

CONSULTATIVE PAPER

Introducing a Deposit Protection Scheme in Guernsey

This paper, which is issued by the Guernsey Financial Services Commission, examines the rationale for a deposit protection scheme, reviews the implications of such a scheme for Guernsey and assesses the choices to be made to tailor it to the Island's needs. Comments from banks and other interested parties are invited on particular points, with a view to seeking broad consensus on the way forward.

Section 1 Executive Summary

1. The Preferred Option

- 1.1 Before setting out the consultation process and the main areas where the Commission is inviting comments it may be helpful if the Commission indicates the current preferred option.
- 1.2 It is proposed that the scheme should be retroactive and should be administered by a separate body capable of functioning immediately after the failure of a bank. Hence the proposal would not involve pre-funding of the scheme.

It is proposed that the beneficiaries of the scheme (i.e. the potential claimants) should be all depositors (resident and non-resident) excluding inter-bank and bank placed fiduciary deposits (which are predominantly Swiss). Depositors in any currency should be eligible to make a claim. It is proposed that the pay out should be limited to a maximum sum per individual depositor but that individual depositors may include a company or trustees.

It is proposed that the maximum pay out should be at or around European average levels and in line with the UK's new depositor protection levels (£35,000 maximum). On balance the Commission favours a scheme with a small proportion of co-insurance - claimants receiving ninety per cent of the maximum figure and having to bear the loss of a small top slice of their deposits.

The scheme should be funded by a levy on all banks. The international norm is for that levy to be calculated according to the size of each bank's eligible deposit base, but at this stage we are retaining an open mind on the other option of a single equal levy to be paid by each bank.

It is the preference of the Commission that Guernsey's scheme should be structured to be equivalent or as close as possible to the proposed Jersey scheme so as to avoid regulatory arbitrage.

1.3 The Consultation Process

The Commission would like to receive the views of interested parties on the structure of a possible scheme and in particular invites responses on the issues set out below not all of which are addressed in the above preferred option.

Responses should be addressed to:

Director of Banking
Guernsey Financial Services Commission
La Plaiderie Chambers
La Plaiderie
St Peter Port
Guernsey GY1 1WG

Section 2 : Summary of Issues on which Comments are Invited:

2.1 Should the scheme be retroactive?

The issue here is whether the proposed scheme should be pre-funded or whether it should only require funding following the collapse of a bank. A third course would be to have partial funding in place to be topped up by a levy subsequent to a bank's failure.

2.2 Who should be the beneficiaries of the scheme?

There are a number of possible options here.

- a) Should the scheme be restricted to Guernsey residents?
- b) Should the scheme include small businesses and if so using what criteria to define them and should there be a cut off point?
- c) Should the scheme be restricted to one pay out per customer or should there be pay outs per account?
- d) Should the scheme exclude inter-bank deposits? Should overseas bank placed fiduciary deposits be excluded (i.e. treated as inter-bank and be excluded)?
- e) Should the scheme look behind trusts at the underlying beneficiaries or simply treat a trust account just like any other personal account?
- f) How should the scheme treat:-
 - (i) Pooled accounts?
 - (ii) Joint accounts and partnerships?
 - (iii) Nominee accounts?

2.3. How should the scheme be financed?

In paragraph 5.3 below there is a list of financing options. However in practice it is anticipated that in Guernsey such a scheme would have to be financed by banks. The further question arises as to what methodology should be applied:

- a) A flat fee applied across the board to all deposit takers?
- b) A graded fee assessed:-
 - (i) By size of deposit base of each bank?
 - (ii) By size of eligible deposit base excluding inter-bank and bank placed fiduciary deposits?
 - (iii) By number of accounts?

2.4. Should there be a cap on the total obligation of the scheme i.e. a maximum pot out of which depositors may make claims?

If so, should this maximum sum be fixed:-

- a) Per event {e.g. £50 million per bank failure}?
- b) An annual amount {e.g. £50 million in any one year}?
- c) An absolute figure limiting the total obligations under the scheme?

