Guernsey Financial Services Commission

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Banking Supervision and Policy Division Presentation:
Guernsey – International and Interconnected

Jeremy Quick, Director
Andrea Sarchet-Luff, Acting Deputy Director

Good day. Before handing over to Andrea, I would like to spend ten minutes considering some key trends in global regulatory banking practice since 2007 and their impact on Guernsey.

The Bailiwick is an international financial centre and regulation is therefore subject to international norms. This is nowhere more so than in banking where the Bailiwick acts as an entirely host regime. So how have international regulatory developments affected the Bailiwick recently?

In some areas, we have been more-or-less unaffected. Bonus constraint, trading book reforms, fx and interest rate market issues have all passed us by as they are of limited relevance to the business model of banking in Guernsey.

In other areas, the Commission itself has taken care to apply a proportionate and limited response. For example, our recent stress test was far simpler than that applied in some other regimes, we remain wary of detailed model validation, and our rulebook remains relatively slim.

However, certain international developments have materially affected Guernsey banks; and this journey is far from over. Just to give you an example of this, whereas Basel II represented a defined set of requirements to be implemented, Basel III has become a moveable feast where change has become almost permanent. Indeed it is sometimes difficult to predict where Basel III will go next, however well-connected we may be. This is not least as the Basel Committee – which is more like a regulatory body – now operates under the aegis of the Financial Stability Board, which is more sensitive to wider considerations.

One key regulatory result of the crisis was the demand for more and better quality capital. In terms of the quality of capital this has had little effect in Guernsey as capital here has always been almost entirely tier one and this will remain the case.

In terms of quantity, Guernsey banks have generally always had lots of capital, not least for large exposure purposes. This has traditionally made our ICAAP discussions with banks more an exercise in risk identification than capital setting per se, as the bank has always had much more capital than necessary for regulatory purposes. However, since 2007 several home governments have made it easier to repatriate oversees capital, home regulators are increasingly demanding more capital for the home bank especially under the single point of entry model and some local banks here are holding larger credit books, in part due to up-streaming issues. With local capital less ubiquitous than before, this may in the future bring more edge to the question of how much capital Guernsey banks need.

It is in this context that the Crown Dependency ('CD') regulators have been considering the application of Basel III capital standards – including the leverage ratio – to the CDs, and several Guernsey banks this year have acknowledged that ICGs can go up as well as down, sometimes with encouragement from the Commission.

Whilst therefore Guernsey banks remain well-capitalised and will remain so, capital may emerge as more of a discussion point between the Commission and the industry than before. This of course in the context of effective risk management is no bad thing. It is however a change brought about by post-2007 global economic and regulatory factors and an example of where global trends are affecting the Bailiwick.

The 2007 crisis began as one of liquidity. Since 2007, there has therefore been more of an emphasis on a stock, as opposed to a mismatch, approach to liquidity. The Commission moved early here and its 2009 liquidity policy includes a stock approach. So far this has not posed too much difficulty for Guernsey banks, especially when they have already held a stock of assets. However, we have not yet implemented Basel III so we cannot yet be sure about the full implications for Guernsey of the stock approach. This will emerge as we work with the other CDs on a common approach over the next two years or so.

Another lesson of the 2007 crisis was that inter-bank and sovereign risk had been underestimated. This was reflected when this year the Commission revised its Large Exposure Policy – something long overdue as this had been written in the 1990s. The new policy has required for smaller banks a diversification in inter-bank deposits. The new policy is also leading to a run down in some larger non-bank exposures. The new policy has not signalled any change in the Commissions' approach to parental counter-party risk – that is up-streaming – which the Commission recognises as part of the business model. Despite this, there will continue to be a business impact here for Guernsey banks in so far as home regulators regard subsidiary up streaming for liquidity purposes as volatile wholesale rather than secure retail funding. This has already had a major impact on the attractiveness of Guernsey for UK bank subsidiaries for instance; and remains an issue. Again this is a change brought about by outside factors.

