



**XIX
2008**

BILLET D'ÉTAT

WEDNESDAY, 26th NOVEMBER, 2008

COMMERCE AND EMPLOYMENT DEPARTMENT -
DEPOSITOR COMPENSATION SCHEME

B I L L E T D ' É T A T

TO THE MEMBERS OF THE STATES OF THE ISLAND OF GUERNSEY

I have the honour to inform you that a Meeting of the States of Deliberation will be held at **THE ROYAL COURT HOUSE, on WEDNESDAY, the 26th NOVEMBER, 2008,** immediately before the meetings already convened for that day, to consider the item contained in this Billet d'État which has been submitted for debate.

G. R. ROWLAND
Bailiff and Presiding Officer

The Royal Court House
Guernsey
21 November 2008

COMMERCE AND EMPLOYMENT DEPARTMENT

DEPOSITOR COMPENSATION SCHEME

The Chief Minister
Policy Council
Sir Charles Frossard House
La Charroterie
St Peter Port

17th November 2008

Dear Sir

1. Executive Summary

1.1. This report recommends that the States approve the accompanying Ordinance under section 46 of the Banking Supervision (Bailiwick of Guernsey) Law, 1994, which introduces a depositor compensation scheme in Guernsey.

1.2. The essential features of the scheme are as follows:

- The scheme will apply when a bank is unable to repay its depositors.
- The total amount of compensation will be a maximum of £50,000 per depositor per licensed bank.
- Compensation will be available to local or non-local individual retail depositors.
- Compensation will be payable for deposits in any currency.
- The compensation will be funded by a combination of insurance and a levy on all banks licensed to conduct activities in the Bailiwick.

1.3. The Department is grateful to the Policy Council which, with the concurrence of the Presiding Officer, has agreed that this report and the draft Ordinance appear in the same Billet d'État.

1.4. This report is structured as follows:

- Part 2 sets out the policy objectives behind introducing a depositor compensation scheme.
- Part 3 provides background information on the preparation of this report and the accompanying Ordinance.

- Part 4 discusses the international recommendations for depositor compensation schemes as well outlining some of the more complex issues that must be considered when introducing such a scheme. The most difficult issue to address is that the behaviour of depositors and financial institutions can change increasing risk and long term instability (“moral hazard”).
- Part 5 provides information on the diversity of Guernsey’s banking industry. This diversity makes the introduction of a depositor compensation scheme more complex as it is not possible to introduce a “one-size-fits-all” solution. Any attempt to introduce such a scheme could adversely affect business models, unnecessarily increase costs and harm an industry which is a significant employer and contributor to the economy. It is also the case that the international banking landscape has changed significantly in the past few months.
- Part 6 outlines how the scheme will be established.
- Part 7 explains the estimated costs of establishing and running the scheme.
- Parts 8, 9 and 10 explain the administration costs, the use of insurance and the funding of compensation in the event of a bank failure.
- Parts 11 and 12 provide the mechanisms for responding to a banking failure and explains the additional powers of the scheme to deal with such an event.
- Part 13 provides information on how the proposed scheme addresses moral hazard.

2. The reasons for providing depositor compensation

- 2.1. Jurisdictions choose to introduce depositor compensation schemes to meet a number of different policy objectives. The policy objectives behind the scheme proposed in this report are as follows:
- The scheme will protect small retail depositors from losing their deposits in a banking collapse, and
 - The introduction of a scheme will enhance Guernsey’s international reputation as a well regulated financial centre.
- 2.2. In choosing as a specific policy objective the protection of small depositors, large and corporate depositors will have a continuing obligation to select carefully the financial institutions in which they choose to make deposits.

3. Background

- 3.1. Following the experience of Northern Rock (Guernsey) Limited, the Guernsey Financial Services Commission (“the Commission”), with the support of the Department, has been in discussions with the banking industry about a number of possible changes to the regulation of banking in Guernsey. Included in those discussions was the possible introduction of a depositor compensation scheme or depositor protection scheme.¹
- 3.2. In August 2008, following several months of private and informal discussions between the Commission, the banking industry and the Finance Sector Group,² a public consultation paper was released by the Commission which outlined its initial suggestions for a depositor compensation scheme. Following the closure of the consultation period the Commission continued to work on its proposals with representatives of the banking industry.
- 3.3. In late September and early October the global turmoil in the financial markets became extreme. Major international banks experienced difficulties and despite a range of interventions by national governments several failed. Those difficulties and failures had knock on effects in many countries, and the Crown Dependencies were not immune.
- 3.4. By October it had become apparent to the Department and the Policy Council that the introduction of a depositor compensation scheme was both necessary and urgent. On 6 October, following a presentation to States Members by the Department, the Policy Council and the Commission, the Policy Council unanimously supported introducing a depositor compensation scheme as a matter of urgency.
- 3.5. With the agreement of the Department, the Policy Council invited Deputy Charles Parkinson to chair a working group with a view to bringing final proposals to the States as quickly as possible. That group included representatives from the Commerce and Employment Department, the Commission and the Association of Guernsey Banks (“the AGB”).
- 3.6. The working group considered the following issues:
 - The nature of the deposit base in Guernsey, in order to determine an appropriate level of cover.

¹ The Department has chosen to use the term “compensation” as the scheme is designed to compensate individuals for any loss rather than protect deposits within the strict meaning of the word “protection”.

