GUERNSEY
FINANCIAL
SERVICES
COMMISSION

GUIDANCE NOTE ON BANK AUDITORS' REPORTS ON GUERNSEY FINANCIAL SERVICES COMMISSION RETURNS USED FOR PRUDENTIAL PURPOSES

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Table of contents

PART 1: INTRODUCTION

1. In 1988 the Basel Committee on Banking Supervision ("Basel Committee") issued a report entitled "International Convergence of Capital Measurement and Capital Standards". The report was updated in 1997. Its purpose was to secure international convergence of supervisory regulations governing the capital adequacy of international banks. The report has become known in recent years as "Basel I".

   Latterly, the Basel Committee has worked to revise Basel I. The new revised framework was initially published in 2004 and was re-issued as a "Comprehensive Version" in June 2006. The revised framework is referred to hereafter as "Basel II".

   In preparation of the formal adoption by all Guernsey licensed banking institutions of the Basel II Accord the Commission has worked with the banking industry to finalise new quarterly returns, known as form BSL/2, to take into account the new requirements under Basel II. The banks have started to submit their BSL/2 returns in Q1 2008 and will continue to submit these alongside their BSL/1 returns until the Commission formally withdraws the use of the BSL/1 return.

2. The purpose of this Guidance Note is to provide guidance to institutions and to bank auditors. It does not seek to repeat the detailed guidance notes issued by the Commission to date which has been circulated to all banking institutions. These are available on the Commission's website for bank auditor's information and perusal.

   The implementation of Basel II has meant changes to the format and content of the returns. These changes, which have been incorporated into form BSL/2, include but are not limited to:

   - Introducing the concept of a specific capital charge for operational risk for the first time;
   - The risk weighting that is applied to some line items have been updated by the revised accord (for example qualifying residential mortgages have a risk weighting of 35% as oppose to 50% under form BSL/1);
   - Form BSL/2 allows banks to take into consideration credit risk mitigation techniques ('CRM') which the bank may use to reduce the value of certain assets to which the risk weighting applies. This will have the effect of reducing the total risk weighted assets for the bank and in turn reduce the amount of capital required to be held;
   - Whereas form BSL/1 was completed within one module (an excel based file), form BSL/2 is split into a number of modules (excel based files) reflecting the different risks a bank may face (e.g. credit risk module, operational risk module, market risk module, settlement risk). The modules reflect the drivers behind what the revised Basel Accord refers to as the Pillar 1 & Pillar 2 risks;
   - Dependant on the election made by each bank, there are a number of methodologies within each module for calculating each risk which differ in their complexity. For example under the operational risk module a bank can choose to report under a basic indicator module or standardised approach module to operational risk. All banks have already elected which methodologies to use in agreement with the Commission. Any proposed change to the methodologies used requires pre-approval by the Commission.

3. Form BSL/2 for those entities operating in Guernsey as branches of banks incorporated in another jurisdiction consists of only three modules incorporated into a single excel workbook (modules 6, 8 & 9). This reflects the fact that branches are not required to hold any capital and hence their form BSL/2 requirements are less onerous than that of a Guernsey subsidiary bank.

4. The Commission continues to attach great importance to the information contained in the returns submitted to it by licensed institutions and believes that the degree of confidence and reliance it places on that information will be maintained and improved by the exercise of its powers to ask on an annual basis for returns to be examined and reported on by independent accountants. This is in accordance with the condition imposed on all bank licences under section 8 (4) (g) of the Law.[1]

5. The reporting requirements outlined in this Guidance Note relate to those quarterly returns (Form BSL/2) which are submitted to the Banking Division of the Commission which are used for statistical and prudential purposes to enable or assist it to exercise its duties and functions under the Law.

6. The work carried out by bank auditors to verify prudential returns is **not** intended to be an audit and should not be relied upon on that basis.

[1] References in this Notice to "the Law" are to the Banking Supervision (Bailiwick of Guernsey) Law, 2020.

PART 2: BANK AUDITORS' EXAMINATIONS

7. Bank auditors should have a proper understanding and a working knowledge of:-

   (a) the returns submitted by a licensed institution as well as the Commission's current reporting instructions (including notes and definitions) and any further rulings that have been agreed in writing between the Commission and an individual bank to reflect its particular circumstances;

   (b) any principles published by the Commission which relate to the returns;

   (c) the Commission's Guidance Notes issued from time to time as far as they relate to bank auditors and/or supervisory returns.

8. The Commission will, in future, make available to bank auditors, on their appointment, the current reporting instructions, the specific rulings, principles and Guidance Notes referred to above. In addition, it will ensure that auditors are informed of additions and changes to those documents and that they receive replacement or superseding documents as and when they are issued.