Since 2007 many regulators are developing new approaches to bail-in and to recovery and resolution; part of which has included a bolstering up of local compensation schemes so as to reduce the risk to the public purse and improve depositor confidence. This is also linked in some jurisdictions with ring fencing of retail deposits. Let me call this issue the 'resolution question'. Comparability here represents a challenge to Guernsey due to the size of its banking industry compared to its GDP and to the fact that is a host regime. A complicating factor is that the world has still not yet worked out how to deal with cross-border bank resolution. Quite how the Bailiwick and in particular its retail banking sector which is so closely connected with the UK will adjust in this new world remains unclear. This is certainly something that the Commission is closely considering. For example the Revision of Laws Discussion Paper aims to make it easier for information-sharing to take place between home and host regulators for resolution purpose. Nevertheless, the resolution debate and how the Bailiwick might best respond to this remains unclear; and it is another area where Guernsey will have to adapt to global change.

One area that banks across the globe also have to contend more than before is conduct risk; reflecting in part general dissatisfaction with the quality of some banking services. PPI compensation has taken place in Guernsey. With three of the four large clearing banks possessing insurances intermediary licences, some banks have also been touched with the work undertaken by the Commission on sales advice around long-term insurance products. Banks in Guernsey will also need to work with the new Channel Islands Ombudsman from next year. All of this is in line with a greater global focus on conduct. Incidentally, if you allow me to put Financial Crime mitigation under the general heading of Conduct, Bailiwick banks are continually obliged to up their game in response to tougher international standards and oversight; although it is my impression that local banks have generally responded well in this respect. Again this indicates a continuing need to respond to international requirements.

The 2007 crisis has also led regulators to consider their own approach to regulation. They now look more at high-level business plan and are more inclined to challenge boards. I would like to think that we always did that in Guernsey but there can be no doubt that our new risk-based approach through PRISM formally mandates such an approach and embeds it in formal processes.

As you can imagine it is no small task for the Commission to keep abreast of all these developments. However our membership of the Group of International Finance Centre Supervisors and our informal links with home regulators will help.

To conclude, Guernsey is subject to global regulatory and political trends beyond its ability to control. Some of these trends will require little or no change; others will require a lot of change. The trick is to be aware of what is on the menu and to ensure that consequent change takes place in as pragmatic a manner as possible in Guernsey.

Thank you Jeremy.

Good morning ladies and gentlemen. For those of you who do not know me I am Andrea Sarchet-Luff and at the moment I am the Acting Deputy Director for the banking team in the Division. I was appointed to this role in August 2014 to cover a secondment and I will be returning to my normal role, as an Assistant Director, just before Christmas.

In his introduction Jeremy described how key trends in global regulatory banking practice are beginning to impact on Guernsey in some areas.

I'd like to start my session by considering some other external challenges that have already impacted on, or have the potential to impact on, our local banking sector.

Slide: External challenges

There are a number of challenges originating from outside Guernsey that the Commission is aware of:

- *Low Interest rate environment*

We remain alert to the difficult low interest rate environment that banks currently operate in and the subsequent challenges to profitability and potentially, business model. This has recently been exacerbated by the ECB cutting its benchmark interest rate to a new record low of 0.05% in September 2014.

- *Conduct risk*

Local banks have not been significantly impacted by the mis-selling problems of PPI and interest-rate hedging products, but there has nevertheless been the cost of establishing a sales review methodology and undertaking those reviews, despite the relatively low volumes of sales conducted in Guernsey.

- *Exposure to the London property market*

Lending in respect of high end London property is part of the business model for a number of banks, and particularly our private banks. Conservative Loan to Value levels mean that credit risk across the sector is relatively moderate in the event of a significant fall in property values. However, two recent moves by the UK authorities to increase tax take may possibly have an effect on local bank lending in respect of high end UK property.

