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REPORT ON THE OPERATIONS OF THE
GIBRALTAR FINANCIAL SERVICES
COMMISSION

John Aspden, Ian Tower and Paul Wright

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Introduction and principal findings

The Gibraltar Financial Services Commission (GFSC) is the regulator of all financial services activities conducted in Gibraltar. It was established under the Financial Services Commission Act of 2007. Section 13 of the Act requires that supervisory activities of the Commission are subject to regular independent external review. This report has been produced to meet this requirement. It was produced by a team of three independent experts who had full access to GFSC documents, staff and management as well as contact in Gibraltar with a range of financial sector and other stakeholders (Annex 2 contains details of the Report's authors).

The main work of the review, including a visit to Gibraltar, was carried out in October and November 2016. A further short visit aimed at updating the factual basis for the review's findings was undertaken by two members of the team prior to the finalization of this report in June 2017.

The high level objectives of the review were to assess:

- The effectiveness of the GFSC in meeting its statutory and strategic objectives
- Whether the GFSC is in the best position to deal with the future challenges that it will face

Notwithstanding the extremely open and cooperative approach taken by senior staff at the GFSC, this report has inevitable limitations as a result of the limited time the team was able to spend on-site. It does not claim to be an exhaustive audit either of procedures or of the extent to which the GFSC is successful in achieving the standards or outcomes to which it is committed. It is, however, an assessment of its likely effectiveness based on team members' observation and experience of sound supervisory practice in a range of countries.

Our overall finding is that considerable progress has been made in achieving the objectives set out in the GFSC's Strategic Plan 2014-2017. Detailed recommendations are highlighted throughout the report and summarised in an annex. In the broadest terms our main findings are as follows:

- There has been a significant increase in GFSC's staffing. It is not within the scope of this report to offer a view on the optimal level of staffing, but the increase appears fully warranted, particularly given the additional demands being placed on the Commission. New staff members are generally being deployed to good effect. IT support needs to be developed further.
- Inevitably with an influx of new people, there is some way to go in terms of developing the necessary skills and mind-set for the Commission to be a fully effective supervisor. The indications are that the right mechanisms are being put in place to achieve this.
- The GFSC's Senior Management team is relatively new, but its members are energetic and motivated in pursuing the Commission's statutory and strategic objectives.
- A risk-based approach has been adopted which is rigorous and comprehensive. It is important that the right balance is maintained between rigour and usability. The Commission has published a risk appetite statement which could be refined further but usefully underlines the commitment to a risk-based approach and provides insights into how this will operate.
- An extensive set of internal committees has been put in place to manage all aspects of supervision. These appear to be working well but a focused review of whether they are fully meeting current and future needs would be timely.
- Authorisation is a high priority function which attracts a great deal of industry and political attention. It is stronger, more effective and better focused than in the past, with a generally appropriate balance between speed and rigorous decision-taking and there have been recent signs of greater alignment between the GFSC's imperatives and industry's needs. Continued regular communication with applicants on the progress of applications and with the industry more widely on general authorisations matters are needed to ensure that this improvement is sustained.

Introduction and principal findings

- The GFSC has undertaken an extensive programme of work over the past two years involving over 170 authorisations, detailed focus on the funds sector and implementation of the framework for risk-based supervision. A particular area of focus has understandably been the authorisation of Gibraltar International Bank and implementation of major EU directives. We recommend an early move to a more conventional supervisory model, building on existing regular risk assessment practices with a cycle of enhanced supervisory plans and communication to firms.
- All necessary supervisory lessons need to be learned from the failure of Enterprise Insurance plc. Recovery planning should be put in place for insurers as a matter of priority and a supervisory intervention framework should be developed and published to increase supervisory transparency.
- The GFSC board appears relatively remote and hands-off. While the governance structure is by no means unique and different models have pros and cons, we see a case for more frequent board meetings, closer monitoring of the Commission's performance based on key performance indicators and more substantive engagement in potentially high profile authorisation, supervisory and, in particular, enforcement cases.
- Satisfactory completion of the Legislative Review Programme is critical if the GFSC is to operate an efficient supervisory regime in future. In addition to providing necessary legislative streamlining and consolidation, the programme is the means by which the Commission will be provided with a full range of tools, particularly in the areas of Authorisation and Enforcement.
- The relationship with the Government of Gibraltar is a matter which extends beyond the strategic change programme. In this broader context and mindful of the value of flexibility in the arrangements, we recommend the creation of a (published) MoU to put the relationship and the GFSC's funding onto a more regular and transparent footing.
- The Government and GFSC should, as a matter of priority, collaborate on scenario planning for high impact events capable of undermining financial stability. This would help to identify the essential first steps that would need to be taken in these circumstances.
- This report does not cover the operations of the Financial Services Resolution and Compensation Committee (FSRCC). This is already operationally separate from the GFSC Board but periodically reports to it. The aim should be for full separation in due course.

Brexit raises a number of potentially critical issues for Gibraltar. Decisions need to be taken as soon as practicable on the extent to which policy, which has hitherto centred on EU legislation, should in future be aligned with the UK regulatory framework. We recommend the creation of a forum to coordinate UK and Gibraltar positions on Brexit issues and to prepare contingency plans for different scenarios

The financial sector and regulation in Gibraltar

The financial sector in Gibraltar contributes over 20% of GDP from a broad base of activities covering the banking, insurance, funds, trust and company services, and payments areas. Overall GDP is estimated to have increased by 7.5% in real terms in 2015/16, with inflation remaining well below 1%.

Gibraltar's financial sector activities are supported by a professional services sector with international and local operations and are underpinned by a stable political and legal environment. As a British Overseas Territory, Gibraltar has strong links with the UK. The majority of the territory's financial business is conducted with customers in the UK. For example, around 80% of the motor insurance written in Gibraltar, the major insurance business line, is for customers in the UK and Gibraltar accounts for around 20% of total motor insurance written for UK customers. Banks by contrast, either provide commercial banking for the local market or offer a range of private banking and wealth management services to international customers. Access to the wider EU market-place is important for certain businesses and sectors.

While the rate of failure among Gibraltar financial sector licensees has been generally low, high profile failures have occurred in recent years in the insurance sector. Most recently, Enterprise Insurance plc entered into insolvent liquidation in October 2016 with a large deficit in the assets needed to meet liabilities to policyholders in the UK, Ireland and other EU countries, mostly in relation to motor insurance.

Gibraltar aims to be a well-regulated international financial centre complying with applicable international standards of regulation. It faces a number of challenges encountered by many other smaller centres, including access to requisite skills and expertise, sensitivity to the balance between regulating effectively and the impact which too rigid an approach can have on the economy, the need for appropriate home/host relationships with other supervisors, and the importance of being able to stand up to ongoing external scrutiny, for example by international standard setting bodies. Safeguarding the good reputation of the jurisdiction's financial sector is rightly seen as critical.

Gibraltar is to be independently assessed by MONEYVAL in 2018 to evaluate its compliance with the Recommendations of the FATF. Some of the recommendations in this report, in particular those under the heading of financial crime (including the supervision of trust and company service providers) are intended to be helpful in working towards this assessment, which will include a significant new focus on effectiveness.

Over the last two years there has been a major reorganisation of internal processes at the GFSC, as well as the implementation of a new Strategic Plan. To put these measures into effect there has been a significant increase in total staff numbers during the period from 47 at the end of 2013 to around 80 at the time of this report. A major legislative transformation and reform programme is under way (the Legislative Reform Programme or LRP) to consolidate and modernise the financial services regulatory framework and bring the GFSC's powers up-to-date. A large amount of work is therefore currently in progress and the recommendations made in this report should be seen in this context.

GFSC Strategic Plan 2014-2017

In 2014, following a review by the newly-appointed CEO, the Board of the GFSC agreed a Strategic Plan intended to address a number of perceived shortcomings in the structure and functions of the organization and to equip it better for the challenges it faces.

The background to the Strategic Plan was the GFSC's statutory objectives as set out in the 2007 Act. These are:

- The promotion of market confidence
- The reduction of systemic risk
- The promotion of public awareness
- The protection of the good reputation of Gibraltar
- The protection of consumers
- The reduction of financial crime

In achieving these objectives, the GFSC is also expected to operate in a manner consistent with a number of principles of good regulation:

- The effective use of resources
- The application of proportionality
- Facilitation of innovation
- Maintenance of competitiveness
- To minimise the adverse effects of regulation

A number of wider contextual factors were also relevant to development of the plan:

- The need to comply with international and EU standards and regulations
- The policy of the Government of Gibraltar to promote and develop the financial services sector
- The need to increase efficiency and accessibility to stakeholders
- The need to respond to emerging market demands and developments
- The operation of risk-based supervisory framework

The plan identified a number of strategic objectives:

- To be a competent regulator, ahead of important risks, well prepared for domestic, EU and international objectives and acknowledged as expert in regulated markets
- To be an effective and professional cross border regulator
- To support the safe, sustained growth and development of Gibraltar's financial services industry
- To be an efficient, targeted regulator providing value for money
- To be an accessible and efficient regulator

The key steps outlined for the achievement of these strategic objectives were as follows:

1. An organisational restructure designed to improve the effective and efficient operation, involving strengthening of sector-specific and senior management expertise
2. A streamlined and un-bureaucratic authorisation process involving the creation of a dedicated Authorisation function balancing risk with competition and choice while avoiding excessive regulatory barriers

GFSC Strategic Plan 2014-2017

3. A review (undertaken jointly with the Government of Gibraltar) of the legislative framework for financial services regulation and the creation of a simpler and navigable set of standards
4. Development of the GFSC's risk framework and capability with improved understanding of risk and the GFSC's and Government's risk tolerance
5. A more outcomes focused and proportionate approach to supervision focusing on the biggest risks and with proactive intervention where appropriate
6. The adoption of a more forward-facing approach to EU and other international initiatives as well as those emanating from the Government of Gibraltar
7. Maintenance of a credible deterrent through a strengthened enforcement approach which is transparent, consistent and fair with necessary appeal mechanisms
8. Upgraded technology to permit better capture and recording of information to facilitate efficient and effective use of data
9. Recruitment, training and continued development of staff to achieve the appropriate skills, experience, capability and capacity
10. Strengthened engagement with all stakeholders including European supervisory bodies, government, consumers of financial services and supervisors and policy makers in other jurisdictions.

Implementation of the Strategic Plan has driven profound changes to the GFSC's management, internal administration and modus operandi over the past three years. The most visible aspect of this has been a significant increase in resources. The Commission's budget increased from £3.4 million in 2013/4 to £6 million in 2016/17. This increase has been mostly accounted for by an increase in headcount from 47 to a current level of around 80. Progress against the Plan has been reported in published business plan updates and the 2016 Annual Report.

This report focuses largely, though not exclusively, on the principal themes of the Strategic Plan.