2.5. Should there be a cap on the levy payments made by each bank in the event of a failure?

Several schemes impose a maximum on the amount of monies collected from banks in any one year. The cost of a failure to other banks in the scheme would, potentially, be spread out over a number of years. If such an approach is adopted should the maximum levy collectable from each bank under the scheme be set:-

- a) Per event?
- b) For an annual amount?

At what level should the maximum levy per bank be set?

- c) A fixed sum per bank?
- d) A sum based on each bank's eligible deposits?

It is worth noting that the Jersey scheme proposes an annual cap based on each bank's eligible deposits.

2.6. How much should be paid out to each depositor on a bank's failure?

In most schemes the payment out to depositors is subject to a ceiling. If such an approach is adopted, the question remains as to what maximum amount should be paid out. In assessing this issue, should Guernsey's scheme pitch the levels:-

- a) At around £35,000 i.e. broadly in line with the United Kingdom level?
- b) More generous levels of compensation
- c) less generous levels e.g. the European statutory minimum (Euro 20,000)

2.7 Should the scheme involve some form of co-insurance so that depositors would bear the top slice of loss (for example receiving only 90% of the maximum pay out). Alternatively should depositors receive 100% of the maximum pay out or a combination of 100% pay out and a co-insured pay out.

It is worth noting that Jersey proposes a scheme, following the United Kingdom, whereby depositors are compensated 100% for the first £2,000 and thereafter 90% of their deposits up to a level of £35,000. This would make a maximum pay out per depositor of £31,700.

2.8 How should the scheme be administered?

By a separate body? If so, should it be:-

- a) Set up and functioning?
- b) Dormant but activated in the event of a bank failure?

Section 3 : Purpose, Background and Rationale

3.1 By way of background, it is worth recalling the stages leading to the issue of this consultative document. The Home Office Review of Financial Regulation in the Crown Dependencies by Mr Andrew Edwards – “The Edwards Report” – gave the qualified opinion that:

“Although putting adequately resourced schemes in place may be difficult, customer compensation schemes are an element in good practice and the Guernsey and Jersey authorities should consider introducing them.”

The Commission stated in its 2000 Annual Report that, on balance, the Bailiwick would benefit from the introduction of a scheme appropriately tailored to Guernsey banks. This conclusion was reached after discussions with the Post-Edwards Working Group on Banking and the completion of a statistical survey. The working group offered a wide range of views on the perceived benefits and the potential disadvantages that would accrue on the introduction of a deposit protection scheme. The survey focussed on the incidence of small depositors in the Guernsey bank population to determine whether these were widely spread or concentrated in a small number of banks. It was concluded that there was a wide spread of small depositors across the whole population of banks and such depositors were not exclusively clustered in the retail banking specialists, but were a material part of many of the private banking businesses. Further research on the type and structure of a scheme appropriate for Guernsey has been carried out since then.

- 3.1.1 The need for deposit protection or deposit insurance schemes arises from the need to deal with the aftermath of the closure or failure of a bank because it is unable to meet its obligations and pay its depositors on demand or when their deposits fall due. There may be other reasons for closure or revoking a bank’s licence for example it may be in the public interest to do so. The impact of such a closure or failure will be felt not only by individual customers and businesses, but also by other banks and financial institutions with whom the failed bank has relationships.

The convention has arisen that institutions such as banks, insurance companies and other financial institutions, together with large corporations, are big enough to manage their own risks and that the real purpose of any deposit protection scheme is to protect the smaller retail segment of the market place. The large corporate players are judged to be active in the market place and thereby better informed of the risks of placing their funds with particular institutions. At the same time there is a not unreasonable political objective that it is unacceptable that small depositors and savers should lose all of their money or their life savings purely because of the mismanagement of a bank. Hence the schemes are primarily focussed on the protection of individuals and small businesses who can least afford to lose their deposits.

