

CONSULTATION ON
PARENTAL UPSTREAMING
AND THE INTRODUCTION OF
DEPOSITOR PROTECTION AND
OMBUDSMAN SCHEMES

A CONSULTATION PAPER ISSUED
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1. INTRODUCTION AND SUMMARY OF PROPOSALS

Background

- 1.1. Since the second half of 2007, the Guernsey Financial Services Commission (“the Commission”), like regulators all over the world, has been dealing with the consequences of the credit crunch for the banking industry.
- 1.2. As a funding centre, many Guernsey subsidiaries lend a substantial portion of their balance sheet to their overseas parent. Most significantly for this consultation, the credit crunch, and in particular the case of Northern Rock Guernsey, has exposed the possibility of potential losses to depositors and banks in Guernsey due to parental upstreaming if difficulties are faced by their overseas parent companies.
- 1.3. Whilst the UK and other countries have the ability to call on the government or a central bank to provide support for a failing bank, as seen most recently in the case of Northern Rock plc, there is very little likelihood of States of Guernsey support for a failing bank due to the relative sizes of Guernsey banks compared to States resources. In addition, Guernsey cannot rely on support from overseas governments of parent banks, particularly when the nationality of the deposit base of the Guernsey banks is becoming increasingly globalised.
- 1.4. The Commission is aware of the major consultations currently being undertaken in the United Kingdom and other jurisdictions, including in respect of possible changes to bank insolvency laws, which have been initiated in response both to political pressures to reduce risks and to international regulatory expectations to respond to the current crisis. The Commission will continue to monitor these developments but at the present time it is not putting forward proposals to change local regulations other than as set out in this paper.

Executive Summary

- 1.5. In order to provide greater protection for retail depositors it is proposed to:
 - reduce parental upstreaming to a maximum of 85% of total assets. The Commission may impose additional requirements based on the level of perceived risk associated with the parent banks;
 - discourage the use of branch structures for new licensed banks, unless they are perceived to be systemically important at least in their home jurisdiction or are highly specialised in nature;
 - introduce a Depositor Protection Scheme (“DPS”). This would be limited to a maximum of £35,000 per individual depositor and to retail depositors only (as set out in section 3). It would seek to provide depositors with quick access to

funds and also to provide protection (similar to that provided in other jurisdictions) in the event of an ultimate loss;

- strengthen the banking sector by requiring greater transparency through disclosure by individual banks to their depositors of:
 - the existence (or otherwise) in the jurisdiction of a DPS;
 - the existence or possibility of parental upstreaming; and
 - the status and nature of support extended by the parent to the local bank;
- require banks to monitor the liquidity and solvency of the parent entity;
- require banks to have in place a contingency plan to withdraw some or all parental funding without destabilizing the parent;
- require stronger corporate governance through the requirement for at least one independent non-group non-executive director; and
- introduce an Ombudsman Scheme. Whilst this will require further consultation with other regulated financial services industries, the Commission believes that the introduction of such a scheme will afford further safeguards to depositors and customers generally.

2. LIMITS ON UPSTREAMING BY SUBSIDIARIES

Background

2.1. Guernsey is used by many banks as a source of liquidity. Banks take deposits here and then upstream (lend) to their parent. The reasons for this are as follows:

- Some banks have been specifically established in Guernsey to help fund the group with either retail or wholesale deposits or both
- There are limited lending opportunities in a small economy like Guernsey relative to the size of the banking sector
- Much of the international private client customer base is not seeking to borrow money
- Many banks do not have the capability on island to make credit decisions
- Most banks do not have a significant treasury function in Guernsey, preferring to lend funds on to the group's central treasury function.

2.2. Many banks lend a substantial proportion of their assets to their parent: 13 of the 24 banking subsidiaries in Guernsey place more than 50% of their assets intra-group and principally with the parent. In some cases subsidiaries lend almost all of their funds to the parent or hold bonds issued by the parent.

