

**REPORT BY PROMONTORY FINANCIAL GROUP (UK) Ltd TO THE GUERNSEY FINANCIAL SERVICES
COMMISSION (GFSC) – January 2009**

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Introduction

1. The Guernsey Financial Services Commission (GFSC) has commissioned this Report from Promontory Financial Group (UK) Ltd (PFG). The Terms of Reference (TORs) are attached at Annex 1. They identify, in particular, the need:
 - A) to establish the appropriateness of the Commission's responses in relation to Northern Rock (Guernsey) Ltd (NRG) in the context of the events that led to the temporary public ownership of Northern Rock plc (NR);
 - B) to establish the appropriateness of GFSC's responses to the events that led to the placing of Landsbanki (Guernsey) Ltd (LGL) into administration.
2. As referred to in the TORs, the findings of the Inquiry have been reported in full to the Policy Council. However, the nature of the Inquiry, the subject matter under review and the statutory confidentiality requirements under which the Commission must operate mean that PFG is not able to make public the full contents of its report to the Commission. Nevertheless, PFG has been advised by the Commission that, to the fullest extent permissible, having regard to the statutory confidentiality requirements, the conclusions reached by PFG, together with a summary of the work carried out, should be made publicly available in this report.
3. We should like to thank the GFSC staff and Commissioners, who were uniformly generous in the time and attention they gave to our work and who responded quickly and constructively at every point to our questions.
4. We comment later on the quality of the written record in the Commission, which greatly assisted our work.
5. The report is structured as follows. We:
 - A) review the obligations that Guernsey has as a host country banking supervisor when licensing firms like NRG and LGL;
 - B) then look at the picture as it appears to the home regulator;
 - C) turn to the particular challenges faced by a host supervisor that arise out of the business model used by licensees such as NRG and LGL;
 - D) next set out the 'test' that we think should be applied to GFSC's actions and review these actions from 2006 onwards in the light of this test. We also look at a number of potentially significant issues in more detail;
 - E) then make a number of recommendations on process and prospective resource allocation within GFSC; and

F) close with comments about policy issues that have or could emerge from the lessons learned from the NRG and LGL cases.

Section A. Guernsey's obligations as a host supervisor

6. Guernsey is a "host country supervisor" for banks from a wide range of overseas jurisdictions and therefore has to be able to deal with a number of different "home country supervisors". As Guernsey is outside the European Economic Area, the determinants of the relationship between home and host regulator are those set out by the Basel Committee of Banking Supervisors (the Basel Committee, the body which sets and oversees the standards for which banking regulators should aim). That Committee's first description of the minimum standards for the supervision of international banking groups and their cross-border establishments was set out in 1992¹. Although the standards have been revised since then (mostly in the context of aiming to achieve a more effective implementation of Basel II), the four key minimum standards set then still hold.

7. These are:

1) All international banking groups and international banks should be supervised by a home country authority that capably performs consolidated supervision

In the case of both the UK FSA and Iceland's FME, other major regulatory authorities have accepted that these two home supervisors meet this requirement; so Guernsey has conformed to normal practice in accepting both as a competent home country regulator.

2) The creation of a cross-border banking establishment should receive the prior consent of both the host country supervisory authority and the bank's and, if different, banking group's home country supervisory authority

GFSC has met this condition. As part of its due diligence before agreeing to Landsbanki being licensed in 2006, it formally requested consent from the FME.

3) Supervisory authorities should possess the right to gather information from the cross-border banking establishments of the banks or banking groups for which they are the home country supervisor. GFSC's behavior towards both the FSA and FME in the period we reviewed shows that GFSC fully understood its obligations as a host supervisor in this regard.

4) If a host country authority determines that any of the foregoing minimum standards is not met to its satisfaction, that authority could impose restrictive measures necessary to satisfy its prudential concerns consistent with these minimum standards, including the prohibition of the creation of banking establishments.

Again, from the period reviewed, for both NR and Landsbanki, it is evident that GFSC fully understood its right to take action, such as discouraging applications that it considered unlikely

¹ "Basel Committee: Minimum standards for the supervision of international banking groups and their cross-border establishments" July 1992.

to succeed and imposing restrictions on an existing licence in the event that its concerns could not be met in other ways.