² The Finance Sector Group is an interdepartmental group established by the Commerce and Employment Department which includes industry representatives from the Guernsey International Business Association, representatives from the Policy Council, the Department, the Treasury and Resources Department, and the Guernsey Financial Services Commission.

- International recommendations on deposit insurance and compensation mechanisms.
- Various mechanisms for funding so that the scheme was appropriate, sustainable and suited to Guernsey's banking industry.
- A review of the nature of the banking industry to ensure that the scheme was appropriate for the diverse banking industry that exists in Guernsey.
- The structure and powers of the scheme including the appropriate scheme managers, administrative mechanisms and other technical details.

3.7. The schedule of meetings relevant to preparing the report and the accompanying Ordinance were as follows:

- 8 October 2008 - the necessary data on the nature of the deposit base was identified and the process of gathering that data commenced. The Commission and the industry were charged with gathering that information. The Commerce and Employment Department were given responsibility for preparing this report and instructing the Law Officers to prepare the draft Ordinance.
- 22 October 2008 – the deposit base was analysed which provided data on the likely cost of the scheme, the funding arrangements were discussed and agreed “in principle”. An early draft of this report was considered as was a working draft of the Ordinance. The AGB and the Commission were asked to provide an agreed funding model. The Department and the Law Officers were to continue preparing the legislation and the report based on the input received from the working party
- 27 October 2008 – representatives from the Department and the Commission accompanied Deputy Parkinson to meet with insurance experts to discuss whether or not there might be an insurance solution to the question of depositor compensation.
- 28 October 2008 – the working group met for the third time and finalised the principles behind the funding model as well as agreeing on the administrative arrangements for the scheme. A further draft of this report was also considered. Later that day the Commerce and Employment Board reviewed the draft report and approved the key recommendations of the working party.
- 31 October 2008 – representatives of the Commerce and Employment Department attended the Fiscal and Economic Policy Steering Group where the key policy decisions were presented and discussed.
- 3 November 2008 – representatives from the Commerce and Employment Department and the Commission attended the Policy

Council where the key policy decisions made at that stage were presented and discussed.

- 4 November 2008 – a consultation document on the proposals was released to the AGB
- 7 November 2008 – Deputy Parkinson, Deputy McNulty-Bauer, officers of the Commerce Employment Department and the officers of the Commission gave a presentation to AGB members on the proposals.
- 11 November 2008 – the consultation period closed.
- 12 November 2008 – a draft of this report was presented to the Commerce and Employment Board for approval.
- 13 November 2008 – the draft report was circulated to the Policy Council and the Treasury and Resources Department.
- 14 November 2008 – the draft Ordinance was circulated to the Legislation Select Committee.
- 17 November 2008 – the report was considered and approved by Policy Council and the Ordinance was considered and approved by Legislation Select Committee.

3.8. The Department confirms that the proposals in this report have the support of the Commission and the executive committee of the Association of Guernsey Banks.

4. International recommendations for depositor compensation schemes

4.1. At present there is no international standard that requires any jurisdiction to have a depositor compensation scheme. There are several international organisations which have set out guidelines that can be used by a jurisdiction that chooses to introduce a depositor compensation scheme. The European Union is the only transnational organisation that has made depositor compensation compulsory for its member states. In 2001 the Financial Stability Forum³ published guidance and principles for effective depositor insurance schemes.

4.2. In order to ensure that a depositor compensation scheme is effective and sustainable the Financial Stability Forum recommends that when introducing a scheme policy makers should consider the following issues:

³ The Financial Stability Forum is comprised of senior representatives of national financial authorities, central banks, treasury departments and financial regulators established by the G7 group of nations in order to promote international financial stability.

- Membership of a scheme should be compulsory for all banking institutions operating within a jurisdiction.
- The scheme must be introduced in such a way as to ensure that there are proper mechanisms for mitigating any increase in moral hazard such as effective regulation and strong corporate governance.
- The types of deposits that are protected under the scheme must be clearly defined in law.
- The scheme must have access to all funding mechanisms necessary to ensure that depositors receive the best outcome from any bank failure.
- The scheme must be constructed in such a way as to be affordable and sustainable.
- The time that it will take for depositors to be compensated must be clearly communicated to depositors.
- The scheme must have all necessary powers to carry out its functions.
- There must be good communication between the scheme, the regulator and the government.
- Depositor compensation schemes can deal with a limited number of bank failures but cannot deal with a major banking crisis arising out of systemic risk; they are only part of an effective solution. During a major systemic crisis proper corporate governance and regulation are the primary regulatory tools with depositor compensation providing support. It is not appropriate to rely on depositor compensation as a safety net and allow regulatory and corporate governance standards to drop.

What is “Moral Hazard” – how much risk should depositors bear?

4.3. Moral Hazard, in the context of banking, is what economists term the possibility that following the introduction of depositor compensation, depositors and banks may change their behaviour to the detriment of the industry as whole. It is the fundamental question of who should bear the risk of a bank failure. One of the biggest challenges facing policy makers when introducing depositor compensation is how to manage any increased moral hazard. What must be answered are the following questions:

- What risk should depositors be reasonably prepared to accept?
- Who should bear the risk of a bank failure?
- How can the scheme provide incentives to the banking industry to reduce risk?