- 2.3. A subsidiary can be said to have a privileged position with its parent. The Board of the subsidiary has access to information about the parent that is unavailable to the general public. The parent has in all cases been required by the Commission to give a letter of comfort to the subsidiary. In normal circumstances, the parent will want to support the subsidiary for reasons of reputation and credibility. The fact that the parent stands behind the subsidiary is a considerable source of strength for the subsidiary since the parent will also be a bank with a credit rating. Hence in normal circumstances the single counterparty credit risk is low.
- 2.4. Nevertheless, the recent events have demonstrated that management of risk must include the consideration of extreme and unusual circumstances. Upstreaming funds to the parent poses a particular challenge to Guernsey banks. It may be that the subsidiary bank is in excellent health but if its parent defaults, it would be unable to repay the funds received from the subsidiary, putting the subsidiary in jeopardy. Generally banks in Guernsey hold well in excess of their minimum regulatory capital, but where there is a high level of funding of the parent Guernsey depositors potentially stand to lose a large percentage of their money in the event of the failure of the parent. The need for insolvency proceedings to take their course could mean it would take a long time before repayments of deposits could be made. In this event the reputation of the Bailiwick is likely to be severely damaged.
- 2.5. Current policies adopted by the Commission in respect of large exposures do not place specific restrictions on lending to a parent bank nor is there any limit on a subsidiary holding bonds issued by its parent. The Commission has historically taken the view that within the group of banks permitted to operate in Guernsey banking failure was extremely unlikely. Recent events have shown that the risks of failure have increased, causing the international regulatory community including the Commission to reconsider the regulatory requirements.
- 2.6. The Commission has reviewed international practice on cross-jurisdictional upstreaming in key jurisdictions across the world. In general, the practice is to limit such activity to a very significant extent. The reason for this is that different countries have different laws on insolvency and depositor protection and there is an absence of a global unified supervisory process. In addition, the business drivers for such cross jurisdictional activity, whilst considerable, are in most jurisdictions mitigated by the ability to undertake business on both sides of the balance sheet, for example, in a large economy where plenty of lending opportunities exist. In Guernsey, however, the banking sector is much larger in relation to the wider economy than in a large economy jurisdiction. Therefore, whilst banks do lend locally and are active in serving clients both in Guernsey and elsewhere, not least those in the local fund industry, there are, in general, not enough lending opportunities available to enable the banks to deploy their funds viably. The Commission has therefore recognised that permitting upstreaming of locally deposited funds is appropriate in the context of the economic and commercial circumstances.
- 2.7. The alternative to permitting such upstreaming would be to require banks in Guernsey to develop substantial credit books and bond portfolios. There would

be significant risks and costs associated with this approach both in the extent to which local subsidiaries would be obliged to assess and limit credit exposure, and in the need to recruit and retain in Guernsey experts with credit and trading expertise. On balance, and taking into account the economic implications of severely limiting upstreaming, the Commission is of the view that the practice should be allowed to continue subject to the introduction of certain additional risk mitigation measures. The Commission therefore considers that the best way to protect depositors is to allow parental funding, with a cap, while putting in place additional mitigation measures.

- 2.8. The positions of a branch and a subsidiary are significantly different. A branch generally stands or falls by the health of the bank in its entirety. There is very little likelihood of the head office walking away from a branch as it is legally the same entity, but equally there is no ability to protect local depositors if the bank as a whole is in trouble. By contrast, a subsidiary has its own board and capital of its own, and the potential to be ring-fenced so that the failure of its parent need not affect the ability of the Guernsey bank's depositors to be repaid. This means that a regulator may be able to arrange more protection for the depositors of a subsidiary than a branch.
- 2.9. Depositors in a branch of a bank which is systemically important in its home jurisdiction may be able to take comfort from the possibility that the bank will not be allowed to fail by its home government. While this may be a political judgment and not a precise science it is based on the economic reality that the bank is one of a handful of banks and there would be severe disruption to the functioning of the economy if it was allowed to fail.
- 2.10. Banks which the Commission considers to be systemically important may be permitted to establish a branch in Guernsey. Where a bank is not considered to be systemically important it will only be permitted to apply to establish a subsidiary. Exceptionally the Commission may consider permitting banks of a highly specialised nature (e.g. specialising in corporate business or trade finance) to set up a branch in Guernsey.

Proposals

- 2.11. The additional risk mitigation measures proposed by the Commission in respect of subsidiary operations are as follows:
 - An absolute cap on the amount of parental upstreaming that can be undertaken of 85% of the total assets of the bank. The figure of 85% has been identified as being appropriate in the context of local practice because it will create a block of assets which would be unaffected by the failure of the parent without impacting adversely on the business models currently employed by the banking industry in Guernsey. This would be a 'hard' cap i.e. banks would not be allowed to go above it. The cap would apply on a daily basis.

- Whilst the 85% limit would apply to all banks, the Commission would have the ability to set more restrictive requirements where it considered such action to be necessary to protect local depositors, in the light of an assessment of all relevant risks. This is an approach already adopted by the Commission.
- It is proposed that, in order to ensure diversification on the asset side, the assets not placed with the group must be invested in liquid, high quality assets (including bonds), other high-grade loans and/or inter-bank lending. Banks may be allowed by the Commission to outsource the administration of these asset portfolios on an agency basis to the parent bank with oversight being provided by local management. Investment in similar assets to those held by the parent would only be permitted where it would be possible to avoid replicating parental vulnerability at a local level.
- The Commission would permit the establishment of new bank branches in Guernsey only where they are branches of systemically important banks or exceptionally banks of a highly specialised nature.

2.12. The Commission has considered the possibility of imposing additional capital requirements for parental lending where upstreaming occurs above a given threshold. This approach is not being proposed because any loss that would be suffered in the event of a parental failure is likely to be much greater than any plausible increase in capital requirements. The Commission believes that capping the level of upstreaming provides more protection than requiring additional capital at the local level.

3. DEPOSITOR PROTECTION SCHEME (DPS)

Background

3.1. There are three broad categories of banks operating in Guernsey – clearing banks, deposit takers and other banks. The clearing banks support the local population and local businesses in their everyday transactions. The deposit takers include the subsidiaries of building societies and former building societies whose target market covers both Guernsey resident savers and investors and expatriate workers around the world, along with UK depositors seeking to receive their interest gross without deduction of tax. However, there is some overlap and there are deposit taking business lines among the clearers. The other banks include international private banks and corporate banks. This segment includes the Swiss private banks which receive large volumes of Swiss fiduciary deposits on an inter bank basis in the form of wholesale deposits. In respect of the clearing banks the risk of failure is considered as a whole to be low since they are regarded as systemically important banks in the UK. The deposit takers are considered to be more vulnerable. They engage in high levels of upstreaming and there are high asset concentrations by their parent banks particularly in the UK mortgage market. By contrast, the parents of the private

banks have more diversified balance sheets although some perform specialist roles.