- 3.3 There remains, at least theoretically, a “moral hazard” issue in respect of depositor protection. If depositors are protected by schemes to the extent that, for the bulk of the population, their entire capital on deposit is guaranteed by a scheme this has, so the argument goes, a deleterious effect both on depositors and on banks. Banks are encouraged to take greater risks to offer better returns to attract depositors in the knowledge that depositors are protected in the event of

failure. Badly run, more risky, banks offering higher rates of interest may gain a temporary advantage over secure, sensible, well-run banks. Recent history tells us that the theory has some substance since this was essentially the scenario which led to the insolvency and subsequent Government rescue of the American savings and loan industry in the early 1990s, fuelled by high risk property lending. It is largely this behavioural hypothesis which leads to the conclusion that it is not prudent for depositors to be fully protected from loss and that there should be at least some onus on depositors to be selective as to the institution with which they place their deposits. They should not face a no-loss situation and should bear some of any loss themselves. The theory also has practical appeal to Governments since it keeps the costs of a scheme down.

3.4 The Rationale for Deposit Protection in Guernsey.

3.4.1 The question should be asked: who should deposit protection in Guernsey be seeking to protect? In the first instance we should protect depositors and savers who are not well placed to be able to discriminate between the riskiness of banks that have been licensed. This should include small businesses that are likely to suffer if their liquid funds are lost or frozen. On the other hand we should perhaps not seek to protect large corporations who can look after themselves. Some schemes only set out to protect residents of their own jurisdiction.

3.4.2 On the introduction of a deposit protection scheme one should ask the question: is it only small depositors who will benefit? Or are there other benefits that might flow from introducing a scheme? It can be argued that the adoption of a scheme will add to the stability of the banking sector. It can also be argued that the international reputation of Guernsey will benefit from the introduction of a scheme. Currently without a scheme, advertisements for Guernsey banks have to point out that depositors will not be a member of a scheme and that other schemes, such as the United Kingdom scheme, do not extend to Guernsey. It is now an international expectation that mature finance centres should have a deposit protection scheme in place to protect the stability of the banking sector and a proportion of the cash savings of the population.

3.4.3 The question may also be asked: why is a scheme needed in Guernsey now, when we have managed quite well without one for many years – does the need to introduce a scheme imply that some banks are more vulnerable to failure than we did previously? The Commission is satisfied that it is not the case that banks are more vulnerable than previously. The supervisory regime already reflects the implicit riskiness of banks through the amount of capital required to support the assessed risks of each bank's particular chosen mix of business. Similarly, as supervisors of banks, the Commission applies more resources to those banks that are seen as being intrinsically more risky.

One related point, on which experts agree, is that if a country is to introduce a new scheme then the best time to do it is when the macroeconomic environment is stable and the banking system is sound overall and not troubled or in crisis. On this basis, now is a good time to introduce a scheme to Guernsey.

- 3.4.4 This further raises the question of what hypothetical bank failure scenarios have been envisaged when considering introducing a scheme in Guernsey? Those with long memories will recall the demise of Barnett Christie in 1976 and the subsequent settlement of claims by the States of Guernsey in 1984. Even though Guernsey has some relatively small banks, we no longer have any indigenous Guernsey banks or banks whose sole operation is in Guernsey. The last one of that type, namely Hanson Bank Limited, surrendered its licence in 1998. All the banks currently represented here are part of international banking groups elsewhere. All Guernsey subsidiaries of international banks have letters of comfort in place that represent an expression of the intention to support the subsidiary by the parent. A branch of an international bank is an integral part of the whole bank so the branch stands or falls on the health of the bank in its entirety. That said, it is worth considering another scenario that may be pertinent to a Guernsey scheme, namely the failure of the parent bank in another jurisdiction. Even if the local Guernsey operation is established as a subsidiary and is effectively ring-fenced so that it is a pure stand-alone operation and the failure of its parent should not affect the Guernsey bank's depositors, the reality is that most subsidiary banks have loans and placements with their parent or other parts of the parent group so that it cannot stand in isolation from the health of the parent. This scenario was, indeed, faced in Guernsey in 1995 with the failure and subsequent rescue of Baring Brothers in the UK. That said, no bank has failed in recent years in Guernsey and depositors have not materially lost any money as a result of the failure of a bank here.
- 3.4.5 Given that track record it could be argued that there is no compelling need to adopt a deposit protection scheme if we do not see our banks as being fragile or especially vulnerable. However, international expectations have changed and jurisdictions without deposit protection schemes are beginning to look out of step with the international community. International bodies (such as the IMF) now presume that well ordered and well-regulated centres will have adopted a deposit protection or insurance scheme for the benefit of their depositors. The availability of deposit protection is seen by the Basel Committee on Banking Supervision as a complementary facility to banking supervision in the context of efficient resolution of problems in banks. The basic principles of deposit insurance are included as an appendix to the internationally recognised standard setting document, Core Principles for Effective Banking Supervision, published by the Basel Committee in 1997. In September 2001, the Financial Stability Forum published a "Guidance for Developing Effective

Deposit Insurance Systems”. This paper is designed to deal with the issues raised by the Forum.

