Consultation Paper on Amendments to the Banking Rules on Accounts, Disclosure, & Large Exposures

Issued 16 March 2021

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Responding to the Consultation Paper

Responses to this Consultation Paper are welcomed before 11 May 2021.

You can send your response to us via the Consultation Hub section of the Commission's website (www.gfsc.gg).

https://consultationhub.gfsc.gg

Introduction

Purpose of the Consultation Paper

The purpose of this Consultation Paper is to seek feedback from stakeholders and interested parties on the issues contained in the paper and the proposed revisions to the relevant rules and guidance issued under the *Banking Supervision (Bailiwick of Guernsey) Law, 2020*[1] ("The Law"), which is intended to replace the *Banking Supervision (Bailiwick of Guernsey) Law 1994*[2]. This includes the Banking (Accounts) Rules 1994 and the Large Exposure Policy.

The proposals in this Consultation Paper are relevant to all institutions in Guernsey that hold a banking licence ("Licensed Institutions") under The Law.

The Commission is committed to meeting international standards to ensure the continuing credibility of Guernsey as an international financial services centre. We are also committed to introducing rules, on a proportionate basis, to implement standards which take proper account of the economic wellbeing of the Bailiwick and the firms which operate in it; as well as safeguarding depositors.

The Commission has been considering internally the updates to the Basel III standards finalised in December 2017 (sometimes colloquially referred to as Basel IV) and how best to implement them in a way that makes sense for the local banking sector. Given that the implementation date has been deferred by one year to 2023 we do not intend to consult on these issues now.

The above exercise highlighted a number of areas where the Commission's supervisory framework needed to be updated to meet the Basel Framework for banking regulation. It is the policy of the Commission to adopt international standards that are proportionate to the scale and nature of the Bailiwick's industry. The proposals in this consultation are intended to address those points.

The areas addressed in this paper are:

- Accounting Information and Disclosure
    - The Commission proposes to clarify the accounting standards Licensed Institutions incorporated in the Bailiwick may use and update the existing disclosure requirements to include a limited amount of key regulatory information.
- Large Exposures and Upstreaming
    - The Commission proposes to update its large exposure and upstreaming regime to bring it more fully in line with international standards and reduce concentration risk, while making a number of allowances for the nature of the local industry. This will only effect Licensed Institutions incorporated in the Bailiwick.

[1] The 2020 Banking Law: Banking Supervision (Bailiwick of Guernsey) Law, 2020 - Guernsey Legal Resources
[2] The 1994 Banking Law: Banking Supervision (Bailiwick of Guernsey) Law, 1994

The Commission is also planning to update the sign off and verification requirements for its banking regulatory returns. We are taking this opportunity to inform licensees of this change.

The key aims of the proposals in this Consultation Paper are to:

- enhance the effectiveness, clarity and transparency of the regulatory requirements;
- increase the information available for stakeholders;
- reduce concentration risk in order to increase the soundness of the banking sector and protect depositors; and
- meet international standards.

The content of this Consultation Paper is at the proposal stage and does not prejudge any final decision to be made by the Commission.

Next Steps

The closing date for the Consultation Paper is 11 May 2021. Responses to this Consultation Paper will be considered by the Commission prior to issuing new rules and guidance under The Law.

Part 1 – Accounting Information and Disclosure

The proposals in this section apply to Licensed Institutions incorporated in the Bailiwick.

1.1 Accounting rules

The Commission proposes to require licensed institutions to use one of a number of specific accounting standards permitted by the Commission. The proposal would apply to subsidiary banks, which are incorporated in the Bailiwick but not to licensees incorporated elsewhere (branches).

Rationale

It is important that accounts prepared by licensees conform to acceptable international accounting standards and provide the robust financial reporting and information required by the Commission. The Basel Framework[3] includes an obligation that "*banks and banking groups maintain adequate and reliable records, prepare financial statements in accordance with accounting policies and practices that are widely accepted internationally and annually publish information that fairly reflects their financial condition and performance and bears an independent external auditor's opinion*[4]*"*.

All licensed institutions are required to prepare accounts containing the information specified in the law and other guidelines issued by the Commission. The current rules[5] date back to 1994 and do not specify which accounting standards should be used. Guernsey based banks make use of several different accounting standards, including various IFRS and national GAAP standards.

The standards proposed are internationally recognised and are already in use by the banks incorporated in the Bailiwick. They meet the Commission's reporting requirements and are in line with the principles of the Basel Framework.

