Guernsey Financial Services Commission

Industry Seminar – 18 November 2015

Banking Supervision and Policy Division Presentation

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Before Caroline considers banking issues specific to Guernsey, the question I would like to address in the next few minutes is whether, in the wake of the post 2007 crisis, the global banking system – eight years down the line and after a lot of political focus – is now safe to a level the public might expect.

There are several factors that have made the banking system safer. Banks now have more capital with the amount still rising. It is better quality capital. The potential demands of taxpayers have been reduced through new bail-in structures. Banks are more liquid. The costs of either corporate or personal misbehaviour are higher. Some investment activity has been moved out of the banking system or is now better priced.

On the other hand, there are still several areas of potential weakness. The use of internal models can materially reduce a bank's regulatory capital. Stress-testing has often proved unreliable. There are practical and theoretical problems around provisioning. Regulatory leverage ratios are not yet generally in force. Credit quality has not yet been tested by higher interest rates. Cross-border bank resolution is unresolved. There are issues around bond and FX market liquidity due to regulatory pressure on banks.

On top of this, much change has yet to take place. In the UK, there is the issue of the ring fencing of UK clearer retail operations and the push to encourage Challenger banks. The Basel Committee is still undertaking work on off-balance items and has yet to set out its definitive thoughts on both a new operational risk capital charge and revised credit risk weightings. On the wider stage, we have yet to see how monetary policy makers mix together asset pricing, credit controls and regulatory policy. I leave you to consider whether the EU's approach to financial stability is more functional now than it was in 2007.

Were we to agree that the global banking system is safer than before 2007, we would still have to ask ourselves how far banks are insulated against the risks that may have been driven out of the banking system only to remain in the wider financial system. That is question that few central bankers answer with confidence.

We live in a different world to pre-2007 that has its own risks. This world includes low to negative interest rates, low price but high asset inflation, a rock bottom oil price, competing exchange rates, higher levels of public and private indebtedness, and an on-going re-balancing of economic power between the West and the East. So any comparison between 2007 and today needs to be qualified.

In aggregate, I suggest that the banking system is safer than in 2007 – and this is cause for optimism. The main reason is we are now moving to a point where the public sector is operationally able in a crisis to lift systemic financial infrastructure – such as retail deposits – out of the hands of the private sector without paying a rent. Having said that, this is not to say that the banking system is yet safe to the level the public might reasonably expect in the wake of 2007. This is a sobering thought but, if I may adapt a common saying, whilst a financial crisis may be easy to start, it is difficult to end.

With that thought in mind, I will now hand over to Caroline.

Slide: Agenda

Thank you Jeremy and good morning everyone.

In his introduction Jeremy posed the question as to whether banks are safer now than they were in 2007. My part of the session will touch on how we in Guernsey are contributing to improved safety in the banking system here by following Basel III principles. I will review some of the activity we have conducted in 2015 and look ahead to what we propose for 2016.

Firstly though I wanted to spend a few minutes considering how the industry looks today and what external economic issues might influence us in the future.

The UK tax changes in relation to Non-Dom status and the general global anti-avoidance agenda will be watched with interest. Will the use of offshore structures to hold property, offshore mortgages and banking facilities still be worthwhile? I know that some of you are thinking about these issues.
Will the OECD Common Reporting Standards for the automatic exchange of information impact on the use of offshore bank accounts once the reporting requirement kicks in? What will the cost be of implementing the framework? Now that FATCA has settled down it may be that this additional reporting requirement is not significant but is everyone ready for it in 2016?

Will the general global moves towards anti-tax avoidance and transparency, BEPS and DPT, ultimately make the use offshore structures less attractive from a cost and effectiveness perspective?

Does crowdfunding pose a threat to the private banking and wealth management industries? Or is it an opportunity for Guernsey? I am sure my colleagues in the Fiduciary and Innovations division will talk about this this afternoon.

I don't pretend to have the answers to these questions but they amongst others will need to be faced by our industry in the near future.

Slide: Number of Guernsey banking licences

Turning now to look at trends in the banking sector over the past year:

The number of licensed banks has fallen to 29 following two branch surrenders this year. The rate of closure seems to have tailed off but further surrenders, not least as part of rationalisation processes are likely. However, this year we have had conversations with prospective banking licensees so there is interest out there in Guernsey as a banking centre. We are of course happy to speak with any prospective applicant at an early stage in order to give them a clear steer as to what the Commission's expectations and approach will be.