Section 4 : Clarifying what should **not** be expected of a Deposit Protection Scheme

- 4.1 A deposit protection scheme should not be a substitute for a fully functioning and resourced banking supervisory regime. A deposit protection scheme should be independent of the banking supervisory regime. Furthermore, the introduction of a scheme should in no way mean that the banking supervisory regime might be relaxed in any way. In addition such a scheme is also not a mechanism for effecting mergers and acquisitions or consolidation within the banking sector. Finally, and most importantly, a scheme should not be regarded as a lender of last resort. In many countries the supervisory function is provided by the Central Bank which also has the role of lender of last resort. Clearly a lender of last resort (for example, the Bank of England, la Banque de France or the Federal Reserve System in the USA) would have the ability to provide liquidity to support failing banks if they judged it was in the public interest and in the interests of maintaining the stability of the banking system to support and keep afloat banks which might otherwise become insolvent. Financial stability is a prerequisite of an economy which seeks to use monetary policy as a macroeconomic tool. The purpose of a deposit protection scheme should in no way be confused with that role. It is perhaps not surprising that such confusion has clouded the picture, particularly when some deposit protection schemes have built up large funds, in which cases they get drawn into a judgement as to whether it is better to use those funds to prevent a bank failing rather than allowing it to fail and then paying compensation to the depositors.

Section 5 : What types of scheme are available?

- 5.1 There is no definitive way to set the level of cover provided for depositors. This might be related to average deposit size, but to determine the appropriate level would require a lengthy empirical exercise. An international comparison is provided by the IMF that uses two times mean per capita income as a rule of thumb or proxy to evaluate coverage levels. The European average is set at 1.6 x GDP per head, although that average embraces a range including 0.8 x GDP per head in the pre-2001 UK scheme, 1.3 x GDP per head in Germany, 1.6 x GDP per head in Switzerland and 2.6 x GDP per head in France. The ratio in the USA is 3.3 x GDP per head. Proceeding on that basis, if we took per capita GDP in Guernsey at circa £21,937 per head in 2000 then it would take a maximum cover of £42,000 to match the IMF benchmark of 2 x per capita income per head, and some £32,000 to match the European average of 1.6 x GDP per head.

Setting the level of cover involves making a set of judgements about how we want to be regarded internationally and how a scheme can viably fund itself. International plaudits might come from structuring a scheme which sits alongside

the most generous but Guernsey might feel more comfortable with a scheme giving closer to minimal coverage if it could be relied upon to be funded and delivered smoothly and without strains on the local banks.

- 5.2 The issue of moral hazard raised above also needs to be factored into the equation and can be addressed in two ways. First, by addressing the level of coverage in relation to average deposit size. A high level of coverage (eg as in USA) is likely to exacerbate the moral hazard issue. If the maximum compensation is £30,000 then depositors above that level, say, with a deposit of £50,000 have an interest in avoiding those banks most likely to fail. But if, as in the USA, the maximum compensation is US\$100,000 then fewer depositors are likely to worry about possible bank failure.

One means of imposing the discipline on depositors of being selective where they place their deposits is through co-insurance, a form of risk sharing. Where this is in place depositors only get back a proportion, say 75% or 90%, of their deposits up to a maximum ceiling and have to bear the loss of the top slice of their deposits. This would mean that every depositor would have to bear some loss. At the same time it would have the effect of reducing the overall cost of the scheme. However, it involves the presumption that depositors have sufficient knowledge to make reasonable judgements on avoiding the most risky banks.

- 5.3 Who pays and how do schemes operate?