Proposal

The Commission proposes to update its rules to specify relevant accounting standards to ensure that licensed institutions which are incorporated within the Bailiwick continue to use appropriate standards that meet the Commission's requirements.

The existing (1994) rules will be replaced by the *Banking Supervision (Accounts, Disclosure & Reporting) Rules 2021*, as set out in Annex A. The new rules will require banks to use one of the following accounting standards approved by the Commission for the purpose of financial reporting:

- IFRS;

[3] Basel Framework – Core Principles BCP01 - The core principles (bis.org)
[4] Principle 27 of the Basel Core Principles: BCP01 - The core principles (bis.org)
[5] *The Banking Supervision (Accounts) Rules, 1994* which came into effect 1 October 1994

- UK GAAP; and
- US GAAP.

As this covers the range of standards in use by licensed institutions incorporated within the Bailiwick, no licensed institution would be required to change the accounting standard it currently uses. The Commission may approve the use of a different accounting standard by a licensee or potential licensee on a case by case basis.

A number of bank branches are part of groups which adopt different accounting standards. Since they are incorporated outside the Bailiwick, they will not be affected by this proposal.

Consultation questions

Respondents are asked to comment on:
1. Should the GFSC specify relevant accounting standards for Licensed Institutions? If not, why not?
2. Should additional accounting standards be included in this list? If so, which standards and why?

1.2 Disclosure

The Commission proposes to update its rules on disclosure to modernize its approach and improve accessibility and the range of information reported, to bring us closer into line with the Basel Principle. In particular, the principle that supervisors should require that banks should regularly publish information which fairly reflects their financial performance and risk exposures.

This proposal applies to licensed institutions which are incorporated within the Bailiwick (subsidiary banks).

Rationale

Disclosure of information is an existing obligation for all licensed institutions (bank branches and subsidiary banks) operating in Guernsey, and has been for many years, in line with section 31 of the *Banking Supervision Law 1994*, and *The Banking Supervision (Accounts) Rules 1994*.

Under the current (1994) Rules, Licensed Institutions incorporated in the Bailiwick of Guernsey (subsidiary banks) are required to make a copy of their audited accounts and auditor's report available to any person on request. For Licensed Institutions incorporated in the Bailiwick of Guernsey, the accounts provided must be audited and include at least the information set out in guidelines[6] issued by the Commission from time to time. Other licensed institutions (branches) are required to provide to the Commission and make available on request the audited accounts of the main group.

The BCBS (Basel Committee on Banking Supervision) sets out the core principles which reflect minimum standards that should be applied by all banking supervisors. Within the Basel Core Principles, BCP 28[7] specifies that supervisors should require banks to "*regularly publish information on a consolidated and where appropriate solo basis that is easily accessible and fairly reflects their financial condition, performance, risk exposures and corporate governance policies and processes".* It goes on set out the essential criteria relating to this principle, including that the supervisor determine the required disclosure of qualitative and quantitative information and that the supervisor or other government agency effectively review and enforce compliance with disclosure standards.

The current approach by the Commission is limited to financial accounts, it does not include information on other key metrics which are relevant to the prudential regulation of banks, and access is through specific requests made in person at a local branch of the bank, which does not make information easily accessible.

[6] Existing guidelines may be found here:
Guidelines to Banks and their Auditors issued under s1(a) of the Banking Supervision (Accounts) Rules 1994;
Guidelines to Banks and their auditors issued under s1(b) (ii) of the Banking Supervision (Accounts) Rules 1994.
[7] Principle 28 of the Basel Core Principles (see s01.33): BCP01 - The core principles (bis.org)

The way in which the majority of people engage with financial institutions and access the information they need to make informed decisions about finances and investment has changed substantially since 1994. Customers and depositors expect to be better informed, better protected and better able to access information in a way which is convenient to them. This generally means that information should be made available online, on the bank's website. Limiting access to information to those who are able to visit a specific office in person is unduly restrictive. There are those for whom this simply would not be a practical option – for reasons of accessibility, for example – or because of other restrictions as highlighted by the corona virus pandemic, and it is important that such parties should have access to the same information as other depositors or potential depositors.

The Commission considers that information should be made available by licensed institutions in order to ensure that their customers and prospective customers are able to make well informed decisions about the security of their deposits with Licensed Institutions. In addition to the accounts and auditor's report, this should include key metrics relating to bank stability and liquidity.

The Commission recognises that the parent groups of local bank branches fall within the oversight of their home jurisdictions and these banks already publish accounts and key information at a group level.