3.2. The following table illustrates the scale and distribution of deposits in Guernsey.

Analysis of Banking Sector (£millions) as at 31 March 2008

Type of Bank	No of Banks	Deposits	Percentage of total	Guernsey Households & Individual Trusts	Guernsey Households & Individual Trusts as a percent of segment deposits
Clearing Banks	7	13,902	10.9%	1,578	11.3%
Deposit Takers	7	3,948	3.1%	695	17.6%
Other Banks	<u>33</u>	<u>109,597</u>	<u>86.0%</u>	2,829	2.6%
Totals	<u>47</u>	<u>127,447</u>	<u>100.0%</u>	5,102	4.0%

3.3. We know from the licensed banks statistical returns to the Commission that the bulk of deposits in Guernsey banks are wholesale deposits with the “other banks” sub-sector accounting for some 86% of total deposits. Clearing banks and deposit takers together account for 14% of total deposits. Local deposits or deposits from retail customers are not directly reported by banks although deposits reported as from households and individual trusts represent the best available indicator of retail deposits. Local deposits from Guernsey households and individual trusts form only a small part (2.6%) of the deposit base of the “other banks” reflecting their international private banking business whereas Guernsey households and individual trusts form much more significant proportions of the deposit takers deposit base (17.6%) and of the deposit base of the clearing banks (11.3%). Among the deposit taker segment, if those banks which have systemically important bank parentage are excluded, the proportion of Guernsey households and individual trust deposits rises to nearly a fifth of their deposit base.

3.4. The Commission and the industry last considered a DPS in 2002 in tandem with Jersey as part of the follow on from the Edwards Report. This did not attract support from the industry or the political authorities. In the wake of the Northern Rock crisis, the Commission has taken the view that having a DPS in Guernsey would bring considerable benefits. Depending on the terms of the DPS (as outlined below), depositors would be given a degree of protection from loss as well as immediate access to some funds if a bank failed.

3.5. More generally, a DPS would support the development and maintenance of the banking industry in Guernsey by increasing depositor confidence. Recent press comment suggests that, so long as Guernsey does not have a DPS, depositors

may be steered away from banks here even if local interest rates are attractive. A DPS would “remove a negative” and reinforce the status of the Bailiwick as a mature, high-quality financial centre.

- 3.6. Most developed countries have a DPS. In the European Community it is a requirement. In the Crown Dependencies, the Isle of Man has a DPS. Jersey does not have a DPS but it is possible that pressure for Jersey to introduce one will increase in the event that Guernsey introduces a DPS.
- 3.7. In Guernsey, local deposits make up a significant proportion of depositors’ funds in the deposit taker sector which performs the traditional function of mobilising long-term savings. The deposit taker sector, as in the UK, provides competition to the clearers and therefore adds value. A DPS would protect this sector by safeguarding local depositors.

Proposals

- 3.8. The Commission has reviewed DPSs in other countries and engaged in informal consultation with the local banking community, in addition to taking into account those consumer views expressed to it. Having considered all the comments received the Commission proposes the following as key features of a Guernsey DPS:
 - In order to protect the most vulnerable type of depositor and in order to limit the drain on local banking resources that the failure of a bank might entail, the scheme would cover only individual retail depositors. It would not cover corporate depositors or deposits by trusts.
 - In order to be fair to all retail depositors and to safeguard Guernsey’s position as an international finance centre, the scheme would cover all retail depositors wherever resident.
 - Retail depositors with deposits at both Guernsey incorporated subsidiary banks and with the Guernsey branches of banks incorporated overseas would be covered.
 - As the scheme is for the benefit of Guernsey depositors, deposits with branches of Guernsey banks outside the Bailiwick would not be covered (although at present there are very few such branches).
 - The scheme would guarantee deposits up to a maximum amount of £35,000. This is the same as the current level of protection in the UK – the most natural comparator for Guernsey. There is no assumption that Guernsey would follow any changes to the level of coverage in the UK, for example if the UK were to adopt protection up to £50,000 which is currently under consultation in the UK.