Operation of the Board, the GFSC's relationship with Government and structure

1. Relations with Government

The relationship between supervisory bodies and governments in small countries is different from that in larger ones. It is typically characterised by a higher degree of informality and there is relatively greater focus at government level on the balance between regulatory standards and the development of the financial centre. This is reflected in extensive interaction between the regulator and the (usually separate) authorities responsible for promotion. Funding arrangements are often more complex. It may be difficult for supervisory agencies to fund themselves fully from fees charged to the regulated population, resulting in the need for some form of subvention. This needs careful handling to ensure that the independence of the regulator from undue political influence is not compromised, either in perception or reality.

We understand that the GFSC enjoys a positive relationship with the Minister for Commerce (formerly the Minister for Financial Services and Gaming) and with the Financial Secretary at the Ministry of Finance. There is frequent dialogue between the GFSC CEO and the Minister, while the Chairman also meets the Minister on a regular basis. The GFSC appears to operate with a high degree of independence and largely free from political involvement in operational matters. There is a clear separation of regulation from the promotion activities carried out by Gibraltar Finance which also reports to the Minister for Commerce (though GFSC staff maintain constructive working relations with Gibraltar Finance).

Notwithstanding this effective separation, there is some risk (as in other jurisdictions) of the GFSC's operational independence being compromised in certain circumstances, especially where its approach to meeting its regulatory objectives could be seen as hindering realisation of the government's vision for financial sector development. Close working relationships help to head off any such tensions but need to be based on a shared understanding of the limits of Government's and the regulator's responsibilities.

The reporting line of the GFSC to the Minister of Commerce rather than the Minister of Finance (currently the Chief Minister) could expose the jurisdiction to potential criticism – for example in reviews to assess Gibraltar's compliance with international standards which normally seek separation between regulation and financial promotion. Gibraltar Finance is a separate agency but it also reports to the Minister of Commerce.

It is recognized that overall responsibility for these functions needs to come together somewhere in government; that there have been few if any examples of conflicts in the recent period and that the Minister of Commerce is able to devote more time to regulatory matters than might be possible if the Minister of Finance had direct responsibility. Nonetheless the government needs to remain aware that the current arrangements could be seen as potentially compromising the independence of the GFSC and these need to be kept under review to ensure that conflicts do not arise, in reality or perception.

The Commission's recent expansion and increased budget have been supported by an annual subvention from Government (which is planned to reduce from £1mn per annum in 2016/17 to zero over the next 10 years). The Commission is expected to fulfil its general statutory functions and the Government is looking in particular for it to facilitate an efficient and speedy process for authorisation decisions. The Commission is expected to be open to new products, business models and innovation while also maintaining effective due diligence in the authorisation process.

We understand that while under the 2007 Act the GFSC is required to submit its annual report to Parliament, there is no regular debate nor any procedure by which the Chief Executive appears before Parliament on an annual basis, or otherwise, to be questioned about the report or any aspect of the Commission's operations. Accountability to the Government of Gibraltar is therefore achieved mainly through the relationship with the Minister of Commerce and, to a lesser extent, the Chief Minister/Minister of Finance. This is in line with the established model of accountability in Gibraltar which does not, for example, provide for the use of standing committees to undertake scrutiny of the executive.

In view of the critical importance of the GFSC's work and its contribution to the financial stability of Gibraltar, we would see advantage in adopting a number of measures to make the GFSC's accountability to Parliament and to the public more effective in practice.

Operation of the Board, the GFSC's relationship with Government and structure

Recommendations

1.1 There could be a regular, if not necessarily annual, debate in Parliament of the Commission's Annual Report. This would provide the opportunity for questions to be posed in a formal and accountable setting on the GFSC's performance against its statutory functions, the exercise of its statutory powers and the overall condition of the sectors which it is regulating. This would also raise public awareness of the work of the GFSC.

1.2 The GFSC's Annual Report could usefully be expanded to include more information about the challenges which the GFSC faces, more detail on how it is conducting supervision and exercising its powers, and performance against a number of indicators.

1.3 It is noticeable that there is little statistical information published about Gibraltar's financial sector. More data could usefully be given in the Annual Report as well as on the GFSC's website. These measures would not only increase accountability and transparency but would also help to promote a greater understanding of the environment in which the Commission operates and some of the difficult issues it has to address.

As noted, the GFSC has a positive working relationship with Government. However, there are a number of dynamics which could affect the current high level of mutual understanding. These include a change in Government or of relevant ministers; a change in the senior management of the Commission, increased economic pressures (which could - unfairly - be blamed on regulation) or a more proactive role of the Commission using its new powers. Informal relationships, in other words, always depend on personalities and circumstances which may change. There would therefore be benefits in establishing clearer ground rules for cooperation between Commission and government to ensure the preservation of both close working relationships and operational independence for the Commission whatever changes may occur in the future.

- Policy issues on which the Government has the right to decide or be consulted upon before wider discussion with stakeholders;
- The basis on which Government provides a financial subvention (in the short- and long-term) to the Commission and the way in which this is disbursed/drawn down;
- Precise demarcation of responsibility for supervisory and financial stability issues. The MoU would underline the GFSC's independence while recognizing that Ministers have a legitimate interest in several of its areas of responsibility.

- The MoU would set out the very limited basis, already established in law, under which government may be involved in supervisory decisions.
- It would also set out the limited circumstances in which government can expect to be pre- or post notified of decisions in the following broad areas:
 - Risk tolerance and financial stability
 - Authorisation, supervision and enforcement
 - Publications, recruitment decisions and other operational decisions where communication would be helpful in support of a 'no surprises' principle for Ministers
- The thresholds for pre-notification of decisions would be set appropriately high and in this respect the MoU would underline the operational independence of the GFSC

The MOU would provide greater clarity and certainty than at present as to how the relationship with government works. We recommend it be published to give greater transparency for the public.

1.5 In the longer term, it could be appropriate to consider a change in the reporting line of the GFSC within government. While current arrangements work well, a change in the reporting line to the Minister of Finance could, in principle, help reinforce the separation of regulation and promotion and recognise the increasingly broad range of policy issues for which the Commission is responsible (including financial stability). To the extent that the GFSC remains in receipt of a subvention from government, it would clarify responsibilities in respect of the Commission's funding. The review recognises however that, for as long as the Minister of Finance role is held by the Chief Minister, such a change would be practically difficult and the current arrangement confers some operational advantages. There is however an important point of principle involved and these relationships should however be kept under review, including as part of the next five-yearly Statutory Review.

Corporate Governance and Internal Management

2. The GFSC Board

The relationship between the Board and executive of any supervisory body always needs to strike an appropriate balance. The Board should provide direction on policy matters, risk tolerance and on the highest profile management issues such as the budget, the overall level of resourcing and the broad allocation of resources. Day to day operational and management issues should be delegated to the executive to the maximum extent that is feasible and prudent. Beyond this level of principle, governance arrangements can vary and different models which involve varying levels of autonomy for the executive have their pros and cons. In our view Boards need to be kept apprised of, and be prepared to involve themselves in, a range of operational issues particularly those involving authorisation; significant remediation actions; enforcement actions in respect of high impact entities and key matters of regulatory policy. Boards should be expected to provide direction or at least endorsement of the executive's proposed actions in such cases.

The Board of the GFSC, in line with the requirements of the law, comprises eight persons including the UK-based Chairman, two other independent persons with international experience (currently these are from the UK) and four non-executive persons from Gibraltar. The Chief Executive is also a member of the Board. The Board meets quarterly. In between meetings the Chief Executive routinely meets with all three UK Board members and meets the Chairman for update briefings in Gibraltar. The Commission's executive also seeks the advice of local Board members on an as-needed basis. As the four local Board members remain active in business in Gibraltar, we were informed that arrangements are in place to ensure that conflicts of interest are appropriately managed. We understand that the Board is seldom, if ever, formally involved in decision-making on case work however. Most of the relevant powers have been delegated to the Chief Executive, who keeps Board members informed as she feels appropriate.

Our overall view is that the current mode of the Board's operation provides insufficient engagement to cope with the increasingly complex nature of the GFSC's remit and responsibilities going forward. The Board is de jure the Commission and while there is no evidence that the existing degree of delegation to the Executive has been problematic in practice, the Board should be engaged more directly in key aspects of the Commission's work. We see this as an imperative in several areas of the GFSC's operations and set out specific recommendations for the area of enforcement in section 8 below. These recommendations include a searching review of the processes and culture surrounding potential conflicts of interest affecting Board members.

Recommendations

2.1 The Board should become more involved in oversight of key areas of the Commission's operations and should be prepared to take decisions on high-impact matters (see section 3 below on internal corporate governance). This should involve use of a quorum when necessary to support rapid and flexible decision making. In particular, the Board's role in significant enforcement cases needs to be reconsidered.

2.2 It is recommended that, to enable it to perform this enhanced role, the Board should meet more frequently – at least six times a year and preferably eight times. It is recognised that preparation for Board meetings creates a considerable workload for the executive. This would need to be managed and balanced against potentially shorter agendas, less need for updating and greater engagement by the Board itself.

2.3 While the composition of the Board provides a breadth of relevant and current experience, the practice of recruiting to the Board persons active in the local market gives rise to conflicts of interest, however well managed these may be. It means that Board members have to recuse themselves when conflicts occur and this can quickly reduce the number available to participate in Board deliberations and decisions.

- a) It is recommended that as rotations at Board level occur, consideration be given to recruiting local experienced professionals who have retired or otherwise moved on from active duties in the local market. We understand that the Financial Services Resolution and Compensation Committee (FSRCC) is staffed on this basis.
- b) We also recommend that the processes and culture surrounding Board members' potential conflicts of interest are reviewed and revised. Specific recommendations in this area are set out in section 8 of this report which deals with the Board's role in enforcement matters.

Corporate Governance and Internal Management

2.4 With the greater involvement which the above arrangements would confer, it is also recommended that the Board should review the cycle of formal reports which it receives from the executive. This should form part of the strategy of continuous improvement highlighted in the 2017/18 Business Plan. The Board already receives an extensive pack providing progress on key projects, HR information and an overview of authorisation, prudential, conduct and enforcement issues. It is also provided with detailed information on strategic, operational and regulatory risks. While delegations from the Board are conferred by statute, it is recommended that the following additional topics should be included for routine review and, in the case of material decisions not covered by statute, Board approval.

