

direct supervisory control, branches can be accommodated where the parent is one of the strongest international groups. The GFSC needs to (a) be ready to progressively limit exposures of a bank (subsidiary) to its parent, as strains become apparent; (b) improve corporate governance at financial institutions; and (c) engage even more extensively with supervisors of the parent groups, while recognizing the practical limits on such cooperation, especially in time of stress.

**The establishment of the DCS is welcome, but its limitations must be carefully communicated to depositors.** The importance of the proposed measure is underscored by the liquidity risks discussed in the text, the deposit-based nature of banks, and the large size of the banking sector in relation to the economy (close to 8,000 percent of GDP). However, unlike in most other (large) jurisdictions (and international best practice), the scheme does not provide that depositors will always be fully compensated in a certain amount and the target payout time is longer than elsewhere. The approach should be reviewed in the medium term in the light of developing international standards.

**Guernsey should review its institutional arrangements for addressing financial stability issues.** Consideration could be given to establishing a forum devoted to monitoring financial stability and coordinating policy. Within the GFSC, financial stability work could be supported by dedicated resources covering the full scope of GFSC responsibilities.

**Table 1. Guernsey FSAP Update—Key Recommendations**

High priority	Timeline
<ul style="list-style-type: none"> <li>Monitor financial position of bank parent companies, using financial soundness indicators (FSIs) relating to solvency. Add and monitor data on large exposures (for borrower units).</li> </ul>	Short-term (within 12 months)
<ul style="list-style-type: none"> <li>Add senior analyst level expertise to the staff of the GFSC to analyze risk across sectors using supervisory data and other information.</li> </ul>	Short-term (within 12 months)
<ul style="list-style-type: none"> <li>Establish a forum devoted to monitoring financial stability and coordinating policy responses.</li> </ul>	Short-term (within 12 months)
<ul style="list-style-type: none"> <li>Complete preparations on potential deposit compensation payouts (should the need arise in the future).</li> </ul>	Short-term (within 12 months)
Medium priority	Timeline
<ul style="list-style-type: none"> <li>Amend the Financial Services Commission (Bailiwick of Guernsey) Law (FSC Law) to provide for longer terms of office for the chairman of the GFSC.</li> </ul>	Medium-term (1-3 years)
<ul style="list-style-type: none"> <li>Broaden the range of enforcement powers for insurance regulation.</li> </ul>	Medium-term (1-3 years)
<ul style="list-style-type: none"> <li>Consider how best to implement the public disclosure standards established by the IAIS for insurance regulation.</li> </ul>	Short-term (within 12 months)
<ul style="list-style-type: none"> <li>Collect and publish statistics on assets held by trusts and companies serviced by the Guernsey fiduciary sector. Make more comprehensive insurance sector data available.</li> </ul>	Medium-term (1-3 years)
<ul style="list-style-type: none"> <li>Further develop the assessments of economic capital requirements (OSCA) and stress tests for insurers</li> </ul>	Medium-term (1-3 years)
<ul style="list-style-type: none"> <li>Create an ombudsman service for adjudicating complaints by individual retail consumers.</li> </ul>	Medium-term (1-3 years)
<ul style="list-style-type: none"> <li>Extend investor compensation arrangements beyond current limited scope. Review the DCS in light of international standards.</li> </ul>	Medium-term (1-3 years)

## I. MACROECONOMIC AND FINANCIAL SETTING

### A. Purpose of the FSAP Update

1. **Developments in the financial sector and regulatory framework warrant an update of the assessment conducted under the Fund’s OFC program and finalized in 2003.** Furthermore, the integration of the OFC program into the FSAP (Executive Board meeting 08/48 on May 30, 2008) has widened the scope of the assessment to include stability-related issues and stress tests of certain sectors. This report therefore covers both regulation and supervision and matters relating to the soundness of the financial system and its ability to cope with stress. AML/CFT issues will be dealt with in a separate report.

### B. Context

2. **Guernsey is one of the three British Crown Dependencies, the others being Jersey and the Isle of Man (IOM).**<sup>2</sup> It is not part of the United Kingdom (UK) or a member of the European Union (EU), and has its own parliament (the States of Deliberation), legal and regulatory system, and tax regime. Its economy is, however, oriented toward that of the UK and it uses the pound Sterling as its currency—i.e., it has no central bank. As Guernsey does not have an independent monetary policy, imbalances have to be adjusted through price and wage flexibility, labor mobility, and fiscal measures. Guernsey is in a customs union with the EU (i.e., its physical exports enjoy access to member countries without tariff barriers). The population is around 60,000 and GDP was GBP 1.9 billion in 2009.

3. **Economic growth is driven by financial services. It is believed to have slowed in response to the global slowdown which commenced in fall 2008.** The principal sectors of the economy are financial services (accounting for nearly 40 percent of GDP and a quarter of total employment in 2009), retail, and construction. The main financial services are banking, insurance (particularly through captive insurers<sup>3</sup>), as well as trust and company services related to (mainly nonretail) CIS. The total number of financial institutions on the island has been rising steadily. However, the number of banks licensed has fallen, from a high of 54 in 2002 to 43 at December 31, 2009.

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<sup>2</sup> The Bailiwick of Guernsey (“Guernsey” for the purposes of this report) comprises the island of Guernsey itself and six other islands. However, financial services are concentrated in the island of Guernsey. FSAP Update reports for the IOM and Jersey were published in September 2009.

<sup>3</sup> Defined by the IAIS as “an insurance or reinsurance entity created and owned, directly or indirectly, by one or more industrial, commercial or financial entities, the purpose of which is to provide insurance or reinsurance cover for risks of the entity or entities to which it belongs, or for entities connected to those entities and only a small part if any of its risk exposure is related to providing insurance or reinsurance to other parties.”

**4. Growth and inflation rates are correlated with those in Jersey and the UK.**

Guernsey's real GDP growth has averaged 2 percent over the last decade, but is relatively volatile and was negative in 2003 and 2005. After GDP growth of 5.2 percent in 2008, driven by a double digit growth of the financial services sector, growth dropped to -2.2 percent in 2009, after a significant weakness, including in financial services, in the early months. Housing prices fell in the year and the number of unemployed rose (and has doubled since mid-2007), although the unemployment rate is still low, at 1.4 percent. Retail price inflation was 2.2 percent for 2009.

**5. Guernsey has a low taxation regime, which was comprehensively reviewed in 2007:**

- (i) Under the 2007 review, a 20 percent rate for individual income tax was retained. Guernsey participates in the EU Savings Directive framework and currently withholds tax on payments of savings income to EU residents under a transitional option. However, depositors in EU countries other than the UK are few and many already opt for exchange of information. On July 28, 2010, the Policy Council announced a movement to full automatic exchange of information from January 1, 2011 (to be completed by July 1, 2011).
- (ii) The corporate income tax rate was reduced from the start of 2008 to zero, except for the rate on profits derived from traditional banking (i.e., lending) activities (10 percent) and utilities and property companies (20 percent).
- (iii) There are no capital gains, wealth, inheritance, or general sales taxes, but residents are subject to social security contributions.

