Industry Seminar – 6 December 2013

Banking Supervision and Policy Division Presentation: Supervisory Challenges

John Dunford, Deputy Director

Introduction by Jeremy Quick

Thank you Dale and good day everybody.

I am going to speak for a few minutes before handing over to John.

We have another year ahead of us and the question therefore arises as to what are the prospects for the Guernsey banking community.

Well, there is some sunlight in that asset values appear relatively stable and the UK economy seems at last to be reviving. However elsewhere, the outlook remains darker. The US economic revival is weak, euro land has continuing structural problems and the story for the BRICS is varied.

More generally the net interest margin is at an historic low. Even if global interest rates were to rise over the next year by one percentage point, the margin would remain depressed. This is in the context where many Guernsey banks earn in historic terms around half their income in net interest income. Meanwhile global deleveraging continues apace and banks these days operate in a more confined space than before the crisis.

So the trading environment over the next year is going to remain tough.

In addition, banks are not entirely masters of their own fate in Guernsey. The recent crisis has played out relatively well for some banking groups here and less well for others; and this trend will continue as banking groups jockey for position in the post-crisis world.

Nevertheless there is room for optimism. In matters of credit exposure private banks came out of the crisis relatively well, although many clients were less than impressed about the quality of financial advice they had been given and the industry's cost base remains high.

The global Gini-coefficent is worsening as BRIC industrialisation takes place. This means that there are more and more wealthy people in the world who need financial advice. The problem for us of course is that these people are mostly in the BRICS; although we should never of course lose sight of the fact that the developed world remains our main market. If the Guernsey banking industry gets the balance between the old and the new right, continues to improve processes and it if continues to invest in good client relationship managers, then opportunities should emerge. Guernsey banks can also strive to pick up business as it comes unstuck from other jurisdictions.

Finally, I would like to suggest two risks that banks in Guernsey may want to look out for. Of course I have no more insight in this than you, not least as in a recent FT survey, two thirds of the finance industry thought that regulators had no particular ability to forestall the next crisis and, more worryingly, a third thought that regulators had still to understand the causes of the last crisis.

Nevertheless if I were in your shoes I would be worried about two operational risks – that is AML/CFT contraventions and mis-selling. I imagine the AML/CFT risk is widely acknowledged. But mis-selling to wealthy and advised clients is a little less obvious. However Madoff was I suggest a game changer here and it may be in future that courts and possibly global regulators will become more client focused here. At least it will be interesting to see how this issue develops.
So, I have been realistic about the next year but there are some bright spots. I will now hand over to John to take you through the rest of this presentation. Thank you for your time.

John Dunford

Thank you Jeremy.

Good afternoon ladies and gentlemen and welcome to the Banking presentation. For those of you who do not know me. I am John Dunford the Deputy Director of Banking. I was appointed to this role in July 2013 and would like to take this opportunity to thank you all for helping me in my new role.

In his introduction Jeremy described some key areas of focus and concern for the Guernsey banking industry and for us as the regulator.

Before considering the local banking environment it is important to take stock of the European and Global situation. Yesterday, in his keynote speech, Sir Callum McCarthy was much more eloquent and knowledgeable but …..

Cause of the crisis

Let's start by quickly looking back at the financial crisis and how that has influenced where we find ourselves today.

Slide: Principal reasons for the banking crisis

Any analysis of the cause of the financial crisis, even after five years of reflection, is necessarily subjective and, as sir Callum McCarthy said it is not easy to identify what went wrong. In looking at the plethora of ongoing global reforms there are five principal reasons for the crisis:

- Low capital where the scale of leverage was not understood
- Weak funding structures

- Poor lending
- Poor trading investments
- Misguided mergers and acquisitions

If these are the five main causes of the financial crisis then globally regulators can claim partial victory on four of them. Capital levels are now three times higher than they were before the crisis as banks pre-empt the new Basel III requirements, financing is more stable, banks hold minimum levels of cash and safe assets with increased focus on liquidity and big acquisitions are a thing of the past. That leaves the need to make the right credit decisions and ultimately that is down to the banks.

Slide: Too big to fail

There has been the belief that certain banks are too big to fail.

Worries persist about the size and complexity of banks, a problem that has, if anything intensified. Sir Callum McCarthy said yesterday that the Too Big to Fail problem has become bigger not smaller. The banks that were too big to fail five years ago are now even bigger. Lloyd's Banking Group after the government sanctioned takeover of HBOS is twice the size it was before the crisis. In 2007 there were only six banks in the world with assets of more than US$2 trillion. Today there are 13.

Fairness demands the end of a system that privatises gains but socialises losses.

Systemic resilience depends upon being able to resolve failing banks in a way that does not threaten the entire system. UK Banking Reform and bail-in provisions should establish a more resilient, stable and competitive banking sector which will protect taxpayers and reduce the severity of any future financial crisis.

Guernsey specific

That is a brief summary of international developments following the financial crisis. What about Guernsey? What are the trends? Let's take a whistle stop tour.