- The effectiveness of procedures followed by Authorisations in reviewing applications for new licences as captured in a set of KPIs for this function (see recommendation 6.2 below) and a regular update on progress with applications currently outstanding
- An annual high level overview of the supervisory programme covering the risk-based assessment of licence holders, as well as the nature, intensity and frequency of supervision to be exercised. This should include an update on any material departure from the overall supervisory plan and how the resulting risks are to be covered
- High-impact cases where serious regulatory shortcomings have been identified
- Sensitive or high impact license applications (whilst remaining consistent with the higher level of engagement envisaged for the Board)
- Enforcement policies and issues (whilst remaining consistent with the higher level of engagement envisaged for the Board as per the recommendations in section 8 below)
- Delegated authorities and how they are being exercised
- Contingency planning for the GFSC's own operations
- Matters potentially affecting financial stability
- An annual update on ongoing progress in meeting international regulatory and AML/CFT standards

At present the FSRCC provides periodic reports to the GFSC Board. This reporting is deliberately limited to maintain operational separation and is confined to a general report on activities, resourcing, key risks and any conflicts between the FSRCC's role as resolution authority and manager of the Deposit Guarantee Scheme.

2.5 Whilst currently the arrangements for keeping engagement between the GFSC and FSRCC at arm's length are appropriate, it is recommended that in time the FSRCC should be fully separated from the GFSC, so that during a crisis the former manages resolution matters and the latter can maintain its proper focus on supervision.

3. GFSC corporate governance and management

As noted, we were informed that the Board (other than Chief Executive) does not become involved in decisions on case matters. All the key powers have been delegated to the Chief Executive, who in turn has made certain delegations to other GFSC staff and committees¹. This arrangement exists in some other regulatory bodies and is therefore not unique to the GFSC. It has the advantage that decisions can be made quickly so that the supervisor can be appropriately responsive and flexible. However it also means that some of the most important regulatory decisions – for example, the granting and withdrawal of licences and the imposition of formal regulatory sanctions in high profile cases – are not required to be submitted to the Board for formal agreement – much less that the Board is the formal decision maker.

While it is recognised that discussions routinely take place with individual Board members on many matters, typically these do not involve a full Board review or decision. In our view this exposes both the Board and the Executive. Major decisions with potential legal or reputational implications are being taken effectively in the Board's name without any formal requirement for consultation. The CEO may also wish to have the benefit of formal Board approval for a particular course of action with potentially significant legal or reputational consequences, notwithstanding the arrangements that currently exist for discussion between formal Board meetings. These issues will be particularly acute in cases where the views of the Board and Executive may differ but even where there is no significant difference, the absence of formal Board involvement creates a source of vulnerability. Sanctions such as the withdrawing of a licence or other enforcement actions can be hotly contested and potentially commit the GFSC to lengthy and expensive litigation. There may also be the threat of a judicial review of how certain regulatory action was taken, where the Commission's reputation could be at stake. It is suggested that these are all matters where the Board should wish to be involved to ensure that the Commission is acting as a single united body, albeit in a way which does not get in the way of nimble and flexible decision making.

Corporate Governance and Internal Management

Recommendations

3.1 The Board should reconsider its delegated authorities with a view to retaining some or all of the following decisions.

- The granting of a domestic bank licence, or any other licence which could impact on Gibraltar's financial stability or carries material reputational risk
- The withdrawal of any licence
- A decision that a person or licence holder is deemed as not fit and proper.
- Other serious enforcement action. We see the Board's lack of general involvement in important enforcement action as particularly problematic at the moment and recommend that this is changed. The issues are set out in some detail in section 8 below.

3.2 It is also recommended that the Board should undertake a review of all delegated authorities to establish whether there are other existing powers which, because of their significance, should be retained.

In line with the Strategic Plan the Commission has undergone a restructuring involving a move to a broadly functional approach with separation of legal/policy/enforcement, regulatory operations (including authorization and supervision) and strategy and planning. The approach continues to bed down following the recent recruitment of senior staff but appears to be enabling greater specialisation and improved decision-taking. A significant amount of the Commission's work, including decision-making, is also handled through what has become an extensive framework of internal committee structures. This has a number of clear benefits. It creates an architecture in which different perspectives can be brought to bear on key decisions, drawing on a broad range of experience and creates a formal process to prevent matters going unattended.

3.3 However, we recommend that a review should be undertaken to ensure that the internal processes are, and will remain, fully fit for purpose. The results of such a review should be reported to the Board.

Work on Key Performance Indicators (KPIs) is ongoing. KPIs act as an important management tool to monitor performance, including the delivery of a satisfactory level of service for stakeholders. By definition successful outcomes in supervision, which typically involve the avoidance of adverse counterfactuals, cannot readily be measured. Short of this, two broad types of proxy measures can be sought. The first are straightforward measures of *means* such as budgets, numbers of staff, measurable competencies and so on.

3.4 It is recommended that KPIs approximating to desired supervisory outcomes should be further developed for all operational areas including Authorisation, Supervision and Enforcement. Once developed, such KPIs can be used extensively in regular discussions of resource allocation and budgets.

¹ A current exception to this is the treatment of investigation and enforcement issues arising out of the insolvency of Enterprise Insurance Company plc – which is being handled by a committee of the Board.

4. Fees and budget

The GFSC has prepared a plan under which the subvention provided by Government is to be reduced over ten years from just over £1mn per annum to zero. This is based on a projected increase in licence fee income of 17% over the next five years and of 26% over the full ten years. We understand that, following a consultation on fees conducted in 2016, the Chief Minister set out in a speech to the finance sector, and subsequently confirmed in writing, an outline of future financing arrangements, including a commitment to the broad plan for continuing subventions to the Commission. In April of this year it was announced that the increase in fee levels in 2017/18 should be 2% (rather than the 4% proposed earlier) with the revenue shortfall being made up through an increase in the government's subvention. It is still the intention however that the subvention should remain on a downward trend in the long term.

In meetings with the industry, the comment was made that the longer term arrangements drawn up for GFSC financing were proposed before the Brexit vote had been conducted. Commentators felt that, depending on what arrangements emerge for continuing market access (both in respect of the UK and the EU) the long term trajectory for fees increases may not be sustainable and should be revisited. It is essential that regulation remains properly funded at all times and there is presently little surplus in each of the coming years to absorb any decline in revenue. A rigid adherence to an unrealistic trajectory for fees if combined with a long term reluctance on the part of government to make up any shortfall could, in time, have serious consequences for the Commission's ability to discharge the increased burden of responsibilities placed on it, notwithstanding efforts it will make to contain costs.

Recommendations

4.1 This review fully supports the longer term objective of charging the full cost of regulation to licensees. Given the uncertainties which have recently emerged, however, the GFSC should review both its longer term revenue and expenditure assumptions to assess the extent to which prospects for eliminating the subvention in the stated time-frame stated are realistically achievable. Government may, in practice, need to show continued flexibility in its attitude to the future level of subvention and the GFSC may need to be in a position where it can negotiate in advance some scope to maintain subventions at a somewhat higher level than set out in the current 10 year plan in case of shortfalls in fee income.

4.2 Provision should be made, perhaps in the MoU recommended in section 1 above, for a long term approach to government subventions. These should normally be related to specific and identified needs, such as the necessity to develop a regulatory regime in response to new financial services businesses/business lines or the need for the GFSC to support an agreed area of innovation in the financial sector. This would recognise that while in general the industry should pay for regulation, there is sometimes a need in smaller international financial centres for investment in new areas of business. In such cases, government financing may be needed to support the development of new areas of regulation in pursuit of agreed public policy objectives.

4.3 IT is a strategic investment for the GFSC and expenditure on this will continue to be material. There is a need in particular to develop the IT tools required to support effective risk-based supervision. It is recommended that the costs of IT and its future development, whether met from fee income or subvention, should constitute a separate line item in the annual budget. Given its fundamental importance, IT needs to be seen as a key, discrete area of investment, and not an activity that is expected to be funded from savings in other areas.

Corporate Governance and Internal Management

Supervision, which is the principal focus of the GFSC's work, can be considered broadly in terms of a continuum of activities.

- Identification of risks, both external or sector-wide and internal to the GFSC
- Authorisation, including approvals of key individuals
- Supervision – identification and addressing firm-specific and 'horizontal' or thematic risks
- Enforcement
- Recovery and resolution planning for relevant parts of the financial sector

5. Risk identification

a) External risks

In common with other small international financial centres, Gibraltar is susceptible to external or macroprudential risks. The most pressing current example is Brexit which has potentially profound implications for both the policy environment and the viability of current business models. Less immediately visible but also important are sources of risk such as changing market conditions for general insurance in the UK and the increasingly competitive climate for international banking, which is influencing location decisions for banks such as those in Gibraltar (a number have withdrawn from the jurisdiction in recent years). Not only is the soundness and viability of international business potentially at risk but also the provision of core financial services on which the local population relies. Indeed, it emerged from our discussions that concerns about continuity of provision of financial services to the local population and substitutability weigh more heavily in considerations of systemic risk than the prospect of a catastrophic failure.

Paradoxically, while small countries with international financial activities are particularly susceptible to external risks, they also tend to have the least well-developed mechanisms for identifying and managing them. They typically have neither central banks, resources dedicated to the identification or analysis of external/macroprudential risks nor the tools to address these.

While this is true of Gibraltar, we found a number of indications that the GFSC is appropriately cognisant of macroprudential risks. It is extremely focused on Brexit; extensive discussions have been, and will continue to be, held with the Government of Gibraltar regarding the implications as these become clearer.

The GFSC also worked constructively with government and industry in responding to the withdrawal of Barclays and the establishment of government-owned Gibraltar International Bank in response to concerns about the availability of retail banking facilities.

In identifying external/macroprudential risks, the GFSC depends largely on information arising out of firms' returns, market intelligence, discussions with government and Board 'Blue Skies' discussions and input from European agencies such as EBA and EIOPA as well as national regulatory agencies, especially in the UK. It has internal processes for scanning the horizon for risks arising out of specific sectors on a rolling basis. Its Risk Management Framework helpfully seeks to identify and address external and strategic risks alongside firm-specific ones.

Recommendation

5.1 The Commission needs to work more closely with the Government of Gibraltar in identifying and planning for scenarios which could pose serious threats to financial stability and/or continuity in the provision of financial services. These could be financial, such as a liquidity drain in a domestic bank, or reputational. While it is not possible to trace through all the possible stages of such an emergency, there is merit in planning the first steps of the required response, including the necessary dialogue with the UK Government and other stakeholders that would need to be undertaken. In many jurisdictions this work is undertaken through a financial stability committee structure. A version of such a structure could usefully be considered in Gibraltar.

b) Internal risks

A further important category of risk is that arising from the GFSC's own internal processes and controls. The GFSC's Risk Management Framework aims to capture sector- and industry-wide regulatory risks (which can be identified from a range of sources, including meetings at which risks in all licensees are evaluated, and Board 'blue skies' sessions) as well as 'strategic and operational risks' which are largely internal to the Commission. This forms a parallel track to the framework for firm-facing risk-based supervision which focuses on risks in individual entities. Within the overall risk management framework, risks and 'risk events' are identified and classified using the same broad impact and likelihood based methodology as that used for classifying firm-facing risks.