**6. As in the other Crown Dependencies, the corporate tax regime is presently again under review following communication via the UK that certain member states considered the “zero/ten” corporate tax regime to be noncompliant with the spirit of the EU Code of Conduct.** Guernsey's consultation document was published on June 21, 2010 outlining several technical options for consideration within a framework of applying a general non-zero rate of corporate taxation.<sup>4</sup> Guernsey has been deemed by the OECD to have implemented international standards on exchange of tax information. It has signed 15 tax information exchange agreements (TIEAs) and is negotiating more—the minimum number asked for by the OECD is 12.

**7. The GFSC is responsible for the supervision of financial services.** Most financial services, including trust and company services, are regulated, exceptions being consumer credit and pensions.

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<sup>4</sup> One alternative discussed at the time of the mission was a uniform 10 percent rate.

### C. Financial Sector Structure

8. **The financial sector is diverse, with complementarities and interrelationships between different services.** Unlike in Jersey and the IOM, the CIS sector (50 percent of total financial sector assets, Table 2) is the largest (by value of assets), rather than banking (43 percent). There is a significant insurance sector (7 percent). Many regulated companies (including banks) provide administration, trustee, and custodial services to CIS'. Fund management, stock broking, and other investment services are more limited. There are many thousands of Guernsey-based or foreign trusts and companies serviced by fiduciary and company service providers on the island. Banks support other sectors with deposit and lending services to funds and trusts and with letters of credit to captive insurance companies.

**Table 2. Guernsey: Financial System Structure, 2003-09**

	2003 /1			2007			2009 /2			
	Number	Assets (GBP billion)	Percent of total assets	Number	Assets (GBP billion)	Percent of total assets	Number	Assets (GBP billion)	Percent of total assets	Percent of GDP
Banking Sector	61	72.9	56.3	47	131.9	44.6	44	135.8	43.5	7,894
Joint stock and private banks	32	22.7	17.6	21	29.4	9.9	21	36.3	11.6	2,109
<i>of which: Subsidiaries of UK banks</i>	10	9.7	7.5	7	6.3	2.1	7	14.2	4.6	827
<i>of which: Subsidiaries of other EU banks</i>	8	3.7	2.8	3	1.6	0.6	3	1.5	0.5	90
Bank branches	25	47.9	37.0	23	100.1	33.8	21	97.7	31.3	5,680
<i>of which: UK</i>	12	16.8	13.0	9	27.6	9.3	10	18.4	5.9	1,070
<i>of which: Other EU</i>	5	5.0	3.9	6	4.2	1.4	4	2.1	0.7	124
Other	4	2.3	1.7	3	2.4	0.8	2	1.8	0.6	106
Insurance sector	406	14.7	11.4	404	18.5	6.2	396	21.0	6.7	1,223
Life insurance companies	22	3.6	2.8	23	8.6	2.9	32	9.8	3.1	569
Non-life companies	...	...	...	...	...	...	51	1	...	30
Reinsurance	...	...	...	...	...	...	13	1	...	32
Captives	384	11.0	8.5	381	9.9	3.3	300	10.2	3.3	591
Other financial institutions/3	488	41.8	32.3	851	145.6	49.2	969	155.5	49.8	9,037
Total financial system	955	129.4	100.0	1,302	296.0	100.0	1,409	312.3	100.0	18,153
Memo items:										
Number of company service providers/4	...	...	...	...	...	...	199	...	...	...
Number of trust service providers	...	...	...	...	...	...	199	...	...	...
Number of employees in the financial sector	...	...	...	...	...	...	6,975	...	21.6	...
<i>of which: Banking</i>	...	...	...	...	...	...	1,926	...	6.0	...
Total employment	...	...	...	...	...	...	32,332	...	100.0	...
Financial sector contribution to GDP (GBP millions)	...	...	...	590	...	35.0	...	...	...	...
Total GDP (GBP millions)	...	...	...	1,685	...	...	...	...	...	...

Source: Guernsey Financial Services Commission

1/ Insurance figures for 2003 represent situation at end 2004

2/ Insurance figures for 2009 represent situation at end 2008

3/ Other financial institutions are by vast majority collective investment schemes

4/ Figure includes businesses and individuals

9. **Guernsey offers several advantages of a financial center.** Fiscal neutrality is a key driver of the success of the island's services, and the government stated that an objective of any revised regime would be to safeguard tax neutrality applying to the broadest range of financial services products. However, Guernsey has other advantages, including its legal and regulatory system, time zone, and skilled workforce.

10. **There is an accelerating trend away from retail business.** Besides the "traditional" business model of channeling savings to parent banks, banks are focusing more on private banking and other services to high net worth individuals, and to institutional fund and

securities services (e.g., for private equity funds). With this has come greater complexity in Guernsey's financial services. There is limited treasury, trading, or capital markets businesses on the island.

**11. As an OFC, Guernsey's financial sector is internationally-oriented, while major regulated financial companies are foreign-owned.** All the banks on the island and all the insurers undertaking international businesses are foreign-owned, generally branches or subsidiaries of the UK or major international groups.

**12. Banks' main activities are deposit-gathering and private banking, with claims on parent groups the major asset class.** Consolidation in global banking and the impact of the crisis has contributed to falling numbers of banks on the island—down from 54 to 45 (total bank licenses) from 2004 to 2009 (see Table 2). Treasury operations once carried out on the island have now mostly been centralized in the parent. The large U.K. banks and building societies have operations on the island and 40 percent of banks' total assets are in the UK. However, many banks are from outside the EU.<sup>5</sup> Total assets grew steadily from 2004 until 2009, when they fell 40 percent, reflecting falls in Swiss fiduciary deposits in particular, partly due to exchange rate effects. Lending is mainly linked to funds, trusts, and companies serviced on the island, although some banks hold significant portfolios of loans originated in the parent country, particularly mortgages in the UK. Most assets, however, are claims on parent or group banks, representing some 70 percent of the total (Table 3).

**13. The global crisis has had an impact on certain banks in Guernsey, because of problems in the parent banks.** The most significant stresses were as follows:

- (i) In 2007, the intervention in Northern Rock, a U.K.-based bank with a Guernsey subsidiary, created uncertainty over the position of Guernsey depositors until a U.K. guarantee for the U.K. bank's liabilities was extended to amounts owed to the Guernsey subsidiary. The UK subsequently took the bank into public ownership.
- (ii) In late 2008, the Guernsey subsidiary of the Icelandic group, Landsbanki, was placed in administration when the bank faced escalating deposit withdrawals and was unable to draw down funds placed elsewhere in the group. 1,600 depositors had £120 million on deposit. There was, at the time, no deposit compensation scheme and payments to depositors from recoveries so far have amounted to 67.5 percent of deposits with the Joint Administrators projecting recoveries of up to 91 percent of deposits.

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<sup>5</sup> From, for example, Bahrain, Bermuda, Canada, Switzerland, and the United States.