Proposal

The Commission proposes that licensed institutions incorporated in the Bailiwick (subsidiary banks) should make available their audited annual accounts (an already long-standing requirement in the Bailiwick) together with information on key metrics for liquidity and financial stability. Such information including the key ratios is already routinely published at the group/parent level. This information should be made available in a way that is accessible and reflects the way in which most customers and their advisors would choose to access information.

The Commission proposes to update its rules on disclosure so that:

- information is published online on the licensed institution's own website;
- information is made available in a form that is accessible and reflects the substantial changes to technology since the original rules were made in 1994; and
- the disclosure requirements include information on key metrics in addition to the financial accounts and auditor's report.

It is proposed that the key metrics should comprise the following additional information:

- the Common Equity Tier 1 Capital Asset Ratio (CET1 CAR) calculated as the ratio of CET1 capital to total risk weighted assets;

- the Liquidity Coverage Ratio ("LCR"), or Liquidity Mismatch Ratio ("LMR") as appropriate[8];
- the Net Stable Funding Ratio ("NSFR"); and
- the Leverage Ratio.

This information is already reported to the Commission by licensed institutions in their regulatory returns on a monthly or quarterly basis. It is proposed that the information is published annually at the same time as the relevant set of financial accounts.

The figures disclosed should be the figures reported to the Commission at the accounting year-end of the bank, and that information should be published on the licensed institution's website. If the licensed institution does not have a website of its own, it may publish the information on the group website.

Therefore *The Banking Supervision (Accounts) Rules, 1994,* shall be replaced with the *Banking Supervision (Accounts, Disclosure & Reporting) Rules, 2021*, as set out in Annex A, which clarify the requirement for disclosure; specify the information that should be made available and in what form.

Consultation questions

Respondents are asked to comment on:
3. Do you agree that the information to be disclosed is appropriate? Have we identified the correct key metrics?
4. How should information on the key metrics be reported? Should it be limited to the headline ratios (as proposed) or should it include underlying information used to calculate the key metrics?

[8] The ratios are specified here: Guidance on Liquidity Risk Management

Part 2 – Large Exposures and Upstreaming

This section of the Consultation paper is relevant to Licensed Institutions incorporated in the Bailiwick (subsidiary banks).

2.1 Large Exposures

Strategic direction

In the past, there have been a number of bank failures due to significant, concentrated exposures to individual counterparties. Some of the issues leading to the 2008 Financial Crisis were, in part, caused by this. As a hypothetical example, consider a bank that makes a loan to a client that is worth more than 100% of its capital base. If that client were to default on that loan, the bank would become insolvent, leading to potentially significant losses for its depositors.

Over time large exposures rules and regulations have been developed as a means to limit the maximum loss a bank could face in the event of a sudden counterparty failure to a level that does not endanger the bank's solvency, and by extension, its depositors. One of the main ways this is achieved is through placing limits on the maximum size of an exposure that a bank can have to a particular counterparty, as a percentage of the bank's capital base.

Another significant contributor to the 2008 Financial Crisis was the level of interconnectedness between financial institutions and the fact that connections were not readily apparent. There are two other important parts to a large exposure framework that are intended to help address this issue. The first is the requirement that banks aggregate all exposures to counterparties that are connected when measuring large exposures and applying exposure limits. For example, when lending to two entities with the same beneficial owner, banks would need to aggregate those loans. The second element is the requirement to look through to any underlying security. Banks will often take a charge over the assets of a client or receive a guarantee from a separate party in order to reduce the credit risk of a loan. When they do so for large exposure purposes, they also need to recognize an exposure to that security. Taken together, these elements are intended to make sure the banks are fully identifying all the parties they have exposures to, how those parties are related and connected and how risk could be transferred through those connections.

This is important given how interconnected the financial system is and how complex certain structures can be, particularly within the wealth management and trust sectors.

The Commission is proposing a number of changes to its Large Exposure Policy to bring it in line with the updated Basel Framework and address some of the issues highlighted by the 2008 financial crisis that drove those updates. It is the policy of the Commission to adopt international standards that are proportionate to the scale and nature of the Bailiwick's industry.

However, there are some elements of the Basel Framework that we are not proposing to implement or where our proposals diverge slightly. This is for a number of different reasons.

The Basel Framework focuses on the supervision of large international banks at a group level and some elements are not relevant to local banks. The Basel Framework is also complex and inter-connected. In some areas we have sought to simplify the requirements or make proportional allowances given the nature and characteristics of the local banking sector.