This information is captured in a central risk register in which risks are recorded along with identified owners, the senior staff members who are accountable, mitigating actions and timeframes. Changes to the register (including the addition of new risks), progress with mitigation, risks which are judged to be outside the risk appetite and methodology issues are discussed at the monthly Risk Management Forum which the senior management team attend. The deliberations of this group form the basis for a comprehensive quarterly report to the Risk and Audit Committee and the Board which also lists progress on a range of identified management actions. We understand that there is also an annual stocktake on risk. A short and user friendly internal guide to the risk management framework has been produced for the use of GFSC staff.

Supervisory Processes

Aspects of the Risk Management Framework are still in the process of development but the approach being adopted is to be commended on several grounds. It is rigorous and comprehensive while also being action-focused with appropriate emphasis on ownership and accountability for addressing identified internal and external risks.

Recommendation

5.2 As noted in Recommendation 5.1, more remains to be done in identifying and thinking through the impact and response to the highest impact risks (such as fundamental threats to locally incorporated banks). Scenario planning, undertaken in collaboration and encompassing the identification of risks and the key elements of likely responses, needs to be strengthened.

5.3 The Risk Management Framework itself needs to steer a careful course between being appropriately rigorous and somewhat over-engineered. Any tendency to the latter will tend to diminish its effectiveness. It is important that the Risk Register is seen as a living, action-focused document. The intention is that risks will be reviewed regularly and closed off or effectively archived where appropriate. It is important that these mechanisms are used to ensure that the register does not become cluttered with stale, unmitigated risks.

a) Risk tolerance

As part of the delivery of the Strategic Plan, the GFSC has published a Risk Appetite Statement. Establishing such a framework for a supervisory body is not straightforward given the difficulty of quantifying residual risk after supervisory actions have been taken. It would be possible to challenge aspects of the statement. Some matters for which the Commission is said to have an appetite, such as raising standards, are aspirational and could not meaningfully be challenged.

Publication of the statement is, however, extremely positive overall. It underscores the risk-based approach and recognizes that undesirable outcomes may occur and will, in some circumstances, be tolerated.

The most useful statements in any such document are the ones which provide a true guide to decision making in the sense that the priorities and appetite described could meaningfully be different. Zero tolerance for deliberate, reckless or complacent bad behaviour comes into this category as does a willingness to take decisions with the best available (and hence, by implication, imperfect) information and to tolerate legal challenge, if necessary, in furtherance of the GFSC's regulatory objectives. Considerable progress has already been made internally in classifying identified risks according to how they relate to stated risk appetite.

Recommendation

5.4 The Risk Appetite Statement should be refined further and more work should be undertaken to develop a reporting framework to provide Senior Management and the Board with the regular information required to provide assurance that decisions, deployment of resources and operations are consistent with it. The decision that the Risk Management function will report on compliance with the framework to the senior management team every six months is an important step in this. Reporting should also be in place to allow the Board to take informed decisions when the boundaries of the risk appetite are challenged.

Supervisory Processes

6. Authorisation

The Authorisation function, in its role as gate-keeper to the regulated population, is both highly visible and critical to the perceived effectiveness of the supervisor. Applicants for authorisation and their advisers inevitably view the authorisation process as a more or less bureaucratic hurdle. If standards are perceived as too demanding and/or the time taken to reach a decision disproportionate, this will quickly become a focus for dissatisfaction and complaints that the supervisor is insufficiently sensitive to the needs of industry. This can spill over into a broader concern that the supervisor is standing in the way of economic progress.

In carrying out its responsibilities, the supervisory body needs to set a risk-based threshold for authorisations. This will involve some trade-off with subsequent supervision so that the bar for authorisations may be set relatively high to establish tough entry standards or at a lower level with more appetite for risk at the authorisation stage in the expectation that this will be mitigated through subsequent supervision. These decisions are taken in circumstances of considerable uncertainty in the absence (by definition) of any track record for the entity concerned. It also needs to be recognized that undertaking the necessary due diligence to support authorisation decisions takes more time than stakeholders would typically wish, however streamlined and efficient the process. This is particularly true in an international financial centre where applications will be mostly from entities or individuals outside the jurisdiction

In the case of Gibraltar, the Strategic Plan for 2014-17 addressed these issues by proposing a streamlined, un-bureaucratic authorisation process supported by a risk-based approach leading to consistent, fair and efficient decisions with an appropriate appeal mechanism. The plan recognized the need to maintain appropriate regulatory standards whilst not stifling competition or consumer choice. A demonstrably stronger and more responsive Authorisation function which facilitates the bringing of suitable new firms quickly (but also safely) to market is seen by government as a key deliverable in return for the substantial increase in the GFSC's resources over the past two years.

As part of the strategic plan, the GFSC has implemented a number of important measures designed to increase both the effectiveness and efficiency of the authorisation process:

- A dedicated Authorisations function has been established consisting of a Head of Function leading a team of ten staff. In the case of larger authorisation cases, the resources of the Authorisation function are augmented through close collaboration with the supervisors

- Authorisation criteria and ongoing requirements have been published with criteria and information requirements spelled out in a dedicated section of the GFSC website
- There has been a deliberate campaign to engage more directly with applicants – for example through conversations with applicants rather than email exchanges with their advisers
- Interviews are conducted with those proposing to undertake key roles as well as prospective directors and senior managers
- Risk assessments are undertaken of all new applicants. The level of detail of these increases for larger/higher impact applicants and may involve extensive collaboration with the supervisors who will take over supervision once the entity is authorised
- Service level standards have been introduced, setting out the maximum elapsed time permitted until a formal decision is made
- Applicants receive regular monthly updates on the progress of their applications, including reminders of missing information and details of milestones and next steps
- Dedicated staff liaise directly with applicants and their advisers (liaison solely with advisers having proved problematic in the past)
- An extensive programme of workshops has been held for applicants and their advisers, setting out the process and requirements and feedback on the process has been sought

Whilst the authorisation process culminates in a formal decision by the GFSC, earlier stages involve a number of less formal interactions with applicants. Extensive use is made of pre-application discussions, providing an opportunity for Commission officials to understand business plans and assumptions in more detail. These discussions allow potential show stoppers to be identified in good time and for less intractable problem issues to be addressed. As a consequence, the formal decision making process results in few refusals and the Commission is able credibly to claim that it is disposed to authorise new applicants in the absence of show stoppers (which should have been identified before the formal decision stage). Use is also made of 'authorisations in principle' where a firm may be required to meet further conditions and/or Commission staff will undertake an on-site visit before it can begin operations.

Supervisory Processes

The GFSC has made considerable progress in strengthening the Authorisation function to make it both more effective and efficient whilst maintaining an appropriately flexible, judgement based approach. As noted above, authorisation will never be a popular function and the inevitable time taken to undertake necessary due diligence will always be a source of frustration, however efficient the authorising body. The new approach, however, along with an improved 'tone from the top', has been recognised by many sections of the industry. There are encouraging signs that the GFSC's new approach has produced positive results in the first half of 2017 in terms of a better alignment of applications with the GFSC's expectations and requirements.

This is encouraging but it would be premature to declare victory. Authorisation is an area in which perceptions are particularly important and notwithstanding the clear improvements to the process (and potentially to outcomes), we have a number of recommendations concerning ways in which the Authorisation function might be strengthened still further and be better perceived.

Recommendations

6.1 It would be possible and worthwhile to articulate in some more detail the GFSC's risk tolerance in the area of authorisation. The general approach taken to the Commission's risk tolerance lends itself to identifying lines in the sand or propositions for which there is zero tolerance. It might also address generic cases that raise particular policy issues. An example of this might be applications for bank licenses from foreign-owned entities with a parent banks based in a jurisdiction with no relationship with Gibraltar or that have no bank parent at all. The general willingness to take decisions on the basis of imperfect information could be translated into a set of guidelines for the level and type of risk that would be countenanced at the authorisation stage. There would be merit in publishing guidance to the industry, based on these considerations, which would help them better understand what would be acceptable in applications. Our discussions with industry representations suggested that such guidance would be welcome.

6.2 The GFSC should also develop key performance indicators (KPIs) specifically in the area of authorisation. The Board receives fairly comprehensive information on authorisation as part of the pack for its meetings, including compliance with service standards but there are not at present any KPIs relating to authorisation. Such KPIs should include indicators of the timeliness and effectiveness of the authorisation process as well as data (in due course) on indicators such as survival rates of newly authorised entities which could inform future Board discussions of risk tolerance in this area.

As in a number of other areas, the Board's involvement in authorisation issues is very limited. In terms of process, we believe it should be more active in monitoring authorisation outcomes to provide itself with the necessary assurance that processes are appropriately effective and efficient and are being complied with. This would enable the Board to satisfy itself and assure outside stakeholders that authorisations are being handled as expeditiously as is consistent with undertaking proper due diligence and risk assessment.

6.4 In addition, we believe that in the area of authorisation (as in a number of others) the Board should have a more substantive role, in individual higher profile decisions. These are currently delegated entirely to the CEO who may choose to consult Board members, either formally or informally. High profile decisions, which may be complex and have significant implications for the GFSC's reputation should formally be considered by the Board, in whose name they are being taken. Greater Board involvement would clearly need to be managed to ensure that it did not lead to unwarranted delays in authorisation decisions and potential conflicts would need to be managed.

6.5 Real and effective efforts have been made to strengthen communications around the authorisation process and the progress of individual cases. Notwithstanding this, the Director of Regulatory Operations, the CEO and perhaps Board members may need to go even further in continuing to communicate the progress that is being made. Opportunities should be taken to convey the message that while authorisations take time, procedures are in all cases being followed in a way which keeps this to a minimum.

7. Entity specific risk-based supervision – prudential and conduct of business

Most supervisors globally have adopted (or are in the process of adopting) a risk-based approach to supervision of authorised firms. This typically involves the following elements:

- Identification and classification of risks and authorised firms according to impact (how important it would be if risks – to firms or groups of firms were to crystallise) and likelihood (the probability of this occurring)
- Requirements on firms regarding a programme of action to mitigate the risks
- Allocation of supervisory resources and decision making on the basis of identified risk

The GFSC has adopted a detailed and generally well-considered approach to firm-based supervision. Firms are assessed initially on the basis of impact (largely size) which governs the level of scrutiny of the risks they pose. The analysis of risk is undertaken on the basis of a matrix detailing common risk areas such as strategy, legal and operational risk, internal governance and control and financial resources. Where entities are part of a wider group, the risk assessments (and subsequent discussion) of the constituent parts are undertaken on an individual licensee basis but together in order to identify common issues and ensure consistency.

An internal mechanism has been established for scrutinizing firm-based risk assessments and agreeing on necessary follow up actions. Every authorised firm is looked at at least annually by an internal group which provides the main forum for risk oversight, quality assurance and a check on consistency of approach. This process has been explicitly designed to generate challenge and constructive debate and, in addition to providing the main forum for the assessment of risk, it also decides on the direction of follow-up work for the firm concerned. In effect, it 'owns' the supervisory programme. In the case of smaller/low impact firms, the assessment is likely to be desk based and follow up may involve horizontal or thematic work, in which risks common to groups of firms are assessed and dealt with on a common basis.