**Table 3. Guernsey. Balance Sheet of Banking System, End-2009**

	GBP millions	Percent of total assets	Percent of subgroup	Percent of GDP /1
<b>Assets</b>	<b>135,803</b>	<b>100.0</b>	<b>100.0</b>	<b>7,893.9</b>
Cash	25	0.0	100.0	1.5
Loans to Banks	75,605	55.7	100.0	4,394.7
Loans to parent	56,464	41.9	75.3	3,282.1
Loans to fellow banking subsidiaries	16,619	12.3	22.2	966.0
Loans to other banks	2,522	1.9	3.4	146.6
Marketable Assets	24,353	17.2	100.0	1,415.6
Loans and Advances	25,710	18.9	100.0	1,494.5
Other non-banking financial institutions	18,128	13.5	71.1	1,053.7
Sovereigns	3	0.0	0.0	0.1
Public sector enterprises	69	0.1	0.3	4.0
Corporate lending	2,167	1.6	8.5	125.9
Retail lending	2,541	1.9	10.0	147.7
Residential mortgages	2,730	2.0	10.7	158.7
Capital connected lending	73	0.1	0.3	4.2
Investments	6,791	5.0	100.0	394.7
Non marketable debt - other non-banking financial institutions	5,987	4.4	88.9	348.0
Non marketable debt - corporate	155	0.1	2.3	9.0
Capital investments in Subsidiaries and other associated companies	21	0.0	0.3	1.2
Equity - corporate	274	0.2	4.1	15.9
Other Financial	3,144	2.3	100.0	182.8
<i>of which: All past due assets</i>	76	0.1	2.4	4.4
Other	175	0.1	100.0	10.2
<i>of which: Intangible assets including goodwill</i>	87	0.1	49.9	5.1
<b>Liabilities</b>	<b>135,803</b>	<b>100.0</b>	<b>100.0</b>	<b>7,893.9</b>
Deposits due to:	114,751	84.5	100.0	6,670.2
Parent/holding company or group	65,508	48.2	57.1	3,807.9
Retail accounts	9,288	6.8	8.1	539.9
All other depositors	39,955	29.4	34.8	2,322.5
CDs and Other Debt	14,312	10.5	100.0	831.9
Creditors & Accruals, etc.	4,467	3.3	100.0	259.6
Capital	2,273	1.7	100.0	132.1

Sources: GFSC and staff estimates.

/1/ Percent of end 2008 GDP (Source: Guernsey, Policy Council)

14. **The authorities have responded to the crisis with significant reforms.** These include a strengthening by the GFSC of its approach to (a) banks' exposure to parents, the main source of stress to banks in the crisis—it has introduced disclosure requirements (to inform depositors on the exposure to parents); (b) exposure limits (set individually by bank); and (c) and contingency planning (for problems at the parent). The authorities also moved swiftly in late 2008 to introduce a DCS, taking advantage of enabling provisions that had been introduced by secondary legislation some years ago.

15. **The insurance industry in Guernsey comprises two distinct segments: domestic and international.** The domestic segment (21 insurers) caters to the insurance needs of residents and risks based in Guernsey. The international sector (678 firms, including 323

cells in protected cell companies (PCC)<sup>6</sup> and incorporated cell companies (ICCs)<sup>7</sup> comprises captives and commercial insurers writing an extensive range of business, including employers/public liability, business interruption, motor, property damage, and catastrophe risks. International life insurers service high net worth individuals and companies providing insurance-based employee benefits. Captive insurers account for around 60 percent of the market. Most are owned by U.K. parents (some 40 percent of U.K.'s FTSE 100 companies own captives in Guernsey) and employ fronting arrangements<sup>8</sup> using EU insurers, mainly from the UK. All but one captive insurer are managed by licensed insurance managers. Total premiums in 2008 were GBP 3.3 billion and the sector held gross assets of GBP 21 billion.

**16. The insurance industry is mainly exposed to external risks and threats.**

Catastrophic weather conditions in Guernsey would affect only local insurers underwriting motor and property insurance. A sustained worldwide economic downturn could affect the captive and international life insurers. As life insurers offer mainly unit-linked products (policyholders typically bear the investment risks), market risks have minimal impact. A current challenge for the insurance sector is the Solvency II Equivalence<sup>9</sup>, which appears to have implications for captive insurers in particular. Guernsey is considering whether to seek recognition as an equivalent jurisdiction.

**17. Guernsey's insurance sector has not been immune to the financial crisis.**

A number of captive insurers had exposures to Icelandic banks or parents or placed reinsurance with a reinsurer in distress. Several insurers writing mortgage indemnity lines ceased business. Life insurers saw lower profitability mainly as a result of reduced management fees derived from reduced policy values. With the exception of some captives, the sector is not exposed as banks to parent companies.

**18. Administration and custody of open and closed-ended CIS are the main focus of investment businesses.**

Investors include Guernsey residents and local and overseas

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<sup>6</sup> A PCC is a single legal entity divided into an unlimited number of cells whose assets and liabilities are legally segregated from each other and from the general assets of the "core" cell.

<sup>7</sup> An ICC is a legal structure where each of the cells is a separate company in its own right with limited liabilities. It is unlike the PCC structure, where the cells are not separate companies.

<sup>8</sup> In many jurisdictions, mandatory insurance such as motor third party liability and workers compensation can be underwritten only by insurers licensed in that jurisdiction. To insure such risks with a related captive that is not located/licensed in that jurisdiction, a parent company will arrange with a licensed insurer to accept the risks with a back-to-back "reinsurance" to a related captive, termed "fronting."

<sup>9</sup> Solvency II, the "Basel II for insurers," is the revised regulatory requirements for insurance firms that operate in the EU, coming into effect by end-2012. Solvency II is based on a risk-based measurement of capital requirements.

institutions and professional firms. Fund sponsors are mostly based abroad as is the management of the funds (for example investment strategy). Guernsey companies carry out administration (including company secretarial services) and trustee/custodial services. The GFSC licenses companies in respect of the different services they provide to funds.

**19. The numbers of funds (open-ended and closed) have been growing steadily.**

While still smaller than Jersey's, the sector comprises nearly 900 funds<sup>10</sup> with GBP 133 billion under management, measured by net asset value (a reduction from nearly GBP 160 billion before the financial crisis). Gross assets, taking into account leverage, total GBP 161 billion. Non-domiciled open-ended schemes total a further GBP 49 billion.

**20. Funds are increasingly being established for professional investors.** In recent years, the focus of the funds sector has moved away from retail investor funds to funds targeting institutional, professional, and high net worth investors. There has been a particular increase in the use of structures such as umbrella and multi-class funds, including PCCs and ICCs. Private equity funds (closed-ended vehicles with a high minimum initial subscription) are a growing area of specialty as are property funds and funds of hedge funds rather than hedge funds themselves.

**21. A wide range of other investment services are also provided in Guernsey.** These include discretionary and non-discretionary asset management, for private, professional, and corporate clients, including insurers and trusts and companies serviced on the island; stock broking; investment advice; investment performance monitoring (mainly for trusts) and intermediary services, mainly to the local population. The Channel Islands Stock Exchange (CISX), offers primary and secondary listings, and provides screen-based trading, for over 2,000 CISs, structured debt instruments, securities and shares issued by Channel Islands companies and overseas companies.

**22. Investment businesses were also affected by the crisis, although less severely than banking.** New fund launches fell sharply. Valuations were hampered by market illiquidity and a number of open-ended funds that experienced liquidity pressures as investors sought to make redemptions. Gating provisions (i.e., suspensions of withdrawals) had to be invoked in some cases, particularly where funds were significantly leveraged. The market falls led to reduced income for fund administrators and, more seriously, exposed some cases of inappropriate or improper portfolio selection.

