The Gibraltar Financial Services Commission

Risk Outlook

Published: April 2016

1 Foreword

Gibraltar has a very diverse financial services industry. Keeping up with emerging trends and industry developments, staying informed of new products and services is a challenging but key focus for the Gibraltar Financial Services Commission (GFSC).

The regulatory landscape has changed significantly since the financial crisis as international, European and domestic policy makers attempt to rectify the weaknesses and issues identified within the international financial services industry. The focus has been on improving how firms are structured and governed to ensure they are run based on sound business practices; that they instil a culture that promotes ethical behaviour and has the best interests of its consumers at the centre of its operations; that they have increased levels and better quality of capital that can be relied upon during periods of stress to absorb losses; that there are robust recovery and resolution plans to be able to dissolve failed institutions with limited impact and disruption to financial stability, customers and without resorting to bail outs funded by tax payers. There is increased focus on risk management as regulators seek evidence that Boards and senior management are aware of, and understand, the risks that their firms are exposed to, and that sound, prudent decisions which are aligned to firms' defined risk appetites are being taken.

The recent terrorist attacks have once again brought to the forefront the need for international organisations to work together in the fight against crime. Terrorist organisations need financial support in order to operate. Financial institutions and professional services firms play a vital role in combating terrorist financial risks.

Political, economic, social, technological, environmental and legal changes all effect the environment in which a firm operates. In order to survive, firms need to adapt their business models. Whether it is increased regulatory costs driving mergers and acquisitions, international initiatives pushing changes to tax regimes, increased competition or changing consumer needs, the environment in which the firms operate will inevitably influence behaviour.

As a regulator, we need to create a regulatory environment that supports innovation and allows businesses to adapt to the changing environment, whilst ensuring that consumers and the reputation of Gibraltar are protected at all times. Acting in the best interest of consumers and maintaining the good reputation of Gibraltar should be a common objective shared by the financial services industry, the GFSC, and any other stakeholder with an interest in Gibraltar.

We need to focus on the long term benefits and at times this will require us to make tough decisions. Decisions that might have an adverse effect on firms in the short term, but that will benefit the wider community in the long run.

What is crucial to meeting both regulatory and commercial objectives is having a thorough understating of the key risks, thus allowing us to adopt a risk based approach which focuses on what really matters. Regular, open and transparent engagement between us and licensees is therefore vital.

Samantha Barrass
Chief Executive Officer
April 2016

2. Introduction to the Risk Outlook

This is the first edition of the new Risk Outlook. It supports our aim of regulating in an effective and efficient manner through the promotion of good business practice and establishing more effective engagement with our key stakeholders.

The Risk Outlook sets some of the key risks to our objectives. It identifies the areas which will help inform our regulatory activity moving forward and that have shaped our Business Plan for 2016-17. It also provides an overview of the risk landscape including some new and emerging trends that may impact on the integrity and stability of the Gibraltar financial services industry and its consumers.

The information presented is drawn from a wide range of sources using both internal and external data which in conjunction with our Strategy and Risk Management Framework will form part of our overall approach to the management of risk.

Although this is not an exhaustive list, we hope that by communicating what we perceive to be some of the principle risks, highlighting new and emerging trends, changes to the regulatory environments and our approach to managing these, individual licensees will be better equipped to manage their own current and future risks thus maintaining the good reputation of Gibraltar, protecting consumers, reducing systemic risk and promoting market confidence.

3. Our Risk Based Supervisory Approach

Our Risk Based Approach to Supervision ensures that resources are focused on managing the most material areas of risk in a consistent manner. The approach will ensure that firms which pose the biggest risk to the financial stability of the jurisdiction, its reputation, or to consumers, receive an appropriate level of regulatory support, guidance and supervision.

Our approach is underpinned by 3 principle considerations:

1. The approach is designed to identify the most material risks to our objectives.
2. It recognises that different sectors and firms that we regulate pose different risks and our approach can therefore be tailored to each individual licensee with greater reliance on judgement.
3. The approach is designed to be proportionate and pragmatic and this will be evident in our targeted supervisory engagement with licensees.

Further details on our Risk Based Approach to Supervision including what we expect from licensees and what licensees can expect from us can be found on our website.

4 Supervisory Focus

As mentioned earlier in this document, the regulatory landscape has changed. One of the key driving factors was the financial crisis of 2007-08. Policy makers are using the ‘lessons learnt’ from past events to help shape the regulatory landscape of the future. Some of the key weaknesses identified include weak Boards, cultures which incentivised excessive and careless risk taking, little customer focus and inadequate capital levels and composition.