The first of these is the proposal to bring non-resident individuals, trustees and partners within the capital gains regime for gains on UK property with effect from April 2015. The second was a surprise announcement by HMRC in August 2014 that it had changed its position on the taxation of non-doms who use foreign assets as collateral to finance purchases in the UK. The position is that these assets will now be classed as transfers of wealth into the UK and are therefore taxable both for existing homeowners and new buyers. It is too early to tell yet how these two moves might impact on demand for high end London property.

- *Political risk*

Politicians and the media in other jurisdictions continue to focus on tax avoidance and on small financial centres in particular, and whilst problems in the Eurozone persist this scrutiny is unlikely to decrease. There is a cost, not only for those banks that suddenly find themselves mentioned in a national newspaper article, but more generally in terms of senior management time spent explaining to parent banks the context of media coverage and its relevance, or lack thereof, to the operation in Guernsey.

Slide: Trends in Guernsey

I'd like to turn to Guernsey now and have a look at the trends in the banking sector over the past year, using data up to and including the September 2014 BSL/2 return.

Slide: Number of banking licensees

The number of licensees had reduced to 30 during 2014 but in October we were pleased to be able to do something that has become fairly unusual in the last few years and that is to issue a new banking licence to a branch that will be operational early next year. It is generally the smaller banks that have closed due to Group re-organisation during this extended period of low interest rates and deleveraging, but as Jeremy mentioned, we have also seen some Guernsey subsidiaries surrender over the past few years because up-streamed funding is no longer regarded as secure retail funding.

Slide: Staff numbers in Guernsey banks

Since our last industry presentation in December 2013, the trend of falling numbers of staff employed within the Guernsey banking sector appears to have stabilised and currently stands at around 1659 full and part time staff. The island has benefitted this year from new business arising from Group acquisitions. Anecdotally we are aware that there also appears to be a shortage of Client Relationship Managers, which has the potential to push those staffing figures up further.

Slide: Total Assets held by Guernsey banks

Total assets held by Guernsey banks continue to fall and currently stand at £107bn, albeit the last quarter has seen a £5bn increase. As you can see the reduction in Swiss Fiduciary Deposits as a result of low interest rate returns is a key trend, but we've also seen some chunky outflows as banking groups continue to consolidate or re-organise their operations.

Slide: Average net capital per subsidiary bank

Reflective of the global trend the capital held per subsidiary bank has continued to increase although 2013 saw a decrease due to the repatriation of capital by way of dividend by a number of banks. Jeremy has alluded to the pressure on local capital from the centre, but conversely we are also seeing some banks paying smaller dividends in order to retain capital for large exposure purposes. Bear in mind that this chart doesn't include a number of dividend payments that we anticipate will be made during the final quarter of this year which will have the effect of reducing the £136m average shown as at September.

Slide: Minimum ICGs for Guernsey subsidiaries

I'd like to talk a bit about minimum regulatory capital which those subsidiaries amongst us will recognise as the "Individual Capital Guidance" figure or ICG. When John Dunford was speaking at this event last year he observed that he had yet to see an ICAAP submission that recommended increasing the ICG. It has been a little different this year however, and we have seen some ICAAPs that have resulted in an increased ICG. In some cases this has been because a contraction in the balance sheet has reduced the Pillar 1 charge which in turn tends to inflate the ICG, but we are now into our fourth iteration of the ICAAP and banks are becoming more comfortable about calculating Pillar 2 charges direct or finding a reasonable proxy.

The Commission wants to see appropriate ICG levels – no-one here is going to die of shock at that admission – and in some cases we have increased the ICG beyond that suggested by the individual bank. Why is that? Well, we have the higher capital levels required by home regulators that Jeremy alluded to at the back of our mind and our approach has been to raise capital requirements in an incremental way. Additionally on occasion we have been able to suggest risks not previously considered by a bank because we have the advantage of knowing what other banks have considered to be material risks requiring a capital add-on.