Slide: Number of banking licensees

The number of licensees has remained at 32 during 2013 but is expected to fall to 28 by the end of 2014. It is generally the smaller banks that have closed due to Group reorganisation during this extended period of low interest rates and deleveraging.

Slide: Staff numbers in Guernsey banks

The number of staff employed within the Guernsey banking sector continues to fall and currently stands at around 1800 full and part time staff although anecdotal evidence suggests that a number of banks are currently slightly increasing their numbers.

Slide: Average net capital per subsidiary bank

Reflective of the global trend the capital held per subsidiary bank has continued to increase although there has been a slight decrease in 2013 due to the repatriation of capital by way of dividend by a number of banks.

Slide: Total Assets held by Guernsey banks

Total assets held by Guernsey banks has now fallen below 2007 levels primarily due mainly to the reduction in Swiss Fiduciary Deposits as a result of low interest rate returns and the payment of dividends in 2013.

Slide: Pre-tax return on Assets

Despite the fall in total assets held the return on those assets has also fallen as all banks including those in Guernsey struggle with the low interest rate environment.

Slide: Cost/Income Ratio

At the same time the cost income ratio continues to rise although it remains below 45% which reflects a fall in income due mainly to the current interest rate environment.

Turning to the main supervisory work undertaken by the division

Slides: Supervision

The main areas are ICAAP reviews, Credit on-sites, Prudential meetings, AML/CFT reviews, Colleges, and meetings with the Crown Dependencies and other regulators.

The principal supervisory tool we currently use for subsidiary banks is the Internal Capital Adequacy Assessment Process, the ICAAP, and the Supervisory Review and Evaluation Process review, the SREP.

Slides: Regulatory ICG v Actual ICG

The average regulatory Individual Capital Guidance, ICG for all subsidiaries is currently 148% whilst the actual capital figure divided by Pillar 1 capital is 266%.

47% of subsidiaries currently have an ICG of between 130% and 149% whilst one fifth are over 170%. What I have noticed in the SREPs I have been involved with is how the ICAAP has become an integral part of the banks’ risk management culture and discipline and is not seen as just another regulatory requirement. Having said that there is a trend to reduce the ICG. I have yet to see an ICAAP submission which recommends increasing the ICG !

Slide: Bank Credit Reviews

In the past two years we have undertaken a large number of credit on-site reviews. These inform us about the state of credit quality and credit risk at the banks. They are confirming that in the main credit books are well collateralised and well controlled with risk being recognised and proactively managed.

Slide: Prudential Meetings

By the end of the year we will have held 11 prudential meetings with local banks in addition to our regular quarterly meetings with the branches of the UK clearers. These keep us better informed of the activities, culture and activities of those banks and provide considerable insight into how they are managed and how they are positioned within their larger groups.

Slide: AML/CFT

We have also been monitoring the planning and implementation by a number of banks of AML remediation activities following the identification of breaches of the AML/CFT Handbook as discovered during on-site visits. AML/CFT on-sites are now undertaken by the Financial Crime Division following close liaison with ourselves in Banking.

Slide: Colleges

Participation in Colleges of Supervisors continues to be an increasingly important essential element in our supervisory programme. These help us to understand better the strategy and capital and liquidity strength of parent banks. Whilst not facilitating such in depth analysis as Colleges attendance at bilateral meetings with home supervisors gives us insight into the strengths and weaknesses of parents of our licensed banks and enables and encourages constructive dialogue.

Slide: Meetings with Crown Dependencies

We have held three Tri-Party meetings during the year with the regulatory Commissions of the other Crown Dependencies, Isle of Man and Jersey, to ensure a consistent approach on such matters as Basel III Capital requirements, the leverage ratio, D-SIBS and UK Banking Reform. In addition at the last meeting in November we took the opportunity to hold a mini-college meeting for Guernsey branches of either IoM or Jersey subsidiaries.

During the year the JFSC came to Guernsey ,as the “home” supervisor for four specific banks and undertook their own prudential meetings which we also attended.

We have also attended prudential meetings by the PRA, as home supervisor, at a Guernsey private bank.

Slide: Policy

Those are the key supervisory undertakings of the past year . What policy work have we been undertaking.

The key areas of policy work are:

- Large Exposures

- Basel III
- Basel Core Principles
- UK Banking Reform

Slide: Large Exposures

Turning to large exposures.

A consultation paper on large exposures was sent to all banks by the Commission in March 2013. Eight banks took up the offer to meet with the Commission during the consultation and twelve responses to the consultation paper were received, including responses from two bank branches.

Responses were generally supportive with an acceptance that the current regime is out of date and needs to change in the light of the financial crisis and developments in large exposure regimes elsewhere. The Commission has taken note of the responses to the consultation and wherever possible it has amended its proposals accordingly. The balance between regulatory prudence as required by international banking supervision standards and a pragmatic approach to business of Guernsey's lenders is not always an easy one to strike and the new regime will not please everyone. One further influence on the Commission's post-consultation consideration of the large exposure regime has been its move to risk-based supervision, which will entail regulatory resources being directed to those licensees who may have the greatest impact if they were to fail

A feedback paper on the large exposure consultation has been produced along with draft large exposure principles and guidance reflecting the new regime and this will be sent to you all for any final comments. When the Commission released its large exposure consultation paper it aspired to a 1 January 2014 effective date. To allow everyone time to get used to the new regime, the effective date will be 1 July 2014 but there will be tasks to complete ahead of this deadline.