Our supervisory focus aims to address some of these weaknesses by focusing on the following risk areas.

4.1 Poor Corporate Governance and Lack of Individual Accountability

As part of our Risk Based Approach to Supervision, we will be assessing the suitability of the corporate governance arrangements of licensees. Good corporate governance is crucial if a business is to succeed. It establishes the system by which a firm runs and oversees its business, including its structure, processes, culture and strategies. It governs the rules by which authority is exercised and decisions taken and implemented to manage all risk types and exposures.

Areas of focus will include:

- board structure, including composition to ensure that there is a good balance and mix of skills and experience to complement the business;
- effective use of Non-Executive Directors and Independent Non-Executive Directors including their involvement in key decision making, understanding of the business, and testing their independence where applicable;
- adequate application of the Four Eyes principle;
- open and transparent relationship with regulators;
- timeliness, relevance and quality of reporting to the Board;
- culture, including the “tone from the top”, and behaviours;
- delegation of authorities and accountabilities; and
- decision making, review and challenge processes.

In pursuit of our objectives, we will look to make individuals accountable for actions taken that result in risks to the firm, its consumers or the reputation of Gibraltar. Individuals being proposed for notifiable positions within licensees will be interviewed by the GFSC to assess their suitability for the roles to which they are being appointed.

Corporate governance issues that have been identified in the past which have led to the materialisation of key risks include:

- organisations with poor governance and systems of internal control;
- individuals who are not fit & proper holding influential positions;
- individuals who put their own interests ahead of customers and the reputation of Gibraltar;
- Boards which lack depth of experience and knowledge of the industry in which they operate;
- lack of clear roles and responsibility of board members;
- senior managers taking on too many responsibilities;
- inability to act independently and challenge other Board members; and
- overly dominant CEOs/MDs.

4.2 Poor Customer Focus

Protecting consumers is one of our principle objectives. A prominent risk highlighted by the financial crisis, at an international level, is the evident lack of customer focus from many financial institutions.

In our supervisory approach, we will focus on a firm's interaction with its customers. This will include client communications, the client take-on process, how advice is provided to customers and whether appropriate disclosures are made, how a firm advertises and markets its products and services, and how firms document client activity and record correspondence/meetings with clients.

Where a firm holds or controls customer monies, we will need to be satisfied that there are appropriate controls in place to ensure that funds are appropriately segregated and reconciled.

Ultimately the GFSC will be seeking assurance that firms conduct themselves in a manner that places consumer interests and market integrity at the heart of their operations.

Examples of conduct issues previously identified by the GFSC include:

- mismatch between the product sold to a retail customer and the customer's risk appetite;
- inadequate categorisation of customers;
- conflicts of interest where products with higher commissions are being recommended to customers as opposed to the most suitable;
- charging excessive fees;
- misleading marketing material; and
- failure to highlight risks associated with products and services being sold.

4.3 Inadequate Capital and Financial Planning

As mentioned earlier, part of the focus and drive for some of the regulatory changes to come out of the European Union, such as the Capital Requirements Directive IV and Solvency II, was to improve the level and quality of capital held by financial institutions. The Bank Recovery and Resolution Directive imposes a requirement for banks and investment companies to have robust recovery and resolution plans and minimise impact and disruption to the financial stability of the jurisdiction, and avoid the need for future bailouts using tax payers' money.

For certain types of institutions, such as banks and insurance companies, holding adequate reserves is fundamental. As part of our supervisory process, we will be assessing the financial standing of licensees to ensure that they are being run in a sound and safe manner. We will monitor the capital levels of licensees to ensure that sufficient capital is held to support business objectives. Stress testing will be a fundamental part of the assessments on certain types of licensees.

The GFSC will also assess the firm's liquidity or asset and liability mix and the composition of liquidity to allow funding of the operational and financial obligations both on a day-to-day basis and in a crisis situation.

However, in fulfilling our regulatory obligations, we will not attempt to prevent regulated entities from failing. In any market economy, firms will fail. Our priority in such cases is to ensure an orderly wind-down, with minimum disruption to consumers or the stability of the local market.

Examples of prudential issues previously identified by the GFSC include:

- licensees concerned with holding the minimum capital requirement set by regulation as opposed to holding sufficient economic capital and resources to be able to support the future needs of the business;
- inadequate or overly optimistic/unrealistic budgeting and forecasting;
- under reserving;
- insufficiently severe stress testing; and
- poor strategic long term planning.