- To reflect the international nature of Guernsey and the increasingly globalised nature of people's financial arrangements, the scheme would cover the equivalent of £35,000 in all currencies.
- To deliver protection to individuals holding joint accounts, the £35,000 limit would apply per person (i.e. a £70,000 account held by two people would be covered 100%).
- In order to prevent one depositor from unfairly having multiple coverage through several accounts, the compensation limit would apply to each depositor rather than to each account.
- Loans made to a depositor covered by the DPS would be netted against deposits made with the same bank.
- In the event of a bank failure, the depositors' rights would be assigned to the DPS if they claimed compensation- the concept of subrogation. The DPS would then pay out to each depositor up to £35,000. Whatever funds are eventually recovered from the failed bank would be paid to the DPS to form part of the pool of funding available to finance the compensation payments made. In the event that there was any surplus due to the depositor for amounts in excess of £35,000 that would be paid out to each depositor. If there was a shortfall the DPS would suffer all the loss up to £35,000 per depositor. Any loss over this amount would be borne by the depositor.
- Although the right of subrogation will be effective under Guernsey law, we have been advised that there may be cases where that right might not be recognised in a foreign liquidation of either a Guernsey bank or a foreign bank. Although in many cases this difficulty can be overcome by requiring an effective express assignment of rights in favour of the Scheme before the payment of any compensation, there may still be a residual risk that the Scheme might pay compensation and be unable to participate in the liquidation of the failed bank. We have been advised that in practice there should not be any such difficulties in the case of a Guernsey branch or subsidiary of a UK bank.

The Funding Mechanics of a DPS

- 3.9. The following section outlines the proposed mechanics for funding the DPS.
- 3.10. The most common method by which a DPS is funded is for the banks to provide finance to the DPS after a bank fails. This is known as '*post-funding*' and would work as follows.
- 3.11. In the event of a bank failure, the DPS would assess how much it needed to pay out to depositors. Payments would be made to eligible depositors as soon as possible by drawing on lines of credit established with a number of banks. The Commission has not yet sought to agree these bank lines as to do so would be premature. The DPS would, however be legally entitled to recover losses in due

course from the banks, and therefore it should be feasible to arrange such credit lines.

- 3.12. In due course, the total amount paid to depositors by the DPS would become clear. It is this amount which the banks taking part in the scheme would be legally obliged to pay.
- 3.13. In order to protect against the possibility that a particular bank would have to provide a sum so large that its business would be adversely affected, maximum yearly payments to the post-funded scheme would be set. The size of this cap will be worked out with the banks later as the details of the DPS are finalised.
- 3.14. It is proposed that the banks which have the most to gain in terms of customer protection would provide greater funding to the DPS. However, given the overall benefit to the jurisdiction and the industry from the establishment of a scheme, all banks would be required to provide some of the funding for the scheme. The Commission's initial proposals in this respect envisage that the funding requirement for each participating bank would be calculated by splitting the funding requirement into two parts. There would be a basic fixed levy component which all banks would pay and there would be a variable levy chargeable to those banks with retail deposits. The overall funding requirement would be calculated as two elements – 10 per cent would be funded by the basic levy (i.e. divided equally by the number of licensed banks) and 90 per cent would be funded by those banks with retail deposits i.e. divided pro rata according to the proportion each bank has of the total of retail deposits. In that way the total contribution will be predominantly driven by the size of a bank's retail deposit base relative to Guernsey's retail deposit base. Hence those banks with larger proportions of the total retail deposit base would pay more than banks with small proportions of the retail deposit base.
- 3.15. The above approach envisages that banks would pay the DPS after the failure of a bank. However, another option would be to '*pre-fund*' the DPS. That is to say that the DPS would raise or be lent funds of its own before a bank failure has occurred. These would be immediately available in the event of a bank failure. This is not an approach which is commercially attractive to the local banking industry which would prefer to fund the losses if and when they occur. This is a view taken by banks across the world and for this reason few schemes are pre-funded. The Commission's view is that pre-funding is not necessary as the local banking industry is strong enough to support a DPS on a post-funded basis.
- 3.16. The possibility of establishing a local captive insurance company to provide part or all of the support for a DPS has been suggested. The Commission is willing to consider such an arrangement further if banks in Guernsey wish to do so.

The Estimated Cost of a DPS

- 3.17. This section estimates the potential cost of a DPS. It should be emphasised that the following is only a very preliminary estimate designed to give some sense of the scale of a possible funding requirement.

- 3.18. The Commission does not presently have data on the amount of retail deposits held by each bank i.e. those deposits which would be covered by the DPS. Prudential returns made by the banks to the Commission do not distinguish between retail deposits and deposits from trusts. It was considered inappropriate to require banks to bear the administrative costs of providing such information on a one-off basis prior to this consultation taking place. Once such data is available, the estimate of the overall cost of the DPS may be different as may the distribution of payments by the banks. On the assumption that a DPS is agreed in principle, the Commission will work with banks to define and assess the amount of the retail deposit base, excluding trusts. For the purpose of this consultation exercise the total deposit figure in the worked example has been divided by assuming that 85% will be retail deposits and 15% will be trust and non-eligible deposits. This is more prudent than the figures we have obtained from the industry on a sample basis but a degree of in-built conservatism is thought to be appropriate for the purposes of this exercise.
- 3.19. The Commission has considered basing the levy on the degree of risk posed by each bank. However, this would be potentially contentious and difficult to administer. A levy based on deposits is easier to apply.
- 3.20. As part of the process of consultation, banks will be asked whether they wish a low annual cap to be established on their payments. If so, it is possible that the DPS funding requirement would have to be met over a number of years and the aggregate cost for the DPS will increase by virtue of the interest that would be required to be paid by the DPS on the outstanding balance of loans arranged to fund initial payments to depositors. To avoid this, the Commission has assumed that banks will want to fund the total amount required soon as possible.
- 3.21. In order to make a broad estimate of the potential cost of a DPS the Commission has used a scenario based on an extreme, but plausible, event. The Commission has assumed the failure of a non-clearing bank that specialises in taking retail deposits. To take a prudent view, it has been assumed that the bank is bigger than any such bank currently in the Bailiwick. In addition, a loss of 30% of assets deposited with the parent has been assumed.
- 3.22. At present deposit takers in Guernsey have balance sheets that are relatively small. The above scenario, which assumes a bigger balance sheet than any of these banks currently have, is therefore conservative. However, it is possible to envisage that a large deposit taker of this kind might emerge either through the growth or amalgamation of those banks already on the island or as a consequence of a new bank entering the market. Were such a bank to fail, then the cost to the DPS could be higher than envisaged here. The Commission has powers to mitigate this risk by not allowing such a situation to develop, by placing restrictions on the operations of a bank and by reducing the amount of parental funding it can undertake. The Commission would not hesitate to adopt whatever means are necessary to protect the DPS.
- 3.23. The average balance in the deposit taker sector on the island is well over £100,000. This reflects the fact that Guernsey acts as deposit centre for high