**23. Numerous trust and company service providers (fiduciary companies) operate on the island.** Fiduciary services comprise trust and company management and

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<sup>10</sup> 101 open-ended and 40 closed-ended investment funds are established as PCCs and another 9 open-ended and 4 closed-ended investment funds as ICCs.



administration and, to a lesser extent, executorship services. Most trusts are private discretionary trusts used by families and as investment vehicles for company pension and employee benefit schemes. Both Guernsey and non-Guernsey companies are administered by company service providers. The settlers and beneficiaries of trusts and the beneficial owners of companies are from all over the world. Guernsey is not a major host of special purpose vehicles (SPVs), structured investment vehicles (SIVs), and other corporate entities used in securitization and in transfers of banks' assets off balance sheets before the crisis.

24. **A wide range of legal and accountancy services are available in the island.** All four major international accountancy firms are represented. Accounting standards used in the financial sector are typically International Financial Accounting Standards (IFRS), U.S. General Agreed Accounting Principles (GAAP), and U.K. GAAP; and Guernsey does not set its own standards. Nor is there anybody in Guernsey overseeing the audit work of accountancy practices, although U.K. firms are subject to peer review by the U.K. profession. The judicial system is expert in financial matters, and statutes are supported by extensive case laws.

#### **D. Outlook**

25. **The complementarity of businesses on the island, combined with tax and regulatory advantages, has supported continued growth, but there are challenges.** The volume of businesses originated by funds, trusts, and companies is a key driver of business in the island. Low taxation and a commitment to strong regulation are essential supports. However, staff costs are high, while recruitment (particularly of certain specialists) can be difficult, reflecting limited local skills pools and restrictions on immigration and housing availability. Competition from other international centers remains intense, while regulatory changes in major markets may have adverse impacts. There is a particular risk that new EU regulations could be damaging to the interests of the significant parts of Guernsey business orientated toward the EU. While Guernsey may choose to adopt equivalent measures (and apply to the EU for recognition of equivalence), these may not always be suited to the specific characteristics of Guernsey business. Combined with EU and wider pressures in the area of taxation, these developments are reducing the scope for Guernsey to maintain a distinct approach to regulation and other aspects of its success as an offshore center.

## **II. STABILITY ISSUES**

### **A. Vulnerabilities of the Financial System**

26. **Although the financial crisis has adversely affected banks and other financial institutions, the system has been shown to be relatively stable.** The banking system did not have major exposures to the asset classes most affected by the crisis (structured credit), and the deposit-based nature of the banks' business model has supported stability and

prevented shocks channeled through the interbank and securities markets. As described above, two Guernsey banks were subject to particularly severe stress and one had to be put in administration during 2008. In both cases, the difficulties resulted from the financial stress of their parent. The experience underlines the key risk faced by many institutions on the island—exposure to the weaknesses of their parent institutions. In large part because of the crisis measures taken by authorities in the major economies, additional stress from this exposure was avoided in the crisis, but the financial system remains subject to risks (see Table 4). The risks are low probability–high impact, which warrants particularly careful monitoring and proactive action by the authorities, if necessary.

27. **Guernsey’s banking system remains vulnerable to shocks.** Risks are still high in the global financial system overall, while Guernsey is linked to other financial centers (and large international parent banks), particularly in the UK.<sup>11</sup> It is important that the GFSC continue and extend their systematic monitoring of the evolution of aggregate credit risk in the system across sectors, in particular to related large counterparties. Key risks for the Guernsey banking system remain (see summary in Table 4):

- (i) The system is particularly vulnerable to intra-group contagion, given that 42 percent of the banks’ assets constitute direct credit exposure within the groups (see Table 3).
- (ii) Concentration of credit among the local economy (almost 6 percent of assets) and other financial sector counterparties (13.5 percent of assets) poses risks of contagion, as indicated by the stress tests, and large exposures should be carefully monitored by the GFSC.<sup>12</sup>
- (iii) Lending to real sector borrowers is more limited than in Jersey and the IOM and is based on conservative lending practices (use of collateral and other risk mitigants), but should remain subject to close monitoring given the high absolute level of credit in relation to the economy (about 400 percent of GDP) (see Table 3).

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<sup>11</sup> While the risk of contagion is high for the Guernsey financial system, the reverse risk for the financial systems of the home countries is limited, resulting from the relative size of the Guernsey financial system, which is less than 2 percent of the UK bank system.

<sup>12</sup> To do so, the GFSC should improve its database in order to monitor exposure to borrower units on a timely basis (both the volume and default probability of the large exposures).

- (iv) The system is also exposed to FX rate risk, which is mainly hedged, but considerable movements in FX rates could potentially result in a decrease of the capital bases of a few financial institutions if not monitored and managed properly.<sup>13</sup>

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<sup>13</sup> Two banks with significant capital bases had already addressed the issue some years ago and have denominated their capital in US Dollars.

**Table 4. Risk Assessment Matrix**

Nature/Source of Main Threats	Overall Level of Concern	
	Likelihood of Realization of Threat Sometime in the Next Three Years	Expected Impact on Financial Stability if Threat is Realized
<p>1. Solvency or liquidity problem of parent bank</p>	<p><i>Assessment: Low</i></p> <p>Solvency and liquidity risks of parent banks could be triggered by a global double-dip scenario, and/or an idiosyncratic shock to specific (host) countries or banks.</p> <p>Changes to the solvency and/or liquidity position of Guernsey banks could also be triggered by regulatory reforms and practices centered on Basel III, namely related to the regulation of Systemically Important Financial Institutions (SIFIs), as well as lessons learnt from the crisis.</p>	<p><i>Assessment: High</i></p> <p>The impact of a financial deterioration of a parent bank depends on the extent of the exposure to the parent in the specific case (as well as its liquidity position). Because of the scale of these exposures generally, the impact would be highly adverse in the host country, but also in Guernsey (also due to a reputational effect), which is clearly shown by the stress tests.</p> <p>The authorities can mitigate the impact by closely monitoring the solvency of parent banks (through market indicators, cooperation with the home supervisor and financial stability analysis) and through risk-mitigating strategies (for example by selective licensing and/or setting restrictions on banks' risk taking, limiting up-streaming of deposits and other ring-fencing measures, if adequate). Liquidity risks can be mitigated through a strengthening of the DCS and an increase in holdings of marketable liquid assets (for example in case of a deterioration of the solvency of the parent), but remain an issue overall given the lack of a lender of last resort.</p>
<p>2. Failure of one or more large exposures</p>	<p><i>Assessment: Low to Medium</i></p> <p>The failure of one or more counterparts that constitute a large exposure for the Guernsey banks (particularly exposures to other Guernsey banks, non-bank financial institutions and other counterparts) could be triggered by a macroeconomic or idiosyncratic shock and lead to contagion to the rest of the system. In either case, contagion effects could lead to a chain reaction.</p>	<p><i>Assessment: High</i></p> <p>The failure of one or more large exposures could trigger a threat to the solvency of single institutions and the system overall through contagion. The failure of large exposure has been identified as potentially being the second most devastating risk (after problems at parent banks) for Guernsey banks—even without considering potential second-round effects.</p> <p>Evolving risks in specific sectors and spillover risks should be assessed and mitigated through financial stability analysis. Given the importance of non-bank financial institutions in Guernsey, these analysis should focus (but not be limited) on insurers and mutual funds. For the insurers, an economic measure of capital adequacy and separate stress tests would allow monitoring risks faced by the sector.</p>

28. **Pressures on banks to cut costs may now create additional risks.** There may be limited room for banks to develop income, much of which derives from the upstreaming of customer deposits, at least in the near future. There will therefore be rising pressure for rationalization measures (for example cuts in staff numbers and outsourcing). Any cost-

cutting should not come at the cost of excessive risk or weakening of risk management. Diversification of income sources (for example into private banking) could helpfully complement cost-cutting efforts in ensuring a way forward for banks that does not put stability at risk.