8. Developments in banking since 1992 (such as the centralization of treasury functions in banking groups) have tended to emphasise the relative importance of the home supervisor at the expense of the host. Only the home supervisor can form an overall view of the strengths and weaknesses of what have become increasingly complex groups – complex both in terms of geographic reach and product range. As noted earlier, the new Basel II arrangements have recognized this (and moved the balance further towards the home supervisor, because that is who plays the primary role in determining the acceptability of a bank’s models for credit, market and operational risk for the capital concessions given for “advanced” banks).
9. Nevertheless, the Basel Committee continues to stress the importance of information sharing between home and host supervisor. Thus, for example, the 2006 Basel paper on *“Home-host information for effective Basel II implementation”* states:
*“These discussions have confirmed the need to develop more robust information-sharing arrangements between home and host supervisors as set out in the High-level principles for the cross-border implementation of the New Accord... Consolidated supervision of international banking groups requires effective cooperation and exchange between home supervisors and host supervisors...”*²
10. We discuss below what we consider to be good practice on the part of both the home and host supervisor. But it is important to stress that the Basel standards, and indeed the Memoranda of Understanding (MoUs) of the kind that are frequently signed between a home and a host regulator (such as that which Guernsey has signed with the FSA) create no legally binding obligations. Rather, they are based on the assumption that home and host supervisor will both benefit from a suitably open and frank exchange of views and information; and that working together produces a better outcome for depositors in the group. It is evident to us that GFSC were firmly of this view and conducted their engagement with home supervisors in this spirit.

Section B. The home country regulator’s typical view

11. The home regulator has the advantage of being able to see the position across the whole of the bank being supervised (on the assumption that it does indeed practice consolidated supervision adequately); and it will have access to a wide range of powers over the bank with which to exert influence in the event of difficulties.
12. However, where the bank has extensive operations overseas, the home regulator will inevitably find it more difficult to monitor these than for similar operations in the home country. In the case of deposits being raised, this is not usually a major problem where the percentage of

² Published in June 2006.

deposits being raised in the foreign jurisdiction is proportionately small, as was the case of NR where Guernsey accounted for about 2% of the funds raised by the group.

13. In the case of Landsbanki, the position was more complicated because the bank raised extensive funds in the UK through its branch and with the operation of its subsidiary Heritable and was also raising funds through its Guernsey subsidiary. Significant Landsbanki assets were being held in the UK, so that, from the point of view of GFSC, a three –way relationship was needed between GFSC, FSA and FME.
14. Typically, the home supervisor will want the host regulator’s views on a wide range of issues, including the stability of the deposits being raised and the quality of any assets being added. But, particularly where there are numerous host regulators, it becomes impossible for each host country to be kept informed of every step in a rapidly moving picture when a bank is in trouble. Where host jurisdictions account for only a small proportion of the funds raised by the whole group, they may be particularly vulnerable to being “cut out of the loop” in a crisis.
15. The home regulator, however, has to weigh two facts against that. Even in normal times, it will be important to engage the host regulator sufficiently that the latter is comfortable with developments (such as the approval by the home regulator of advanced Basel II models for the parent bank). When things are more difficult, the home regulator needs to recall that – if pushed – the host regulator may take action (such as demanding more capital or liquidity be held in the local subsidiary) that could work against what the home regulator is trying to do to rectify a problem. Worse, if the local action is reported publicly or can be identified in the market place (because, for example, the local subsidiary starts placing inter-bank deposits in its own name where it has not done this before), this news may be the very thing to exacerbate concerns about the group – and may indeed start the “run” that the home regulator is seeking to prevent.
16. If the bank’s condition becomes critical, the entity and probably the home regulator may be very anxious to see all available liquidity brought home and key decisions taken there, as this will maximize the chance of the bank staying afloat. An excellent recent example of this – outside the traditional banking sphere - was provided recently in the Lehman case, where the UK Administrator has reported that spare cash was swept back to the US every evening to help with liquidity management there. He is now pressing for the return of over \$8 billion, which illustrates readily the downside for the host country if the group still fails.

Section C. The host regulator’s options and the particular regulatory challenge of up-streaming of deposits to the parent

17. Of course, it is exactly at times of crisis when the home supervisor is likely to be most reluctant to share information (for fear of leaks or just because the picture is fast changing) that the host supervisor will be most concerned. The host will be unable to see the bigger picture and, in a case like Guernsey’s for NR or for LGL, will know that the local bank lacks assets under its own control to pay off local depositors in full.