value savings and that these banks tend not to be used for everyday purposes where the outstanding balance would be a very few hundred or a few thousand pounds. This means that, in the event of a bank failure, the DPS would be exposed to a smaller number of claimants than would be the case if a greater number of people had deposits of £35,000 or more.

- 3.24. In addition to the requirement to fund the repayment of deposits by the DPS there is also the cost of raising and administering the funding to consider. The DPS would have to borrow in order to make payments to depositors and it is unlikely that the interest costs would be able to be recovered by the DPS. In our scenario it is assumed that none of this cost will be recovered and that a market interest rate will be payable for two years on the balance of the outstanding sum owed to banks.
- 3.25. The scenario itself is set out in detail in the Appendix. Using this scenario, and based on the assumptions set out above, the funding levy to be raised by the DPS would be approximately £112mn. In order to give context to this number, as a percentage of total profit made by the banking sector as a whole last year this would amount to around 16 percent and to around 19 percent as a percentage of average profits over the last four years.

The Establishment and Running of a DPS

- 3.26. Across the world, there are some DPSs that are large and complex to run on an everyday basis. This would not be the case in Guernsey as the Guernsey DPS would not be pre-funded. This means that, with the exception of a small annual charge to cover running costs, the DPS would not levy the banking industry other than in the case when a bank fails. So the DPS would not have to administer a substantial and potentially volatile annual charging process for the banks. The absence of pre-funding also means that the Guernsey DPS would have no funds of its own – other than those necessary for administrative purposes. This means that the Guernsey DPS would not need to execute an investment strategy for such funds.
- 3.27. The DPS would need to be established by law and be run as a separate legal entity. This will require an Ordinance under The Banking Supervision (Bailiwick of Guernsey) Law, 1994 as amended (“the Banking Law”). The Ordinance will set out such key issues as the constitution, governance, coverage and funding requirements. The Ordinance could be prepared by the Commission for consideration by the Law Officers. To ensure the criteria are suited to the local industry it would be beneficial for the Commission to be supported by a committee of the Association of Guernsey Banks.
- 3.28. The Commission proposes that the DPS Board comprise 5 members. One member each could be provided ex officio by a Government Department and by the Commission. The three other members – including the Chair – could be appointed by the appropriate Minister for say a single period of 5 years each. These members could be drawn from the local banking community.

- 3.29. Once the Ordinance is enacted, the Board of the DPS would need to put forward an implementation plan.
- 3.30. The main operational challenge for the DPS would be to ensure that, were a bank to fail, it would have the ability to meet its obligations to pay-out quickly to depositors. The UK DPS works to a payout period of 7 days. In Guernsey many accounts are postal in nature, the usage of internet accounts for savings deposits is more limited as many depositors reside in locations far from the Bailiwick. For this reason the payout period is likely to be longer i.e. around one month.
- 3.31. The DPS would need to put in place processes to facilitate swift payments. This will require for example the ability to sub-contract to an IT company to collate payment requirements, to a call centre provider to answer depositor enquiries, and to one or more banks to make payments. The DPS would also have to have in place the ability to call upon banks for funding lines at short notice. There will also need to be business continuity and disaster planning. These processes should be tested from time-to-time e.g. once every three years or so.
- 3.32. The DPS would also be obliged to ensure that the public are made aware of the DPS and that banks promote the DPS in their marketing literature appropriately. The DPS would be required to produce an annual report and would be subject to an annual external audit.
- 3.33. The DPS would require a part-time Secretary to facilitate the above, as well as to provide support to the Board. For these reasons the DPS would incur running costs. A rough estimate of annual running costs (which would be split equally between all licensed institutions) might be as follows:

Independent Board members - £3,000 x 3	£9,000
Part-time Secretary	£10,000
Occasional use of an office plus incidental office costs	£10,000
External Audit	£5,000
Contingency Plan maintenance and testing - £30,000/every three years	£10,000
Total	£44,000

- 3.34. In addition, there would be first-year set up costs. These would be:

Initial Testing of Contingency Plan	£30,000
Reserve – i.e. 6 months cost	£22,000
Other costs – as above	£34,000
Total	£86,000

- 3.35. This means that in the first year the DPS would cost £86,000 and £44,000 each year thereafter. This sum would be paid for by the banks on the same basis as the levy.