For larger firms, the assessment will be more detailed and based on extensive contact with the firm. Follow up is likely to consist of a bespoke programme tailored to the risks focusing on prudential and/or conduct issues with a particular focus on areas of greatest risk and/or issues which have proved particularly problematic.

The limited number of large firms to whom we spoke reported favourably on the willingness and ability of the staff to provide useful feedback and guidance on supervisory issues. In the case of firms with significant cross border operations, GFSC staff participate in international colleges.

Considerable work has been undertaken to refine the GFSC's information needs. Firms have to submit an annual compliance statement to which a variety of internal reports are appended. Industry views were somewhat mixed about the value of this. Reporting requirements have also changed with the implementation of European directives. Work continues to be done on the level and nature of reporting which will best enable the GFSC to make risk based assessments. All indications are that the internal mechanisms for identifying firm-specific risks, maintaining quality, challenging assessments and focusing follow up work are effective. However, the firm-facing aspects of the GFSC's supervision do not conform fully to a 'standard' risk-based pattern which typically involves a regular cycle of risk assessment followed by a communication to the firm setting out an assessment of risk (sometimes including an explicit rating) together with the supervisor's expectations for remediation and a supervisory work plan, at least for larger firms.

The GFSC does not communicate its overall risk assessment rating to the firms. The arguments for doing this are finely balanced. It is generally seen as sound practice for the supervisor to provide to the firm a clear statement of its assessment of the risks it is running. Issuing a summary rating can be an effective means of achieving this. There is, on the other hand, a concern that the rating per se, rather than the key judgments in the risk assessment and the remedial action required of the firm, may become too much the focus of discussion and hence a distraction. On balance, we come down on the side of providing a rating. Even if this is judged inappropriate, a clear statement to the firm of the risks embodied in the rating is, in our view, indispensable.

Particularly significant has been the GFSC's decision to date not to provide an annual letter or other communication setting out its expectations of firms with respect to remedial action and appropriate parts of the supervisory work plan. Several firms commented on this – though not all saw it as a problem. We welcome the commitment in the 2017/18 Business Plan to communicate supervisory plans to firms at least annually to provide them with a clear understanding of what engagement to expect from the GFSC.

Supervisory Processes

The GFSC has undertaken an extensive programme of work over the past two years in all areas of its responsibility. Much of its supervisory work has been focused on the implementation of a number of major EU directives (Solvency II, the BRRD, CRD IV) and there has been extensive interaction with the industry as a whole and with individual firms regarding their implementation of these. The run-down of Barclays and the authorisation and commencement of operations of Gibraltar International Bank have also made considerable demands on supervisory resources. We suggest, however, that a more systematic programme of communication with at least the larger (higher impact) firms is implemented as soon as is practicable. This need not in itself be a resource intensive process. Each firm receives some attention at least annually as part of the internal process for evaluating risk and this would be an appropriate basis for such communication. The nature and detail of the interactions with the firms should reflect their impact and perceived risks and any annual communication should be consistent with this.

The regulatory framework and perimeter have continued to evolve. In early 2017 the framework was extended, after consultation, to cover a broader range of activities connected to personal pensions. While occupational pension schemes were already subject to regulation, the GFSC is now also responsible for the licensing and supervision of personal pension scheme controllers and pensions advisers. Financial and conduct requirements are in place which should help address, for example, the abuse of pension vehicles to expose transferring UK customers to excessive risk or even fraud. The GFSC has a new unit of three staff to handle this. Extensive work has also been undertaken to develop a regulatory regime for distributed ledger technology.

Recommendations

7.1 While the implementation of European directives is a key preoccupation at present, consideration should be given to putting in place a more routine set of supervisory processes involving regular communication with firms regarding risk as soon as practicable. The internal process for evaluating risks in all licensees could be the basis for this. This should involve at least the following elements:

- An annual communication to all authorised firms above a de minimis impact level setting out the risk assessment key points, preferably with the risk rating but certainly with any required remedial measures. The commitment set out in the 2017/18 Business Plan noted above is welcome in this regard
 - The type and frequency of monitoring of remedial measures to be implemented
 - An indication of other likely interactions with the firm over the next twelve months, whether on-site work or involvement in thematic reviews. This would draw on a supervisory plan agreed in the course of the internal risk evaluation.
- 7.2 The commitment to supervisory work at individual firms would need to reflect total available resources at the GFSC and the risk appetite. For example, it would not be necessary for GFSC to commit to a particular level of on-site supervisory work at all licensees (such as an annual examination as is common in many jurisdictions). However, it is recommended that the GFSC build into their supervisory model a minimum amount of on-site work at the higher impact firms – where, the risk assessment needs to be continually revisited to identify and address new risks that may be arising.
- 7.3 An extensive set of internal committees and decision-making structures has evolved over the past two years. While there is no reason to believe that these are not working effectively, the Board should undertake a review to ensure that they remain fit for purpose and effective, and support clear and accountable decision making.
- 7.4 The GFSC should develop an intervention framework outlining the types of supervisory responses that are likely to result from different levels of perceived risk. In respect to prudential risks at banks and insurers, the UK PRA's Proactive Intervention Framework or the Canadian OSFI Staging process could be used as a model for this framework, which should be communicated to firms and other stakeholders.
- 7.5 This could be combined with a publication setting out the supervisory 'tool kit' – that is the range of measures available to the GFSC and the typical circumstances in which each would be used (such a toolkit is actually described in the Enforcement Strategy document). As part of this exercise, more consideration could be given to how reliance on the 'sound and prudent management' requirement might continue to be used to best effect. It would also provide the opportunity to evaluate the greater use that has recently been made of skilled persons reports.

Supervisory Processes

7.6 A 'lessons learned' exercise should, as soon as practicably possible, be undertaken in respect of Enterprise Insurance Company plc, the insurer which has recently entered into liquidation, and any other significant failures. While the fundamental factors leading to the failure of Enterprise seem likely to have pre-dated the GFSC in its current form, there may be lessons to be learned, including from the handling of the period leading up to its failure and the management of the failure when it occurred. The purpose of such an exercise would be solely technical - to establish what (if anything) might be done better in future. It would not be an exercise in attributing blame to supervisors and would be quite separate from any enforcement or other legal follow up to the insolvency. The Commission should ensure that all supervisory lessons learned are applied to other 'legacy' insurance companies authorised some years ago which may share features of the Enterprise case.

7.7 Systems and software work are under way to support the IT based case management tool. This will streamline information gathering about firm-specific and sector-wide risk. It should also be used as the basis for a twice-yearly discussion of risk-based resource allocation, the results of which should be transmitted to the Board. As such, the completion of the tool should be a priority.

7.8 We welcome the commitment in the 2017/18 business plan to consider, in consultation with industry, whether a recovery and resolution framework should be put in place for insurers. While the question of whether resolution planning is necessary or appropriate for insurers remains a contentious one (particularly in regard to general insurance) recovery planning for these firms is a clear imperative and should be progressed, particularly for larger or more complex companies.

7.9 The recommendations in this area have implications for resource allocation at the FSC. It is not within the scope of this report to comment on the overall level of resources and GFSC management have demonstrated a willingness to flex resources as needs have arisen and priorities shifted. It is important to note, however, that as supervisory work acquires more of a routine firm-facing focus, and as it is supplemented by increased emphasis on crisis planning, recovery and resolution work and the need to take into account lessons from the Enterprise failure, there could be a need for some increase in prudential supervisory resources. There is a clear link here with the funding recommendation made at 4.1 (above).

7.10 While the firm-facing risk assessment framework is generally well thought out and effective, we also offer the following detailed recommendations:

- The fact that risks are recorded as 'net' – that is, after the application of management and controls means that the evaluation may not discriminate sufficiently between gross or business risks and the effectiveness of mitigation. We understand that these are assessed separately; they also need to be evaluated separately when forming risk based judgements
- The risks from financial crime need to be integrated more fully into the risk assessments. This is desirable in its own right but may also be highlighted as part of a MONEYVAL assessment
- There may be some merit in reviewing the approach to assessing risks embodied in TCSPs, drawing on the results of the recent thematic work in this sector.

8. Enforcement

Authorisation and supervision functions need to be accompanied by an effective and proportionate Enforcement function. In common with many other supervisors, the GFSC does not see enforcement as a first resort but as a tool to be used in a measured and proportionate way. Where firms demonstrate that they are unwilling or unable to comply with regulatory requirements or where serious or persistent breaches occur, there is a presumption in favour of using enforcement powers. Enforcement also has a valuable role in policing the regulatory perimeter even though the application of sanctions in such cases may fall to other bodies.

The Enforcement function has undergone considerable strengthening as part of the Strategic Plan. Prior to 2015, enforcement was largely devolved to sectoral supervision and undertaken on a reactive, case by case basis with little strategic coherence. The function is now organized under the Director of Legal, Enforcement and Regulatory Policy and consists of a dedicated team of four staff. Enforcement decisions are taken by the CEO together with two other members of the Senior Management Team who are independent of the case in hand. A comprehensive set of documents outlining the enforcement approach was published in 2016.

Supervisory Processes

Notwithstanding these positive developments, the future coherence and effectiveness of enforcement depends to a large degree on the outcome of the Legislative Reform Programme. There is still a shortage of graduated powers which can be deployed ahead of the 'nuclear option' of license revocation. Sanctions and penalties differ according to the legislative context within which enforcement action is being taken (for example the European directive concerned) as do the arrangements for appeal.

Within these constraints, the evidence is that enforcement and the threat of enforcement are being used in an effective and proportionate way. This is recognized by the industry which, on the basis of the firms we spoke to, has confidence that the current measured approach will continue. There is no wish to bring enforcement cases purely for demonstration purposes – powers will be used only when the established criteria are met, with risks to customers being foremost among these. The outcome of the Advalorem Value Asset Fund case, in which the use of formal sanctions by the GFSC was upheld by the Supreme Court and subsequently by the Court of Appeal, sent a valuable message about the willingness to use enforcement powers and the ability of these to withstand legal challenge.

We found evidence of constructive collaboration of the Enforcement function with supervisors within the GFSC. The participation of a senior member of the Enforcement team in the internal risk assessment process, the practice of involving enforcement staff in supervisory visits and the constructive use made of the 'sound and prudent management' requirement where more specific enforceable requirements are not available are all indicators of this. The willingness to make use of settlement and redress are also positive signs that enforcement measures are appropriately focused on achieving the right regulatory outcomes.