4.4 Poor Risk Culture and Weak Controls

A firm's culture is a system of shared assumptions, values, and beliefs, which govern how people within an organisation behave. Culture has been identified as the route cause for many failings. Setting the right "tone from the top" is fundamental in creating the right culture within an organisation.

The embedding of an effective risk and control culture remains a significant focus for the GFSC as it is an important aspect to ensuring that all firms manage their risk appropriately.

We expects firms to have processes and systems to identify, measure, monitor and control exposure to all risk types in an appropriate and timely manner. Risk controls can involve the implementation of new polices and standards as well as physical or procedural changes that can mitigate reduce or eliminate certain risks within core processes and systems.

Embedding a prudent risk culture requires all staff to understand and accept the values and practices of the firm. This means that firms must ensure that all of their processes support and reinforce the culture they want to promote. As part of our supervision of licensees we will seek evidence that a firm's culture promotes good risk management and ethical behaviours.

Examples of poor risk cultures and risk management include:

- incentives that encourage excessive risk taking with focus on short term benefits;
- disregard for regulatory requirement;
- lack of professional courtesy in dealings with regulators;
- taking a 'tick box' approach to risk management rather than embedding and using risk management in business decisions; and
- inadequate internal audit function to review and test performance and design of controls and poor internal audit plans in terms of cycle and coverage.

4.5 Financial Crime Risk

This continues to be a key area of focus. Risks arise from action not being taken to prevent money laundering, terrorist financing, fraud, tax evasion, bribery and corruption. The potential, for exploitation by criminals to launder the proceeds of crime, and for terrorists to use Gibraltar's financial services sector to fund terrorist activity, are prominent risks to the reputation of Gibraltar.

Firms that fail to place adequate emphasis on implementing necessary systems and controls are more vulnerable. As part of our supervisory process we will consider the firm's inherent risk exposure to financial crime and ensure that appropriate and proportionate safeguards are implemented.

It is imperative for firms to know who they are doing business with and, although not an exhaustive list, firms should be asking themselves the following questions:

- who am I doing business with and who is the ultimate beneficial owner?
- what business are they in?
- what is the purpose of the account being opened, company being formed or financial transaction?
- what is the source of the funds and how has the wealth being generated?
- does the structure of the business and the movement of funds make commercial sense and is it in line with the expected activity and nature of the business?

Whether it is financing terrorist activity, laundering the proceeds of illicit trades or the evasion of tax, by understanding the people with whom we do business we will be in a better position to identify and stop financial crime.

The GFSC works closely with international and other local authorities to combat current and emerging financial crime threats. The EU has adopted the Fourth Money Laundering Directive, which will be transposed into Gibraltar law.

Examples of weakened controls and increased levels of risk include:

- firms increasing their risk appetite during periods of slow economic growth to take on new clients without adequately assessing the financial crime risks or implementing satisfactory controls;
- poor internal controls leading to internal fraud;
- marketing of products and services on the basis on anonymity;
- lack of understanding of who the client is and the business carried out by a client;
- use of overly complex company structures;
- adoption of a 'tick box' approach to AML/CFT controls.

4.6 Unsustainable Business Models

As indicated earlier in this document, the environment in which a firm operates will change over time. There are many factors driving change, and this includes for example, the regulatory landscape, technological advances and consumer demands. In order to survive, firms need to adapt their business models. A business model that has proved commercially viable and profitable can become redundant quite quickly if the individuals steering the business fail to identify the changes happening around them.

The GFSC assesses the viability of licensees' business models on the basis of its ability to generate acceptable returns and the sustainability of the strategy over a forward-looking period. The focus is on identifying any business and strategic risks.

Areas which are considered may include:

- achievability of the firm's strategy;
- quantitative and qualitative forward looking analysis of financial projections and strategic plan;
- implementation and performance tracking of strategy;
- implications of strategy for key areas including Risk Appetite;
- products and services;
- sources of business & distribution; and
- types of customers.

Examples of issues that have led to strategic failings include:

- overly optimistic/unrealistic business plans which are not based on historical or market performance;
- business plans that are disconnected from the firm's capital needs;
- insufficiently detailed business plans e.g. business plans based on quantitative information without accompanying narrative and explanation;
- changes to strategies without assessment of additional risks and consideration to risk appetite; and
- failure to recognise changes to the market and adapt accordingly.

4.7 Thematic Reviews

The GFSC will be carrying out a number of thematic reviews during 2016. These will primarily focus on areas covering corporate governance, conduct and consumers and financial reserving.