Over the years, one of the more difficult questions in this context has been: if a bank fails, whose responsibility is it to compensate the depositors of the failed bank? There are a number of possible alternatives:

- (i) The Government
- (ii) The Central Bank
- (iii) The banking supervisor
- (iv) The liquidator of the failed bank
- (v) Other banks
- (vi) Some other body
- (vii) No-one.

In practice, the answer boils down to a choice between “the Government” and “other banks”. In general and in order to avoid the on-going obligation of underpinning a country’s banking system, most governments have sought to set up schemes which pass the responsibility to a specially created agency and shift the costs of compensating depositors to “other banks”. This is now the accepted pattern for compensation of the depositors of failed banks. Having said this, there is one leading industrial nation (Italy), which has set up a scheme with the cost burden to be borne by “other banks” where the government has decided against activating the scheme and has compensated the depositors of failed banks directly itself.

That aside, the international model is to set up a scheme whereby a levy is imposed on other banks which then provides a pool of funds to pay out compensation to eligible depositors. The next big question is: should that pool be pre-funded or should it be collected after the event (usually referred to as an ex-

post scheme) i.e. should the levy only be triggered after the failure of a bank? Both types of scheme are common and both types have their advantages and disadvantages. The question is which is most appropriate for the circumstances of Guernsey – a funded scheme or an “ex-post” scheme.

The United States and Canadian schemes are well regarded and held up as models of funded schemes. However, the US banking system has thousands of relatively small banks and historically the level of protection has been high. Both the US and the Canadian deposit protection agencies are involved in the supervision of the banks they protect. This complicates banking supervision in those countries as it leads to multiple agencies being involved in the process. The availability of such funded schemes is clearly regarded in those countries as part of the infrastructure contributing to financial stability.

Funded schemes also involve the complexity of requiring investment functions in order to decide how to employ the funds that are collected from banks. Under an ex-post scheme a stable and easy to calculate mandatory levy may be helpful to the banking sector as they can factor this into the cost of doing business. An ex-post scheme would render banks potentially liable to the imposition of a levy in the event of a bank failure. The banks would technically have a contingent liability towards the scheme.

In the Commission’s view, the fact of Guernsey not having experienced a recent bank failure and the fact that we have no indigenous banks suggests that there are no strong arguments for adopting a pre-funded scheme at this time. If a workable scheme can be devised, it would seem more appropriate to go forward with an ex-post scheme. Such schemes are operated by some 25 jurisdictions world-wide including France, Luxembourg, the Netherlands and Switzerland. The UK has a scheme that is partially funded up front, in order to provide an administrative capability to allow it to function smoothly in the event of bank failure, but which is principally funded after the event. Our banking industry has several similarities with Luxembourg, notably the prevalence of branches and subsidiaries of international banks, so it is worth observing that that country has an ex-post scheme. It is worth noting that member states of the EU have to conform to the EU Directive on Deposit Guarantee schemes. Although there is some variety in the detail of schemes the Directive mandates each member country to provide a minimum level of deposit protection and allow for claims to be made against each scheme by depositors in other member countries within the Union. Gibraltar in 1997 established a scheme that conforms to that EU Directive.

Section 6 : Pre-conditions for setting up a Scheme

Whether a scheme is pre-funded or funded after the event, the “event” in question is the failure or closure of a bank, which would be the result of the licensed institution having become insolvent and unable to repay all its deposit commitments.

If a bank is of fragile solvency with a question mark over its ability to pay its debts as they fall due, there is no doubt that its demise can be hastened by the actions of persistent creditors. However, there may be a public interest in keeping the bank alive by providing a breathing space (with protection from those pressing creditors) to see if the business can be recapitalised (or sold) and put on a more solid footing so that it can continue to trade.

The United Kingdom introduced the concept of administration in its 1986 insolvency legislation. This put it alongside Chapter 11 of the United States bankruptcy code that gives companies the facility of protection from their creditors with the authority of the courts.

As yet that facility is not available under Guernsey law. However, the current proposals for company law reform do contain significant proposals to that end. A draft law containing company administration proposals is due to be issued for consultation in 2002.