18. At the same time, the host regulator will know that precipitate unilateral action may trigger adverse market reactions; and even if its action does not exacerbate the crisis, it is likely that future relations between the host regulator and home regulator - and between the host and the bank itself - may be seriously damaged.
19. There is no universally agreed blueprint” for handling situations like these, not least because every case will have its own particular features. The host regulator is not likely to abdicate its own responsibility and leave the problem primarily to the home regulator, except in return for a “bankable assurance” that the local deposits will be protected in full. Where the host remains anxious to retain its own discretion to act, a critical question then becomes “what is the quality and speed of interaction between the home and host regulator?”
20. The issues confronting the host regulator are sharper where the subsidiary up-streams to its parent most of the deposits raised. Such up-streaming is one of a number of normal business models in many smaller tax-competitive jurisdictions. Up-streaming recognizes the economies of scale that can be achieved if deposits can be gathered in several jurisdictions and then concentrated in one centre where the bank already has the necessary infrastructure (notably treasury management, and the ability to generate loans or other assets for the balance sheet).
21. This model inevitably means that the local subsidiary’s presence is confined to a limited deposit-generating capacity, that it has little or no treasury or asset-generating capacity of its own and that the local directors – unless they have positions elsewhere in the group - have no personal insight into the overall management or performance of the group. Any independent local director is therefore reliant upon the group for information on how it is faring; while, for directors who are executives elsewhere in the group, there is the temptation to view any problems as ‘group problems’ and to seek solutions that are seen as beneficial for the group, even if they entail greater risk for local depositors³.
22. Given this business model, it can readily be seen that any significant change requested by the host regulator is likely to run into significant opposition from the local Board as well as the parent. If the host regulator wants restraint on the volume of deposits taken locally or an increase in the liquidity available directly to the subsidiary (rather than being available through the parent), the Board will argue that such steps undermine the rationale for the subsidiary and/or its financial viability. In time of need it is also likely to be difficult to get liquidity back to the subsidiary and – even where possible – may be very evident, with consequent risks that adverse conclusions will be drawn in the market or by depositors. For example, if liquid assets are invested in the market in the subsidiary’s name when normally this does not appear in the markets, professional counterparties will immediately become aware of the change.
23. It is even more difficult for the subsidiary to generate lending on its own initiative (as it will lack any credit risk controls or infrastructure and the people needed to take decisions in such areas).

³ By which is meant depositors with the local subsidiary, not just depositors who live in the host jurisdiction.

The most viable outcome may be for the subsidiary to take ownership of assets already generated elsewhere in the group. But even here, the local entity will struggle to do its own due diligence on the assets being obtained and will be dependent on another part of the group to service the assets. Depending on how the deal is structured, there may also be legal issues or challenges if the group fails.

24. It is evident that the Commission and its staff were well aware of the strengths and the weaknesses of the up-streaming model from the outset. Much of their dilemma – particularly in respect of LGL – was how to balance the need to protect local depositors without undermining the financial position of the group.

Section D. Good practice for the host regulator and how GFSC measured up to it in the cases of NR and LGL

25. We identify 6 strands of activity by the host regulator that, properly done, should meet its obligations under the Basel Core principles and also constitute “good practice” in normal or abnormal times. The host regulator should:
- A) understand the strategy of the parent bank and the role to be played by the local subsidiary;
 - B) maintain adequate oversight of activity in the local subsidiary and of its directors/key staff (which would include regular phone and personal contact) and oversee compliance with local banking regulations;
 - C) monitor the parent bank, in particular news affecting the group (such as results, rating agency assessments, and general press comment). This would also cover monitoring of the economic news about the home country and any third country in which the group had significant business interests.
 - D) maintain regular and proactive contact with the home and any other relevant regulators. Such contact would typically include periodic visits by the host supervisor and the creation of a relationship in which it was considered normal for either side to pick up the phone to the other when events make it necessary;
 - E) volunteer information to the home regulator or other regulator whenever this might be thought likely to improve the overall picture that this regulator had of the group/bank for which it was responsible; and
 - F) formulate and keep current its own strategy for dealing with the local licensee in the light of the information obtained above.
26. Two common threads underlie these six points: first, the proactive maintenance by the host regulator of its contacts with the local subsidiary, with the parent and with other regulators; and second having a strategy for dealing with problems as they arise.
27. We can say immediately that we found no evidence of any “bad faith” on the part of GFSC. By this we mean we saw no evidence that anyone in GFSC acted in such a way as to knowingly or recklessly put depositors of the Guernsey licensee at risk in the case either of NRG or LGL.

28. In order to see how GFSC “measured up” to the key duties identified above of a host regulator, the relevant test is we think a “not unreasonable” test. Competent regulators can easily disagree over which course of action is the “best to follow” in a particular circumstance; and, particularly as we have the benefit of hindsight, it is not a fair test to ask whether the authors of this Inquiry would have done exactly what GFSC did in fact do.
29. A well-established test in this area is, rather, that criticism is justified if the action followed (or indeed “inaction”) was one that a competent regulator could not reasonably have chosen given the facts that were or could have been established at the time⁴.
30. The UK Parliamentary Ombudsman has recently suggested an interpretation on the same point relevant to the regulation of financial institutions, which she applied in her second review of Equitable Life. *“First I establish the facts and the overall standard which applies to the events which form the basis of the complaints made to me. I then assess the facts against that overall standard. In particular, I assess whether or not an act or omission on the part of the body complained about....constituted a departure from the applicable standard. If so, I assess whether that act or omission was so unreasonable in the particular circumstances, when regard is had to the specific legal or administrative context of the case, as to constitute maladministration.....”*⁵
31. We now summarise our conclusions when measuring GFSC’s performance against the “not unreasonable” test, looking at each of the 6 strands of “good practice” identified in paragraph 25 above. Wherever possible, we relate them to key events/decisions during the period and go on later to consider a handful of particularly important issues in their own right. We conclude that GFSC did not act unreasonably in any of the events reviewed. We see no evidence of “regulatory failure” on the part of GFSC.