The ownership and governance of enforcement

Whilst considerable progress has been made in strengthening the Enforcement function within the GFSC, we believe that the ownership and governance of decision making, at least in respect of high impact enforcement cases needs to be revisited. We have argued elsewhere in this report that the Board should be more engaged in active, high impact cases. This applies at all stages of the supervisory process, from authorisation through supervision to enforcement. Enforcement however raises particular management and governance issues which need to be addressed in some detail. We set out the issues below, together with what seems to us to be a preferred option. Ultimately the optimum arrangement is a decision for the Board itself.

There are two essential requirements for an effective enforcement function:

- There needs to be separation of responsibility. The members of the executive who undertake investigative work and make the judgement as to whether there may be a case for taking enforcement action cannot also be the decision makers regarding the use of sanctions. The functions must be separate to avoid any possibility that enforcement decisions are influenced by the investigation process or that the executive is 'judge, jury and executioner'.
- It is critically important that decision makers are (and be seen to be) completely independent and impartial in the sense of being free from any outside pressures (commercial or otherwise) which could affect their judgements.

There are perhaps four possible mechanisms for handling enforcement cases. The critical issue in each is where the final decision regarding enforcement and the potential use of penalties is taken. In each of the cases discussed below, the assumption is that the executive undertakes the necessary investigative work and arrives at a recommendation as to whether there is a prima facie case for the use of enforcement.

1. The CEO may be the formal decision maker, supported by members of the senior team who have not been involved in the case at hand. This is generally the status quo in Gibraltar at the moment (although exceptionally, a committee of the Board has been established to address potential enforcement matters arising out of the insolvency of the Enterprise Insurance Company plc). The CEO and senior staff should not be exposed to commercial or other conflicts of interest so this solution goes some way to meeting the independence criterion set out above. However it is an unsatisfactory solution in other respects. The CEO is head of the executive so that in order to achieve the necessary separation of responsibilities she/he needs actively to distance themselves from the work undertaken by the Enforcement team for which the CEO is responsible in organizational terms. This means for example that they cannot be involved in judgements regarding whether the use of enforcement in a specific case is consistent with a wider enforcement strategy. The CEO (and any supporting senior staff) would also be acting effectively in isolation in this case without the necessary support and engagement of Board members.

Supervisory Processes

3. The Board could be the enforcement decision maker. In this case, the Board (or a representative sub group of it) would receive the results of the executive's analysis and its recommendation and then make a formal decision as to whether enforcement action is warranted and, if so, what form this should take. This satisfactorily achieves the separation of responsibilities (the CEO would not be one of the decisions makers but would present the executive's case). The key issue here is that all Board members, including those who are active in the local financial sector must be demonstrably free of potential conflicts of interest. This is an absolute requirement: Board members must be above any suspicion in this regard.
4. If there is any doubt at all about the ability of local members effectively to manage potential conflicts, enforcement decisions could be made solely the responsibility of Board members who have no engagement in the local financial sector (and who have no other potential conflicts). This in principle would address both of the criteria set out above. However this solution would have two potential downsides: a) it could be divisive and politically unpalatable; and b) it would risk losing the useful local insight and perspective offered by local Board members. This might be addressed by giving local Board members some sort of advisory role but this would go only part of the way to addressing the problems raised.
2. It is our view that the ownership and governance of enforcement decisions in Gibraltar needs to be changed. The mechanism ultimately chosen is a matter for the Board who need to make their choice in the light of local information and constraints. Our tentative preference, however, is for solution 2 – that is for the Board as a whole to take important enforcement decisions. It is fully recognized however that in any small jurisdiction the pool of local individuals qualified to serve on the Board of the regulatory body is small and that, because such individuals are very likely to be engaged at some level in the local financial community, there is considerable scope for conflicts of interest or, equally serious, the perception of conflicts of interest to arise. The general perception is that conflicts have in the past been managed well in Gibraltar. Very high profile and contentious enforcement cases however inevitably pose a severe test for the management of conflicts. Board members have to be seen to be completely above reproach or suspicion if the Board's enforcement work – and hence the mechanism set out in approach 2 - is to be seen as credible.

An alternative to having the Board as decision maker would be to have an independent standing committee of qualified people to undertake this function. In this case the Enforcement function within the executive would provide the committee with their analysis and recommendation. The committee, exercising a function specifically delegated by the Board, would then decide on potential enforcement action. This could be a way of meeting both criteria set out above but would of course be viable only if the members of the committee were immune from the conflicts of interest to which Board members are judged to be susceptible.

It has been proposed that, as part of the Legislative Review Programme, an appeals body may be established with powers to review enforcement decisions. We would welcome any such additional level of due process but do not believe that its existence would have a fundamental bearing on which of the four mechanisms above should be chosen.

Recommendations

8.1 The Legislative Review Programme needs to be completed. This holds out the prospect of a set of unified, escalating powers which will help the GFSC deliver on its commitment to make proportionate use of enforcement. The Commission should (in common with UK regulators) have powers to intervene effectively to require actions of firms and to impose sanctions via administrative means. For example, the Commission should be able to impose enforceable directions on all licensees, under a single legislative framework, to take or desist from specific actions and should be able to impose financial penalties on firms and relevant individuals for breaches of the requirements. This should be subject to a schedule of types of offences and amounts of fines set by the Commission.

8.2 Such powers need to be accompanied by appropriate appeal mechanisms. This should involve the use of a tribunal which is competent to examine the processes followed. The appeal mechanism needs to be open and fair but with powers to dismiss vexatious claims and, where appropriate, to award costs in favour of the Commission.

Supervisory Processes

Without such safeguards, appellants with deep pockets may be willing and able to subvert the work of the regulator, especially if the climate were to become more litigious. There should be a single set of provisions on the circumstances in which actions taken by the Commission may be stayed on appeal (different provisions currently apply across the many laws and regulations administered by the Commission) with the presumption being that action is not stayed pending determination of an appeal.

8.3 KPIs should be developed which can provide reassurance to the Board and management that enforcement processes are being followed and that their aims are being broadly met. These should be reported regularly to the Board so that it can be assured that the strategy and implicit risk appetite for enforcement are being adhered to.

8.4 The ownership and governance of major enforcement cases needs, in our view, to be changed. Our preference is for option 2 above (involvement of the whole Board) though the judgement regarding the optimum arrangement is one for the GFSC Board itself. The following actions would, in our view, reinforce the impact of such a change:

- Policies regarding the declaration and management of conflicts need to be revisited and a 'protocol' drawn up which sets out with complete clarity how conflicts (which will vary in severity from case to case) are to be identified, reported and managed. We believe that, as a general matter, Board members' potential conflicts should be disclosed publicly.
- The Board needs to consider carefully whether its culture regarding the management of conflicts is adequate. Formal processes aside, Board members – especially the chair – need to be willing constructively to challenge one another where there is any possibility that conflicts exist or that Board discussions are being tainted by outside pressures or extraneous considerations. Board members should operate with the presumption that they will recuse themselves from any discussions in which there is the smallest possibility of a conflict – actual or perceived. And where this happens, it needs to be understood that Board members will not influence decisions – either knowingly or unwittingly, formally or informally. The spirit of the Board's deliberations is every bit as important as adherence to the letter of any policy.

- There needs to be a clear statement of the Board's support of the executive's broad approach to enforcement matters. This is not to say of course that the Board will always accept the executive's recommendations in specific cases. But the Board needs explicitly to agree a general approach to enforcement matters (including its tolerance for appeals and litigation) and the executive has the right to expect that, on the basis of its periodic reports indicating compliance with this approach, it has the Board's full support.
- The Board should subject itself to an independent outside evaluation of whether its conflicts management policies and culture are sufficiently rigorous to create and maintain complete public confidence in its independence.

8.5 If there is any reason to suspect that the Board's impartiality is compromised – either because a critical mass of directors is conflicted on any particular issue or because it is judged (notwithstanding the best intentions) to be endemically impossible to achieve the necessary impartiality in a small jurisdiction, consideration would need to be given to the expert panel approach set out in option 4 above.

9. Financial Crime

Gibraltar places a high priority on combatting money laundering and terrorist financing, along with other types of financial crime and having in place appropriate measures to comply with the FATF Recommendations. Gibraltar is to be visited by MONEYVAL in 2018 (the FATF Style Regional Body responsible for assessing Gibraltar's compliance with the FATF Recommendations). This will be an assessment against the FATF's revised Recommendations which for the first time will contain an important element of the effectiveness of implementation - apart from technical compliance on its own. A new Head of Financial Crime was appointed in February 2017 and a key responsibility will be to lead the preparatory work on MONEYVAL.

The GFSC Supervisory Approach document of April 2016 states that "we will consider the firm's inherent risk exposure to financial crime and ensure that appropriate and proportionate safeguards are implemented". In discussion with the executive we were informed that evaluation of compliance with AML/CFT requirements and the risk of financial crime are integrated into internal risk assessment oversight processes, the integration of these elements into the firm-facing framework for risk evaluation of all licencees is still work in progress.

Supervisory Processes

Experience suggests that the business of undertaking trust and company administration (a licensed activity in Gibraltar) can give rise to significant risk. This is the perception of the FATF and its regional bodies. Risks can arise from failure by TCSPs to know their customers adequately and to monitor the ongoing activities of the entities which they are administering; the scope for money laundering; failure to segregate client monies and negligence in carrying out duties as trustee or director. While there is no reason to believe that these risks are higher in Gibraltar than in other centres, we welcome the thematic work that has been undertaken on risks in the TCSP sector which, we understand, has borne out this general view.

Recommendations

9.1 The full integration of AML/CFT requirements into the risk-based framework should be expedited as soon as possible. This will be an important area in which to be able to demonstrate a very proactive approach to MONEYVAL, and it is recommended that AML/CFT risk formally becomes a more significant and distinct item to be considered within the routine risk-based review of licensed firms

9.2 Ahead of the MONEYVAL assessment, the GFSC should build on the results of its thematic review of TCSPs. This has been identified as a priority sector. A stepped up programme of on-site visits and inspections in line with an enhanced risk-based view of the sector, possibly incorporating a thematic approach, should be considered.

10. Regulatory policy and powers

The Commission regulates and supervises a wide range of financial sector businesses under multiple laws and regulations that have developed over time. In most cases, they reflect the requirements of EU law although the Commission also has regard to wider international standards such as the core principles of the Basel Committee and International Association of Insurance Supervisors. This review did not extend to an assessment of compliance with these standards or otherwise to a detailed assessment of regulatory requirements.

The Government traditionally relied broadly on a “copy-out” approach to implementation of EU directives into Gibraltar law with the avoidance of gold plating. In the past this created timeliness problems and the constraints imposed by the directives resulted in a patchwork of requirements, often with little consistency across sectors.