- 4.4. In the context of banking, an increase in moral hazard may have the effect of increasing the overall risk of bank failures and intensifying banking crises. Increased moral hazard results in people taking less care of where they choose to place their deposits; it rewards risky business models and punishes the prudent.
- 4.5. Guernsey has been fortunate in that its banking industry is broadly conservative. The recent difficulties experienced in Guernsey have been imported from other jurisdictions and do not have events in Guernsey at their core.
- 4.6. It needs to be remembered that depositing money in a bank is a form of investment. Interest rates offered by banks are a price mechanism reflecting the bank's need to bid for funds. The interest rate offered sets out not only the likely return on the "investment" but also the potential risk associated with that "investment". No investment is ever risk free.⁴ In the absence of a depositor compensation scheme, in principle, the onus is on depositors to select carefully the bank in which they choose to deposit and to continue to monitor that investment and the financial health of the chosen bank or suffer any loss in the event of that bank failing.
- 4.7. The Financial Stability Forum makes the following comments on the importance of properly addressing moral hazard in the context of depositor compensation:

"A well-designed financial safety net contributes to the stability of the financial system; however, if poorly designed, it may increase risks, notably, moral hazard. Good corporate governance and sound risk management of individual banks, effective market discipline, and frameworks for strong prudential regulation, supervision and laws, can mitigate moral hazard and these elements are most effective when used in concert.

Good corporate governance and sound risk management of individual banks help to ensure that business strategies are consistent with safe and sound operation, and thus can act as the first line of defence against excessive risk taking. Good corporate governance and sound risk management includes standards, processes, and systems for ensuring appropriate direction and oversight by directors and senior managers; adequate internal controls and audits; management of risks and the evaluation of bank performance; the alignment of remuneration with appropriate business objectives; and management of capital and liquidity positions. Effective market discipline requires sound accounting and disclosure regimes and the ongoing attention to a bank's soundness by ratings agencies, market analysts, financial commentators and other professionals. Regulatory discipline can be exercised through effective regulation covering the establishment of new banks, the imposition of

⁴ The nearest indicator of a "risk free" investment in sterling interest rates would be the yield on UK Government bonds

minimum capital requirements, the qualifications of directors and managers, sound business activities, a fit-and-proper test for controlling shareholders, standards for risk management, strong internal controls and external audit. Supervisory discipline can be exercised by ensuring that banks are monitored for safety and soundness as well as compliance issues and that corrective actions are taken promptly when problems surface, including the closure of banks when necessary.

Ensuring that a deposit insurance system contains certain design features can also mitigate moral hazard. These features may include: placing limits on the amounts insured; excluding certain categories of depositors from coverage; using certain forms of co-insurance; implementing differential or risk-adjusted premium assessment; minimising the risk of loss through early closure of troubled banks; and demonstrating a willingness to take legal action, where warranted, against directors and others for improper acts.”

- 4.8. Guernsey already complies with all internationally accepted standards on banking regulation and has a well deserved reputation for high standards of corporate governance. What is missing is a depositor compensation scheme. When introducing such a scheme Guernsey can take comfort from its strong regulatory regime and high standards of corporate governance, nevertheless the question of how to address increased moral hazard must still be answered.
- 4.9. A real world example of moral hazard exists in the case of Northern Rock. Northern Rock was fundamentally a UK problem. Northern Rock’s business model in the UK was heavily reliant on obtaining credit from the wholesale credit market. With hindsight it is now generally accepted that this was a high risk strategy as in the event that the credit market dried up Northern Rock would be unable to obtain funding. Of course before the summer of 2007 the chance that the wholesale credit markets might seize up was considered so small as to be inconceivable. As events unfolded, that previously unimaginable eventuality did occur; Northern Rock Plc. faced a severe funding shortage, which had the potential to result in the bank becoming insolvent. The UK government stepped in to underwrite the deposits in Northern Rock Plc. increasing moral hazard.
- 4.10. The government guarantee created an incentive for depositors to put their money in Northern Rock. Northern Rock received significant inflows of deposits in the UK and recently had to stop accepting deposits due to it obtaining more than 1.5% of the total UK deposit base. The result is that Northern Rock, which with hindsight had an extremely high risk business strategy, was ultimately rewarded for adopting that high risk strategy by a government guarantee. The competitors of Northern Rock which had a much more conservative business model were punished as deposits fled those banks and were instead shifted to Northern Rock. The end result being that the “rescue” of Northern Rock has “rewarded” a high risk business model.

- 4.11. In its report “Run on the Rock” the House of Commons Treasury Select Committee examined the circumstances surrounding the rescue of Northern Rock and made the following observations:

“We have concluded that banks must be allowed to fail, and that such failures must be managed in an orderly manner. For the sake of clarity and transparency, it is important that all stakeholders in banks should be aware how the risk of bank failure is distributed. In general, in non-financial companies, shareholders and creditors take on the risk of company failure, but the situation with regard to banks is more complex. If, as happened with Northern Rock, the Government steps in to prevent the collapse of a bank, it takes on a significant risk on behalf of taxpayers. Depositors are treated as unsecured creditors under the existing arrangements, so clearly bear the risk that they could lose the rights to their deposits.”

- 4.12. The Treasury Select Committee made the following recommendation:

“The taxpayer should not bear the risk of banks failing. Nor do we believe that small depositors should bear such risk. Rather, the risk of failure should be borne by a bank's shareholders and creditors but exclude small depositors. The Government must ensure that the framework for handling failing banks insulates taxpayers and that small depositors should also be protected from the risk of banks failing.