Just to illustrate what I have been saying by way of something visual, here is the split of ICGs as at the end of 2013, versus the split as at today's date. The trend, with the exception of the very highest level of ICG shown in green, has been to increase in the incremental way I have described.

So what has the Division been doing over the last year?

Slide: What have we been doing this year?

- *Colleges*

Participation in Colleges of Supervisors continues to be an essential element in our supervisory programme and the Commission has attended six of these during 2014. They help us to understand better the strategy and the capital and liquidity strength of parent banks, and they assist us in understanding the risks or issues faced by other banks in the group. Our impression thus far has been that our licensees are relatively problem-free when compared to some other group banks. The Colleges are also extremely useful opportunities to build good relationships with home supervisors.

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. The Commission has attended several such bilateral meetings in 2014.

- *Meetings with Crown Dependencies*

We have held five Tri-Party meetings during the year with the regulatory Commissions of the Isle of Man and Jersey, to ensure a consistent approach on such matters as Basel III Capital requirements, the leverage ratio, Domestic Systemically Important Banks, and UK Banking Reform.

On this latter subject, the future structure of Guernsey retail banking operations in the wake of UK Banking Reform remains uncertain.

The Commission will continue to monitor the impact of developments on the jurisdiction with respect to continuity of banking services and the safety of Guernsey deposits.

- *Stress testing*

There is a periodic need for supervisory stress testing to assess risk sensitivity across the sector and to identify any emerging sources of risk. Over the summer of this year subsidiary banks have been required to undertake a series of stress tests, including single factor stress tests and a reverse stress test. Thinking the unthinkable around extreme events leading to institutional failure is the foundation of reverse stress testing.

What has been interesting has been the extent to which some banks still struggle with the reverse stress concept of starting with a capital breach and then identifying a related scenario that could have caused it. The tendency of some banks was to start from the other end of the problem by identifying a scenario and then seeing what impact on capital it might have.

The Commission will be publishing a summary of the findings shortly although this will not identify individual banks.

- *Locational statistics*

Since 2001 Guernsey banks have been submitting the quarterly LOC/1 locational statistics return to the Commission, following a request for such information from the Bank of International Settlements (BIS). The Commission aggregates this data for onward encrypted submission to the BIS.

At the end of 2013, the BIS issued requirements for ‘Stage 2 enhancements’ that called for a considerable increase in the granularity of data. It is testament to the hard work of those of you in each bank that are responsible for preparing these statistics that this Stage 2 reporting has not only been tested, but it is now live. That has enabled Guernsey to be in the vanguard of jurisdictions successfully meeting the BIS’s requirements and there are a lot of other jurisdictions who are still struggling with the testing phase, so a big thank you to all of you involved in that process.

The last bullet on this slide is a subject in itself, so I'm going to spend a little time on this.

Slide: Policy

- *Large Exposures*

The new large exposure regime went live on 1 July 2014, with exposures existing as at the effective date being grandfathered through. The introduction of stricter collateral requirements for client exposures in excess of 25% of capital has not produced any material difficulties, largely because existing client exposures have been grandfathered through, but also because the majority of banks had already walked away from doing big ticket client exposures before the revised regime came into place.

Placing limits on interbank exposures has undoubtedly been the most unpopular part of the new regime but not to have done so would have flown in the face of the international practice which was implemented in the wake of the financial crisis. Again, the impact is mixed; for some banks the limits on interbank exposures were in excess of internal limits that the bank had set itself; for other smaller banks, being forced to diversify interbank exposures amongst additional counterparties has been painful, despite the fact that existing interbank exposures are also grandfathered through to expiry.

We are now in the process of agreeing up-streaming limits with individual subsidiary banks that will come into effect from 1 January 2015 and we don't expect the limits to have a negative impact on banks. The process has been more complex this year because of the inclusion of off balance sheet liabilities for the first time and we have some lessons to learn for next year's process.