To provide stronger support to the government implementation of EU directives, the GFSC has now assembled a dedicated team responsible for the Legislative Reform Programme and transposition of most EU Directives relating to financial services (though there are some exceptions such as the Solvency II Directive). It is now possible to apply a considered policy approach to areas where derogations are available, focusing on the needs of the jurisdiction with the accepted parameters of the directives. The GFSC has worked with expert legal drafters and its close cooperation with the government appears to be working well. It is recognised that there are challenges in implementing all new directives in a timely way and the Commission is working to address these.

Without routine direct access to EU fora on regulation and supervision, the GFSC has been dependent on dialogue with UK regulators to inform its understanding of EU legislative and policy developments and to support its implementation work. In some areas of regulation not subject to EU directives, including the regulation of persons, Gibraltar’s regulation has fallen behind practice in many countries and in particular has not been aligned to the UK’s approach. There are other areas where a Gibraltar-specific approach has developed, including provisions enabling insurance companies to choose between self-management and the use of a specialist insurance manager.

The reviewers observed that the Commission has taken a number of significant actions, in particular:

- Seeking to overhaul the framework of requirements as a key objective of the Legislative Reform Programme (a programme being undertaken jointly with the Government of Gibraltar). This will consolidate the multiple separate requirements into a single framework law (and regulatory activities order) and Handbook of Regulations setting out the detailed requirements. This is an ambitious undertaking, which has been complicated by resourcing issues and by the need to correct and clarify existing requirements in a number of areas before consolidation can occur. It is soon to result in initial drafts of new instruments.
- Ensuring, as part of the LRP work and to support the case for extensions to regulatory powers, that all existing powers have been reviewed to ensure that they are being fully used, thereby identifying clearly the gaps.

Supervisory Processes

- Seeking to extend the regulatory framework to include an ‘individually-regulated persons regime’ similar to the UK approved persons regime. This will focus on role holders in governance functions who would be subject to competence and other standards to be set by the FSC and would involve prior approval. Provisions enabling the GFSC to impose administrative penalties will also be added. The reviewers understand that the government is, in principle, supportive of these extensions to regulation.
- Equipping the GFSC with an increased, dedicated in-house capacity to develop and draft new regulation and advise on the application of existing requirements. This is supported by increased technical expertise in supervision including the recruitment of individuals with actuarial expertise.
- Extending and deepening contacts with UK and other regulators (for example, in relation to technical issues on implementation of Solvency II) as well as opening the GFSC’s work up to external evaluation – as, for example, was undertaken by EIOPA in a February 2016 review of Solvency II implementation and insurance regulation.

It is expected that the package of new measures will be completed, following consultation, by the end of 2017 and that the necessary legislation will be in place early in 2018.

Recommendations

10.1 The Government and GFSC should complete the Legislative Reform Programme as planned, delivering consolidated legislation and Handbook requirements. It should integrate lessons learned from recent failures and ensure, when considering powers, that the Commission is able to require licensees to prepare for responding to crises, for example by undertaking recovery planning.

10.2 As a key part of the LRP, the GFSC and Government of Gibraltar are encouraged to implement the GFSC’s preferred approach to the regulation of persons employed by licensees (the already proposed ‘individually-regulated persons regime’). This should be introduced in a manner proportionate to Gibraltar’s needs. It is for consideration whether the emphasis should be on broad coverage of senior management in GFSC-regulated sectors; extend to customer-facing functions or involve a deeper regime (as in the UK now) for senior managers of banks and insurers. It is recommended that Gibraltar focus on fit and proper requirements for directors and individuals in senior management positions or who have responsibility for key control functions at all licensees. These would broadly align with the UK Significant Influence Functions.

10.3 The Government and GFSC should also consider the development of a whistleblowing regime on the lines of that now recently introduced in the UK, with responsibility allocated to a senior manager of institutions covered by the regime. We understand that an initial assessment of such a regime has already been conducted.

10.4 In preparation for Brexit and recognizing the importance of business undertaken from Gibraltar into the UK (and the separate legislative arrangements for passporting into the UK) the Gibraltar authorities should as soon as practicable adopt a policy on the extent to which its approach, hitherto centred on EU legislation, should be aligned with the UK regulatory framework in future. This needs to take into account that, post-Brexit, there will remain opportunities for continued access to EU markets, with a likely requirement for equivalence to EU standards. The Government should consider creation of a forum or similar body to coordinate UK and Gibraltar positions on Brexit issues as the negotiations develop.

10.5 In their communication with industry, both the GFSC and Government of Gibraltar should emphasise that the measured use of appropriate fitness requirements and other enforcement mechanisms are completely compatible with a vibrant and attractive financial centre.

11. GFSC Skills and Competencies

The GFSC faces challenges, in common with most financial regulators, of matching the skills and competencies of its staff to the growth and increasing complexity of financial services and the regulatory regime. Staff members need an understanding of business models and associated risks and of the regulatory regime together with a mindset consistent with the exercise of judgment in the application of wide-ranging powers. Technical skills need to be supplemented with a willingness to take well-judged and resolute actions and staff need to be appropriately responsive to stakeholders if the Commission is to meet industry expectations of them. There are particular challenges in a small international financial centre where most business is transacted abroad, out of sight of supervisors, and where the pool of skilled staff available for recruitment is naturally small.

Supervisory Processes

The GFSC under the Strategic Plan has been recruiting significant numbers of new staff, as mentioned, and has been developing a more structured approach to staff skills and competencies:

- It has developed a performance management framework comprising twelve technical and four behavioural skills and has assessed and fed back to staff where they stand: a common gap, reflecting the extent of recent recruitment, is in knowledge of the regulatory regime.
- It has created a growing number of technical specialist roles, including some involving actuarial expertise (as is appropriate to a jurisdiction with a significant insurance sector) to which both new recruits and experienced GFSC staff have been assigned.
- It has developed what the reviewers understand is a relatively competitive remuneration package, within the broad market for regulation, including leave and pension arrangements.
- It has fostered learning and development through training, sharing of knowledge within the Commission, secondments and workshops that bring in experts from outside Gibraltar. An emphasis has been placed on risk awareness with dedicated training and coordination across the organization.

Recommendations

11.1 The Commission should further deepen its training and development cooperation with UK and other regulators, and continue to offer secondments in both directions, to help develop technical expertise and improve understanding of the main external market for Gibraltar services. We also support the idea of secondments from industry where appropriate, both (in the case of inward secondments) to help with resource pressures and to help promote a two way understanding of regulation and commercial practices.

12. Assessing overall effectiveness

A definitive assessment of the effectiveness of any supervisory body is inevitably limited by lack of information on whether the objectives of regulation would have been met without the interventions which it involves. Judgments can nonetheless be made, based on the perceived robustness of the regulatory and supervisory system, taking into account international standards and established practices, and the evidence from intermediate outcomes such as the incidence of company and other significant failures in the regulated sector.

There are particular challenges in making a definitive assessment of the effectiveness of the GFSC at this stage in its development. The past two years have been a period of extensive change which inevitably is continuing to bed down. Much of the regulatory system is based on EU legislation and it has yet to be fully tailored to local requirements as envisaged in the LRP. The risk-based supervisory system is well designed but has been too recently implemented to deliver reliable insights into how effectively risks have been identified and addressed in practice. There is a need for contingency planning and related measures as identified in recommendation 5.1 (above). Supervision work has inevitably been skewed towards implementation of key EU legislation, valuable as this has been in enhancing aspects of effectiveness. There have been failures of regulated companies of which that of Enterprise Insurance is particularly significant, though it is recognized that the root causes of this (and other failures) seem likely to pre-date the current supervisory regime. The regime has not been tested by a broader or systemic crisis, local or imported, from which it is certainly not immune; nor by a full international review in recent years, although the forthcoming MONEYVAL assessment will yield important insights. The GFSC is developing its own indicators of regulatory effectiveness (the KPIs), but these remains under development.

Notwithstanding these limitations on our assessment, it is possible to say with a high degree of confidence that the regulatory and supervisory regime has been moving in the right direction in recent years and at a fast pace. The 2014-17 Strategic Plan addressed the key challenges to the GFSC, given its statutory objectives and the importance of financial services to the economy. These were reflected in the particular importance attached to authorisation. The LRP covers the main areas where the government and GFSC need to work together on the broader regulatory framework. The case for change and the plan for achieving it have therefore been spelled out clearly.

Implementation to date has also generally been sound, including the restructuring and recruitment of new staff and the development of its risk-based supervisory approach. Delivery of the LRP has lagged, largely as a result of factors beyond the GFSC's control but the programme is now being reset. The process of supervisory strengthening has not been deflected by challenges such as the withdrawal of a major domestic retail bank, which has been met with effective cooperation amongst authorities and the market.

Supervisory Processes

The changes in style and approach have been noted and generally welcomed by the financial sector participants. Because the focus has been on core aspects of the regulatory system, there is scope for strengthening the governance of the GFSC and formalising aspects of its relationship with government, to complement and protect the improvements in the regulatory framework against future developments.

This report makes a number of recommendations, many of them detailed, in areas of regulation and supervision and in relation to planning for future stresses. The overarching recommendation is essentially that the government and GFSC maintain broadly the current trajectory. Doing so will equip the GFSC not only better to meet its objectives but also to measure and report on its own effectiveness. In particular, the reviewers recommend as priorities:

- Completing the development of the GFSC's risk appetite work, to support not only increased transparency to stakeholders but its own approach to authorisations, recognising that demands for faster.
- Developing its risk-based supervision approach, especially in relation to prudential supervision, including addressing remaining issues in "legacy companies", keeping supervisory resources under close review.
- Continuing to focus on sources of major shocks and preparing for how the GFSC and government would handle them.
- Investing further in the relationship with UK and other regulators to ensure not only alignment with international requirements but also to promote a good understanding of the effectiveness of Gibraltar's approach in other jurisdictions.
- Investing in increased transparency on the part of the GFSC of how it sees its challenges and how it seeks to meet its objectives, focusing not only in its own priorities but how it is addressing the expectations of others, for example in relation to authorisations.

As mentioned, such developments would also be supported by strengthening the governance of the GFSC, to enhance the role of the Board in giving direction to the executive and having decision making responsibility for significant enforcement cases. We also recommend formalising aspects of its relationship with Government by means of an MoU to ensure continued close collaboration within a framework of operational independence.

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Annex 1 : Summary of Recommendations

Relations with Government

1.1 There could be a regular, if not necessarily annual, debate in Parliament of the GFSC's Annual Report.

1.2 The GFSC's Annual Report could usefully be expanded to include more information about the challenges which the GFSC faces, more detail on how it is conducting supervision and exercising its powers, and performance against performance indicators.

1.3 More data on the financial sector could usefully be given in the Annual Report as well as on the GFSC's website.

1.4 A Memorandum of Understanding should be developed between the Government of Gibraltar and the GFSC to establish greater clarity than at present on how aspects of the relationship are expected to work.