An example of an element that is not relevant to local banks would be the trading book requirements. The Commission understands that licensed institutions incorporated in the Bailiwick do not engage in significant trading book activities for their own account. As such the Commission does not propose to implement the trading book elements of the Basel Large Exposure Framework.

While making these changes the Commission has re-stated the Large Exposure Policy as a set of rules and guidance. This should improve the clarity of the requirements and make them easier to reference. However, as a consequence, it is not practical to provide a black-lined version showing the changes between the new and old documents as the transition to rules has resulted in significant changes to the structure of the document and the language used. Other than the specific changes noted in this paper, much of the content of the current Large Exposure Policy has been retained in the proposed Rules and Guidance. Footnotes have been included in each section with page or section numbers for the Commission's current Large Exposure Policy, the proposed Draft Rules and the Basel Framework in order to make it easier to reference the changes and see where the proposals align or diverge from Basel.

There are a number of blue text boxes in this section of the Consultation Paper. They are used for more technical discussions of why and how the Commission's draft Rules represent a proportional local market specific implementation of the Basel Framework or to provide a more detailed definition of some terms and concepts.

For example:

Exposures:

The total amount at risk from all of a bank's assets, should the counterparties to those assets default.

Large Exposure:

An exposure to a counterparty or group of connected counterparties that is greater than or equal to 10% of the bank's net capital base.

Related party exposures[9]

The current Large Exposure Policy (and the proposed large Exposure Rules) include requirements for the treatment of related party exposures. These state that any exposures to entities and persons related to the bank must be carried out on an arm's length basis.

In line with other rules and the Basel Core Principles the definition of a related party has been expanded to cover the directors, controllers and key staff of related companies and their associates.

Exposure limits

Under the Commission's current policy large exposure limits are defined in relation to total regulatory capital. In alignment with the Basel Framework, it is proposed that large exposure limits will be defined in relation to Tier 1 Capital only in the draft new Rules[10]. A number of licensed institutions hold Tier 2 capital, so this change will involve an adjustment for those entities.

> Tier 1 and Tier 2 Capital
>
> Tier 1 Capital is high quality capital. It is mainly made up of share capital, retained earnings and other reserves, with the addition of some regulatory adjustments and deductions. It is the most permanent form of capital and the most readily available to absorb losses.
>
> Tier 2 Capital is viewed as lower quality than Tier 1. It mainly consists of debt instruments issued by the bank that are subject to convertibility or written-down provisions. It is less permanent than Tier 1 and less readily available to absorb losses.
>
> For these reasons, it is appropriate to set large exposure limits in relation to Tier 1 capital.

<u>Client Exposure Limits</u>[11]

Currently exposures to any individual client or group of connected clients are subject to a limit of 25% of capital. The Commission is not proposing to change this, other than the change from total capital to Tier 1 Capital. This is in line with the Basel Framework.

<u>Interbank Exposure Limits</u>[12]

With regard to interbank exposures, there are a number of issues to consider. The Basel Framework does not distinguish between interbank large exposures and exposures to other types of entity and sets an exposure limit of 25% of Tier 1 Capital for all large exposures. A direct application, therefore, would entail a significant reduction from the current limit of 100%

[9] Large Exposure Policy - 2014 – pg.7, Draft Large Exposure Rules 2021 – 2.3.3, Basel Core Principles – Principle 20
[10] Large Exposure Policy - 2014 – pg.4, Draft Large Exposure Rules 2021 – 2.2, Basel Framework – LEX10.8
[11] Large Exposure Policy - 2014 – pg.13, Draft Large Exposure Rules 2021 – 5.2(1), Basel Framework – LEX20.1
[12] Large Exposure Policy - 2014 – pg. 10, Draft Large Exposure Rules 2021 – 5.2(2), Basel Framework – LEX20.1

of total capital to 25% of Tier 1 Capital. This would likely result in licensed institutions needing to substantially increase their number of interbank counterparties or collateralise more of their interbank lending. Given the relatively small size of many local banks they may also struggle to find counterparties in the inter-bank market that are prepared to accept placements at the reduced limit. For this reason, internationally it is commonly accepted practice to make allowances for smaller banks when setting interbank large exposure limits.

The Commission's preferred approach therefore would be to set an interbank exposure limit of 50% of Tier 1 Capital. This would allow a licensed institution to weather the failure of at least one interbank counterparty. All entities would be operating to the same limit and it would not require adjustment in the future, unlike a limit defined in relation to a specific amount of capital.