The importance for banks of such a facility is primarily the obtaining of a breathing space which might avoid a “run on the bank”, and the creation of the opportunity for the existing owners to recapitalise or to bring in new shareholders with new capital. If the Administrator is unable to obtain an injection of new capital he has the option of selling the business as a whole or piecemeal to new owners who can extract economic value from the assets. In that scenario, value for the depositors can be conserved with a view to avoiding potential losses of their deposits. Economically, the Administrator also performs the useful function of recycling economic resources to owners who may manage them more efficiently.

Such a corporate rescue facility is important in the context of introducing a deposit protection scheme in Guernsey. First because it significantly increases the likelihood of avoiding a liquidation or insolvency event which might trigger the coming into play of the deposit protection scheme itself and, second, because it would allow the scheme to minimise the cost of any bank failure.

In an interim period of recapitalisation or of attempting to find a buyer it would be the Administrator who would run the bank and the Commission would have to consider issuing a new licence to that effect e.g. XYZ Bank (Guernsey) Limited (In Administration). The bank could then legally continue to take deposits from the public either as existing monies or new funds. The Administrator would be accountable to the courts for his or her stewardship of the bank within a prescribed time period. The Administration Order made by the Court could lay down the terms of the relationship

between the Administrator and the Commission but, even if it did not, the Administrator's need to preserve the bank's licence would mean that the Administrator would be in close and continuing contact with the Commission for its day to day banking supervision, particularly in respect of its ongoing liquidity.

Section 7 : Who should be Eligible Depositors?

The establishment of a scheme would have the effect of safeguarding the most vulnerable depositors. Core to the widespread acceptance of a scheme is the definition of precisely who is protected. Clarity and simplicity are important criteria in determining eligibility if the scheme is going to be effective. They may also be important influences as to whether the scheme is going to be cost efficient but there will be a range of factors that work on that consideration. The Commission is seeking a pragmatic consensus from government, the public and the industry as to which depositors should be eligible for protection.

7.1 Guernsey Residents and Non-Residents

The first important question is: should the scheme be available only to residents of the Bailiwick? While restricting the scheme in this way would limit the numbers of those entitled and thereby also the cost of the scheme, the Bailiwick would not be able to hold itself out internationally as having a broadly based depositor protection scheme. This may be material for the expatriate segment which is targeted by many banks in the "affluent" market sector.

7.2 Inter-Bank and Government Deposits

Banks should be well informed about financial markets and should have robust risk management systems enabling them to look after themselves. It is usual therefore to exclude all inter-bank deposits – in other words, deposits by other deposit taking and credit institutions – from being covered by a deposit protection scheme. The convention has also evolved that deposits from governments and public corporations should be excluded on the basis that they also are well informed and should be able to look after themselves.

7.3 Fiduciary Deposits

A large proportion of deposits in Guernsey is placed on deposit in Guernsey by overseas banks. Some are pooled in the country of origin. It would be inappropriate to look beyond the fiduciary relationship of the bank to the beneficial owner and compensate depositors who would most likely have recourse against the bank in their home country. It would seem sensible that fiduciary deposits should be treated as inter-bank deposits since that reflects the legal position.

7.4 Trust and Client Accounts

Deposits by trusts are an important part of banking business in Guernsey, so it is important to determine whether they should be regarded as eligible deposits. Once again, the question needs to be asked: should the scheme look beyond a trust? There are many different types of trust. One approach would be to make a distinction between trusts established by companies and private family trusts, albeit this has led to complicated definitions in other jurisdictions. Another approach would be not to look beyond the trust, to treat all trusts as separate eligible depositors. The same approach could be applied to co-mingled accounts such as lawyers' client accounts.

7.5 Joint Accounts and Partnerships

If international precedents are followed joint accounts and partnerships should be eligible for compensation under the scheme, and should be treated as being transparent as to ownership – for example joint accounts being apportioned 50% to each of the two account holders and in other cases, the account being apportioned in pro-rata percentages according to the number of account holders/partners. The convention in most schemes is that the percentage share should be aggregated with any other accounts held by the individual to determine how much that individual is entitled to claim.