1.5 In the longer term, it could be appropriate to consider a change in the reporting line of the GFSC within government. It is recognized that this would be practically difficult and the current arrangements have operational advantages. But the reporting arrangements should at least be kept under review (for example in the cycle of Statutory Reviews).

Corporate Governance and Internal Management

2.1 The Board should become more involved in oversight of key areas of the Commission's operations and be willing to take decisions on high-impact matters with the use of a quorum when necessary. Its role in significant enforcement cases should be reconsidered.

2.2 The Board should meet more frequently than at present – it is suggested at least six times a year and preferably eight times.

2.3 As rotations at Board level occur, consideration should be given to recruiting local experienced professionals who have retired or otherwise moved on from active duties in Gibraltar. Procedures and cultural issues concerning Board members' potential conflicts of interest need to be examined (see also recommendation 8.4 below).

2.4 The Board should review the cycle of formal reports which it receives from the executive. Additional topics should be included for routine review and, in the case of material decisions not covered by statute, Board approval.

2.5 In time the FSRCC should be fully separated from the GFSC, so that during a crisis the former manages resolution matters and the latter is left free to concentrate on supervision.

Internal Governance and Management

3.1 The Board should reconsider its delegated authorities with a view to retaining some or all of the following decisions.

- The granting of a domestic bank licence, or any other licence which could impact on Gibraltar's financial stability or carries material reputational risk
- The withdrawal of any licence
- A decision that a person or licence holder is deemed as not fit and proper.
- Serious enforcement actions. We recommend that the Board's role in respect of significant enforcement action should change.

3.2 The Board should undertake a review of its delegated authorities to establish whether there are other existing powers which, because of their significance, should be retained.

3.3 A review should be undertaken of the extensive internal committee framework that has been developed to ensure that internal processes are, and will remain, fit for purpose. The results of such a review should be reported to the Board.

3.4 Key Performance Indicators (KPIs) approximating to desired supervisory outcomes should be further developed, for all operational areas, including Authorisation, Supervision and Enforcement. Once developed, extensive use can be made of such KPIs in regular discussions of resource allocation and budgets.

Fees and Budget

4.1 The GFSC should review its longer term revenue and expenditure assumptions to assess the whether elimination of the subvention in the time-frame stated is realistically achievable given the many uncertainties that exist. Government may need to show continued flexibility in its attitude to the future level of subvention in case of shortfalls in fee income.

Annex 1 : Summary of Recommendations

4.2 Provision should be made in the suggested MoU for the government to base any subvention in the longer term on specific and identified needs related to the development of financial services business in the jurisdiction.

4.3 The costs of IT and its future development, whether met from fee income or subvention, should constitute a separate line item in the annual budget. It needs to be seen as a key, discrete area of investment and not an activity that is expected to be financed from savings in other areas.

Risk Assessment

5.1 The Commission needs to work more closely with the Government of Gibraltar in identifying and planning for scenarios which could pose serious threats to financial stability and/or continuity in the provision of financial services. There is a need to plan for at least the first steps in the required response, including any necessary dialogue with HMG and other stakeholders.

5.2 The mechanisms for identifying the highest impact risks (such as fundamental threats to locally incorporated banks) need to be developed further. Scenario planning, encompassing both the identification of risks and the key elements of likely responses, needs to be strengthened.

5.3 The Risk Register needs to be seen as a living, action-focused document. Full use of existing mechanisms is needed to ensure the timely closing-off and effectively archiving of risks.

5.4 The Risk Appetite Statement should be refined further and more work undertaken to develop a reporting framework to provide Senior Management and the Board with the regular information required to provide assurance that decisions, deployment of resources and operations are consistent with it. Such reporting should also allow the Board to take informed decisions when the boundaries of the risk appetite are challenged.

Authorisation

6.1 It would be possible and worthwhile to articulate in more detail the GFSC's risk tolerance in the area of authorisation. There would be merit in publishing guidance to the industry, based on these considerations, which would help applicants better understand what would be acceptable in applications.

The GFSC should develop KPIs specifically in the area of authorisation. These should include indicators of the timeliness and effectiveness of the authorisation process as well as data (in due course) on indicators such as survival rates of newly authorised entities which could inform future Board discussions of risk tolerance in this area.

6.3 The Board should be more active in monitoring authorisation outcomes to provide itself with the necessary assurance that processes are appropriately effective and efficient and are being complied with. This would enable the Board to satisfy itself and assure outside stakeholders that authorisations are being handled as expeditiously as is consistent with undertaking proper due diligence and risk assessment.

6.4 The Board should have a more substantive role in individual higher profile authorisation decisions whilst not being a source of unwarranted delay. Such decisions, which may be complex and have significant implications for the GFSC's reputation, should formally be considered by the Board, in whose name they are being taken.

6.5 The Director of Regulatory Operations, the CEO and perhaps Board members may need to go still further than recently in continuing to communicate the progress that is being made in improving the efficiency and effectiveness of authorisation. Opportunities should be taken to convey the message that while authorisations take time, procedures are in all cases being followed in a way which keeps this to a minimum.

Prudential and conduct of business supervision

7.1 Consideration should be given, as soon as practicable, to putting in place more routine set of supervisory processes involving regular communication with licensed firms. The internal process for routinely evaluating risks in licencees could be the basis for this. This should involve at least the following elements:

- An annual communication to all firms above a de minimis impact level involving risk assessment key points and any required remedial measures (as per the 2017/18 Business Plan)
- The type and frequency of monitoring of remedial measures
- An indication of other likely interactions with the firm over the next twelve months, whether on-site work or involvement in thematic reviews, drawing on the outcome of the internal supervisory review process.

Annex 1 : Summary of Recommendations

7.2 The GFSC should build into their supervisory model a minimum amount of on-site work at the higher impact firms – where the risk assessment needs to be continually revisited - to identify and enable the supervisor to address new risks.

7.3 The Board should undertake a review to ensure that the extensive set of internal decision making structures remains fit for purpose and effective, and supports clear and accountable decision making.

7.4 The GFSC should develop an intervention framework outlining the types of supervisory responses that are likely to result from different levels of perceived risk. This should be communicated to firms and other stakeholders.

7.5 This could be combined with a publication setting out the supervisory ‘tool kit’ – the range of measures available to the GFSC and the typical circumstances in which each would be used. More consideration could be given to how the ‘sound and prudent management’ requirement might continue to be used to best effect and greater use continue to be made of skilled persons reports.

7.6 A largely technical ‘lessons learned’ exercise should be undertaken as soon as practicably possible in respect of Enterprise Insurance Company plc, the insurer which last year entered into liquidation, and any other significant failures.

7.7 Completion of the IT based case management tool should be a priority. This will streamline information gathering about firm-specific and sector-wide risk and it should be used as the basis for a twice-yearly discussion of risk-based resource allocation, the results of which should be transmitted to the Board.

7.8 We welcome the commitment in the 2017/18 Business Plan to consider a requirement for recovery and resolution plans for insurers. We see recovery planning for these firms in particular as a clear imperative which should be progressed.

7.9 The recommendations in the area of risk assessment have implications for resource allocation at the FSC. It is not within the scope of this report to comment on the overall level of resources but there could be a need for some increase in insurance prudential supervisory resources in particular notwithstanding the good experience of flexing existing resources in response to need.

7.10 The firm-facing risk assessment framework is well designed but would benefit from the following modifications:

- Gross or business risks and control risks should be evaluated separately in risk oversight discussions
- The risks from financial crime need to be integrated more fully into the risk assessments. This is desirable in its own right and may be highlighted as part of a MONEYVAL assessment.
- An efficient means needs to be found to address the risks embodied in TCSPs.

Enforcement

8.1 The Legislative Review Programme needs to be completed. The Commission should have powers to intervene effectively to require actions of firms and to impose sanctions via administrative means.

8.2 Such powers need to be accompanied by appropriate appeal mechanisms. This should involve the use of a tribunal which is open and fair with powers to dismiss vexatious claims and, where appropriate, to award costs in favour of the Commission. There should be a single set of provisions on the circumstances in which actions taken by the Commission may be stayed on appeal.

8.3 KPIs should be developed which can provide reassurance to the Board and management that enforcement processes are being followed and that their aims are being broadly met.

8.4 The ownership and governance of major enforcement cases needs, in our view, to be changed. Our preference is for an option involving the whole Board in enforcement decisions though the judgement regarding the optimum arrangement is one for the GFSC Board itself. The effective management of Board members’ actual or perceived conflicts of interest is critical to the success of this approach. We recommend a number of actions which would, in our view, reinforce the impact of such a change.

8.5 If there is any reason to suspect that the Board’s impartiality is compromised – either because a critical mass of directors is conflicted on any particular issue or because it is judged (notwithstanding the best intentions) to be endemically impossible to achieve the necessary impartiality in a small jurisdiction, consideration would need to be given to an expert panel approach as set out in option 4 in the main report.

Annex 1 : Summary of Recommendations

Financial Crime

9.1 AML/CFT risk should be integrated fully into the risk-based framework as soon as possible to enable it to be considered within the routine risk-based reviews of licensed firms.

9.2 Ahead of the MONEYVAL assessment the GFSC should build on the results of its thematic review TCSPs with a view to implementing a programme of more active engagement .

Regulatory Policy and Powers

10.1 The LRP should be completed to deliver consolidated legislation and Handbook requirements. It should integrate lessons learned from recent failures and ensure that the Commission is able to require licensees to prepare for responding to crisis, for example by undertaking recovery planning.

10.2 As a key part of the LRP, the GFSC and Government of Gibraltar are encouraged to implement the GFSC's preferred approach to the regulation of persons employed by licensees (the already proposed 'individually-regulated persons regime'). This should be introduced in a manner proportionate to Gibraltar's needs.

10.3 The Government and GFSC should consider the development of a whistleblowing regime on the lines of that now recently introduced in the UK.

10.4 The GFSC, in preparation for Brexit should, as soon as practicable, adopt a policy on the extent to which its approach hitherto centred on EU legislation, should be aligned with the UK regulatory framework in future. The government should consider creation of a forum or similar body to coordinate UK and Gibraltar positions on Brexit issues as the negotiations develop.

10.5 In its communication with industry, both the GFSC and the Government of Gibraltar should emphasise the complete compatibility of an appropriate fit and proper regime and enforcement framework with a vibrant and attractive financial centre.

Skills and Competencies

11.1 The Commission should further deepen its training and development cooperation with the UK regulators, and continue to support secondments in both directions, to help develop technical expertise and improve understanding of the main external market for Gibraltar services.

Annex 2 : Report Authors

This report has been produced by a team consisting of Paul Wright (leader), John Aspden and Ian Tower. Brief biographical details are given below:



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Ian Tower is an independent expert on financial regulation. He undertakes assessment work for the IMF and World Bank and has provided specialist technical assistance and training on regulation to a range of countries under the auspices of a number of international bodies. He previously worked at the UK FSA, Bank of England and the IMF.