One aspect of the Basel Framework that the Commission is proposing to implement in a proportionate Bailiwick specific fashion is the exclusion of intraday interbank exposures from the large exposure framework. This is for a number of reasons, set out below[13].

Intraday interbank exposures. The aim of excluding these types of exposures in the Basel Framework is to avoid disturbing the ordinary payment and settlement processes. The Commission achieves this aim by specifically excluding exposures due to settlement and payment activities in both the current policy and the proposed new Rules[14]. Directly applying the intraday exclusion has the potential to result in there effectively being no interbank exposure limit as a bank could choose to deposit all its excess funds overnight. This would not meet the Commission's aim of to limit the maximum loss a bank could face in the event of a sudden counterparty failure to a level that does not endanger the bank's solvency, and by extension, its depositors. While short term exposures carry less risk of default, they are not completely without risk as, historically, some bank failures have occurred very quickly.

This restriction on interbank exposures may still cause some licensed institutions difficulties in making overnight placements of funds. This may be due to, for example, large, unexpected flows of funds while interbank exposures are close to the limit with longer term placements. To aid licensed institutions in their handling of this practical challenge, the Commission proposes to allow the interbank limit to be exceeded on a temporary basis subject to the excess being cleared within 2-3 working days and the Commission being notified post-event[15]. This would then not be considered a breach of the Rules, although the Commission would not expect to see this happen regularly.

[13] Basel Framework – LEX30.36
[14] Large Exposure Policy - 2014 – pg. 6, Draft Large Exposure Rules 2021 – 3.2
[15] Draft Large Exposure Rules 2021 – 6.4

However, under the proposed new rules, the Commission will retain the ability to vary the interbank exposure limit (and other exposure limits) or exclude some exposures in individual cases if appropriate and prudent to do so.

Sovereign Exposure Limits[16]

In line with the Basel Framework, it is proposed that under the draft new Rules exposures to sovereigns and multilateral development banks will no longer be subject to a large exposure limit. Sovereigns include the governments of Guernsey, Jersey and the Isle of Man. The Commission expects licensed institutions to continue to manage their exposures to governmental counterparties prudently.

> Sovereigns
>
> Sovereign exposures include both direct exposures to a government, such as through the holding of UK government Gilts, or exposures to government agencies that have the full faith and credit of the government. Exposures to agencies and public bodies that do not have such an unconditional guarantee are not eligible for treatment as a sovereign exposure.

Covered Bonds[17]

The Basel Framework includes provisions for the valuing of covered bonds for large exposure purposes that are not included in the Commission's current Policy so we are proposing to include them in the draft new Rules.

Covered bonds that meet specific criteria around the quality of the assets backing the bond can be assigned an exposure value of 20% of the nominal or face value of the bond for large exposure purposes.

> Covered Bonds
>
> Covered bonds are bonds issued by a bank or mortgage institution collateralized against a pool of assets, often mortgages, that can be used to cover claims. They are subject by law to special public supervision designed to protect bond holders.
>
> Covered bonds stay on the balance sheet of the issuer, unlike asset-backed securities, so the investor has recourse to both the issuer and the pool of assets.
>
> They are commonly issued in a number of European countries, with Denmark, Germany and France being amongst the largest issuers.

[16] Large Exposure Policy - 2014 – pg. 11, Draft Large Exposure Rules 2021 – 5.3, Basel Framework – LEX30.32
[17] Draft Large Exposure Rules 2021 – 3.1(7), Basel Framework – LEX30.38

Exposures to Central Counterparties[18]

The Commission's current large exposure policy does not specifically address exposures to central counterparties. However, the Basel Framework excludes from the aggregation of large exposures, exposures to qualifying central counterparties that are related to clearing activities. So in the draft new Rules the Commission is proposing to do the same.

> Central Counterparties
>
> Central counterparties, sometimes referred to as central clearing counterparties, are institutions that provide clearing and settlement services for trades in derivatives, foreign exchange, options and securities. They take on the counterparty credit risk between the two parties to a transaction.
>
> A qualifying central counterparty is an entity that is licensed and regulated to operate as a central counterparty.
>
> An example of a central counterparty is LCH.Clearnet.

Financial collateral and other Credit Risk Mitigation techniques

Currently licensed institutions are able to use financial collateral (limited to cash and government bonds), guarantees and participation agreements to reduce the net value of a large exposure below the relevant limit. These are sometimes referred to as *credit risk mitigation techniques*. The Commission is proposing to adopt the Basel Framework approach to credit risk mitigation. This will expand the types of eligible collateral while also more clearly defining the criteria they must meet. This approach will apply to all types of large exposure and upstreaming regardless of the counterparty.