5 Policy and Regulation

Gibraltar is a full member of the EU Internal Market in Financial Services and is subject to the full array, and benefits, of EU financial services directives. In respect of those areas of financial services business where EU law applies, we are required to supervise and regulate financial services business in accordance with EU obligations and, in those areas, to establish and implement standards and supervisory practices which match the standards and supervisory practices governing the provision of financial services in the United Kingdom.

At the time of publication, the question of the Referendum on EU membership, which is due to take place on the 23 June 2016, casts a shadow of doubt and uncertainty on what the future of the financial services industry in Gibraltar will look like. At this point in time it is difficult to plan or attempt to mitigate any impact from a “No” vote as the future will rest on the outcome of negotiations with the EU. However, we will need to consider short term implications arising from the uncertainty a “No” vote will bring.

5.1 EU and International Initiatives

The changes that are taking place over the next 12 to 18 months in the context of a rapidly changing European and international regulatory landscape, will be placing additional demands on regulated firms. Licensees need to be prepared and plan ahead to ensure they are ready to meet new regulatory requirements.

We have adopted a forward facing approach to EU and other international initiatives with a focus on ensuring preparedness to understand, and safely meet, the challenges that these initiatives may present. The GFSC is committed to proactive engagement with industry and other stakeholders to ensure the smooth delivery, implementation and compliance of these initiatives.

Some of the items coming out of the EU include:

- Market in Financial Instruments Directive II;
- Audit Directive;
- the amendments to the Market Abuse Directive;
- Payment Account Directive;
- 4th Anti-Money Laundering Directive;
- Payment Services Directive II; and
- Insurance Distribution Directive

5.2 Legislative Reform Programme

We have embarked, jointly with the Government of Gibraltar, on a Legislative Reform Programme (LRP) which will provide a much clearer framework for financial services regulation in Gibraltar, as well as improving the powers available to the Commission to enforce those regulations.

The LRP is aimed at delivering a consistent application of risk-based regulation, capable of responding flexibly and in a timely manner to changes in the market, EU policy developments and Government of Gibraltar macro and micro policy decisions. It is expected that the output of the LRP will result in a simpler and navigable set of standards supported by the appropriate statutory powers including risk-based, enforceable principles and rules on both firms and individuals, covering, where appropriate, training and competence requirements that are capable of flexible adjustment to changing circumstances.

One of the key deliverables of the LRP, which reinforces are aim of increasing individual accountability is an individual persons regime.

6 New and Emerging Trends and Innovation

As businesses and markets evolve and adapt to changes within its regulatory, political, social or technological environment, new trends emerge. One clear trend that has emerged in recent years and continues to pick up pace is the development of financial technology (FinTech). Driven by the emergence of innovative start-up companies and a generation of consumers who embrace technological advances, FinTech is a very real disruptor to traditional financial products and services. Whether it's delivering faster and cheaper payments, more convenient ways to pay for goods and services, peer-to-peer lending, on-line access to stockbrokers, equity crowdfunding, or the use of telematics in car insurance, they all have one key selling point - they are designed to improve the customer experience.

As part of our commitment to supporting both existing licensees and those looking to take their first steps into the financial services sector, we have established an Innovate and Create team. The Innovate and Create team is made up of a number of individuals from across the organisation and it has been set up to help encourage innovation by supporting financial services firms and the businesses that assist them when they are looking to develop and introduce innovative ideas into the market and ensure that regulation and regulatory processes do not present unnecessary hurdles.

By engaging with the Innovate and Create team at an early stage, and discussing ideas, we can work together with firms to identify the risks to consumers and the reputation of Gibraltar and work towards managing those risks and bringing them within our risk appetite.

6.1 Cyber-Crime

Cyber-crime resulting in the risk of personal data, consumer funds and other assets being compromised is increasing as a result of the age and complexity of IT systems as well as the increased reliance on web-based front-end channels. The growing inter-connectedness of firms also increases the risk of an impact on one having a knock-on effect on others.

We have seen an increase in the number and the sophistication of cyber-attacks reported over the past 12 months affecting consumers and licensees. This has highlighted the need for better cyber security. Cyber security is the process of applying appropriate security measures to ensure confidentiality, integrity, availability of data, and the protection of assets, staff and consumers.