- 3.36. In the event that a call on the DPS was made, DPS costs would rise. These costs would vary with the nature of the case. However, in the event of the DPS becoming operational, the scale of costs would increase substantially e.g. to £1mn or more.
- 3.37. Accountability for the DPS could lie with either a Government Department or with the Commission. For consideration is the fact that on the one hand the DPS would be established through the States, while on the other hand accountability to a Government Department may be incorrectly perceived to imply States backing for DPS solvency. An alternative to a Government Department would be to make the Commission accountable. Both models are used in other jurisdictions.
- 3.38. The establishment of the DPS would follow the stages set out below:
- *Stage One.* Once the principle is agreed by the States of Guernsey, the DPS would need to be formally established by an Ordinance. Drafting instructions would be provided to the Law Officers Chambers by the Commission.
 - *Stage Two.* With the Ordinance in place, the accountable body will appoint the Board. The first year costs will be paid by the banks.
 - *Stage Three.* The DPS would set out its implementation plan and execute to the point where the Board considers that the DPS is operational. The time period for this would be driven by the Board.
 - *Stage Four.* The DPS goes live.

Detailed Work Required

In the event that the recommendation of the Commission to establish a DPS is accepted, then further, more detailed work will be justified. In particular, the Commission would need to undertake the following:

- Drafting of the Ordinance for the running of the DPS scheme for consideration by the Law Officers
- Assessment of retail deposits for each bank so as to determine the potential cost per bank
- Identification of funding lines from Guernsey banks for the initial funding
- Calculation of the annual payment cap per bank
- Consideration of an insurance company option if proposed by the industry

4. TRANSPARENCY, CORPORATE GOVERNANCE AND OTHER NON-QUANTITATIVE MEASURES

Transparency

- 4.1. To provide clarity to depositors, banks should make clear disclosure in their publications and communications whether or not the parent has committed to providing support to the subsidiary and whether or not there is a Depositor Protection and Ombudsman Scheme in place.
- 4.2. All Guernsey subsidiary banks have letters of comfort in place which represent an expression of the intention of the parent to support the subsidiary. These letters of comfort can take several forms (ranging from general statements about “support” to references to guarantees). However no subsidiary has a parental guarantee in the sense of a legally enforceable document and these letters do not necessarily ensure that the parent bank will support the subsidiary in times of severe crisis. Letters of comfort are statements of intent which are not legally binding. Nevertheless they have value in concentrating minds at the parent particularly where the parent’s name is used in that of the subsidiary. Despite this, there are reputational and legal reasons for making it clear that the subsidiary will not necessarily be protected by the parent during crises.
- 4.3. The Commission will require that banks should be transparent about the level of support provided by its parent. Depositors should know at the outset whether or not this is in the form of a letter of support which the local bank can draw on in the event of a problem at local level.
- 4.4. New product information and promotional material should contain a statement of the nature of support given as follows:
 - XYZ Parent Bank Limited has given an undertaking agreeing to discharge the liabilities of XYZ Guernsey Bank Limited, in so far as XYZ Guernsey Bank Limited is unable to discharge them out of its own assets while XYZ Guernsey Bank Limited remains a subsidiary of XYZ Parent Bank Limited.
- 4.5. In addition to the requirements surrounding parental support, the Commission believes that at the outset of a banking relationship, depositors should be made aware that they may be at risk in the event of parental impairment as a result of upstreaming. As such it proposes to introduce a requirement for all customer acceptance forms to provide such disclosure. In addition further disclosure of this fact should be included in all account statements sent to existing depositors and placed in the subsidiary bank’s financial statements and on its website. The disclosure statement would need to notify depositors, potential depositors and other stakeholders that the bank has lent funds to its parent or might from time to time lend funds to its parent and that as a result the assets of the subsidiary might be at risk in the event that the financial position of the parent was threatened.

Monitoring of the parent

- 4.6. In cases where the subsidiary lends substantial sums to the parent, or where the parent has committed to provide financial support to the subsidiary, then the Commission proposes that local banks be formally required to monitor activity on the liquidity and capital position of the parent. It should therefore be part of a Board's remit to assess the risks in all its chosen asset allocations and thereby validate the decision to lend funds to the parent or group.
- 4.7. The Commission proposes that this requirement would be applied to all subsidiary banks and that it would monitor compliance with that requirement. However the intention would be to make use of existing group management information and not put an administrative burden on licensees by devising and requiring new statistical measures.