Under the Basel Framework[19], credit risk mitigation for large exposures follows the same rules and conditions as credit risk mitigation for capital requirement purposes, under the Standardised Approach to Credit Risk. The Commission is not proposing to replicate elements of our capital requirement framework in the draft new Rules, instead the Rules will simply refer to the Standardised Approach, as published by the Commission.

> The Standardised Approach to Credit Risk[20]
>
> The Standardised Approach to Credit Risk defines how banks are required to calculate the amount of capital they need to maintain to back the loans they've made and other assets they hold. This is done by weighting each of the bank's assets based on how risky the asset is. The level of risk is based on the likelihood that the counterparty to the loan or asset will default and not be able to pay back the bank. These weighting are defined by the Commission. Capital requirements are then based on the weighted asset values.

[18] Draft Large Exposure Rules 2021 – 3.2(1)(e) and (f), Basel Framework – LEX30.55
[19] Basel Framework – LEX30.7
[20] Standardised Approach to Credit Risk

For example, exposures to governments with a high credit rating have a 0% weighting. This means that banks would not have to hold any capital to back an exposure to such a government.

Banks can use credit risk mitigation techniques to reduce the value of an exposure that the weighting is applied to. Under the Standardised Approach banks can use the either the Simple or Comprehensive approach to credit risk mitigation.

The Simple approach operates on the basis of the substitution of risk weights. For example, if a bank made a loan to a counterparty, they would use the risk weight appropriate to that counterparty. If that counterparty provided the bank with a guarantee from a third party or some corporate bonds as collateral, the bank could then use the risk weighting of that third party or corporate instead.

Under the Comprehensive approach, before the weighting is applied the value of the exposure is reduced by the value of the collateral. However, the value of the collateral is first reduced by the application of various haircuts. The haircuts banks must use are defined by the Commission.

Under the proposed new Rules, the types of financial collateral[21] licensed institutions will be able to use to mitigate large exposures will be expanded to include the following:

- Cash on deposit with the licensee and certificates of deposit;
- Gold;
- Sovereign-issued debt securities externally rated BB- or better (S&P or equivalent);
- Other debt securities externally rated BBB- or better (S&P or equivalent);
- Unrated bank debt securities;
- Main index equities or equities listed on a recognised exchange; and
- Collective investment schemes.

In line with the Basel Framework, the Commission is also proposing that licensed institutions will be required to use the same credit risk mitigation techniques for large exposures and capital requirement purposes. For example, if a licensed institution used corporate bonds to mitigate a large exposure, they would have to do the same when calculating their capital requirement due to that exposure.

If an exposure, or portion of an exposure, is mitigated by a credit risk mitigation technique the licensed institution must recognise an exposure to the provider of that credit mitigation which must then be aggregated with other exposures to that counterparty as normal[22].

The exception to the approach set out above is unfunded credit protection which is provided by a licensed institution's Group or parent. These guarantees and/or credit derivatives will not count towards the bank's upstreaming limit. This is discussed in more detail in the "Upstreaming" section of this Consultation Paper.[23]

[21] Large Exposure Policy - 2014 – Pg.13, Draft Large Exposure Rules – 3.3, Basel Framework – LEX30.7
[22] Draft Large Exposure Rules 2021 – 3.3(3), Basel Framework – LEX30.14
[23] Draft Large Exposure Rules 2021 – 5.1(6)

On Balance Sheet Netting[24]

In line with the Basel Framework, the Commission is proposing to allow netting of banking book loans and deposits with the same counterparty for the purpose of determining the level of exposure to that counterparty. A licensed institution may net banking book loan exposures with deposits only where it:

- Has a well-founded legal basis for concluding that the netting or offsetting agreement is enforceable in each relevant jurisdiction regardless of whether the counterparty is insolvent or bankrupt;
- Is able at all times to identify the relevant assets and liabilities;
- Monitors and controls its roll-off risks; and
- Monitors and controls the relevant exposures on a net basis.

It would not be permitted to net on-balance sheet items with off-balance sheet items. In addition, this approach would not be permitted for group exposures.

Reporting of Large Exposures

Prior notification of client large exposures over 25% of capital will still be required under the proposed new Rules[25].