The following slides use data up to Q2 September 2015.

Slide: Staff numbers in Guernsey banks

Total staff numbers have continued to fall slightly and are now below 1,600. You will all be aware of some group restructurings that have been announced, often these are positive for Guernsey but on some occasions they are negative although there is no particular pattern evident to us at the moment.

Slide: Total assets held by Guernsey banks

Total assets have stabilised and now stand at around £109bn. The fall in Swiss fiduciary deposits has slowed and they now stand at around £20bn with others totalling around £89bn of which a key indicator is third party deposits which have remained fairly stable at
around £30bn over the past year.

Slide: Average net capital per subsidiary

Capital held per subsidiary bank has risen slightly during the past three years after falling slightly from 2012-13. Banks appear to be retaining a small amount of profit, dividending back less than 100%, and there have been no significant repatriations of capital or closures of subsidiaries in recent years. Perhaps in preparation for Basell III banks are showing signs of holding on to capital where possible.

Slide: Review of 2015 Activity

This slide shows the main issues to which we devoted our resources during 2015 and I will talk a little about each, policy issues in relation to Basel III, Prism and some practical matters regarding our supervisory programme, continuing developments in UK Banking Reform and our involvement in the SEPA working group.

Slide: Basel III

Firstly, in relation to capital adequacy and leverage ratio, we issued a consultation paper in July this year.

The consultation proposed revised definitions of regulatory capital, the establishment of new minimum regulatory capital requirements, changes to the calculation of risk weighted assets and the introduction of a leverage reporting requirement – all of which are consistent with the Basel III capital adequacy standard.

We provided members of the AGB with a presentation on the proposals in May, in advance of the publication of the consultation paper.

The Commission has now considered the responses to the consultation, all of which were supportive of pressing ahead with the proposals. We are currently testing our new spreadsheet with a couple of willing volunteers and are also having the spreadsheet reviewed by a third party to ensure it works as intended.

It is intended that the Commission will publish the revised policy framework and spreadsheet soon. We then propose to run the old and new frameworks in parallel for Q4 2015 followed by implementation in the first half of 2016. Transitional adjustments can be applied to reduce the impact of the revised policy although this will only rarely be necessary.

The leverage ratio was also discussed in the consultation paper and this remains a reporting requirement at this time although we may take leverage into account in considering the Pillar 2 capital.

Turning now to liquidity and, in July, the three Crown Dependencies issued a tri-party discussion paper on liquidity in relation to subsidiary banks; it is not currently proposed to apply this to branches. Responses to this are also being reviewed and further work will be carried out in 2016, which is likely to include an impact assessment.

Slide: Embedding PRISM - findings

Last year my colleagues spoke to you about our risk and impact based supervisory model – Prism. As you will be aware, each firm is classified by the level of impact it would have on its customers, the financial system in the Bailiwick and elsewhere and to the Bailiwick economy if it were to fail or to engage in persistently poor conduct. By now I am sure most of you will be aware of your impact rating – High, Medium High or Medium Low – we do not have any banks classified as low impact. The level of supervisory engagement is now driven by the impact rating of the firm.

This year the banking supervisors have worked hard to develop and embed this framework and those of you who have already been subject to a Full Risk Assessment will have noticed the in depth work that has been undertaken in order for us to gain a better understanding of your business. Each of the supervisors has found the process to be extremely informative and valuable in deepening their understanding of each bank, its governance, risk management and business model.

This year we have carried out Full Risk Assessments of 8 banks and reported our findings to internal Risk Governance Panels. Any adverse findings have, to date, been around operational risk and the oversight of outsourced functions.

In relation to operational risk, these included; concerns about the adequacy of policy and procedures and the internal communication of those policies and procedures. In some cases we considered that more could be done in training and understanding of key operational risk areas and potential improvements to management information being gathered and reported on were also identified.

In relation to outsourced functions it is of course essential that the board or management committee have adequate oversight of the function and put in place effective controls such as a robust audit process.

One area which we have begun to probe further this year is in relation to Conduct Risk for private banks and wealth management operations. We have always considered conduct aspects of retail banking but are now considering this in relation to High Net Worth individuals. So far we have conducted two in depth reviews and have been pleased not to discover any major causes for concern. We have observed that High Net Worth clients are, as you might expect, much better placed than retail clients to judge the quality of the service and it may therefore be self-fulfilling that they obtain a higher standard of service. We have more work to do in this area and have learned some lessons ourselves in terms of our approach to these reviews.