7.6 Corporate Accounts, Small Businesses, Investment Companies

The conventional assumption is that large corporations, like banks, are big enough to look after themselves. The problem is determining the criteria to be applied. Many schemes distinguish between the size of companies eligible for compensation. Some include small private investment companies with assets, for example, below £1 million-£2 million. It is more difficult to define a small trading company. Some jurisdictions set criteria to define small businesses as, for example, companies, partnerships or unincorporated bodies with a balance sheet of less than, say, £1 million, an annual turnover of below, say, £250,000, and with five or fewer employees. The problem with such an approach is that there will inevitably be difficulties at the margins of these thresholds.

7.7 There may be other types of depositors that it would be sensible to exclude from the definition of eligible depositors. For example:-

- 7.7.1 Deposits by other regulated financial services entities on their own behalf for their own account;
- 7.7.2 Deposits by employment benefit trusts, deposits by pension and retirement funds (other than self-administered pension schemes);
- 7.7.3 Deposits that form part of the defaulting bank's capital;

- 7.7.4 Deposits by directors, controllers and managers of the defaulting bank - possibly extended to include close relatives of such people;
- 7.7.5 Some schemes exclude deposits by a person convicted of money laundering. Some seek to exclude those charged with the offence, but this would seem to condemn them prior to conviction;
- 7.7.6 Deposits by persons deemed by the scheme manager to have benefited directly or indirectly from the circumstances surrounding the financial failure of the bank or whose actions contributed to the bank's failure;

Section 8 : Should the Scheme Compensate Only Sterling Depositors or Include Other Currency Depositors?

- 8.1 Currently 70% of the deposits in the Bailiwick are in currencies other than sterling, principally the US dollar and the Euro. Clearly, there is a strong appetite among depositors for accounts in non-sterling currencies. It may be argued that non-sterling depositors are perhaps more sophisticated and therefore less in need of deposit protection but, on the other hand, there is no evidence to this effect and to exclude them would not appear to be commercially sensible.
- 8.2 There is also the issue of whether the scheme should pay out in the depositing currency or in the sterling value of that currency. If the latter was preferred a decision would have to be taken on whether the exchange rate to be applied should be that at the time of the bank failure or at the time of the distribution.

Section 9 : How should the size of the Levy on Banks be determined?

It may be helpful to give an example of what a bank failure might cost. Clearly, such an exercise will only be as accurate as the assumptions on which it is based.

The key assumptions that need to be made relate to:

- The sort of bank that it is assumed might fail.
- If there is an immediate payout by the scheme, the period over which it is reasonable to spread the collection of the levy.
- The maximum annual amount that banks would be required to pay.
- Whether all banks pay the same levy or whether they pay a levy calculated by reference to the size of their deposit base of eligible deposits.

The first assumption concerns the type of bank most likely to fail. For the purposes of this exercise the focus is placed on estimates of the number of eligible depositors in the

hypothetical bank and how much would be paid out to them. This involves an estimate as to the average payout among smaller depositors and an estimate of how many larger depositors would be subject to the maximum payout. Based on current information about the depositors at banks in Guernsey and about numbers of small depositors the effects of a single bank failure have been analysed.

For the purpose of this exercise it is assumed that the bank which fails is a small bank with 3000 customers with eligible deposits, reasonably typical of our bank population and a maximum pay out per depositor broadly in line with the IMF benchmarks.

Let us assume that the maximum pay out per depositor is £31,700 and that one third of the customers have deposits over that figure. For this exercise it will not matter if they have deposits of over, say £1 million, since their maximum claim will be capped at £31,700.

In this example the total pay out and the figure that will need to be recovered from the banks is as follows:-

Customers making full claim: 2000 at average deposit of £5,400*	£10,800,000
Customers making maximum claim: 1000 at £31,700	£31,700,000
	£42,500,000

Recovery of £42.5 million from banks could be phased over 2 or 3 years to spread the load of the levy so that only £21 million or £14 million is collected in any one year.

Another important issue is how the levy should be apportioned over the whole population of licensed Guernsey banks so that either:-

Methodology (i) each bank pays a levy in the same proportion as the amount of its eligible deposits bear to the total of all eligible deposits – this is the most common method of determining the amount a bank has to pay in existing schemes; or

Methodology (ii) each bank pays the same amount.

Under methodology (i) the largest four banks would pay over £2 million per year, the next 11 banks around a million pounds while the bottom 15 would pay less than £50,000 each. The remainder would lie in between these figures.