The Commission is also proposing to update its BSL/2 Return forms such that large exposures are reported both gross and net of any acceptable collateral. This is so the Commission can more easily monitor licensed institution's portfolios of large exposures. We will also update the relevant sections of the BSL/2 guidance at the same time.

Consultation questions

Respondents are asked to comment on:
5. Do you anticipate that the following changes will pose difficulties for your bank in complying with the Large Exposure Rules: a. The calculation of large exposure reporting thresholds and limits as a % of Tier 1 Capital (in alignment with the Basel Framework) rather than Total Capital? b. The changing of the inter-bank exposure limit to 50% of Tier 1 Capital?
6. Are the proposed Large Exposure Rules sufficiently clear? Are there any areas that require further clarification or guidance?
7. Does your bank have any exposures that would qualify as "trading book" exposures under the Basel Framework?

The Commission is aware that the amendments to the Upstreaming Framework will also have an impact on these points – however, there is a separate list of questions relating to upstreaming, and we request that banks give feedback on intragroup exposure matters with reference to that section of the Consultation Paper.

[24] Draft Large Exposure rules 2021 – 5.2(7), Basel Framework LEX30.12
[25] Large Exposure Policy - 2014 – pg. 14, Draft Large Exposure Rules 2021 – 6.1

2.2 Upstreaming

Strategic direction

Upstreaming refers to the practice whereby a bank lends or deposits excess funds with its parent bank.

For several jurisdictions including Guernsey, upstreaming is a challenge to bank regulators. The basic problem arises from banks having more liabilities than can be absorbed locally. This forces local banks to enter larger markets where their balance sheet is too small to compete. The end result is that banks invest in investment grade bonds or cash; neither of which helps long-term viability and is not financial intermediation. The historic alternative is simply to upstream. This approach, as demonstrated during the 2008 Financial Crisis, in turn creates a potentially fatal exposure to one counterparty.

The risk of cross-border upstreaming has also increased as bank resolution frameworks have been implemented. Foreign resolution authorities are now empowered via bail-in legislation to write-down exposures to institutional creditors (including creditors within the same Group) in order to meet the claims of their "own" legal entities' retail depositors.

In addition, the Commission's current approach of setting bespoke upstreaming limits for individual licensed institutions is not transparent and could lead to the perception, by a bank's senior management or parent, of unfairness or favouritism in the Commission's treatment of the institution or its competitors.

In this section of the Consultation Paper, we attempt to find a compromise that on the one hand limits group exposure whilst on the other allows Guernsey banks to successfully engage in financial intermediation.

Other regulators have adopted a range of approaches to upstreaming. There is no single international approach. However, the Commission wants to move away so far as possible from its current bespoke approach and set a specific cap on upstreaming. However, under the proposed new rules, the Commission will retain the ability to vary the upstreaming limit or exclude some exposures in individual cases if appropriate and prudent to do so.

Group exposure limit[26]

For the reasons set out above, the Commission is proposing a upstreaming limit of 100% of Guernsey-established entities' Tier 1 Capital; i.e. aggregate exposures to all Group entities should not exceed 100% of Tier 1 Capital.

Under the current approach there are separate limits for on-balance sheet upstreaming and off-balance sheet upstreaming. Under the proposed new Rules there will be a single aggregate limit that includes both on and off balance sheet exposures.

[26] Large Exposure Policy - 2014 – pg. 8, Draft Large Exposure Rules 2021 – 5.1

All exposures to Group must mature in 6 months or less, so that the exposure can be managed down if either the licensed institution or the Commission develops serious misgivings about the financial soundness of the Group counterparty. The exception for short term limit excesses discussed earlier also applies to exposures to group banks.

For the purposes of the upstreaming limit, the Commission is concerned only with the naked direct exposure to the Group. Collateralised exposures, where the collateral meets the requirements governing credit risk mitigation outlined in the large exposure section of this paper, will not be counted towards the upstreaming limit. For example, a loan to a parent bank that is collateralised by say government bonds will not count towards the upstreaming limit.

Parental Guarantees[27]

In addition, under the current Large Exposure Policy, one of the ways licensed institutions can mitigate client large exposures and bring them below the 25% of capital exposure limit is to receive a guarantee from their parent bank for the portion of the exposure that is above 25% of capital. At present this guarantee would then be included in the licensed institution's upstreaming limit.

