Guernsey Financial Services Commission

Industry Presentations – 23 November 2012

Banking Division Presentation: Review of Large Exposure Policy

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Good afternoon everyone.

It doesn't seem a year since you were all sitting on those horribly uncomfortable chairs at the Commission's offices and I was telling you about our plans to rewrite and reissue guidance on large exposures.

To the outside world, including your good selves, there is little evidence to show that we have even been thinking about large exposures in the last twelve months, apart from dealing with live cases. However, whilst constraints on our resources mean that we don't have a consultation paper ready for you yet, we have been doing a lot of work on what the new regime might look like, bearing in mind both current and anticipated international standards. My role today is to give you a high level preview of what we will be consulting on with you in due course. Please bear in mind however that this isn't the finished product; there are still some areas that require further thought such as the treatment of certain types of transaction, or the specific arrangements for reporting large exposures.

Slide 1 – the current regime

First, let me recap on where our current large exposure regime now sits in relation to developments in the international environment. As you know, the large exposure regime is all about capturing concentration risk. Conventional wisdom, as dictated by the Capital Requirements Directive and the Basel Core Principles for Banking Supervision, states that no exposure to a client or connected group of clients should equate to more than 25% of capital. Short term interbank exposures have historically been exempt from this requirement. Our current environment reflects these exemptions and also permits exposures to clients to exceed the 25% limit.

Despite the relationship between concentration risk and bank distress in the financial crisis, the Basel Committee guidance on measuring and controlling large exposures dates back to 1991, and our own local regime has not been updated since 1994. However, there have been substantial changes to the EU large exposure regime.

These substantial changes have their origin in late 2007 and early 2008, when the Committee of European Banking Supervisors (CEBS), which has since become the European Banking

Authority, reported to the European Commission on the effectiveness of the large exposure provisions of the Capital Requirements Directive. The report concluded that market failures associated with systemic risk and moral hazard applied to interbank exposures regardless of maturity. Accordingly, the large exposure regime for EU member states was revised with effect from December 2010 to tighten large exposure limits, particularly in relation to interbank and intra-group lending, which the European Commission agreed was a major systemic risk in the wake of the financial crisis. Under the revised EU regime, short term loans to banks are no longer exempt and whilst limited national discretion is available to member states in relation to intra-group lending, loans to third party banks are now capped at 25% of capital, unless the lending bank is very small. In reality, by the time the changes to the EU regime came along, market practice has already changed to reflect this more cautious approach to interbank lending; i.e. bankers were already thinking this way.

It is worth noting that the CEBS conclusions were also reflected in the Vickers Report on banking reform. The HM Treasury white paper "*Banking Reform – delivering stability and supporting a stable economy*" published in June 2012 envisages the limiting of a ring-fenced bank's exposure to financial institutions in order to prevent systemic shocks.

Clearly Guernsey is not in the EU, but nevertheless we would not wish to be a complete outlier in respect of large exposures. In developing our proposals for a new large exposure regime we have had regard to a number of other regimes, including those operating in the UK and the other Crown Dependencies. However, we have also tried to balance the requirements of other regimes against the type of banking business we have here and the intra-group funding that many of our licensees provide.

Here then, in a nutshell, are the broad brush proposals that we will be exploring with you in a consultation paper.

Slide 2 – Proposed regime – headline points

All exemptions in our current regime, namely exposures to Zone A and B governments, and market loans of less than 12 months maturity will disappear. All types of exposure, whatever the maturity, will be in scope.

We are proposing to keep the 800% limit because it provides a useful flag in respect of concentration risk, but the limit relates purely to exposures to clients or groups of connected clients.

Lending to intra-group banks (i.e. upstreaming or sidestreaming) will continue to be agreed on a case by case basis. For all other types of exposure we will be setting common limits and I'll take you through these in a moment.

Finally, we are going to make some changes to the BSL/2 forms so that we can capture exposures that we don't currently collect specific detail on, such as CDs, FRNs, exposures to sovereigns, etc. Although large exposures are less of an issue for branches we plan to collect this information from branches too and we should also like to know whether any of your top ten exposures are a large exposure for your head office bank. From a supervisory

perspective, it would be helpful to know whether we have a significant concentration risk in a branch in Guernsey that may impact on a head office elsewhere.

So, let's now have a closer look at our high level thinking around a proposed new regime. We have grouped large exposures into four broad types, according to the counterparty type, so I'll take you through our thoughts around these now.

Slide 3 – Intra-group exposures

We are proposing that an upstreaming and/or sidestreaming limit will be agreed annually with each subsidiary bank, pretty much as it is at the moment, and that this limit would then be the ceiling for intra-group lending for the following twelve months. However, under the proposed new regime limits would be expressed as a % of capital rather than a % of assets. Measuring upstreaming or sidestreaming in this way aligns intra-group lending with the large exposure regime and better demonstrates the concentration risk to the bank.

