The Right Regulation – the never-ending quest

Evolution, simply put, is a process of change and adaptation. Regulatory practices and approaches evolve too. From a Darwinian position, those characteristics that are functional, effective and desirable are passed down. Those that are not are cast aside. Only the fittest will survive. The weak and ineffective fall away.

To be a resilient and nimble regulator, one has to always focus on the objectives of regulation while being forward-looking. Regulation serves as a system of controls; in this case, those controls are in relation to financial services. Early iterations of regulatory regimes were primarily rules-based. Regulation has since evolved to risk-based, prudential and conduct supervision.

The evolution of regulatory systems typically comes back to the primary objectives of regulation. Every regulatory authority will have its objectives embedded in its mandate. Regardless of the jurisdiction, common threads exist amongst all financial services regulators. Regulators within the financial services industry all seek to promote a fair and transparent market, protect the public, prevent financial crimes in tandem with supervision and monitoring of those it licenses. These objectives must be achieved in an ever-changing and more technologically driven world.

The core element of being effective at regulating is understanding what licensees are doing and plan to do. It is not sufficient for regulators to have a basic understanding of the industries they regulate. In the 21st century, regulators must have a thorough understanding of those industries to be effective – that means regulators need to be engaged in regular dialogue, seek the relevant qualifications and be forward-looking on the trends that are emerging in those industries. Regulating at a 'high level' is no longer vogue.

What regulators are looking at is getting down to the nuts and bolts of the regulated industries' activities. To be effective, a regulator must understand what its licensees are doing, why they are doing it and how. Effective regulators must also engage with industry associations, Boards of Directors of licensees together with the Compliance Officer. Following the global crisis, there was and continues to be rigorous stress testing of banking institutions. Looking at the future, it is inevitable that every financial services sector will evolve to have stress testing. Where Compliance Officers can lend critical input is in the scoping of emerging and existing risks – on a single company level, Group level and industry level.

It is important for Compliance Officers and regulators to have a common understanding of the business modalities and what precisely is being regulated. Compliance Associations may need to come together to produce their own typologies; this may be difficult as some businesses may not want to widely share their experiences, but the benefits would be immense. Technologies available today can anonymize information for typology reports that can lend credence and objective facts to a Compliance Association's engagement with relevant regulators when that all-important dialogue happens.

FATF's review in the 4th Round of Mutual Evaluations focuses on the effectiveness of a country's AML/CFT/PF systems and controls. The next few years will herald an increasing number of other peer assessments. Organisations such as the World Bank and IMF are pushing for international standard setters to carry out their own peer review.

Standard setters like the IAIS, GIFCS and IOSCO focus on specific sectors and have common threads in the standards they ascribe. The GIFCS peer assessments of its members will commence this year in relation to TCSP regulations against the Standard for TCSP. IOSCO has completed several assessments on issues surrounding securities regulation; IAIS has intensified its work in the field of insurance. Arguably, with the focused approach that sector-specific standard setters take, these peer assessments better inform risk-based approaches, regulatory regimes and the resilience of markets and industries. The knock-on effect of the activities of international standard setters is that it affects the way regulators operate.

Beyond regulators and international standard setters, are a myriad of directives and requirements from around the globe that impact Compliance Officers. These include FATCA, AIFMD, CRS and others. It is therefore important that regulators be aware of the demands that the Compliance Officers they typically approve will face. It may also lead to a bifurcation of the compliance function in some firms. Given the penalties and risks faced, the compliance function is increasingly becoming too big to fail.

With the increasing changes in international standards, directives and other requirements, it is important for regulators to continue and increase the dialogue with those that it regulates. Regulators need to be mindful of the pendulum swing that is the ebb and flow of regulatory reform. One of the dangers we now face, particularly with the speed of new requirements and standards, is the possibility of regulatory fatigue in the rush to reform laws. Nimble regulators can be the superstars in their respective jurisdictions. To be nimble, regulators have to be willing to engage. Regulators that win are not the ones that legislate and regulate without engagement, simply because they have the power to do so.

At the time of writing, journalists have published several articles with the caption “Paradise Papers” that impact several jurisdictions in the Caribbean (and beyond). Data leaks affect the Regulator and the regulated. Persons not familiar with financial services and how heavily it is regulated, particularly in the Caribbean region, may be prone to drawing unpleasant conclusions; many are not familiar with Caribbean jurisdictions beyond their tourist attractions.

In some of the more recent leaks, it was not only sensitive client information being published; publications included correspondence between Competent Authorities and the targeted regulated entity. Pairing that leaked information with public perception presents an immediate reputational risk – not just for the jurisdiction and the entity, but for the regulators as well. This is primarily because the regulators may have to defend their actions (or inaction) to key stakeholders. Questions arise on whether the regulator exercised regulatory forbearance or was subject to regulatory capture. Even if it isn’t the case, perception may trump reality. Regardless of the perceptions, it is always important for regulators to be guided by their mandates and not public perceptions.

Finding the right fit in regulation is a never-ending quest. As business practices and technology progress, so must regulation. Whatever the future may bring, all regulators are increasingly aware that they are accountable for their actions. Accountability will be particularly relevant given the increasing assessments that will be undertaken in the future. It is not just standard setters that pay close attention to, and critique the results of these assessments – journalists, politicians and the wider public are also paying closer attention to regulators. If regulators are to remain relevant and ensure their future longevity, they must engage, adapt and embrace transparency in their actions.