Although the Financial Services Compensation Scheme is portrayed as offering protection to the depositors of all financial institutions, examination of its funding indicates that it would not be able to cope with the failure of a medium-sized, let alone a major, financial institution. If such an event were to occur under present arrangements, only the Government, using taxpayers' funds, would be in a position to protect depositors, as it did with Northern Rock. We are concerned that banks and building societies appear to be viewing the Government's support to Northern Rock as an acknowledgement that no bank would be allowed to fail. The Government must take steps to ensure that its framework for maintaining financial stability does not provide free insurance to banks.”

- 4.13. It is now recognised that small depositors lack the capacity and access to information to monitor the financial health of banks in any meaningful way. Indeed there is a growing recognition that small depositors should be totally protected.
- 4.14. The proposals in this report provide a number of mechanisms for addressing any increased moral hazard that may arise due to the introduction of a depositor compensation scheme. The proposals include a number of measures that will provide some counterbalance to any increase in moral hazard at the consumer level that arises from protecting small retail depositors.

- 4.15. The Department considers that the proposals in this report adequately address moral hazard and also comply with the international recommendations of the Financial Stability Forum and the Treasury Select Committee's recommendations.

Key Points:

- Depositor Compensation Schemes can change consumer and bank behaviour and increase risk in the banking system.
- Depositor Compensation Schemes must be crafted in such a way as to minimise any increased risk that results from the introduction of the scheme.
- Banks must be allowed to fail, however regulators must intervene to minimise the loss to depositors and the costs of the scheme.
- The risk of bank failure should not be borne by small depositors or the taxpayer, but should be borne by those best able to make informed investment decisions.
- Guernsey already has a strong regulatory regime and sound corporate governance.

5. The nature of the banking industry in Guernsey

- 5.1. Before analysing the nature of Guernsey's banking industry what must be borne in mind is the fundamental shift that has occurred in the international banking industry over the past year. To borrow the words of Alan Greenspan, the former chairman of the Federal Reserve, the world has suffered a "once in a century credit tsunami". Events that were once beyond the realms of imagination have come to pass. Those events have vastly changed the risk profile of banks globally and, more importantly, will change the risks to which Guernsey banks are exposed.
- 5.2. Turning from the general economic environment to the banking industry in Guernsey, 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 societies⁵ whose target market covers both Guernsey resident savers and investors, 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

⁵ Included in this category are banks that were previously UK building societies.

business lines among the clearers. Indeed the practice of “up-streaming” where deposits are gathered in Guernsey and then placed with the parent bank occurs to some extent in all banks. That is as a result of most banks having centralised treasury operations.

- 5.3. 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.
- 5.4. In respect of the clearing banks they are regarded as systemically important banks in the UK and their other home jurisdictions. They have diverse business models and less exposure to risks in any single market. Recent events have shown that governments are willing to intervene to protect clearing banks⁶.
- 5.5. The banks which are generally classed as “deposit-takers” have a different business model from clearing banks. Those banks tend to gather deposits from both resident and non-resident depositors and then “up-stream” those deposits to their parent or to other banks within the group. Some deposit-takers provide services in competition with the clearing banks such as providing mortgages into the local market and providing an alternative to the clearing banks for deposits generally. These “deposit taking” banks tend to have high asset concentrations in their parent banks and exposure to a single market; particularly the UK mortgage market. Due to the specialised monoline business models of those particular banks they are potentially more exposed to severe changes in the economic climate. This is due to the concentration risk and counterparty risk inherent in the specialised business models under which they operate. Prior to the summer of 2007 there had never been any suggestion that these business models were anything other than sound. In the past these banks have been just as stable and sound as the clearing banks and in normal market conditions pose little risk.
- 5.6. The private and corporate banks have more diversified business models and balance sheets although some perform specialist roles. Private banks generally have high minimum deposit levels and will receive a correspondingly lower benefit from any depositor compensation scheme. Corporate and wholesale banks have a significantly smaller percentage of retail deposits and tend to have diverse operations as well as providing services to the fund administration, insurance, asset management and fiduciary services and dealing in the interbank markets.
- 5.7. The following table illustrates the scale and distribution of deposits in Guernsey. The Commission has provided the following analysis of banking sector as at 31 March 2008:

⁶ For example, the Royal Bank of Scotland, Lloyds TSB, HBOS (UK), Fortis and Dexia (Belgium) and the Irish Banks all systemically important banks which have received support from their home jurisdiction's.

Type of Bank	No of Banks	Deposits £million	Percentage of total
Clearing Banks	7	13,902	10.9%
Deposit Takers	7	3,948	3.1%
Other Banks	<u>33</u>	<u>109,597</u>	<u>86.0%</u>
Totals	<u>47</u>	<u>127,447</u>	<u>100.0%</u>