I should also mention that we are observing positive improvements in the approach to AML within the private banks. My colleagues in the Financial Crime Division were also very appreciative of the assistance provided by the banks in relation to the Moneyval inspection, so thank you to all who were involved.

Slide: Supervisory colleges

We continue to participate in Colleges of Supervisors whenever possible which enables us to participate in a coordinated approach to the supervision of a banking group. Attendance at colleges assists in our understanding of the parent banks due to the exchanges of information that take place, builds relationships with home supervisors and also helps to raise the profile and reputation of Guernsey as a well regulated and cooperative jurisdiction. The frequency of the Colleges is at the discretion of the home supervisor and we do not always have to travel as they are, where feasible, held by videoconference or teleconference.

This year we have attended or will be attending a total of 7 Bank Colleges, 5 in person and 2 by telephone.

Slide: Credit Risk Review

Earlier this year we undertook a series of thematic reviews in relation to credit risk. Although credit risk forms a normal part of the supervisory engagement process we thought it would be helpful to have a specific and more in depth look into this important area in order to compare different business models and to build up the supervisory knowledge in this area.

We selected several banks, each with different business models, and spent two to three days in each bank. There were no major areas of concern although it was interesting to observe the different control environments that had developed with each business model. It was also apparent that problem credits often develop when the banks drifted outside of their target markets; this illustrates the importance of clear credit policies which are strictly adhered to.

There were also issues when the banks had made tacit assumptions regarding the timing and method of repayment without confirming with the client – this led to issues further down the line.

We found this thematic to be extremely useful and it will inform our approach to credit risk in the future.

Slide: UK Banking Reform

UK banking reform is progressing and we know that Guernsey banks will be outside the ringfence. However further clarity is awaited in relation to how the PRA will implement the ringfence and they continue to issue consultation papers and policy papers. The latest papers, issued on 15 October contained no surprises for us.

Each affected bank with a Guernsey presence is considering how best to structure, or restructure, itself for the future. We have held bilateral meetings with the banks when they have been in a position to discuss their proposals so that we can provide early feedback and identify any areas which might concern the Commission. Discussions so far have been positive in that the banks are looking to see how they can continue in Guernsey and perhaps even strengthen their position relative to their group.

Slide: SEPA

The Commission has been involved in the SEPA working party, looking at Guernsey membership of the Single European Payments Area which is administered by the European Payments Council. It is pleasing that this project, which is being undertaken in conjunction with Government and also with Jersey, the Isle of Man and the CIBO office in Brussels, is progressing positively. The Commission has played a supporting role thus far, however, as part of the legislative framework the Commission is likely to have a role in monitoring payment service providers and their compliance with the relevant regulations. Further work on what that might mean, for the Commission and for those banks that join the scheme, will need to be undertaken once the requirements become clearer.

Slide: Looking ahead to 2016

So, now let's look ahead to 2016 and what that holds in store for us.

I mentioned the papers on capital and leverage and we have work to do there to finalise the policy framework – I spoke about this earlier.

Following on from the Crown Dependencies discussion paper on liquidity we will work with you to carry out an impact assessment prior to issuing our own consultation paper during the first half of next year.

The Revision of laws project will take up some of our time during 2016 although there are not any banking specific matters which fall into that project. However, to the extent that the more general changes will impact on banks we will keep you informed.

During 2016 our preparation for an IMF visit, which will have a prudential and macroeconomic focus, will get underway in earnest. We are not concerned about this, having carried out a gap analysis some time ago, but there is a considerable amount of work to do in getting ready for such a visit.

For next year's thematic review we plan to do some assurance work around prudential regulatory reporting. We propose to look at the controls around the production of the returns, the level of review and sign off, the audit process and the accuracy of the returns. You may wish to review the paper published by the JFSC last year on their themed examination programme on prudential reporting.

It will not surprise you to learn that we are also considering resolution and how Guernsey should respond to international developments in this area. The Financial Stability Board has identified resolution regimes as a priority area and it is something that the IMF has begun to look at as part of the FSAP process. In Guernsey we do host subsidiaries and branches which will be impacted by home authority resolution regimes. Guernsey would need a channel through which to deal with the unlikely event of a bank failure and also to enable communication with future resolution colleges involving banks with Guernsey operations. Work on this subject is at an early stage but will need to be considered in detail in 2016 in conjunction with government and other crown dependencies.

That is all I wanted to say today but Jeremy and I will be happy to answer any questions.