29. **There are also residual liquidity risks for banks.** The banking sector as a whole appears to have access to sufficient liquidity (through short-term claims on parent banks). However, a crisis affecting a particular bank or a general shock to consumer confidence could result in a rapid withdrawal of deposits. This risk could, in principle, result in a potential shortage of liquidity for specific institutions, which has been confirmed by the outcome of the stress tests. Liquidity risk is likely to increase further once key central banks tighten policy rates and assets are held at longer maturities.

30. **Stability risks in the insurance and investment sectors are more limited, but crisis-related pressures require continued vigilance.** In terms of assets, Guernsey's investment sector is as important as the banking sector (with 50 percent share of the system's total assets), but the risk to the system's stability remains low given limited leverage. Because of the dynamic nature of this sector (assets under management increased by 300 percent during the last seven years), however, evolving risks should be monitored carefully, particularly if interest rates remain at current levels for a long period of time—as investors could again start searching for yield by means of more risky investments. Guernsey's insurance sector poses limited stability risk, but monitoring should move to a risk-based approach in order to identify potential risk. Most businesses are unit-linked life insurance and captive insurance and are therefore low risk in general, while capitalization levels of insurers are solid both in statutory solvency terms and in economic terms. Specific insurers have been hit by the crisis, however, and went out of business.

31. **While major crisis stability threats have come from outside Guernsey, there are also internal risks.** Any threats to Guernsey's reputation for probity and safety would be a potential vulnerability (see Table 4). A significant adverse event that was seen to originate on the island, such as an instance of major fraud or mismanagement leading to loss to depositors, investors, or trusts or companies serviced on the island, could be immediately destabilizing, for example by precipitating withdrawal of deposits from banks, as well as putting at risk long term prospects for the island. The authorities recognize these risks and respond to them through the intensity of their regulatory and supervisory strategies.

32. **There may also be risks from business conditions on the island.** There are some concerns in the financial sector, for example, that immigration restrictions may lead to control weaknesses as managers resort to inadequate hirings and excessive outsourcing to

compensate for shortages of required skills on the island.<sup>14</sup> Were any of these internal risks to materialize and result in major losses, there would be an adverse effect on the local economy (see Table 1).

**33. Guernsey is unlikely to be an originator of a major systemic shock with international effects.** Even severe losses at a financial institution would be unlikely to directly threaten the parent group or home market. Guernsey companies are not large in relation to the wider groups, although problems in Guernsey could still create adverse effects on confidence.

## **B. Performance and Stability Indicators**

**34. After the stresses in the financial system during 2008, Guernsey banks have been recovering during 2009.** Stress was in particular reflected in credit losses and a drop in capitalization by 4-5 percentage points compared with pre-crisis levels (to 14.9 percent by end 2008) (Table 5). By end-2009, banks' asset quality, profitability and capitalization were back at pre-crisis levels, supported by healthy retained profits. Nevertheless, Guernsey banks appear to have earned lower returns on capital than Jersey and IOM banks during recent years. During 2008, the system appears to have enjoyed positive flight-to-quality deposit flows, with deposits peaking at GBP 158 bn. However, deposits have since dropped back to the 2007 level at around GBP 120 bn.

**35. Insurance companies appear financially sound in overall terms.** On statutory rules, solvency remains comfortable: based on share capital, the coverage ratio<sup>15</sup> based on share capital is more than 1200 percent for the life companies and more than 800 percent for the non-life firms, but differences across firms are considerable.<sup>16</sup> Profits have remained stable during recent years in absolute terms for the system, and appear to be retained to self-finance growth and for tax management purposes. However, financial stress was visible in 2008, yielding a negative return on equity (ROE) for the life-insurers overall (mainly driven by one company) and a drop of profits by one third for the non-life companies due to losses on the asset side. In line with the development in the banking sector, the situation appears to have improved, though data for 2009 were not available for all companies at the time of the mission. As economic capital assessments undertaken by insurance companies highlight that statutory minimum solvency margins are relatively low (at least seen from a post-crisis perspective), the authorities should further develop the assessments of economic capital

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<sup>14</sup> This finding is based on feedback from the industry and was raised by various firms in all financial sectors.

<sup>15</sup> Capital divided by the minimum solvency margin.

<sup>16</sup> It is worth mentioning that the average is distorted by a limited number of insurers with very high levels of solvency according to statutory rules.

requirements (e.g., OSCA) and stress tests and develop databases and methods to run proprietary analysis in order to monitor the risk in the system on a timely basis.

**Table 5. Guernsey: Financial Soundness Indicators for the Banking Sector**  
(In percent)

	2003	2004	2005	2006	2007	2008	2009
<i>Capital adequacy</i>							
Regulatory capital to risk-weighted assets	19.8	20.4	18.8	19.0	17.6	14.9	19.3
Regulatory Tier I capital to risk-weighted assets	19.5	20.1	18.4	18.3	17.0	13.8	18.0
Capital to assets	2.0	1.9	1.5	1.4	1.2	1.2	1.7
<i>Asset composition</i>							
<i>Geographical distribution of loans to total loans</i>							
Domestic	7.5	8.0	5.6	5.3	5.0	4.8	9.7
Cross-border	92.5	92.0	94.4	94.7	95.0	95.2	90.3
<i>of which:</i> UK	48.5	47.2	50.8	43.8	40.8	43.0	46.4
Other EU	16.0	16.5	15.8	13.3	8.1	7.8	7.7
Other	28.0	28.3	27.8	37.6	46.2	44.4	36.2
<i>Asset quality</i>							
Nonperforming loans (NPLs) to total gross loans /1	0.02	0.02	0.02	0.04	0.01	0.03	0.09
Loan-loss provisions to nonperforming loans	21.7	21.2	55.4	19.3	20.0	16.5	7.5
Total foreign currency-denominated loans to total loans	49.4	47.5	59.2	63.1	68.0	75.0	73.4
Sum of ten largest exposures to capital	201.7	198.6	224.1	304.4	270.9	233.2	132.9
<i>Earnings and profitability</i>							
Return on assets	0.5	0.6	0.6	0.5	0.5	0.6	0.5
Return on equity	10.7	11.3	13.2	12.2	14.6	10.8	15.8
Net interest income to gross income	63.0	70.6	60.8	63.8	49.9	61.7	119.3
Noninterest expenses to gross income	33.6	30.1	29.8	33.0	27.6	22.7	41.1
Personnel expenses as a percentage of noninterest expenses	48.6	49.8	45.1	44.6	41.9	39.0	43.6
<i>Liquidity</i>							
Liquid assets to total assets	62.2	63.2	70.6	74.5	77.2	64.4	61.3
Liquid assets to short-term liabilities	70.5	71.3	79.7	82.7	86.7	85.5	85.2
Foreign currency-denominated liabilities to total liabilities	65.5	63.9	67.7	68.9	72.9	79.3	77.8
Deposits as a percentage of assets	94.2	92.5	90.7	90.9	88.7	87.7	86.5
Loans as a percentage of deposits	63.9	66.1	82.9	84.3	89.4	88.1	88.3
<i>Sensitivity to market risk</i>							
Off-balance sheet operations as a percentage of assets	44.6	48.6	52.5	42.2	41.5	28.3	29.5
<i>of which:</i> interest rate contracts	13.7	15.1	11.8	5.5	5.3	1.1	3.2
forex contracts	27.7	29.7	37.0	32.6	32.7	24.7	23.6
other derivatives	3.1	3.8	3.7	4.2	3.1	2.5	2.7
Duration of assets (in percent of total assets)							
Less than 3 months	62.2	63.2	70.6	74.5	77.2	64.4	60.3
Between 3 months and 1 year	7.5	8.9	8.0	10.1	9.3	11.2	10.9
Between 1 and 5 years	20.4	17.1	12.4	7.8	6.5	14.8	18.1
More than 5 years	9.9	10.8	9.0	7.6	6.6	9.6	10.7
Duration of liabilities (in percent of total liabilities)							
Less than 3 months	87.4	87.2	86.7	87.6	87.5	73.9	68.7
Between 3 months and 1 year	5.0	5.7	5.2	5.9	5.8	7.4	7.7
Between 1 and 5 years	3.5	3.4	4.7	3.0	3.1	10.2	12.1
More than 5 years	4.1	3.7	3.4	3.5	3.6	8.5	11.5
Net open position in foreign exchange to capital	1.4	1.5	1.9	2.0	0.6	1.1	1.5