- 5.8. 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.
- 5.9. What this table demonstrates is that the vast majority of deposits in Guernsey banks are “non-retail” and made up of inter-bank deposits, corporate deposits, or deposits associated with other aspects of the finance industry. The retail deposit taker sector is a much smaller percentage of the banking sector. Despite the relatively small size of the retail deposit taking sector the collapse of a retail deposit taker is likely to have a more significant effect on individual depositors and Guernsey’s international reputation.
- 5.10. The private banks and corporate banks hold a much greater proportion of deposits. Those banks will receive only a marginal benefit from the introduction of any depositor compensation scheme due to the relatively small retail deposit base of those banks. Private banks have minimum deposit levels well in excess of the amount of protection afforded by many depositor compensation schemes. There are some which have a minimum deposit of more than £250,000. Private and corporate banking are significant contributors to Guernsey’s economy yet stand to receive very little benefit from a depositor compensation scheme.
- 5.11. When introducing a depositor compensation scheme care must be taken to ensure that the costs to each individual bank reflects the risk it brings to the scheme. This will minimize the effect of imposing potentially significant costs in a manner that may result in it being uneconomic for some banks to continue operations in Guernsey. The funding mechanism must be such that it meets the objective of providing a reasonable level of protection whilst ensuring that the cost to each individual bank is equitable.
- 5.12. The banking industry employs approximately 2900 people. The average salary of those employed in the banking sector is approximately £55,000 per annum. The banks provide a significant number of well paid highly skilled jobs for locals. As a result of the large number of highly paid jobs, through that employment the States receives a significant amount of tax revenues through employee tax instalments. A reasonable estimate is approximately £20 million in total ETI payments.
- 5.13. Under the States zero/10 taxation strategy the banking industry continues to pay tax on specified banking profits albeit at a reduced rate. The direct tax

contribution under the new tax strategy is expected to be approximately £20 million per annum.

- 5.14. The banking sector, particularly the clearing and corporate banks provide key services to the other sectors in the financial services industry, particularly in the areas of investment funds and fiduciary services. The continued existence of a strong banking sector is vital to the interests of the Guernsey economy.

Key Points:

- The international banking landscape has changed dramatically over the past few months.
- The banking sector provides well paid highly skilled jobs to 2900 islanders.
- The banking sector contributes approximately £40 million in tax each year.
- A strong banking sector is in the interests of the finance industry and the Guernsey economy.
- Guernsey's banking industry is diverse with different banks providing different services with retail deposits being a relatively small part of the Island's total banking business.
- A depositor compensation scheme must be designed in such a way as to provide adequate protection for depositors while properly ensuring that the cost to industry is distributed appropriately.

6. Key features of the Guernsey depositor compensation scheme

- 6.1. The Department proposes the following as key features of the Guernsey scheme:

- In order to protect the most vulnerable type of depositor the scheme will cover only individual retail depositors. It will not cover corporate depositors or deposits by trusts, except in certain defined circumstances such as executorships or bank accounts held by parents on trust for their children and Retirement Annuity Trust Schemes ("RATS"). The Ordinance clearly defines which types of deposits are included in the scheme.
- In order to be fair to all retail depositors and to safeguard Guernsey's position as an international finance centre, the scheme will cover all retail depositors wherever resident. It will not cover deposits in branches of Guernsey Banks outside the Bailiwick.

- The scheme would provide compensation for the loss of a deposit arising from a bank failure up to a maximum amount of £50,000. This is the same as the current level of protection in the UK and the Isle of Man.
- To reflect the international nature of Guernsey and the increasingly globalised nature of people's financial arrangements, the scheme would cover the equivalent of £50,000 in all currencies. Where a deposit is in a currency other than sterling the exchange rate would be set at the rate that existed on the date that the bank defaulted on its obligations.
- To deliver protection to individuals holding joint accounts, the £50,000 limit would apply per person (i.e. a £100,000 account held by two people would be covered 100%).
- The compensation limit would apply to each depositor rather than to each account so a single person who has four accounts with the one licensed bank would only be entitled to a maximum of £50,000. A person who has an account with 2 different banks would be entitled to claim against each bank in the highly unlikely event that both banks failed. The coverage would be per licensed bank, and not per brand. The scheme will publish a list of the banks which will be covered by the scheme.
- Loans made to a depositor covered by the scheme would be netted against deposits made with the same bank where any contractual right of set off existed. For example where a depositor had a deposit of £50,000 and an overdraft of £25,000 then the total compensation payable would be £25,000. Mortgages and credit card debts would not be netted off unless there was a specific pre-existing contractual right between the depositor and the failed bank.
- In the event of a bank failure, the eligible depositors who have claimed against the scheme will be required to assign their rights as creditors of the failed bank to the scheme for any compensation claimed - the concept of subrogation. The scheme would then pay out to each depositor up to £50,000. Whatever funds are eventually recovered from the failed bank would be paid to the scheme up to the total amount of compensation paid out by the scheme. Any residual funds from the bank's liquidation would be distributed to depositors in the normal way when a bank is liquidated. Where there was a shortfall in the value of the assets of the failed bank the scheme would suffer any loss up to £50,000 per depositor. Any loss over this amount would be borne by the depositors. A depositor who had £50,000 on deposit and received compensation from the scheme in that amount would not be paid anything further from the liquidation of the bank. The scheme would receive any funds recovered from the bank instead. Where a depositor had £60,000 in a failed bank, he would

receive £50,000 from the scheme. Assuming that the liquidator recovered 100% then the scheme would get paid £50,000 from the liquidator and the depositor would receive a further £10,000.

- The scheme would only commence once a bank was unable to pay its debts and that would be by reference to a clearly defined event such as a bank being placed in administration or liquidation.
- The scheme will have the power to insure against at least part of the risk and may recover the costs of any such insurance from the banking industry.

6.2. It is proposed to fund the scheme in three ways. Firstly there will be an annual fee payable by all licensed banks to pay for the administration costs of the scheme. That fee will be relatively low. Secondly there will be an upfront insurance premium paid by the industry to insure against a portion of the risk. That premium would be apportioned among the participating banks on the basis of each bank's respective risk. Thirdly in the event of a bank failure there will be a levy on the banks to raise funds to pay compensation. In essence the administration and insurance will be pre-funded but the compensation will be post funded. Those are discussed in more detail below.