Under the proposed new rules, such guarantees would not be included within the upstreaming limit, provided the guarantee is from a licensed bank, and not some other entity with the group. The purpose of this is to allow a Guernsey bank – which may have a small capital base - to engage in financial intermediation and make commercially viable loans to third parties subject to a guarantee from the group. However, the Commission will closely monitor licensed institution's exposure to group entities from such guarantees and may intervene if the exposure become excessive. In addition, the licensed institution's large exposure policy should set out its appetite for such exposures and ensure that they are subject to specific aggregate limits.

As is currently the case, all client large exposures would be subject to maximum, gross limit of 100% of net capital, regardless of the use of collateral.

The overall effect of this approach is to apply cap of 100% of net capital to upstreaming but to take a liberal approach as to what constitutes upstreaming.

Credit Risk Mitigation

The same credit risk mitigation rules that apply to third party exposures will also apply to group exposures under the proposed new rules[28].

In addition, the Commission is proposing that where a licensed institution lends to a Group entity and there is a cut-through clause to the Group entity's commercial or retail mortgage book, this may be treated as an eligible credit risk mitigation technique, as mortgages generally

[27] Large Exposure Policy - 2014 – Pg. 9, Draft Large Exposure Rules 2021 – 5.1(6)
[28] Large Exposure Policy - 2014 – Pg.9, Draft Large Exposure Rules – 3.3, Basel Framework – LEX30.7

are less risky than most other types of private loans. This is to allow Guernsey banks to have exposure to the UK property market rather than simply upstreaming to the group[29].

For the purposes of the Large Exposure Framework, the licensed institution will still not be permitted to treat property as acceptable collateral for its own direct-to-third-party mortgage book.

Consultation questions

Respondents are asked to comment on:
8. Do you agree with the Commission's proposed approach? If not, please explain and provide specific examples.
9. What alternative approach would you suggest that achieves the Commission's goal of reducing concentration and resolution risks? Please provide details.
10. Will the removal of a separate off-balance sheet upstreaming limit cause significant difficulties for your bank? Please provide details

[29] Draft Large Exposure Rules 2021 – 5.1(7)

2.3 *Implementation Timeline*

In order to give banks sufficient time to make any required adjustments to their business model, the Commission is proposing a 12month implementation period, from the date on which the finalised *Large Exposure Rules* are published.

Respondents are asked to comment on:
11. Will the proposed implementation period of 12 months give you sufficient time to make the changes required to comply with the proposed new rules? If not, what period would be sufficient? Would a shorter implementation period be possible?

Part 3 – Regulatory Reporting

Certification of Information

This section applies to all Licensed Institutions.

The Commission is concerned to ensure that information reported by licensed institutions in their Regulatory Returns is accurate and reliable, and therefore intends to update the certification requirements for specific regulatory returns.

This will be updated in the individual returns and the revised wording will require the signatory to certify that:

(i) *the return presents an accurate view of the bank's position as at the above reporting date;*
(ii) *they understand the basis of the information reported and the way in which figures have been prepared;*
(iii) *the bank has in place appropriate and robust reporting systems and processes to provide the Data for this return; and*
(iv) *figures reported are correct and any other information provided is accurate.*

In accordance with The Law (Section 55 – Verification of Information and Execution of Documents), signatories will be required to be the chief executive officer and chief financial officer of the Licensed Institution, who hold supervised roles, in accordance with section 12 of the Law. For licensed institutions which are incorporated outside the bailiwick (bank branches) the Commission recognises that the appropriate level of signatory to provide certification of returns may not be the CEO/CFO but the appropriate senior managers within the branch, who hold supervised roles (eg, branch manager, senior financial manager).

As you are aware the Commission takes a number of matters into account when determining if a person is fit and proper to undertake a supervised role. The provision of materially inaccurate or misleading information to the Commission is certainly a matter which the Commission would have regard to in determining if a person remains fit and proper.

Annexes

Annex A provides a draft copy of the new *Banking Supervision (Accounts, Disclosure and Reporting) Rules 2021* for respondents' information. These rules contain the new measures relating to Parts 1 (Accounting Information and Disclosure) & 3 (Regulatory Reporting) of this Consultation Paper. The new rules will replace the existing *Banking Supervision (Accounts) Rules, 1994*.

Annex B provides a draft copy of the new *Large Exposure Rules 2021* for respondents' information. These rules contain the new measures relating to Part 2 (Large Exposures and Upstreaming) of this Consultation Paper. The new rules will supersede the existing *Large Exposure Policy, 2014.*

Both sets of new Rules will be issued under the *Banking Supervision (Bailiwick of Guernsey) Law, 2020*, which is intended to replace the *Banking Supervision (Bailiwick of Guernsey) Law 1994*.