Source: Guernsey Financial Services Commission

1/ Non-performing loans (NPLs) are defined as substandard loans and losses. The definition produces NPLs close a 90-days-past-due definition.

**36. The investment sector, which accounts for about 50 percent of the Guernsey financial sector, appears to be sound.** Due to a shortage of data the mission did not run quantitative analysis to come up with this conclusion but relied on various meetings with key firms on the island in addition to the available data on business risk. This analysis revealed that—in addition to the fact that the sector weathered the crisis without major problems—the sector’s leverage appears limited and liquidity has, so far, not turned out to be an issue for the sector. The authorities should aim at collecting additional data, which would allow improved monitoring of the sector.

37. **There is scope for the GFSC to further develop its work on financial stability analysis.** Improvements in data collection and the conceptual framework are required. Additional aggregate data for the system as a whole should be produced on a regular basis, including Financial Soundness Indicators (FSIs) (particularly for risky asset types), peer group statistics, and risk-based solvency figures. Data should be thoroughly cross-checked for robustness and quality. The authorities should consider publishing more statistics on banks and other financial institutions, such as aggregate balance sheets and the mean and distribution of FSIs. Publishing these indicators—once available—would contribute further to Guernsey’s reputation for stability and transparency, and facilitate peer group comparisons.

38. **The GFSC should also run top-down (TD) stress tests for the banking system, in order to challenge the banks’ stress tests and to ensure they are carried out in a consistent and reliable manner, as well as standardized bottom-up (BU) tests for the insurance sector.** They will need to add senior analyst level expertise to the staff and cover all parts of the financial sector comprehensively (banks, insurance, and investment). These innovations would complement and build upon the GFSC’s growing use of risk-based capital adequacy frameworks and use of internal economic capital assessments (ICAAP, OSCA) for regulatory purposes.

### C. Stress Test Results

39. **Stress tests were performed to assess the resilience of banks and insurance companies to a variety of shocks.** The methods and shocks were chosen after discussion between the GFSC and the FSAP team (detailed in a technical note on stress testing). The severity of the shocks was based on historical stress scenarios and expert assumptions, reflecting the global financial crisis and thus, while consistent with the tests run for Jersey and the IOM in 2008, more severe. Estimations were performed using both TD and BU approaches (the latter tests carried out by a large selection of individual firms) in order to arrive at a comprehensive view on the risks in the system. About two thirds of the sector assets were covered, including 19 out of 21 subsidiaries and 5 out of 21 branches.

#### *Banking*

40. **Overall, the outcome of the stress tests reflects a persistent high level of uncertainty in the global financial system, which is also evident in Guernsey.** The main risks identified by the tests are potential shocks resulting from credit risk (through parental claims, large exposures other than intra-group exposure and, to a lesser degree, a substantial increase in default rates for all counterparts) (Table 6). Otherwise, risks are minor (interest



rate) or relatively limited (FX rate risk, asset price risk,<sup>17</sup> and operational risk). It is also worth highlighting that high levels of retained profits (although lower than in Jersey and the IOM) and the 2009 re-established high level of bank capitalization serve as a solid risk buffer for losses.