7. The establishment and running of the scheme

7.1. The scheme will be run as a separate legal entity. The structure of the scheme will be as follows:

- The governing body of the scheme will be a board of up to 5 members ("the Board").
- The Board will be appointed by the Department. The appointments will subsequently be laid before the States.
- The Board will be independent of the Department and the Commission.
- When there is no bank in default and the scheme is simply carrying out basic administration and insurance the Board will have the power to delegate those functions with appropriate oversight by the Board.
- The Commission will be responsible for declaring a bank to be in default.
- The Board will have a range of statutory powers that it can exercise.
- The Board would also co-operate with the Commerce Employment Department, the Policy Council, the Commission, and the administrator or liquidator of a failed bank.

- 7.2. The main operational challenge of the scheme would be to ensure that, were a bank to fail, the scheme would have the ability to meet its obligations to pay-out at least partial compensation relatively quickly to depositors.

8. Administration costs

- 8.1. It is almost impossible to provide an accurate estimate of the likely annual administration costs of the scheme. The administration costs would be split equally between all banks.
- 8.2. The estimated annual running costs are as follows:

Chairman	£25,000
Independent Board members - £20,000 x 4	£80,000
Staffing and resources	£100,000
Total	£205,000

- 8.3. In order to establish the scheme quickly it is proposed that the States meet the initial set up costs with the banks paying the annual administration levy from 2009 onwards. This will require the States to allocate £100,000 to the scheme as part of the initial establishment costs.
- 8.4. The scheme will be required to set its administration fees annually on the basis that it is to cover its costs. The scheme will consult with the Commission and the banking industry on the level of fees which will be approved by the Department.
- 8.5. The scheme will be required to prepare an annual report to the Department which will set out its operations in the previous year and include relevant financial statements.

9. Insurance

- 9.1. To give the scheme the maximum flexibility it will have the power to insure against a portion of any claim, either through an insurer or by use of a captive insurance company. Whether the scheme chooses to adopt an insurance solution, and what form that solution may take, will depend on a range of factors.
- 9.2. The working party consulted with insurance experts on the possibility of insuring against some of the risk. The advice received from those experts is that such insurance would not be available in the current economic climate. Even if it were possible to obtain insurance the premium would be unaffordable. However when the economic climate returns to more normal conditions that may change.

- 9.3. Instead the Department is recommending the creation of a captive insurance company to cover the first £20 million of risk. The captive insurance company should be formed as a company limited by Guarantee where the States shall provide an initial guarantee of £20 million plus providing £1 million in initial capital.
- 9.4. Once operating the captive insurance company would continue to build its total funds to £20 million through an annual insurance premium paid by the banking industry. That premium will total approximately £2 million each year. However the insurance premium would not be divided equally between the banks. Instead what is proposed is that each bank would pay a premium calculated on an analysis of the size of its total retail deposits made by depositors eligible for compensation under the scheme and the risk of that bank defaulting and triggering a payout under the scheme.
- 9.5. The calculation of the premium will be complicated and the factors that the scheme needs to consider may change over time and it is not proposed to include a specific formula in the legislation. Instead it is proposed to give the scheme the power to engage appropriate insurance experts to produce a mechanism by which the premium would be apportioned. The AGB will also be consulted during that process to establish the criteria upon which the risk assessment is made. Once those criteria are determined, the scheme will publish the methodology that it uses to calculate the premium. It is envisaged that the criteria will include matters such as: the banking groups' credit rating, the price of the banking groups' credit default swaps, the existence of a credible home government guarantee, the steps taken by local management to reduce its risk profile and the risk it brings to the scheme, and the total compensation payment likely to occur in the event that bank failed. This last factor will ensure that the scheme takes into account the fact that some banks may have very few depositors but each deposit is substantial.
- 9.6. Participants will be entitled to appeal to the Royal Court against any decision of the scheme with respect to the premium.
- 9.7. It is proposed that the scheme will have the power to call for information from all banks on the nature of their business model and the risks to which each bank is exposed in order to enable the scheme to calculate the premium payable by each bank.
- 9.8. This will have the following effects:
- Banks which have greater risks of triggering a payout under the scheme will pay more than those banks which do not take retail deposits or those which have a lower risk of triggering the scheme.
 - It will become more expensive for some banks and some banking business models to operate in Guernsey.

- The fact that the premium is risk based provides one means of addressing moral hazard as the banks will have a financial incentive to reduce risk in their business models.
- It is also fairer than a scheme which is entirely post funded (as in the Isle of Man and the UK) as under a post funded scheme the bank which has defaulted does not contribute to the compensation payments. Under this model all banks will contribute something.

9.9. If a bank failed prior to the captive reaching £20 million in assets the States guarantee would be triggered. However any funds paid out by the States would be recouped through the insurance levy until such time as the total amount paid under the guarantee was repaid. The scheme would then continue building its assets through the on-going insurance premium.

9.10. In the event that a call on the scheme was made, costs would rise. These costs would vary with the nature of the case. However, in the event of the scheme becoming operational, the scale of costs would increase substantially.