Contingency planning

- 4.8. As part of a Guernsey Bank Board's responsibility to assess and react to risk the Board needs to be ready to act if it becomes aware that upstreaming has become significantly more risky. Banks should have the capability to place funds outside the group if the position of the parent deteriorates. Boards will need to decide whether it is in their best interests to buy bonds or deposit large sums at short notice with other banks. The bank will need the capability to execute such actions without raising any concerns in the market about the parent. A contingency plan should have the flexibility to give subsidiaries the option of placing funds at short notice other than with the parent by creating a portfolio of liquid investments or opening credit lines with other banks. It would be prudent periodically to test these lines to ensure that they could be activated when required.
- 4.9. The contingency plan should be constructed in such a way that the parent would not be de-stabilised by these actions. The contingency plan would, therefore, have to be agreed with the parent and the home regulator would need to be aware of it.
- 4.10. The Commission has taken legal advice as to whether the return of funds from the parent could be challenged in the event that the parent failed. It considers that so long as there is clear evidence that any repayment occurred as a result of genuine commercial pressure from the subsidiary which the parent felt obliged to respond to, then any challenge would be unlikely to succeed. This is also likely to be the case where the subsidiary is acting under a formal instruction from the Commission as a genuine expression of regulatory action. If the local Board is unwilling to withdraw funding, then the Commission will impose a licence condition to require it to do so, where the Commission considers that this is necessary in order to protect depositors.

Corporate Governance

4.11. In order to make the governance arrangements of local banks more effective in times of crisis the Commission has considered the composition of Boards of directors of local subsidiaries. In particular the Commission is concerned that group appointed non-executive directors may have a conflict of interest and at times of crisis may act in the best interests of the parent bank and not in the separate interest of the Guernsey subsidiary. At present, the Commission requires that the Board include at least one non-executive director, although non executive directors can be drawn from the senior staff of the group. Many banks do, however, already include one or more local non-executives who are not otherwise employed by the group. The Commission proposes to make this mandatory.

5. OMBUDSMAN SCHEME

Background

- 5.1. This consultation paper revisits the introduction of an Ombudsman Scheme. The introduction of any scheme would involve all types of regulated financial services business within the Bailiwick and not just the banking sector but the Commission believes that it should obtain the views of the banking industry on this subject as part of this current consultation exercise.
- 5.2. In 2002 the States of Guernsey Advisory and Finance Committee (“the Committee”) issued a consultation document, which set out proposals for a financial services ombudsman scheme (“the Scheme”) for the Bailiwick of Guernsey. The Commission considers a formal complaints handling service is an essential element of consumer protection and that the absence of a formal dispute resolution scheme reduces Guernsey’s credibility as an international finance centre. To be effective a complaint handling system needs to have the power and the ability to resolve complaints which the Commission does not. To date the Commission has devoted resources to dealing with complaints which it has received in the absence of a specific body to handle complaints. The Commission believes it is not appropriate that those responsible for supervision should also be undertaking the role of an Ombudsman. The existence of an ombudsman scheme would allow the regulatory Divisions of the Commission to concentrate on their core roles, remove the grey area of their involvement with complaints and remove the basis for criticism of the Bailiwick’s system of dealing with complaints against local financial services firms.
- 5.3. A number of issues were raised in response to the previous consultation document. There was concern at the potential cost of the scheme to the finance sector. There was also concern that the scheme’s complaints handling process might be unfairly weighted towards the complainant and that a financial

institution should have a right of appeal if the Ombudsman ruled in favour of the complainant. The following paragraph addresses these concerns.

- 5.4. In order to contain costs the Commission is prepared to administer the scheme subject to those administering the scheme being entirely separate from the regulatory Divisions of the Commission. It is proposed that the Ombudsman should report directly to the Commissioners; there would not be a separate Board. The scheme should not deal with complaints made before the introduction of the scheme. There should be a three stage complaints handling process: conciliation, the issue of a provisional decision and the issue of a binding formal decision if the complaint remained unresolved. In the previous consultation it was proposed the formal decision would be binding on the institution but not the complainant unless he or she agreed to be bound by it. That choice gave rise to the concern about bias towards the complainant. It is now proposed formal decisions should be automatically binding on both the institution and the complainant. The Ombudsman should have the ability to refuse to deal with frivolous or vexatious complaints but a complaint fee would not be charged so as not to deter access to the service.

Current Proposals

- 5.5. As part of this consultation paper making proposals for greater protection for retail depositors the Commission is inviting comments on the following proposals for the establishment of a cost effective Ombudsman Scheme:

- the Scheme should cover all business activities regulated by the Commission.
- the establishment, functions and basic operation of the Scheme should be defined by law. In addition, the law establishing the Scheme would also amend the proposed Data Protection (Bailiwick of Guernsey) Law, 2001, so that the Ombudsman would be exempt from the need to provide any person with information to the extent that the provision of information is likely to prejudice the Ombudsman's consideration of a complaint.
- the Scheme should be administered by an operationally independent department of the Commission - headed by the Ombudsman.
- the Ombudsman should be accountable to the Commission's Commissioners (assuming that the Ombudsman is administered by a separate department of the Commission).
- the Ombudsman should be able to make rules governing all aspects of the complaints process.
- the Scheme should offer a three-stage process for dealing with what appears to be a valid complaint, namely:-
 - conciliation;
 - if conciliation does not resolve the complaint, the issue of a provisional decision;

- if a provisional decision does not resolve the complaint, the issue of a formal binding decision. At this stage, as the decision will be binding, in order to satisfy the European Convention on Human Rights, independent arbitrators should be appointed to consider the complaint and issue the formal decision.
- the maximum compensation award which should be awarded to a complainant proposed in the previous consultation document was £100,000, and the Commission sees no reason to change that figure.
- the Ombudsman and his staff should be capable of suing and being sued. They should not be personally liable in respect of anything done or omitted to be done unless they have acted in bad faith.
- the Ombudsman should be able to handle complaints from:-
 - a private individual; or
 - a charity which has an annual income of less than £1 million at the time the complainant raises the complaint with the institution.

