Guernsey Financial
Services Commission

Banking Division presentation - Upstreaming and Large Exposures: Andrea Sarchet-Luff

Upstreaming risk has already been mentioned by Philip Marr in the context of concentration risk. I'm going to talk briefly about the history of upstreaming risk from the Commission's perspective, what we see as the pros and cons of upstreaming, and how upstreaming links with the large exposure regime. I'll finish off with the couple of slides about the large exposure regime in general.

Let's start with a history of upstreaming risk.

Upstreaming – a potted history

Funding the parent - Providing funding to the parent has been a major rationale for subsidiary banks in Guernsey, particular those following the traditional retail deposit gatherer model where the vast majority of assets, or in some cases, 100% of assets were upstreamed to the parent bank.
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Northern Rock - The first manifestation of the major concentration risk that this business model carried came in September 2007 with the onset of the Northern Rock crisis. Fortunately, loss to Northern Rock Guernsey was avoided firstly through the provision of the UK Government guarantee and latterly through the nationalisation of Northern Rock plc.

Upstreaming risk crystallised one year later, when Landsbanki Guernsey Limited failed. Following the Northern Rock crisis, the Commission had worked with Landsbanki Guernsey to change its asset mix and reduce the original high level of upstreaming to its Icelandic parent to a much smaller proportion of assets. In the event this proved to be a prudent decision; the administrators of the bank were able to recover almost all assets other than this exposure to the parent, and that element remains the main source of loss to the depositors of Landsbanki Guernsey Limited.

Options to reduce upstreaming
Broadly, the conclusion of the Hunt Review of 2009 was that there continued to be significant risk to Guernsey's reputation and to the Deposit Compensation Scheme from the activities of retail deposit gathering banks. The Commission has therefore worked with retail deposit gathering subsidiaries to reduce upstreaming risk. For retail deposit gatherers, the amount upstreamed is typically equivalent to multiples of the bank's capital. Assigning capital to cover the risk is not a practical option therefore and the Commission has instead explored with these banks the possibility of diversifying assets away from upstreaming.

For banks where the levels of upstreaming are less material, upstreaming risk has been addressed through the assigning of Pillar 2 capital for concentration risk. Please remember that we are talking about subsidiaries here – branches will routinely place funds with their Head Office which is legally the same entity.

Experience - The experience of the Commission has been that some licensees struggle to "think the impossible" about a potential failure of their parent and as a result, discussions about reducing upstreaming risk have proved difficult or protracted in some cases. Others have considered the scenario more willingly.

FSA liquidity - More recently, the FSA liquidity regime has impacted on upstreaming by making it less cost-effective for UK parent banks to receive funding upstreamed from overseas subsidiaries. UK owned retail deposit gatherers have been hardest hit by the FSA regime and this has resulted either in a change of the mix

of assets away from upstreaming or the surrender of the licence because the economic model is no longer viable.

So that's our perspective on the development of upstreaming risk. I'd like to move on to the pros and cons of upstreaming.

Upstreaming - pros and cons

The **pros** of upstreaming as the Commission sees them are as follows:

Better the devil you know – many subsidiaries receive updates or internal data from their parent which gives them an insight into, for example, the liquidity, funding and asset quality of those parents. This is not information that would be available were funds to be placed with a third party.

Provides funding to the Group – i.e. for many licensees, this is the rationale for their existence.

One stop shop – if liquidity is needed, it can be drawn from one source, rather than multiple sources.

The **cons** are as follows:

Credit concentration risk – there is a significant credit concentration risk which can be many multiples of the entire capital of the subsidiary. Fine in the good times, but it may be a concern in times of stress.

FSA liquidity – as already mentioned, for UK parents, being funded from outside the UK is not as attractive as it once was.

Documentation – we have noted that there is often no formal documentation around intra-group placements.

I'd like to talk now about the link between upstreaming and large exposures.

Upstreaming and large exposures

Large exposure regime - As you know, the Large Exposure regime, which derives from s24 of the Banking Supervision Law, is designed to capture concentration risk, where that risk is equivalent to 25% or more of the bank's capital base.

Most upstreaming is a large exposure -
Because Guernsey subsidiaries have relatively small capital bases, most upstreaming is equivalent to 25% or more of the capital base, and it therefore meets the definition of a large exposure given by s24(1) of the Banking Supervision Law.

Individual upstreaming limits - When the Commission has previously advised subsidiaries of their upstreaming limit, it has not articulated in those advice letters the link between upstreaming and the large exposure regime. It is proper to do so and going forward the Commission intends to advise individual upstreaming limits in the context of s24 of the Law.

Individual upstreaming limits will continue to be expressed as a % of assets, and will be determined by the risks to which each bank is exposed. These will include, for example, the systemic strength of the parent.

However, the Commission is considering treating upstreaming formally as a large exposure, and placing on a more formalised basis the work it has already been doing with some licensees in the context of upstreaming; i.e. considering whether a material concentration risk exists and whether steps to protect the bank's capital base are required.

No requirement to notify - drawing a link between upstreaming and the large exposure regime will not change the current notification requirements for exposures over 25% of capital. Banks aren't required to notify the Commission if the large exposure is a market loan of less than one years' maturity, and that won't change under the new treatment of upstreaming.

I said that I would finish off with a couple of slides around the large exposure regime.

Large Exposure Principles paper

The Commission is aware that the current Large Exposure Principles and Guidance paper dates from 1994.

The Principles paper will be updated in 2012 and the Commission will be using the guidance on large exposures issued by the European Banking Authority. We will also look at what concessions to the guidance that we may wish to use our national discretion to permit, and what concessions have been permitted by other regulators. For example, the current upstreaming limits are a concession in that we have historically allowed banks to lend more than 25% of capital to their parents.

We will be rewriting the Principles document with any eye on a more logical order to it, the use of plain English and the clarification of a number of definitions. We will also ask for your feedback on any particular areas of difficulty with the current regime. For example, in the past there was confusion between the concepts of related exposures and connected exposures and we will endeavour to remove any remaining confusion.

Upstreaming and Large Exposures – branches

Large exposures are not generally an issue for branches because there is no capital, and upstreaming placements to the parent are going to what is the same legal entity.

However, we do have branches in Guernsey that offer chunky loans and they report these as part of the quarterly prudential reporting. Where the Commission sees a particularly large exposure entered into by a branch, it may require additional information on a case by case basis, such as the value of the exposure as a % of parental capital. If the exposure is significant, the Commission will also want to monitor this as a discrete pocket of risk for the Guernsey licensee.

Things to consider…

Two things that we would like you to consider from today's presentation

For subsidiaries, you will need to cover upstreaming in your large exposure policy if you don't already do this.

For branches, you should be aware of and compliant with your parent's large exposure policy, and you should also monitor any discrete pockets of risk arising as a result of specific large exposures entered into by the Guernsey branch.

So that's all I wanted to say at this point on the subject of large exposures and upstreaming. Thank you very much for listening.