’ attention lately. It is being discussed at the G20 level, it is being discussed at the Financial Stability Board and it is being discussed at the level of the European Union. It all goes under the strict principle agreed at the highest level in 2008 that no financial activity should go unregulated or unsupervised. The intention thus is to drag these activities out of the perceived shadows. In Luxembourg, we already had the principle that all financial activities should be licensed and supervised. Now with the transposition of the AIMF Directive we have an opportunity to regulate at least a major part of the non-bank sector better.

Q. You mentioned your criteria of ‘fit and proper’. What happens when you come across cultures that find these questions intrusive and aren’t used to these kinds of investigations?

A. Yes that happens but if somebody wants to come here he has to play according to our rules. That may sometimes be awkward and need some explaining but that is how it is.

Q. This question is addressed to you in your capacity as a board member of ESMA. On the scale of 1-10 how optimistic are you about global regulation given the discrepancy between the European and American views?

A. If you asked me about the European level I would put it at above 5. If you ask me about the global level, especially the United States, I would put it at below 5. It is indeed fairly difficult to get agreement, especially on technical details, with the Americans - accounting rules are an example. At the European level it will take some more time for the new authorities to reach cruising speed especially if they are restricted in their resources – thus I am above 5 for Europe but it will take time.

Q. You have mentioned the quality of honesty. A lot of what went wrong in the crisis with structured products could be put down to an absence of common sense or traditional banking skills. A lot of people working on these products work in silos and do not seem to have a proper perspective partly as a result of Chinese walls imposed by regulators. Do you see a solution to this?

A. You are certainly right about a lack of common sense in many of the reactions to the crisis. It’s called common sense but it’s not that common. We saw plenty of panicky reactions. Forcing people to sell at a loss. It’s not what you would tell your customers to do, which is to buy low and sell high. This kind of thing goes beyond my understanding. In a complex organisation many people who are doing the actual business will not have a global view and this may result in uncoordinated action. This is a question of corporate governance, of grasping all implications of one’s actions at management level and even at the level of the board.

Q What are the requirements for an organisation that wants to establish in Luxembourg?

A. The requirements cannot be other than are established in law. For example transparency; the transparency of the whole structure; the funding and the origin of funds has to be transparent; supervision afterwards must not be encumbered by the structure of an organisation. All these elements come from European Directives and are enshrined in our laws. Actually they date back to the BCCI case when we did not have all those laws and therefore authorities were powerless to take action as the structure was not transparent and almost impossible to supervise since no single supervisor had a full view of the group. These laws were put in place at that time and Luxembourg was at the forefront of this.

Q. How does the regulator see the importance of banking secrecy for the Luxembourg financial centre in the light of the Savings Directive and requests for full exchange of information and also in the light of what Switzerland has agreed with the UK and Germany?

A. Being on the regulatory side and previously on the Treasury side it is obvious to me that integrity also involves paying one's taxes. Bank secrecy should not impede the honest payment of taxes. Actually, bank secrecy is a term which is becoming much less used. Now-a-days the accent is much more on the duty of confidentiality which is very much what this topic is all about. We have tried to explain this before but it is sheer impossible. Confidentiality is required because people don't want their financial affairs to be known too widely, put on the public place. It is no different from having your medical records put in the public place. Besides, the duty of confidentiality is not contested, also not by GAFI and the OECD. Tax issues as such have become much less relevant. When the withholding tax went up from 20% to 35%, a rate higher than many income tax rates, there was virtually no impact. Many customers have actually opted for exchange of information, an option which exists also here in Luxembourg and is thus widely used. This should facilitate the on-going discussions at the European level on reforms to the Savings Directive because the amounts involved are getting smaller. The agreements between Switzerland and the two member states in question are an interesting element for Luxembourg and also a somewhat awkward element for the Commission as well as for those two member states. One will somehow have to find a way of squaring that circle. Of course there is, and rightly so, the argument that being inside the Union is different from being outside. I don't know what the outcome will be, but it is an interesting evolution which we are watching very closely; on the other hand as I say the real problem is actually shrinking.

Q. What is the biggest reputational risk for the Luxembourg financial sector from the regulator's point of view?

A. You are never completely certain that there cannot be fraud. You can't regulate it away. If something happens the media quickly pick it up and your reputation suffers. Apart from that ever-present danger, the place would run a serious reputational risk if its regulation and supervision as well as the implementation of all legal and prudential requirements by the financial actors present here were not up to the highest international standards. We cannot afford to get bad marks from the increasingly tough outside scrutiny by our peers and by international institutions.

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