Slide: Basel III – Capital Adequacy

Considerable time and effort has been expended by the Crown Dependencies in developing a consistent approach to the Basel III capital adequacy requirements.

The Tri-Party Group distributed a Discussion Paper on Basel III in September 2012 and all banks that are incorporated in the Crown Dependencies – Guernsey, Isle of Man and Jersey to provide information on Basel III and an indication of the Group's initial views and in order to solicit feedback.

The Basel III capital standard creates a new, higher quality, sub-category of capital – Core Equity Tier 1 (CET1).

The Basel III capital standard provides an extended implementation timescale, with grandfathering rules, in respect of the changes to CET1, AT1 and Tier 2 capital. Most ineligible items are phased out over 5 years from 2014.

In response to the DP, several banks sought confirmation that Basel III would be adopted, with respondents pointing out that compliance with a different local standard would be more burdensome, as Basel III would be adopted at group level. Only a small number of banks opposed the change on cost grounds, both for existing banks and so as to offer a competitively cheaper environment to potential new entrants.

The Tri-party Group considers that none of the specific proposed changes is without merit, none were singled out as being unwarranted and that using the definitions set out in Basel III would reduce compliance costs.

Timescales for implementation are uncertain at this time, principally due to practical constraints. The DP asked about transitional adjustments and feedback was strongest for implementation in line with CRD IV. The Group intends to aim to begin transition before the end of 2015. However, it is not intended that this delay should have an impact on the end date for the transitional period and hence it is proposed that the transitional adjustments allowed in Basel III for each year should apply as stated in Basel III, without any alteration to reflect any delay in starting the local transitional period.

As an indication, it is envisaged that, initially at least, reports on Basel III would be required separately from current reports and that ICAAPs will be required to consider the impact of Basel III

Slide: Basel Core Principles

The Commission has undertaken a gap analysis of the revised Basel Core Principles against which, as a jurisdiction, we are assessed for compliance with international regulatory standards. We are in the process of developing an action plan to ensure that gaps identified are remedied.

A new corporate Governance core principle has been added but the main thrust of the revision has been to sharpen existing core principles to reflect experience in the 2008 banking crisis and to focus on their implementation and relevance to financial stability.

GIFCS

The Commission attended the Group of International Finance Centre Supervisors (GIFCS) meeting which provides one of our important opportunities for interaction with fellow Crown Dependencies and also peer financial centres elsewhere such as Gibraltar, Bermuda, Cayman, BVI and Bahamas

Slide: Probability Risk and Impact SysteM – PRISM

As I said earlier the Commission is introducing a much more risk based approach to supervision.

Risk based supervision starts with the premise that not all firms are equally important to the economy and that a regulator can deliver most value through focusing its energies and finite resources on the firms that are most significant and on the risks that pose the greatest threat to financial stability and consumers.

To be properly risk-based one has to know where the risks lie. Impact is a major component of this as impact indicates the degree of damage a firm could cause to the financial system, economy and population were it to fail.

The adoption of PRISM will change the way we supervise banks

There will be changes to our approach and the intensity of our engagement with firms dependent upon our assessment of their impact risk.

We are currently preparing for a pilot Risk Governance Panel review of one of our recent credit reviews to provide a useful indication of how PRISM works in practical terms.

In order to fully complete risk and impact assessments of the banks there will need to be a two-way process with yourselves. We will provide regular updates via AGB as to how we expect the move to PRISM to impact on local banks.

Slide: Risks

Upstreaming

Upstreaming to parent banks or head office continues to be an area of focus for the Division When a bank upstreams the majority of its assets to the parent bank in another jurisdiction then in a time of crisis the ability to recover those assets in to meet the deposit liabilities due to local or expat depositors is extremely difficult to impose. European banks continue to be undercapitalised which adds to the risks of upstreaming.

PPI & Interest Rate hedging products

Local banks have not been significantly impacted by the mis-selling problems of PPI and interest rate hedging products. Banks have undertaken or are undertaking reviews and where necessary have settled with customers who have been unfairly sold products.

Low Interest environment

We remain alert to the difficult low interest rate environment banks currently operate in and the subsequent challenges on profitability. This has recently been exacerbated by the ECB 25 basis point cut in rates at the beginning of November to a new record low.

Credit Books

Slide: Credit

The Credit Reviews we have undertaken in the past year and our ICAAP reviews and SREP meetings have confirmed that a considerable amount of the Guernsey credit books are collateralised on Central London properties. Is this a substantial concentration risk we should be considering? Probably not given that the highest LTV is probably around 70% with the average being closer to 50%.

Slide: Conduct Unit

Some of you may have attended the presentation by Rosemary Stevens who heads the Conduct Unit. Rosemary liaises extremely closely with Banking and I know that she has been communicating with a number of you on a number of matters already and I thank you for your close cooperation with her.