Examples of cyber-attacks recently evidenced include:

- identity theft leading to financial losses;
- unauthorised access to corporate emails and document management systems;
- loss of market integrity creating reputational damage in field of business expertise;
- loss or leakage of confidential customer information as a result of cyber-crime attacks which could lead to client base litigation on damages; and
- loss of systems leading to financial loss as well as reputational loss.

6.2 Virtual Currencies

The European Banking Authority (EBA) has defined virtual currency as "a digital representation of value that is neither issued by a central bank or a public authority, nor necessarily attached to a fiat currency, but is accepted by natural or legal persons as a means of payment and can be transferred, stored or traded electronically".

Virtual currencies have grown in popularity over recent years attracting the attention of central governments, regulators and large financial services institutions. The most obvious example of a virtual currency is Bitcoin.

There are a number of diverging views on the benefits virtual currencies can offer, and the risks they pose. Some of the associated benefits to consumers include cheaper and faster payments particularly for cross-border transactions, and increased accessibility. This is largely due to the fact that there is no need for traditional intermediaries such as banks. The ledger technology that underpins many virtual currency systems is another associated benefit which is now being explored by large corporates and central governments.

Financial crime risk is one of the biggest risks commonly associated with virtual currencies. This is mainly driven by the fear of anonymity or the 'pseudonymity' that some assert is provided by virtual currencies. The distributed ledger stores and validates all transactions and therefore does not meet the definition of an anonymous payment mechanism. As with any payment method, it is the information that is available on those payments and the participants to them that determine the risk of misuse of payment methods for criminal or illicit purposes and this can be mandated for virtual currencies in the same away as it is for fiat currency. The security benefit of the blockchain is being increasingly explored by traditional banks and even central banks. Fear of loss or theft of virtual currencies (or fiat currencies when they are converted), insolvency of virtual currency operators and bad operators are key risks to consumers.

The Financial Action Task Force published a number of recommendations for dealing with virtual currencies in June 2015. In summary, it recommends that jurisdictions apply a regulatory approach and supervise exchanges that facilitate the conversion of virtual currencies into fiat currencies. It recommends bringing virtual currencies within the scope of a jurisdiction's AML/CFT regimes and that a risk based approach is applied. The European Commission Action Plan, published in February 2016, confirmed the intention to add virtual currency exchanges to the 4th Anti-Money Laundering Directive in 2016 i.e. prior to the date for member state transposition.

Likewise, similar changes to other European directives and regulations such as the Payment Services and Electronic Money Directives are anticipated to incorporate virtual currency exchange and wallet operators in the future.

Virtual currencies and associated activities are not regulated in Gibraltar at present, therefore firms acting as an exchange, wallet provider or other, can legally establish themselves and operate from Gibraltar. The Gibraltar Government is currently considering its position following a paper prepared by a select working group and representations received by several interested stakeholders. However, one key point to note is that in some instances, depending on the "wrapper", or the way in which the activity is carried out, current regulatory arrangements could apply to virtual currency activity and legal advice should be sought.

We would encourage anyone, whether already licensed to carry out a regulated financial or professional service activity or not, who is thinking of, or is already carrying out in or from Gibraltar, any virtual currency associated activity, to engage with our Innovate and Create team.

6.3 Crowd Funding

Crowdfunding is the process through which people and businesses can raise money from the public to fund a certain project, investment or venture. An internet platform acts as a moderating organisation, by bringing together a project initiator who proposes an idea, along with individuals who support the idea.

There are 4 main types of crowdfunding:

- Donation;
- Reward;
- Loan (also known as peer-to-peer lending "P2P lending"); and
- Equity.

Crowdfunding is an increasingly growing industry, however, it is important to note that crowdfunding is still in its infancy stage, and this raises a number of questions with regards to risks, benefits and most significantly, regulatory approach.

Crowdfunding can be a good way for start-up businesses to access finance which traditional lenders might not be prepared to offer and it can offer attractive returns for investors. However, as with most types of investment, there is a risk of loss to investors. As it currently stands, crowdfunding platforms have no access to compensation schemes. Unlike investments which have a secondary market, investments made via a crowdfunding platform may not always be cashed in quickly or for as much money as investors pay in. Crowdfunding is generally considered a high-risk investment that can attract inexperienced investors.

At present, the GFSC is monitoring the developments in the crowdfunding market. We do not regulate crowdfunding activity as such, although depending on the way in which the crowdfunding platform is structured the activity carried out may mean it constitutes a licensable activity under current legislation.

We again encourage anyone who is thinking of getting involved with crowdfunding to engage with our Innovate and Create team at an early stage.

Published by:
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