A. Did GFSC understand the strategy of the parent bank and the role to be played by the local subsidiary?

32. In the case of both NRG and LGL, there is clear evidence that GFSC understood very clearly the strategy of the parent bank and the intended purpose of the local subsidiary. In the case of NRG, this understanding had built up over many years. GFSC staff interacted with suitably senior executives of the group through their involvement with NRG and also checked their conclusions in conversations with the FSA (see below).

⁴ This follows from the Wednesbury case (House of Lords 1947), the judgment of which has been summarized as follows: *“Had the local authority (the defendant) taken into account any matter that ought not to have been taken into account or disregarded matters that ought to be taken into account? If it did not obey these rules, it might be said to be acting unreasonably.”*

⁵ *“Equitable Life: a decade of regulatory failure” the Parliamentary and Health Service Ombudsman. Volume 1, page 313, July 2008.*

33. When GFSC came to consider Landsbanki's application to take over the local deposits of the Cheshire Building Society in 2006, the GFSC's concern to understand the rationale and strategy of the new licensee was formalized – as good practice would require – by GFSC requesting and analyzing a 3 year medium term plan for the new operation.

B. Did GFSC maintain adequate oversight of activity in the local subsidiary and of its directors/key staff (which would include regular phone and personal contact) and ensure that local banking regulations were followed?

34. In both cases, there is extensive evidence of continuing and meaningful dialogue between GFSC and executives of the bank. With NRG, daily reporting of flows of funds was initiated by GFSC from 1 September and there was regular interaction between GFSC and NRG as problems continued.

35. With LGL, a substantive discussion by letter of the various options for parental funding and/or transfer of assets commenced on 4th April 2008 and continued through the month.

36. It is clear from the evidence that the relationship involved a two-way dialogue, with bank executives clearly feeling it appropriate to call and visit GFSC as readily as the other way round.

37. We found no evidence of any breach of local banking regulations by either bank during the periods reviewed.

C. Did GFSC monitor the parent bank, in particular news affecting the group (such as results, rating agency assessments and general press comment and including news about countries in which the group operated)?

38. Our observation is that GFSC meticulously followed and analysed the relevant events in each case. For NR, the evidence shows that each significant event (such as NR's trading update in late June 2007), its trading results for the half year published on 25th July 2007, significant changes in share prices and subsequent statements by the UK authorities (such as those on the 13th and 14th September 2007) were all identified quickly by GFSC and analysed appropriately.

39. In the case of Landsbanki, a similar pattern is found. Iceland's nationalization of Glitnir Bank led to an immediate call from GFSC to FME; and there were further discussions after the downgrade of Landsbanki by Moody's and Fitch on 30th September 2008, with GFSC seeking information on Landsbanki (in particular about the group's liquidity position).

D. Did GFSC maintain regular and proactive contact with the home and with any other relevant regulators?

40. GFSC was extremely pro-active in managing its relationship with both FSA and FME. For some time, GFSC had made an annual 2 day visit to FSA, to discuss all UK bank licensees in Guernsey. But throughout the NR saga, GFSC regularly and repeatedly phoned and wrote to the FSA seeking information and/or assurances.

41. In every case, responses were handled by GFSC expeditiously.
42. In the case of Landsbanki, GFSC had to deal both with FME and with FSA. GFSC also spoke with the Central Bank of Iceland when considered appropriate. Regular contact with FME was initiated by GFSC as soon as Landsbanki indicated their interest in the Cheshire licence in 2006 and was continued throughout the period under review. Contact included a visit by GFSC to Reykjavik in January 2008. Phone and written contact was maintained with both FME and with FSA at appropriate levels throughout the period. Again, GFSC regularly responded expeditiously to incoming information.

E. Did GFSC volunteer information to the home regulator or other regulator whenever this might be thought likely to improve the overall picture that regulator had of the group/bank for which it was responsible?

43. GFSC regularly volunteered information to the home regulators on relevant aspects of NRG and LGL.

F. Did GFSC formulate and keep current its own strategy for dealing with the local licensee in the light of the information obtained above?

44. We consider below several specific aspects of GFSC's approach to Landsbanki that, given subsequent events and possible depositor loss, have and may continue to attract particular attention. But, in general, we have concluded that, in dealing with NR and with Landsbanki, GFSC regularly and in timely fashion considered its options, chose a course of action and then pursued it with vigour. It is also clear from the record that GFSC was well aware of the limitations on the choices open to a host regulator and debated what should be done within those confines.
45. Two underlying themes that ran through these decisions are worth noting because they help to explain the actions taken. The first was that any action (such as restrictions placed on a licensee) had to be legally robust if the bank challenged the decision. A regulator should not fear the prospect of challenge but the fundamental point remains correct: namely that a clear case for such action has to be made that would stand up on appeal.
46. The second theme was that GFSC was well aware that the actions of a host regulator might precipitate the crisis that all the relevant regulators will wish to avoid (see the earlier discussion at paragraph 18). GFSC started quite reasonably from the presumption that it should seek to work with the home regulator and not threaten unilateral action. However, GFSC did not flinch from threatening unilateral action if Guernsey depositors would otherwise be disadvantaged.
47. Good examples of GFSC's proactive but constructive approach are provided by:
- the highly active pursuit in December 2007 and January 2008 of comfort on the nature of the UK guarantee of NR; and

- the concentrated effort in April 2008 to get LGL to reduce its Icelandic exposure. This second case is discussed further below.