9. Bank auditors are required to report whether, in their opinion, in all material respects the information contained in the returns examined by them:-

   (a) is complete in so far as all the relevant information contained in the primary books and accounting and other records at the reporting date has been extracted therefrom and recorded in the returns;

   (b) is accurate in so far as it reflects correctly information contained in, and extracted from, the primary books and accounting and other records at the reporting date;

   (c) is an accurate representation of the sterling equivalent of the information contained in, and extracted from, the primary books and accounting and other records at the reporting date;

   (d) is prepared in accordance with the Commission's current reporting instructions (including notes and definitions) and any further written rulings that apply specifically to the particular institution;

   (e) is prepared, in the case of Guernsey subsidiaries, using the same accounting policies as those applied in the current period of statutory accounts; and

   (f) does not contain large, unexplained and unsubstantiated variations in respect of exposures to group and exposures over 25 per cent of the bank's capital base[2] compared with those exposures side of the reporting date at a period to be specified within the auditors report. (This is to ensure, for example, that

[2] "Capital base" is tier 1 and tier 2 capital as defined in the Commission's supervisory returns.

banks do not “windowdress” transactions to ensure that they present an acceptable position on the reporting date).

10. The Commission does **not** require bank auditors reporting in accordance with paragraph 10 above to give an opinion on the completeness and accuracy of the information contained in the underlying primary books and accounting and other records at the reporting date of the returns examined by them. In this exercise it does not require them to report on the systems and controls maintained to provide and ensure the quality of the information for those returns.

11. Bank auditors may consider that the Commission’s reporting instructions (including notes and definitions) do not fully and unambiguously cater for the circumstances and nature of a particular material transaction or series of material transactions. In such circumstances regardless of whether a report contains an unqualified, qualified by exception or an adverse opinion, the treatment in the returns of the material transaction or series of material transactions should be described in the report or in an appendix thereto unless the bank auditor is certain that the bank has previously reported the transaction or transactions to the Commission.

12. The frequency of examination of bank’s returns will be at least annual. In determining the frequency and timing of the examination of a return the Commission will take into account, amongst other factors, the cost to the bank in terms of both management time and reporting accountants’ fees and the scope and volume of business carried out from Guernsey.

13. While undertaking their work as bank auditors a firm of accountants may examine a return submitted to the Commission and conclude that it contains material errors or omissions which have not been subsequently discovered by management or reported by them to the Commission. In such an event the firm of accountants should invite management to bring the matter to the attention of the Commission and if management declines, or fails to do so within a period of time specified by the bank auditor (being no longer than 7 working days) they should bring the matter to the attention of the Commission themselves. Section 33 of the Law relating to the disclosure of information to the Commission should be noted in this respect.

14. In the case of returns which contain information prepared on a consolidated basis the Commission expects auditors to extend their examination of this consolidated information, as they see fit, to the accounting and other records of any group company from which that information has been extracted.

15. Where the Commission has agreed with a particular bank to accept prudential information in addition to, or instead of, the information contained in standard returns, such information will fall within the scope of the reporting requirements of this Guidance Note.

PART 3: THE REQUIRED REPORT

16. After consultation with each bank and *after its submission* of the relevant returns the Commission will specify in writing the particular return or range of returns that it wishes to have examined and reported on by bank auditors. A letter of instruction from the bank to its auditors should then be sent. A copy should also be sent to the Commission.

17. The Commission does not expect a qualified opinion to be given where an error in the information contained in the returns is immaterial; the level of materiality will vary from bank to bank and from one return to another. The Commission will continue to place reliance on each bank auditor's professional judgement as to what they consider to be a material error. For the sake of clarity, it is the Commission's opinion that any error affecting the RAR of a bank or errors affecting memorandum items such as, but not limited to, large exposures and connected party loans should be reported as a matter of course. The Commission will continue to allow each auditor to include less material discrepancies discovered as part of their review in their reporting to banks and to the Commission for the sake of completeness, should they wish to do so.

18. Bank auditors should give their opinion on the matters set out in paragraph 10 above. In the case of the requirement contained in paragraph 10(d) where the information in a return is prepared by a Bailiwick of Guernsey subsidiary institution using accounting policies **different from** those applied in its current statutory accounts, bank auditors should report the fact and circumstances and where practicable, provide a quantification of the effect of their application. The Commission recognises that there may be valid reasons for accounting policies to differ, but nevertheless in discharging its functions under the Law it wishes to be advised of any differences so that, where they are material, it can assess their effect. It will not consider a report to be "qualified" solely because it contains a statement of the application of different accounting policies.

19. The bank auditors' report should be addressed to the directors in the case of a Guernsey subsidiary and to the senior manager in the case of a branch of an overseas-incorporated institution. The Commission also requires the auditors to give an outline of the work they undertook in fulfilling the requirements of the scope of the report as illustrated by way of example in Appendix 1 to this guidance. The report should be completed, dated and submitted, with comments as the institution's management sees fit to make, to the Commission by the bank normally within two months but not, except in exceptional circumstances, more than three months, after the Commission's request for the return (or range of returns) to be examined.

20. If the bank auditors conclude, after discussing the matter with their client, that they will give an adverse opinion (as opposed to one qualified by exceptions) or that the issue of a report will be delayed they must immediately inform the Commission in writing giving their reasons. They should send the bank a copy of their letter. Similarly, if the bank is unable to submit a report to the Commission within the required period it should inform the Commission in writing of the reasons for the

delay.

21. It will be for the Commission to judge in the light of the contents of a report and other information about the institution which is available to it whether or not the requirements of the Law are satisfied.

EFFECTIVE DATE

22. This note is effective from 28 November 2008.

Guernsey Financial Services Commission

November 2008