10. Funding compensation payments

10.1. The most common method for funding a scheme is for the banks to provide finance to the scheme after a bank fails. This is known as '*post-funding*'. A large part of the potential compensation under the proposals in this report will be post-funded. In the event of a bank failure, the scheme would assess how much money it needed to compensate depositors. Payments would begin being made to eligible depositors as soon as possible once all claims had been received and verified by the scheme.

10.2. It is proposed to give the scheme the power to borrow money from any source it considers appropriate to pay out depositors. Once the total liability of each bank was calculated the scheme would then charge each bank an annual levy until such time as that bank's total contribution had been paid.

10.3. The Department, after consultation with the Scheme, will make regulations setting out how the bank's contributions will be calculated. The captive insurance company will pay up to the first £20 million of compensation, the post funded contribution of the banks will be funded on the following basis:

- The first tier of £10 million will be paid by all licensed banks equally.
- The second tier of up to £70 million would be based on the principles similar to those described in paragraph 9.5 (i.e. the analysis of the size of each bank's retail deposits with an adjustment based on the risk to the scheme).

- 10.4. It is proposed that the starting point for a bank's contribution would be a fixed percentage of its total retail deposits by depositors eligible for compensation under the scheme. That amount would be calculated on the total retail deposits in each bank on the last business day of the month preceding the default event.
- 10.5. To compensate for risk the total amount would be adjusted by a factor of between 0.7 and 2.0 depending on risk. This will result in some banks getting a discount of up to 30% and other banks paying up to double their initial contribution. The factors which would be used in setting the relevant factor would be similar to those used to set the insurance premium. The factor would be set on an annual basis so that each bank will know its potential liability on an ongoing basis and would not be exposed to an indeterminate liability. The result of this process is that the largest clearing banks would still pay the highest amount in monetary terms; however their proportion will be reduced. Again the final formula will be prescribed by regulations.
- 10.6. Once the total compensation liability of a bank was calculated the scheme would then make levies against that bank. In order to protect against the possibility that a contributing bank would have to provide a sum so large that its business would be adversely affected, maximum yearly payments to the scheme would be capped, subject to an interest charge. The total cost that any bank would have to pay in any one year would be set as no more than 50% of each participant's average profit in the past 3 years or £1 million whichever is the less. The scheme would also have the flexibility to negotiate an alternative cap with each individual bank if necessary.
- 10.7. Again the Ordinance includes appropriate appeals mechanisms that can be used in the event that there is a dispute about the total cost of any levy.
- 10.8. Depositors may not receive the entire amount of compensation to which they are entitled immediately. Firstly there will be a specified time in which depositors must file their claim with the scheme. Anyone who wishes to claim against the scheme will have to file an application for compensation no more than 12 months after a declaration of default. Claimants will need to provide evidence of their claim to the scheme itself. The scheme will have the option of foregoing this step if satisfied that the eligible depositors can be readily identified from the records of the bank itself.
- 10.9. Once a claim has been received and verified by the scheme then that claimant will receive compensation within 3 months. The scheme may be in a position to commence paying compensation sooner and it is expected that compensation payments may be made within a few weeks in most cases, it will depend on the particular facts surrounding a bank failure.
- 10.10. It is also proposed to cap the total liability of the scheme at £100 million in any 5 year period. The data reviewed by the working group suggests that a sum of £100 million should be more than adequate to cope with any likely collapse i.e.

excluding the possibility of a collapse of a clearing bank. If a bank was to fail and the total liability to the scheme would exceed £100 million then the amount of compensation paid to depositors would be reduced proportionately.

Key Points:

- The scheme will cost approximately £200,000 per annum to administer.
- The States will contribute £100,000 to meet the initial start up costs.
- The scheme will have the flexibility to insure against loss if it chooses, with the cost of that insurance being met by the industry on the basis of risk by use of a captive insurance company if necessary.
- The States would underwrite the liabilities of the captive insurance company by guaranteeing the first £20 million of loss until such a time as the captive builds up the necessary £20 million in capital.
- Banks would be required to contribute on the basis of the benefit they receive from the scheme as well as the relative risk posed by their business models.
- The scheme would pay out within 3 months of receiving a claim.

11. Special powers of the Board

11.1. The Board will also be given the following specific powers:

- The power to participate in an arrangement, reconstruction or sale of the business of a bank in default. Where a bank is in administration the scheme may be able to provide financial assistance to the administrator to facilitate a sale of the bank. It may be that it is cheaper for the scheme to facilitate a sale by underwriting certain risks than it would be to pay out compensation in a winding up. To achieve that the scheme may need to borrow funds to assist in selling a failing bank and then levy the industry to repay that debt.
- The power to require security from participants. Given that the scheme may need to make levies on participants over a number of years the scheme may need to take security from a participant to ensure that the participant meets its obligations. For example if a participant decides to close down its operations in Guernsey but several more years of levies are required to repay the scheme, then the board would be able to ask for security from that participant to cover that participant's liabilities after it has left the jurisdiction.

- 11.2. These additional powers will give the scheme the flexibility to choose the most effective way of protecting depositors. It will also allow the scheme to take swift and decisive action to maximise the return to depositors where those steps are likely to result in a lower long term cost to the banking industry.

12. Co-ordinating a response to a banking crisis

- 12.1. The scheme would ordinarily operate on a standby basis with a relatively low level of activity beyond basic administration and the calculation and collection of insurance premiums. However in the event of a bank failure the needs of the scheme for resources and staff would increase.