Specific issues requiring further analysis

48. There are 4 specific subjects that we can see, from local press comment that merit particular comment. Nothing said below should be taken as implying a caveat to the conclusion already reached that GFSC did not act unreasonably.

Did GFSC do sufficient due diligence on Iceland and on the parent bank when granting a licence to LGL?

49. When an application is received like that in 2006 from Landsbanki, good practice requires a number of specific checks. Among the most important are a soundly-based:

A) analysis of the strength and reputation of the applicant (including of its willingness and ability to stand behind the subsidiary);

B) decision that the home regulator is competent to conduct consolidated supervision and to meet the other attributes required of a home regulator;

C) analysis of the ownership structure of the bank;

D) understanding of the business case for the licence (this point has already been covered);

E) analysis of the adequacy of the management and systems and controls at the licensee.

50. In the case of an applicant such as Landsbanki, no analysis of the strength and reputation of the bank would have been complete without also a review of the country (Iceland) most likely to impact upon Landsbanki's future success. GFSC took fully into account the then current credit rating reports on Iceland and on Landsbanki.

51. In 2005, these reports (on either the bank or the country) had suggested no cause for regulatory concern. For example, Moody's had confirmed Landsbanki's A2/P-1 ratings in August 2005 and Fitch in November had also confirmed their rating for the bank (A, outlook stable). In December 2005 Moody's argued that "the outlook for Iceland's banking system remains stable based on continued good performances and strong likelihood of support [from the Icelandic authorities]".

52. The picture was slightly more mixed in 2006, with Fitch in February revising the outlook for Iceland to "negative" but affirming the existing ratings for its banks. Moody's affirmed the Icelandic banks' deposit and debt ratings in April 2006, though it downgraded the outlook for another measure of Landsbanki's strength (the "bank financial rating strength").

53. The last rating for Iceland that GFSC had before reaching its decision on the licence application came in July 2006 with a very positive review by Moody's affirming Iceland's top (AAA) rating, which was "supported by institutional strength, low government debt and tested ability to withstand shocks".

54. The GFSC reviewed reports by the Central Bank of Iceland and two academics hired by the Iceland Chamber of Commerce that both reached positive conclusions.
55. In deciding that the home regulator (FME) was acceptable, GFSC were following a similar decision already made in the UK (FSA authorized the purchase of Heritable by Landsbanki in 2000) and by other EU regulators. And in reviewing other reputational aspects of the bank, GFSC followed up on concerns that the bank might be a conduit for money-laundering from a third jurisdiction and analysed the personal history of the Chairman (and a major shareholder) of the bank. Nothing was found which gave the GFSC reason to turn down the application and all the normal checks were conducted.
56. GFSC also sought and obtained a "letter of comfort" from Landsbanki in respect of LGL. Such a letter is not, in our view, a requirement before a licence is granted. But it allows the host supervisor to give the subsidiary more operational freedom than would otherwise be appropriate.
57. So far as existing customers of Cheshire Guernsey Ltd (CGL) were concerned, they were written to individually by CGL on 7th August 2006; the Society gave a positive but factually accurate description of the new owner. (It is relevant that, at this time, the Cheshire Building Society was not rated ; had it been rated, it would have been unlikely to have commanded as high a rating as Landsbanki had at that point.) Landsbanki also wrote to depositors on 25th September 2006.

Asset diversification at LGL

58. GFSC kept LGL's position under active review, especially after the NR crisis broke and very sensibly organized a visit to Iceland in January and met with the Central Bank, the FME and with the parent bank.
59. GFSC continued an active dialogue with FME and the bank and, after renewed adverse press comment on Iceland in mid-March 2008, GFSC's thoughts turned quickly to whether some or all of the up-streaming to the parent should be reversed. In the following weeks there was intensive discussion of the options with LGL and conditions were imposed upon the bank.
60. After considerable debate, an agreement was reached that effectively determined the state of LGL's balance sheet at the time of its administration. Put simply, the subsidiary's assets would be split approximately 10% with the parent (less than LGL's capital), 25% on call with Heritable (the UK subsidiary of Landsbanki), 30% in the inter-bank market and 35% in loans already on Heritable's books.
61. There is no way of knowing whether LGL would have agreed to move a higher proportion of assets out of direct or indirect exposure to Landsbanki if GFSC had exerted even more pressure on them. But it is clear that this outcome represented a very much better balance of risks for LGL depositors than the previous distribution of assets had done (where there had been up to 90% direct exposure to the parent). It is clear that only this redistribution of assets has

permitted a 30p in the £ initial distribution since the Administration. It also means that the Administrator has a wider range of potential sources of further value for depositors than would have been the case had the assets remained primarily claims on the parent.