We recognise that some banks are rich in funding but not necessarily rich in assets and limiting intra-group exposures to 25% of capital would not be realistic in the economic environment in which Guernsey banks operate. The limit would therefore be agreed on a case by case basis.

The agreed limit would be reviewed annually and as part of the review we would expect the local licensee to conduct a credit assessment of the counterparty and share that with the Commission. This is good corporate governance and many if not all credit committees will be doing this anyway. We trust therefore that this requirement won't be too arduous.

Slide 4 – Third party bank exposures

In respect of third party bank exposures, we are proposing that all exemptions will disappear such that the regime takes in market loans, regardless of maturity, plus holdings of debt securities. Again, many if not all banks are already adopting this prudent approach.

The maximum exposure to a third party bank would be capped at 100% of capital, but it would be on a sliding scale according to the lowest rating of the counterparty. Please don't worry if you are struggling to see the table on this slide – it will be replicated in the consultation paper and these slides will also be available on our website early next week- but in summary the proposals will set ceilings of 25%, 50%, 75% and 100% of capital according to that rating. We think that it is a rational approach to take in respect of third party bank exposures but we will be asking you in the consultation paper whether you think this works and, if you don't think it works, what alternative workable solution you would propose.

The only exception to the above 100% cap would be for very small banks where it may not be economically realistic to insist that no money market placement exceeds 100% of capital. Consideration is being given to a reserve power that would allow the Commission to deal with these cases on an ad hoc basis but, for the avoidance of doubt, no current licensees fall into this category.

Slide 5 – Sovereign exposures

For sovereigns the current exemptions regarding Zone A and B governments will disappear under the new regime, as will the concept of Zone A and Zone B governments themselves. Instead, we are proposing that we group sovereign exposures into High-Income OECD countries and other countries.

Exposure limits will be determined according to the counterparty's lowest rating and according to whether the sovereign relates to a High Income OECD country or a country outside this grouping. The minimum rating must be investment grade. Again, the table on this slide will be set out in the consultation paper and these slides will also appear on our website early next week.

The maximum possible exposure permitted under this sliding scale will be 1000% of capital. Again, we think that this a reasonable approach, but the consultation paper will ask you whether you think this works and if not, what alternative solution you would propose.

Slide 6 – Client exposures

When we look at client exposures across all of our licensees, there are some clusters of chunky exposures in the 75% to 100% of capital region that are secured by property or portfolios of assets, rather than cash. The Commission has tried to be an accommodating regulator during periods when commercial pressure was put on Guernsey banks to lend at this level. Assessing exposures on a case by case basis has permitted us to allow exposures to clients of more than 25% that are secured by non-cash collateral, subject to certain safeguards and confirmation that the parent group was aware of the exposure.

However, when we have regard to other regimes in operation, Guernsey really is an outlier in respect of exposures to clients of this size and with these particular types of collateral. This is the area therefore where there is the most potential for contrast between our current large exposure regime and our proposed regime.

Our current thinking is that exposures to individual clients or connected groups of clients should be capped at a maximum of 25% of capital unless the portion of the exposure above 25% is secured by cash, High Income OECD securities or both, or, the exposure is subject to a sub-participation agreement such that the residual exposure of the Guernsey bank does not exceed 25% of capital.

We do recognise that occasionally, a chunky loan may be booked in the Channel Islands to benefit the group as a whole, but that such an exposure may not be secured in the way that I have just mentioned. On those occasions, we would consider making an exception to the proposed 25% limit but we would clearly want to discuss the circumstances with the relevant bank on a case by case basis so that we understand the case for booking the exposure with the Guernsey bank. We shall also want to see documentary evidence of the parent group's commitment to the transaction, including arrangements for sharing the risk. This is, in essence, what we have been doing for the last twelve years.

That is our current thinking on exposures to clients. The consultation paper will ask you whether you think this is an appropriate standard, in which case I think that both you and we will sleep better at night, or whether the Commission should be willing to take a more pragmatic view.

Slide 7 – Next steps

So where do we go from here?

As I mentioned right at the beginning, there is still some way to go in refining these broad brush proposals, particularly around the treatment of certain types of exposure and the revised reporting requirements both for subsidiaries and branches. Our intention, because we don't want to disrupt your business, is to grandfather in any new large exposure regime. By that I mean that we will determine a date on which the proposed new regime will come into force, but that large exposures in existence before that date would be able to run their course in line with the arrangements currently in place. Clearly we need to think further about what the effective date might be and how we might treat for example, revolving credit facilities or requests for increases in existing exposures.

Subject to resource constraints, we hope that we will be able to get a consultation paper out to you in Q1 of 2013.

Thank you for your patience, both in listening this afternoon and in bearing with us around the issuing of the consultation paper.