**Table 6. Guernsey: Solvency Stress Test Results for the Banking Sector**

Shocks	Bottom-Up						Top-Down					
	CAR 1/	Mn.	Max.	No. banks breaching min. CAR	Recapitalization needs		CAR 1/	Mn.	Max.	No. banks breaching min. CAR	Recapitalization needs	
	In percent				In GBP m	In Percent	In percent				In GBP m	In Percent of GDP
<b>Pre-shock capital</b>	18.1	10.0	75.0	0	0.0	0.0	18.5	9.8	90.8	1	0.9	0.1
<b>Interest Rate Risk</b>												
I1: Parallel upward shift of the pound sterling yield curve by 200 basis points.	19.2	10.0	75.0	0	0.0	0.0	19.4	9.8	91.1	1	0.7	0.0
I2: Parallel downward shift of the pound sterling yield curve by 200 basis points.	19.3	10.0	75.0	0	0.0	0.0	19.0	9.7	90.5	1	1.1	0.1
I3: Parallel upward shift of the pound sterling yield curve by 300 basis points.	19.2	10.0	75.0	0	0.0	0.0	19.5	9.9	91.5	1	0.5	0.0
I4: Parallel downward shift of the pound sterling yield curve by 300 basis points.	19.3	10.0	75.0	0	0.0	0.0	18.8	9.7	90.1	1	1.3	0.1
I5: Parallel upward shift of the dollar yield curve by 200 basis points.	19.4	10.0	75.0	0	0.0	0.0	19.2	9.8	90.8	1	0.8	0.0
I6: Parallel downward shift of the dollar yield curve by 200 basis points.	19.4	10.0	75.0	0	0.0	0.0	19.2	9.8	90.8	1	0.9	0.1
I7: Parallel upward shift of the dollar yield curve by 300 basis points.	19.4	10.0	75.0	0	0.0	0.0	19.2	9.8	90.8	1	0.8	0.0
I8: Parallel downward shift of the dollar yield curve by 300 basis points.	19.4	10.0	75.0	0	0.0	0.0	19.2	9.8	90.8	1	1.0	0.1
I9: Parallel upward shift of the euro yield curve by 200 basis points.	19.3	10.0	75.0	0	0.0	0.0	19.2	9.8	90.8	1	0.8	0.0
I10: Parallel downward shift of the euro yield curve by 200 basis points.	19.3	10.0	75.0	0	0.0	0.0	19.2	9.8	90.8	1	1.0	0.1
I11: Parallel upward shift of the euro yield curve by 300 basis points.	19.3	10.0	75.0	0	0.0	0.0	19.2	9.8	90.9	1	0.7	0.0
I12: Parallel downward shift of the euro yield curve by 300 basis points.	19.3	10.0	75.0	0	0.0	0.0	19.1	9.7	90.7	1	1.1	0.1
<b>FX Risk</b>												
F1: The pound depreciates by 20 percent against all other currencies.	17.7	8.6	73.4	3	9.6	0.6	17.2	8.3	84.8	1	6.9	0.4
F2: The pound appreciates by 20 percent against all other currencies.	20.3	10.4	76.0	0	0.0	0.0	21.3	11.4	96.4	0	0.0	0.0
F3: The pound depreciates by 30 percent against all other currencies.	16.5	7.8	72.2	4	43.6	2.5	16.4	7.8	82.1	1	9.3	0.5
F4: The pound appreciates by 30 percent against all other currencies.	20.1	10.3	76.5	0	0.0	0.0	22.3	12.2	98.8	0	0.0	0.0
F5: The dollar depreciates by 20 percent against all other currencies.	20.8	10.2	75.5	0	0.0	0.0	20.2	10.8	91.7	0	0.0	0.0
F6: The dollar appreciates by 20 percent against all other currencies.	17.2	8.5	74.2	2	25.5	1.5	18.1	8.8	89.8	1	5.0	0.3
F7: The dollar depreciates by 30 percent against all other currencies.	21.2	9.9	75.6	1	0.3	0.0	20.6	11.2	92.0	0	0.0	0.0
F8: The dollar appreciates by 30 percent against all other currencies.	15.9	7.0	73.8	2	48.9	2.8	17.7	8.4	89.2	1	6.7	0.4
<b>Asset Price Risk</b>												
A1: Prices of all shares listed on foreign stock markets decline by 35 percent.	19.2	8.3	75.0	1	0.2	0.0	19.2	9.8	90.8	1	0.9	0.1
A2: Rated securities are downgraded by two notches.	19.0	8.3	74.0	2	4.2	0.2	16.5	8.4	73.8	1	6.6	0.4
A3: Rated securities are downgraded by four notches.	18.4	3.2	70.8	2	6.1	0.4	13.8	6.5	53.7	4	79.8	4.6
<b>Credit Risk</b>												
C1: Doubling of all probabilities of default (PDs) on loans.	19.3	10.0	75.0	0	0.0	0.0	20.2	10.6	93.2	0	0.0	0.0
C2: Increase of all probabilities of default (PDs) on loans by 300 Percent.	19.3	10.0	75.0	0	0.0	0.0	19.3	-0.5	93.2	1	38.2	2.2
C3: Default of the three largest exposures excluding the parent bank.	15.7	-106.3	75.0	3	244.3	14.2	12.0	-21.6	59.9	6	371.9	21.6
C4: 10 percent of banks' domestic non-interbank bank loan portfolio fails.	19.3	10.0	75.0	0	0.0	0.0	20.6	10.6	93.2	0	0.0	0.0
C5: 10 percent of banks' mortgage loan portfolio fails.	19.1	10.0	75.0	0	0.0	0.0	20.6	10.6	93.2	0	0.0	0.0
C6: 10 percent of UK non-interbank loan portfolio fails.	19.2	10.0	75.0	0	0.0	0.0	20.7	10.6	93.2	0	0.0	0.0
C7: 10 percent of banks' claims on their parent banks fail.	7.6	-109.1	69.6	9	749.8	43.6	0.3	-15.0	73.9	13	1,294.1	75.2
<b>Operational Risk</b>												
O1: Increase of RWAs for operational risk by 50%.	...	...	...	...	...	...	18.6	9.7	84.1	1	1.4	0.1
O2: Increase of RWAs for operational risk by 100%.	...	...	...	...	...	...	18.1	9.5	78.3	1	1.9	0.1
O3: Increase of RWAs for operational risk by 200%.	...	...	...	...	...	...	17.2	9.3	68.8	1	2.9	0.2
<b>Scenario Analysis (I4 &amp; F3 &amp; A2 &amp; C2 &amp; O2)</b>							15.4	-64.5	73.1	3	66.3	3.9

Sources: GFSC, and IMF staff estimates.

1/ The capital and RWA figures used for the top-down tests are the most recent ones and thus slightly different from the ones used for the bottom-up tests.

#### 41. Banks are also relatively resilient to adverse scenarios related to the stress tests.

If the single shocks are aggregated into a combined shock (so-called scenario analysis), simulating a severe macroeconomic shock to the system, three banks (of 19) have been found to be at risk. However, recapitalization needs would be limited, except for one of the banks. Additional sensitivity analysis for credit risk of banks did not reveal noteworthy additional risks not yet highlighted by the previous tests.

<sup>17</sup> Test A3 is probably the most conservative test among all of the tests, which has been taken into account when assessing the overall impact of the tests (and has led to classifying asset price risk among the 'relatively limited' risks).

42. **Liquidity risks could arise from a shock at a particular company or the island's reputation overall, and could materialize through a run on deposits.** In case of a highly severe run on deposits (with a daily withdrawal of 30 percent of deposits<sup>18</sup> for five consecutive days) and limited willingness or ability of parent banks to support their Guernsey subsidiary or branch, some Guernsey banks could run out of liquidity within a week (Table 7). The newly established DCS will help mitigating a name crisis, but a general run on deposits can only be precluded if parent banks are willing and capable to step in given the lack of a lender of last resort. The authorities will also have to assess whether their liquidity position is sufficient to meet the upcoming Basel III standards as well as potential changes with respect to intragroup funding practices.<sup>19</sup> In case of a deterioration of the solvency of a parent bank, Guernsey banks could increase their holding of marketable securities to mitigate a potential shock.

**Table 7. Guernsey: Liquidity Stress Test Results for the Banking Sector**

	(i) All Marketable Securities are Liquid (as is Cash)			(ii) Only Government Securities Remain Liquid (and Cash)		
	Number of illiquid banks			Number of illiquid banks		
	Sub-sidiaries	Branches	Total	Sub-sidiaries	Branches	Total
Test L1 (interbank funding remains available, no additional intragroup funding)						
Day 1	0	1	1	0	3	3
Day 2	0	1	1	2	3	5
Day 3	1	2	3	7	4	11
Day 4	3	2	5	10	4	14
Day 5	7	2	9	13	4	17
Test L2 (interbank funding essentially closed, no additional intragroup funding)						
Day 1	0	1	1	3	3	6
Day 2	1	2	3	6	4	10
Day 3	7	2	9	12	4	16
Day 4	11	2	13	15	4	19
Day 5	12	3	15	16	5	21
Sources: Staff estimates.						

### **Insurance**

43. **A stress test for 22 Guernsey insurers confirms that the Guernsey insurance sector exhibits resilience against shocks.** This reflects the sector's relatively low exposure to risk (being unit-linked business with a low element of pure life insurance risk) and sound levels of capitalization for the vast majority of the firms and the system on average.

<sup>18</sup> The exercise included deposits available within a month.

<sup>19</sup> This analysis was not done during the time of the mission as the final rules were not yet decided on. The FSIs (Table 5) suggest that Guernsey banks do not face major challenges with respect to the Basel III liquidity ratios.

44. **Under a scenario test, three firms would run short of capital.** Given the severity of this shock, however, this outcome confirms that the system overall appears to be well capitalized (see technical note on stress testing for details). However, it also shows that some institutions could face vulnerabilities in case of a highly adverse scenario, which could then yield second-round effects such as contagion. This observation is also confirmed by the fact that there were some losses in life insurance sector in 2008.