The validity of the Administration process

62. Our Terms of Reference ask us to consider “*whether the Commission acted appropriately in supporting the decision of the directors of LGL to apply to the Court for the appointment of an Administrator.*”
63. This can be dealt with very briefly. Our understanding of the background and discussion with HM Procurer (who was present throughout the key meeting on 6th October 2008) indicate very clearly that:
- A) GFSC was wholly entitled to support the request for Administration as having more than adequate cause and as being the only practical way to bring equity as between the different creditors of the bank;
 - B) GFSC’s conduct in the meeting to decide on applying for Administration, was entirely correct and GFSC brought no inappropriate pressure on the directors to reach the decision that they took.

Whether the home/third-country regulators acted as GFSC were entitled to expect.

64. When considering this issue, it is important to remember that FSA (and other UK authorities) may have their own views on what it was possible and expedient to share with GFSC at the key points. We have not had access to UK documents or officials in either the NR or LGL cases.
65. It seems clear that, before NR faced funding problems in August 2007, there was a normal home/host relationship that was seemingly satisfactory to both sides. GFSC had a good understanding of the business strategy of NRG. GFSC had satisfied itself that the subsidiary continued to meet the normal licence requirements and it maintained the usual monitoring of both NR and NRG. GFSC maintained a regular dialogue with the FSA and asked questions about the group as necessary (as it kept an eye on developments that became apparent through the press, from the rating agencies or others). As noted earlier, the home/host relationship also involved the GFSC once a year in visiting London to discuss all the UK licensees operating in Guernsey.
66. FSA itself has subsequently admitted⁶ that it monitored less closely than it should have done developments at NR between 2006 and the first half of 2007. However, in the event, no Guernsey depositor lost money.

⁶ FSA Internal Audit Report “*The supervision of Northern Rock: a lessons learned review*” March 2008

67. We are aware that in the case of LGL certain issues have been raised, specifically:
- A) the extent to which action taken by FSA prevented Heritable from sending some £36 million to LGL just before both banks went into administration;
 - B) whether FSA could and should have said more to GFSC about the inter-relation between the position of Heritable and that of Landsbanki.
68. In light of the position noted at paragraph 64 above, PFG makes no comment in relation to these two issues. It is a matter for GFSC to determine whether it wishes to raise these matters with FSA.

Section E. Procedures within GFSC and resources

69. The procedures to be followed by the banking supervisors in GFSC, in their internal work, in their relations with licensees and overseas regulators and with the Commission were all well laid out, well understood by the senior staff and, in the cases we reviewed were followed to a high standard.
70. Of particular importance were the following:
- A) file notes of meetings, telephone calls and other events were written up to a generally very high standard and also normally very shortly after the event (thus minimizing the risk that memories had become blurred in the meantime);
 - B) where there is external evidence on the same meeting or call (for example when FSA or FME replied in writing after a meeting or a call that GFSC staff had already documented), we were able to establish in every case bar one that GFSC's original conclusion about what had happened was borne out by the subsequent external document;
 - C) given the frequency of recorded communications together with the very limited number of senior people involved, it was generally very easy to establish an audit trail of how and when decisions were taken, deadlines were set or where a response was requested by GFSC in a particular time span.
71. With respect to GFSC internal processes, we would make only two limited process observations for future consideration:
- A) it should be normal practice to put a time as well as a date on events being written up. On days such as 6th October 2008, it took more effort than it need have done to reconstruct the pattern of events;
 - B) any draft prepared (for example) for discussion with a licensee should be clearly marked as a Draft, as otherwise it is not easy to identify what has been sent to the external party as a final and what has not.
72. We also examined the papers prepared for the Commission's monthly meetings and the Minutes of those meetings. Again, in general we were impressed by the clarity of what we saw and – a point confirmed by all the Commissioners we spoke to – there was no suggestion at any point that Commissioners had been provided with less information than they felt they required or that there was ambiguity between the Executive and the Commissioners about what was

being proposed and what had been agreed. Commissioners confirmed that they had a chance annually to stand back and review what was included in their briefing; and that they were generally content.

73. The only observation we would make on the briefing for and reporting of the Commission meetings is that the Commission might like to consider a technique developed by the Bank of England's Board of Banking Supervision (BOBS) during the late 1980s and early 1990s. This involved, for any bank that was effectively on the "Watch List" and that the Executive wished to name to or discuss with the Commission, the provision of a short background note of a rather different kind from the one provided by the GFSC Executive now.
74. The main distinguishing feature of the BOBS note was that it summarized (with a short chronology if necessary) when and how the bank had come to the attention of BOBS before and thus told a more formal story. In particular, it reminded members where a bank had "come and gone" off the Watch List on a number of occasions. This sense of perspective, BOBS members felt, helped them to put the issue into a clearer context and reduced the risk that a case would be allowed to drag on because members had forgotten just how long ago it had first surfaced.
75. This is not to suggest that current processes led to any problems in either the NR or LGL case. But the change may merit consideration and should not involve significant extra work because by definition, once a summary "history" has been prepared for a bank, it only needs refreshing if and when it comes up again.