- 12.2. Once a declaration of default has occurred and the scheme has moved into its compensation phase the scheme will need to carry out the following steps:

- Assessing the scale of the likely compensation payment.
- Assessing whether a compensation payment is likely to be the appropriate measure or whether other steps should be taken to rescue the relevant bank.
- Providing an estimate to each participating bank of its likely contribution.
- Reviewing the deposit base of the bank and assessing which deposits may be subject to the scheme and which may fall outside the scheme.
- Contacting all depositors and informing them of their rights.
- Co-ordinating a response with the Department, the Policy Council and the Commission.
- Communicating with the media on the progress of the scheme.
- Establishing a compensation process for the scheme.

- 12.3. Following the scheme being called into action it would need to rapidly increase staff and resources almost overnight. However once the scheme has fulfilled its statutory duty then it would once again be required to wind down and return to its basic administrative state. In order to achieve this outcome the scheme will have the power to accept secondments of staff from the States of Guernsey and elsewhere. It is proposed that in the event of a default the States of Guernsey would make available premises, communications facilities, staff and information technology, the cost of which would be repaid by the scheme over time. The scheme would also have the option of appointing a private service provider of those services if it decided that was appropriate.

- 12.4. The trigger event for the scheme is a bank being unable to pay its debts as they fall due which will be determined by a clearly defined event such as a bank being placed into administration or liquidation. Once that occurs the Commission will make a declaration of default and the scheme will move out of its “administration stage” and into its compensation stage.

Key Points:

- The scheme will have appropriate powers to assist in the sale or reconstruction of a bank where that is likely to result in a lower cost to the scheme.
- The scheme will co-operate with the authorities and the Commission in responding to any financial crisis.

13. Minimising moral hazard and reducing behavioural changes

- 13.1. Once a depositor compensation scheme is introduced small depositors will no longer have any incentive to monitor the credit worthiness of banks with which they place deposits. Minimising the effects of any increase in moral hazard is addressed by two key aspects of the scheme:

- The scheme does not cover corporate depositors, trusts or provide significant protection to high net worth individuals. That provides an incentive to those investors to continue to monitor the financial health of the banks in which they place deposits.
- The inclusion of a risk based premium and the weighting of post funded compensation levies in favour of low risk institutions provides an economic incentive to banks to minimise risk in their business models.

- 13.2. Shareholders, bond holders, high net worth individuals, corporate depositors and other banks lending in the interbank market are not covered by the scheme. Those depositors face the prospect of losing significant sums of money in the event that a bank fails. Those investors have the necessary skills, resources and incentive to monitor their chosen banks. That scrutiny provides an incentive to the banks to minimise unreasonable risks.

- 13.3. The use of an insurance solution also provides an economic incentive to the banking industry to minimise unreasonable risk in their business models

14. Scheme not to be retrospective in operation

- 14.1. The Law Officers have been consulted and advise that the scheme cannot be retrospective in operation.

15. Consultation

- 15.1. The Guernsey Financial Services Commission has been involved in the working group and supports the proposals in this report.
- 15.2. The committee of the Association of Guernsey Banks has been involved in the working group and supports the proposals contained in this report. The Department has also consulted with the member banks of the Association of Guernsey Banks.
- 15.3. The Law Officers have been consulted and raise no issues with the proposals in this report.
- 15.4. Alderney and Sark have been provided with a copy of this report. There are no independent banks in Alderney and Sark. The banks in Alderney are branches of Guernsey banks and are not separated licensed. The banks in Sark are “offices” of Guernsey Branches. Accordingly the proposals in this report do not impact on the economies of Alderney and Sark. The scheme provides the same level of protection to depositors resident in Alderney and Sark as any other depositors.

16. Recommendation

- 16.1. The Department recommends the States resolve:
- (a) To approve the introduction of a Depositor Compensation Scheme in Guernsey as outlined in this Report;
 - (b) To direct the Treasury and Resources Department to incorporate a captive insurance company and to take such steps as are necessary to provide the guarantee of £20 million and the initial capital of £1 million to the captive insurance company as referred to in paragraph 9.3 of this Report when formed;
 - (c) To direct the Treasury and Resources Department to provide the initial £100,000 of funding towards the administrative costs of the scheme; and
 - (d) To approve the draft Ordinance entitled “Banking Deposit Compensation Scheme (Bailiwick of Guernsey) Ordinance, 2008” and to direct that the same shall have effect as an Ordinance of the States.

Yours faithfully

C S McNulty Bauer
Minister

(NB The Policy Council fully supports the proposals to introduce a Depositor Compensation Scheme, as set out in the Commerce and Employment Department's report, as a matter of urgency.)

(NB The Treasury and Resources Department supports the proposals.)

The States are asked to decide:-

Whether, after consideration of the Report dated 17th November, 2008, of the Commerce and Employment Department, they are of the opinion:-

1. To approve the introduction of a Depositor Compensation Scheme in Guernsey as outlined in that Report.
2. To direct the Treasury and Resources Department to incorporate a captive insurance company and to take such steps as are necessary to provide the guarantee of £20 million and the initial capital of £1 million to the captive insurance company as referred to in paragraph 9.3 of that Report when formed.
3. To direct the Treasury and Resources Department to provide an initial £100,000 of funding towards the administrative costs of the scheme.
4. To approve the draft Ordinance entitled "Banking Deposit Compensation Scheme (Bailiwick of Guernsey) Ordinance, 2008" and to direct that the same shall have effect as Ordinance of the States.