The Commission considers these to be the most vulnerable persons and that the Scheme should therefore include them within its scope.

Next Steps

- 5.6. The Commission is presenting these proposals to the banking industry to seek their views. If they wish to proceed the Commission will have to consult with the other regulated sectors and undertake a more detailed study of the costing of such a scheme and of the best way of recovering the cost of administering the scheme.

6. CONSULTATION

Comments in writing on the proposals in this consultation document are invited by the close of business on [15 September 2008].

Responses should be sent or e-mailed to:

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Appendix - Scenario – Failure of a medium-sized deposit taker

The assumptions used in this scenario are set out below and changes in these assumptions could affect the ultimate funding required for a DPS scheme in Guernsey. The scenario reflects many of the deposit characteristics of the current banking industry.

The scenario used is regarded as prudent in that the level of retail deposits assumed is higher than that currently seen in all deposit takers and other banks in Guernsey although clearing banks would have higher levels of retail deposits. The worked example commences with illustrative ‘round numbers’ but because of the assumptions and in order to allow validation it is not possible to maintain such figures as the example progresses.

The following assumptions are made:

- The bank primarily collects retail deposits.
- It has total deposits of £1.8bn.
- It has 20,000 customers. 10,000 of those customers have a balance of £30,000 and 10,000 a balance of £150,000.
- The bank has other creditors of £100m and capital of £50m
- Total assets are £1.95bn, 85% is up-streamed to the parent (£1.658bn) and 15% (£292m) is held outside the group.
- The bank has a Risk Asset Ratio of 12.8%.
- 15% of depositors would not be eligible for protection under the DPS (i.e. they are companies, trusts and other wholesale deposits) hence eligible retail deposits would amount to £1.53bn. (85% of £1.8 billion).
- The scenario assumes that the DPS is funded by the banks but that it will take 2 years before recoveries are made from the failed bank to repay the funding costs to continuing banks.
- The expected recovery rate of assets placed with the parent bank is 70%.
- The DPS scheme compensation level is up to a maximum of £35,000 per depositor.
- The DPS would take over the rights of the depositor against the bank up to the compensation paid and seek reimbursement from the liquidator for the compensation payment made to depositors.

Assuming a recovery of 70% of the assets with the parent company and 100% recovery of the assets held outside of the group it is expected that the overall recovery rate would be 76.5%. This is calculated as follows:

Total assets recovered from group (70% of £1.658bn)	£1.161bn
Other assets recovered by the Guernsey bank (100% of £292m))	<u>£0.292bn</u>
Total assets recovered by the Guernsey bank	<u>£1.453bn</u>

Depositors are entitled to 94.74% (i.e.£1.8bn/£1.9bn of creditors) of the recovered assets.

This gives an amount recovered to which depositors are entitled of 94.74% x £1.453bn – i.e. £1.377bn. The amount recovered as a percentage of total deposits is the recovery rate of £1.377bn/£1.8bn i.e. 76.5%.

Worked example:

On the basis of the assumptions set out above, each depositor recovers the following:

- 10,000 customers recover £22,950 (76.5% x £30,000)

Under the DPS the depositors covered by the scheme – i.e. excluding the 15% non-eligible depositors, 8,500 people (85% x 10,000) - would receive back the full £30,000 deposited (£22,950 from the bank and the remaining £7,050 from the DPS). The DPS would initially pay out £255m (£30,000 x 8,500).

On liquidation of the failed bank, the DPS (having taken on the rights of depositors making a claim) would recover £195.075m of the initial outlay (76.5% of its £255m outlay) for these customers.

- 10,000 customers recover £114,750 (76.5% x £150,000)

Under the DPS, 8,500 depositors would initially receive £35,000 from the DPS providing initial liquidity i.e. excluding the 15% non-eligible depositors (hence 8,500 x £35,000 = £297.5m). However, these depositors will receive back in excess of £35,000 from the liquidator over time, but it is assumed that the liquidator would not distribute further funds to the depositor until the DPS has been fully repaid.

		Total cost to DPS
		£
Customers able to make a full claim	8,500 at an average deposit of £30,000	255,000,000
Customers making a maximum claim	8,500 at £35,000	297,500,000
		<hr/> 552,500,000
Ultimately recovered from the failed bank on liquidation		
Customers able to make a full claim	76.5% of £255m	195,075,000
Customers making a maximum claim	DPS fully repaid	297,500,000
		<hr/> 492,575,000
Cost of the DPS scheme		59,925,000
Funding Cost (£492.6m x 5.25% x 2years)		51,720,375
Total cost of the DPS scheme *		<hr/> <hr/> 111,645,375

* The total cost of the scheme is to be recovered by the levy imposed on banks. This is simplistically assumed in the worked example to be imposed after two years. However if an early estimate can be made of the recovery rate to be achieved then the levy can be imposed at an earlier stage and that would have a cashflow benefit albeit limited which would reduce the funding cost and in turn the total cost of the DPS scheme.