Resources within GFSC

76. GFSC is inevitably and rightly run with relatively few staff – a budget of 12 for the banking supervisors in 2008. The Commission's Minutes show that resource issues have been monitored regularly and action taken where, for example, it has proved impossible to fill vacant positions promptly. For much of 2008, staff numbers have typically been 9 or 10 and remedial action has included the hiring of external secondees and moving in staff from other Divisions on a temporary basis.
77. The shortfalls in staff numbers have occurred in conditions since August 2007 that have frequently involved crises hitting a number of licensees, sometimes almost simultaneously. The result has been intensive pressure on the senior staff and, as with several other regulators of which we are aware, it has also been necessary for some targets and timetables to slip. We commend the commitment shown by GFSC senior staff but would make the obvious point that, unless conditions return to something close to normal soon, additional resources may have to be found at least temporarily.

Section F. Policy issues

78. We do not offer any views on the Deposit Compensation Scheme nor further comments on the parental up-streaming debate. We do, however, offer observations on several other aspects of the GFSC Consultative paper issued in August 2008.²

Corporate Governance

79. The directors of a bank authorized in Guernsey have responsibilities to their depositors. Especially where the main object is to collect deposits in Guernsey and up-stream them to the parent, the directors will start from the view point that this is in the interests of local depositors. However, if there are problems as with NRG and LGL, a question arises as to whether the composition of the local Board is likely to have a bearing on the view the directors will take of these problems. In particular, what will be their potential willingness to accede to requests from GFSC to change their policy on liquidity and/or on asset distribution?
80. Because of this risk of a conflict of interest within a Board made up wholly or largely of individuals with other interests in the group, we support the proposal mooted in the GFSC CP, (para. 4.11) that at least one non-executive director be a “local” who is not otherwise employed by the group. The bar on “employment” should in our view extend to their not providing or having provided for say 3 years any professional services to the group.
81. We are aware of a broadly similar arrangement put in place by The Bahamas in 2004. After initial resistance by some of the larger foreign-owned firms, the process has settled down and has been found beneficial by the banking supervisor, the Central Bank of The Bahamas. When the scheme was introduced, and periodically afterwards, the Central Bank has held briefing sessions for local NEDs – something that GFSC might itself wish to do in the new regime. The sessions have covered recent regulatory developments but have also provided the opportunity for the regulator to remind the individuals why their particular involvement is so important. It has been stressed that the NED has access to the regulator whenever he/she wishes, to discuss issues of concern such as whether the Board as a whole is giving due attention to the interests of the local depositors. None of this is meant (nor should) alter the fact that every Director of the subsidiary has the same obligations.
82. The range of solutions available to a local Board of course will depend very heavily on the organization of the group, on the amount of funds being up-streamed to the parent and whether or not there is any local infrastructure that readily allows the subsidiary to hold assets (liquid or illiquid) in its own right. It is obvious to us from the GFSC CP and other internal evidence that the main issues are clearly understood and are being earnestly debated.

² *Consultation on parental up-streaming and the introduction of depositor protection and ombudsman scheme”*
GFSC August 2008.

83. In the last resort, it seems to us that the only effective route to avoid future cases like LGL is either to allow only branches to operate in Guernsey or to permit subsidiaries only for those banks that are thought certain to receive home state support in the event of problems. The difficulty with the first leg of this argument is that, in the absence a pan-European bankruptcy regime, it is not absolutely certain that having an overseas branch will always provide equal treatment for local depositors. The difficulty, of course, with the second leg of the argument is that the boundary between which banks will be rescued and which will not have shifted several times in the last year and may well shift again.

Transparency to depositors

84. GFSC's August CP covers two policy issues in this area. The first (paragraphs. 4.3-4) relates to what should be said about any undertaking given by the parent bank towards depositors in the subsidiary and, while we support the principle, we suggest that the wording might usefully be reviewed. At present, for future new product information and promotional literature, the wording suggested is:

"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."

85. Our concern is simply that this representation fails to note that, in the event the parent fails first or is otherwise prevented from making good its undertaking, then the depositors of XYZ Guernsey Limited have no preference over other depositors in the group despite the undertaking. We suggest that further thought be given to the wording of the proposed statement, though we support the idea that a suitable statement should be required.

86. The second policy issue, covered in paragraph. 4.5 of the CP, is whether there should be a requirement to tell depositors up front that – to quote from the CP – *"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."*

87. We support such an initiative though we suggest that the final wording of this (and indeed the draft in paragraph 84 above) be cleared with one of the bodies that certify that "plain English" has been used. (All UK FSA statements involving the public go through that check.) Given the importance of trying to ensure that the depositor understands these statements, it is worth trying to maximize their clarity to a "non-professional".