Under methodology (ii) each bank pays a levy of around £600,000 irrespective of the size of its base of eligible deposits.

* consistent with our data on typical small private banks

Bankers are asked to consider carefully which of the two methodologies they consider to be most appropriate.

Section 10 : Funding the Scheme and Recovering Assets

The conventional expectation of well-structured deposit protection schemes is that claimants can apply to a scheme and expect early reimbursement of their claim - at best within one month (US, Canada) but perhaps more typically within three months (Europe). The benefit of speedy reimbursement is that depositors are not out of pocket for prolonged periods and do not incur consequential losses from not being able to access funds.

There is, of course, a tension between a scheme paying out to claimants as quickly as possible and the time it takes to fund the scheme, both from the point of view of activating the levy and in respect of the realisation of any assets belonging to the failed bank. Insolvency practitioners may take a considerable period of time – years not months – to recover value from the banks’ assets. The bulk of value may be realised in the first three or four months but there is usually a long-tail in collecting value from the rump of less saleable assets.

Section 11: Borrowing to Fund Early Payment to Depositors

As a result a mechanism is required which will cover the timing difference between early payment to claimants and the levying of the banks and/or recovery of the value of the failed bank’s assets. The scheme needs to be established with borrowing powers at the outset so that it has access to liquidity to enable it to make speedy payments to claimants while the levy is made and the liquidator or administrative receiver is working through the process of recovering assets. In the case of Guernsey, which does not have a central bank, the scheme would have to look either to the other members of the fund or to some public sector special purpose entity, empowered to borrow, to provide it with a facility from which it could make early payments. Ultimately in a bank funded scheme, the costs of operating the scheme would be financed by the members of the scheme.

Section 12 : Administration and Staffing of the Scheme

A decision needs to be taken on whether the scheme needs to employ its own staff. If it is considered that there is only a low probability of the scheme being activated, there would seem to be no point in establishing a scheme with permanent staff. It would be more cost effective to set up the scheme with powers to appoint an administrator and for him/her to co-opt staff from accounting firms to administer claims under the scheme as and when necessary.

Section 13 : Mandatory Membership of the Scheme and Interaction with other deposit protection schemes

Since the Bailiwick of Guernsey is not within the European Union for the purposes of financial services a scheme would have to stand-alone with no support from other

schemes. It is the Commission's view that the scheme should embrace all banks licensed in Guernsey. It is therefore proposed that membership of the scheme should be a condition of every banking licence. Since Guernsey is not in the EU it would not have the benefit of cross-jurisdictional arrangements for deposit protection amongst EU member countries. For example depositors with branches of British banks would not have access to the improved compensation scheme recently introduced by the FSA.

Section 14 : The Legal Entity of the Scheme

International experience would suggest that a deposit protection scheme should be set up as a legal entity prior to the scheme coming into effect. As discussed above this could be already staffed or set up in such a way that staffing would flow from an event triggering the scheme. Should this entity be:

- a) A Guernsey Registered Limited Liability Company?
- b) A Board, for example, a Deposit Protection Board?
- c) Some other public sector entity?
- d) Another legal entity such as a trust?
- e) Would this be a suitable role for the Public Trustee?

It is also worth considering whether the positions on the Board, the Chairman and Secretary should be appointed on setting up the scheme. If so should there be a full Board or just a Chairman and Secretary and if so what would be the criteria for such appointments which could include representation from the industry.

Section 15 : Consultation Time-Scale

Responses should reach the Commission by 28 March 2002. They should be addressed to the Director of Banking, Guernsey Financial Services Commission, La Plaiderie Chambers, La Plaiderie, St Peter Port, Guernsey, GY1 1WG.

Section 16: Post Consultation Process

The Commission will review the responses from the consultation period during April and May 2002. A formal proposal for a Deposit Protection Scheme will follow thereafter. The opinion of the Crown Officers will then be sought with the aim of bringing out the appropriate order under the Banking Law to set up a Scheme by the end of 2002.

22 January 2002

F:\Docs\Hbygott-webb\Deposit Protection\201100 draft consultative paper-introducing a Deposit Protection Scheme in Gsy.doc