- *Basel III*

Considerable time and effort has been expended by the Crown Dependencies in developing a consistent approach to Basel III and several joint discussion papers have been issued. The first was a general discussion paper issued in September 2012. This has been followed up with further specific discussion papers on Capital Adequacy, on Domestic Systemically Important Banks, and on the Leverage Ratio.

The objective remains to achieve consistent application, to the extent practical, across the Crown Dependencies. By necessity, however, owing to local implementation processes, consultation papers must be issued individually by each jurisdiction and proposals therein may reflect differences in local reporting format. The Commission plans to issue a Consultation Paper based on the proposals in the Capital Adequacy Discussion Paper in early 2015 with a view to implementation at the beginning of 2016. Other elements of a Basel III consistent regime will follow thereafter with an overall goal of implementation before the end of 2019.

The issue of a Discussion Paper on revisions to regulatory minimum liquidity standards is anticipated in 2015.

- *Basel Core Principles*

The Basel Core Principles for Effective Banking Supervision changed in September 2012 to include a new principle on Corporate Governance and to focus on implementation of the principles. A theme of financial stability, while not a core principle in itself, also runs throughout. A subtle change in the wording of the principles now puts a more proactive burden on the Commission by requiring us to "determine" that X has happened, rather than being merely "satisfied" that X has happened. Given that Guernsey as a jurisdiction is assessed against these principles, the Commission has developed an action plan to ensure that any gaps are remedied in a proportionate manner.

The action needed to close the gaps varies. Some can be addressed through a change in Commission procedures, but at the other end of the scale some changes to supervisory legislation will be needed. These changes have been included in the Revision of Laws project and a Discussion Paper on that project is available on our website. One of the gaps is being addressed through the exercise that we have asked you all to complete this year in tying the verification of prudential return into the financial year end, so that any significant differences between valuations used for financial reporting purposes and regulatory purposes can be identified. I would like to thank you all for your co-operation with this unusual exercise.

One of the biggest tasks for the banking team this year has been getting to grips with a new way of supervising banking licensees.

Slide: Supervision under Probability Risk and Impact SysteM – PRISM

We mentioned at last year's industry presentations that the Commission would be transitioning to a new impact and risk-based supervisory framework in 2014. This framework is called PRISM and we are now underway with it. Only a very few of the banks here will have experienced the revised supervisory approach thus far, so let me set out the objectives of the revised framework and what's different about it.

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 pose the most significant risks and present the greatest threat to financial stability and consumers.

Our first step under PRISM therefore has been to classify all of our firms into four categories of impact – high, medium high, medium low and low. Impact indicates the degree of damage a firm could cause to its consumers, the financial system in the Bailiwick and elsewhere, the Bailiwick economy and the public were it to fail, or to engage in persistently poor conduct.

Our engagement with a firm is driven by its impact level, so those classified as high impact can expect to see the Commission much more regularly than before. Conversely, firms having the lowest impact level will engage with the Commission on a trigger event basis only or through participation in thematic reviews, rather than having regular contact. None of our banks have been rated as low impact, so you can all expect to see the Commission on a periodic basis.

So what's new about banking supervision under PRISM? Well, the cycle of engagement will be very different to the model you have been used to thus far, so for example, branches will no longer have an annual prudential meeting going forward. Similarly, we won't be asking all subsidiaries to submit an ICAAP to us quite as regularly as before. PRISM requires a new set of engagement tasks with greater emphasis on governance, risk management and business model. We will now be meeting on a rolling basis with senior management, with key compliance and risk staff and with non-executive directors. Separate from the cycle of these meetings will be the set piece engagement task – the Full Risk Assessment. This includes a substantial onsite element to consider probability risk and will take place roughly every year for a high impact firm, every three years for a medium high impact firm and every five years for a medium low impact firm.

Slide: Probability Risk

PRISM requires supervisors to consider the level of risk in each of eleven different areas which are referred to as probability risks and here they are. PRISM imposes the discipline of having to consider and articulate conduct and environmental risk directly whereas previously in our supervision of a firm we may have considered these rather more obliquely. Environmental risk by the way is about the risks to a firm arising from its operating environment, both internationally and domestically, so some of the challenges I spoke about earlier in relation to low interest rates or political and media pressure would fit into this category.