SUMMARY

88. We summarise our findings as follows:

GFSC measured up to good practice and met its obligations under the Basel Core Principles, in that it understood the parent's strategy and the subsidiary's role; it maintained adequate oversight of activity, staff and systems; it monitored the parent bank and relevant countries/areas of lending; it volunteered information to other supervisors and it formulated and kept current its own strategy.

Specific issues to highlight on Landsbanki are that GFSC performed appropriate due diligence on the parent bank in the original licensing decision; required LGL to diversify its assets in order to protect depositors and acted appropriately in supporting the decision of the directors of LGL to apply for the appointment of an administrator.

We have suggested some modest process improvements (see above), but found overall that GFSC's limited staff resources managed well in trying conditions. We support the GFSC's view that at least one non-executive director should, in the case of a subsidiary of a foreign parent, be local and not otherwise employed by the group. We have suggested that the proposed statement to depositors regarding undertakings given by a parent bank ought to be amended so as to clarify what is the nature of a parent bank's support.

Our overall conclusion is that there was, on the part of GFSC, no "bad faith", no "unreasonable actions" and no "regulatory failure".

Annexes 1 & 2 attached below.

ANNEX 1 TERMS OF REFERENCE FOR THE INQUIRY

GUERNSEY FINANCIAL SERVICES COMMISSION INQUIRY INTO THE CIRCUMSTANCES LEADING TO THE RESCUE OF NORTHERN ROCK (GUERNSEY) LIMITED (“NRG”) AND THE PLACING OF LANDSBANKI GUERNSEY LIMITED (“LGL”) INTO ADMINISTRATION

Following a recommendation by the Director General, the Commissioners have appointed an independent person of undoubted standing and expertise to conduct a formal Inquiry. The terms of reference of the Inquiry are:

- a. to establish the appropriateness of the Commission’s responses in relation to NRG in the context of the events that led to the temporary public ownership of Northern Rock Plc;
- b. to establish the appropriateness of the Commission’s responses to the events that led to the placing of LGL into administration.

Matters to be considered will include:

- the difficulties experienced by NRG in the period from July/August 2007 leading up to the temporary public ownership of its parent Northern Rock plc;
- the authorisation of Landsbanki Islands hf as a controller of an existing Guernsey bank in September 2006;
- the monitoring and supervision of LGL from the change of controller;
- the actions taken by the Commission in respect of the diversification of LGL’s risk exposure, and the role of the Board of LGL in this respect;
- whether the Commission acted appropriately in supporting the decision of the directors of LGL to apply to the Court for the appointment of an Administrator;
- the effectiveness of inter-regulator co-operation and information flows in respect of NRG and LGL;

- the appropriateness of the Commission's policy reaction during 2008 to the developing liquidity and capital crisis among banks represented in Guernsey, particularly those with a predominantly retail customer base;
- the appropriateness of the Commission's regulatory process and oversight of the retail business of subsidiaries and branches of banking groups in the context of current global conditions.

In carrying out the Inquiry, regard will be paid to:

- the statutory and other powers available to the Commission;
- the international standards relevant to the regulation and supervision of banks;
- the information available to the Commission at the time actions were taken;
- the nature and severity of the developing financial crisis and the effects of this on the markets and general public confidence.

The findings of the Inquiry will be reported to the Policy Council and its conclusions will be made public

ANNEX 2 GLOSSARY OF TERMS

BASEL Committee- the Committee that sets and oversees international standards of banking supervision. The committee is based in Basel Switzerland.

BOBS – Board of Banking Supervision (created 1987 to assist with the oversight of the Bank of England’s supervision of UK banks).

BOE- Bank of England

CBI – the Central Bank of Iceland.

FME – Iceland’s bank regulator.

FSA – UK Financial Services Authority (which regulates, among others, all banks authorized to operate in the UK).

GFSC- the Guernsey Financial Services Commission. Where the Report talks about “the Commission” it refers to the collective group of Commissioners.

HMT- the UK Treasury

HOME REGULATOR- the regulator responsible for regulating or supervising (the terms are used interchangeably in the Report) the banking group in its home country.

HOST REGULATOR- the regulator responsible for regulating or supervising the banking subsidiary in its local jurisdiction.

LANDSBANKI- the Icelandic banking group

LGL- the Guernsey-based subsidiary of Landsbanki.

NR- Northern Rock plc, the UK banking group.

NRG- Northern Rock Guernsey, the Guernsey-based subsidiary of NR.

PFG-Promontory Financial Group (UK) Ltd, the authors of this report.

RATING AGENCIES- the credit rating assessors widely used to help assess the financial strength of countries, banks and other companies. The three main agencies are Moody’s, Standard & Poor (S&P) and Fitch.