The only one of the eleven risks that sits outside of the purview of the banking team is Financial Crime Risk which is assessed by the Commission's Financial Crime Supervision and Policy Division. That division determines the cycle of visits to licensees and keeps the banking team informed of visit findings and any remedial action required. That's important for the banking team because shortcomings in financial crime arrangements may well have implications for strategy/business model risk or for governance risk for example.

From our periodic engagement tasks and in particular our Full Risk Assessment visits, we will be able to form a view as to the likelihood of a problem occurring in a particular risk area. The view on the level of risk requires the supervisory team to use their judgement.

Slide: Supervision under Probability Risk and Impact SysteM – PRISM

Because there is an element of judgement involved, the conclusions that supervisors come to about the level of risk are now subject to internal challenge at cross-Commission Risk Governance Panels. It is the job of these Panels to ensure that the conclusions reached and any outcomes are consistent and proportionate. Where a probability risk is considered to be too high, the Commission will ask a licensee to reduce the level through a Risk Mitigation Plan. Once this Risk Mitigation Plan is complete, the supervisory team will assess the probability risk again.

That's the way that we will be supervising banks from now on. So what else is new?

Slide: What else in 2015?

- *ICAAP+*

We wrote to all subsidiaries in March 2014 explaining that with the advent of PRISM and the need to consider the eleven risk categories that I have just showed you, the scope of the current ICAAP process would be extended and licensees would be asked to provide additional information regarding control framework, governance structure and risk management process. We refer to this as the ICAAP+.

We are in the process of completing our first ICAAP+ which allows us to view the bank's conclusions on capital in the context of the eleven probability risk areas.

One plea that I would make is that despite the additional information required by the ICAAP+ process, the Commission still needs to understand from the ICAAP document itself how a subsidiary bank has arrived at its capital figures. However you got there, whether it is a calculation, a model or a stress test, we need to know how it works, what values you put into it and why. If it's a proxy figure because there isn't an easy way to calculate an appropriate level of capital, please say so. I would also ask that all ICAAP documents include an executive summary clearly setting out the Pillar 1 and 2 charges. These steps will help us enormously in cutting down the list of ICAAP queries that we currently come back to you on.

- *Annual Compliance Form*

In the light of PRISM, we have been looking at how we might streamline certain tasks. All banks undertake the annual section 36C review as required by the Banking Supervision Law and there are no plans to remove that requirement. However, the Commission has always wanted to see a copy of the annual review which means completing a pro forma in some detail to explain how the bank complies with each section. Going forward, it seemed to us that an annual self-certification, with an explanation required only where a bank had discovered shortcomings in its approach, would reduce the burden on banks.

This got us thinking about other possible items for self-certification. All banks are issued with a standard set of licence conditions at the point that they are licensed, but as the point of licensing recedes into the past, so does the institutional memory that these conditions exist. An annual confirmation that licence conditions have been complied with would be a useful memory jogger and a good governance tool.

Finally, there are two additional areas that apply purely to subsidiaries; the first is a requirement to conduct annual liquidity stress testing, and the second is a confirmation that the Board has reviewed the ICAAP regularly and determined that capital is still adequate for the risk profile of the business. Both of these requirements could also be subject to a self-certification.

The Commission proposes therefore that from 2015 onwards, banks would submit an Annual Compliance Form to confirm that the requirements I have just outlined have been completed. Rather than automatically asking for additional documentation when this confirmation is submitted, the Commission would ask to see evidence as part of its next PRISM-related Full Risk Assessment of the bank.

We will roll the new Annual Compliance Form and guidance out to you before Christmas.

That concludes the presentation from the banking team and on behalf of Jeremy and myself I should like to thank you for taking the time to attend this morning. We will now be happy to answer any questions that you may have.