45. **Risk-based stress tests carried out as part of the OSCA exercise show that the same companies identified to be the most vulnerable according to the BU stress tests are also the ones with the lowest capitalization levels in economic OSCA terms (i.e., based on a non-standardized self-assessment).** The economic capital requirements (i.e., OSCA figures) by far exceed the statutory minimum capital requirement levels (for the 2009 stress test sample by 200 percent). Hence, the high level of capitalization under current (statutory) rules should not give a false sense of security. Yet, capitalization still remains good on an overall level.

46. **The authorities should further pursue efforts aimed at risk-based stress testing.** The objective should be to standardize the tests (common solvency measure(s), comparable methods used to run the tests, and the scenario definition) in order to monitor the system in economic terms in a TD manner. The process of moving toward risk-based tests should be accompanied by the collection of pertinent data including FSIs. Overall, these efforts would form a basis to move to a risk based solvency regime (Solvency II or an equivalent framework).

#### **D. Financial Stability Policy**

47. **In the absence of a central bank, financial stability issues fall to the GFSC, supported by the government.** At present, there is no established framework for macro-prudential analysis and decision-taking. In the wake of the crisis, authorities have cooperated on actions designed to safeguard stability and reduce the risk of future stress—including in the rapid establishment of the DCS. However, the importance of the banks, and their vulnerability to problems at their parents, places the GFSC itself at the center of any efforts to maintain stability.

48. **The GFSC has responded with a well thought-out strategy for addressing the risks at banks.** Key elements include a more cautious and restrictive approach to granting new banking licenses; Guernsey had not previously chosen, as had some other offshore jurisdictions, to restrict banking licenses to the strongest international groups. Subsidiaries have advantages over branches—because of the relative ease of supervisory monitoring and control compared to the former, especially in case of emerging stress. However, there will remain good reasons to give licenses to branches, where the parent is one of the strongest international groups and/or from a jurisdiction able to provide effective support to its

systemic institutions. The GFSC has introduced an upstreaming policy, which has resulted in limits on some banks' (subsidiaries') exposures to their parents, and also led to depositors now being potentially better informed, because of GFSC notification requirements that banks' ultimate exposure is to the parent company.

49. **Implementing this strategy will take time.** Much has already been achieved, through rigorous supervisory action and other crisis pressures, to reduce levels of risk in the Guernsey banking system – judged by their vulnerability to further problems originating from abroad. Over a longer period, the GFSC expects the combination of its new supervisory strategy and broader trends toward consolidation in the global banking sector to lead to the established business model of retail deposit-taking and upstreaming to parents giving way to banks orientated toward wealthy private customers and institutional business.

50. **Resolute policy measures in three areas seem essential to the success of this approach.**

- (i) First, the GFSC needs to continue to be ready to limit (additional) upstreaming by individual banks and, if necessary, to ring fence existing deposits thoroughly, as soon as serious concerns arise over the risks from the parental exposure or the possibility of stress. In the nature of supervisory relationships, this will not always be easily achieved and it is important that the GFSC thoroughly considers and fully satisfies itself that it has all the necessary powers, supervisory tools, and resources.
- (ii) Second, the GFSC needs to invest supervisory effort in improving corporate governance at banks (and financial institutions generally) on the island. Boards and managers of banks need to be held responsible for making their own contribution to financial stability on the island, including by monitoring and managing the concentration of risk represented by their parental exposures. Again, this will not come easily given the attractions of the prevailing business model, so additional measures (e.g., ring fencing) might be implemented (see i)).
- (iii) Third, as the GFSC well understands, it needs to engage even more extensively with the supervisors of the parent groups, while recognizing the limits on the practical cooperation, especially in time of stress, which it can expect to receive; the continuing risks that home jurisdictions will give priority in a crisis to local depositors. It needs to create expectations in home supervisors that they will explain their resolution frameworks (and their application to individual groups) and inform and consult with Guernsey ahead of problems arising. This too will be hard, and applying to become members of colleges for the most important banks could be a way forward.

51. **Dialogue with home supervisors and better monitoring of parent companies should be mutually reinforcing.** The GFSC should intensify its own analysis to understand

how changing legal frameworks and policy priorities will affect Guernsey banks; it also needs, as far as possible, to influence the development of policy on cross-border bank resolution so as to reduce the chances of a repeat of the events at Landsbanki's Guernsey subsidiary in 2008. It should also monitor the solvency position of the parent banks directly, including through the use of FSIs related to solvency (such as ratings, CDS spreads, KMV EDFs) and liquidity positions (which is more challenging). Analysis of this sort can inform a better dialogue with the home supervisor.

52. **Guernsey needs to keep a long run strategy under review.** Depending on the progress of the GFSC in developing cooperation from home country supervisors and of work on wider international frameworks for bank regulation and resolution, Guernsey needs to be alert to the possibility that a banking sector business model based on upstreaming may simply involve too much exposure to parent jurisdictions. It should be open to setting limits on all banks' exposures. Equally, the nature of offshore finance means that even without upstreaming, significant vulnerabilities to parents will remain, because of, for example, common management, shared infrastructure, and reputation.

53. **The establishment of the DCS represents a significant change in the relationship between banks, their depositors, and the authorities.** The scheme covers deposits of individual depositors, wherever located, up to a maximum of £50,000 per person. It is not funded, though, although it has government-guaranteed liquidity back-up, but aims to pay compensation within three months of a bank failure. The maximum total amount of compensation is capped at £100 million in any five-year period.<sup>20</sup> Payouts would be scaled back were a number of banks, or one of the largest banks (by covered deposits), to fail in this period. Some 180,000 depositors had deposits covered by the scheme as at September 2008. However, analysis of data on the distribution of deposits as at that time (i.e., before the scheme's establishment) suggest that actual coverage level, in case of a single bank failing, is high—nearly 100 percent in the case of subsidiaries, although lower, at 62 percent, for bank branches. It will be paid for by the banks through annual charges and special charges in the event of a bank failure.

54. **The limitations on the scheme need to be made clear to depositors and practical preparations to make actual payouts should be completed.** The board of the DCS, which is separate from the GFSC, has published details of the scheme, including the limitations. Efforts should continue to prevent misapprehension by depositors of the extent of coverage. While the scheme has a target payout period of three months, which is longer than in other jurisdictions, steps should be taken to ensure payouts as early as possible to help support confidence. A high priority should therefore be given to work on ensuring that banks have the necessary IT systems to facilitate the early and complete identification of covered deposits in case of a failure. Finally, the Board of the DCS has certain powers to take action

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<sup>20</sup> This compares with GBP 1.2 billion in deposits covered by the scheme—i.e., amounts under GBP 50,000.

to ensure the lowest cost resolution in case of an actual or threatened failure, including providing financial support to prevent it. Policies need to be developed on the use of these powers and coordination with the comprehensive powers available to the GFSC (CP 23).

55. **While the establishment of the DCS is, in general terms, a welcome development, a wider review of the DCS should be undertaken in the medium term.** Its creation was a necessary response to the crisis pressures in 2008 and should help to support confidence in the banking system in the future, and its design reflects certain limitations dictated by the nature of the Guernsey financial system. Nonetheless, in due course a wider review of the approach is needed, such as reducing the payout period, a review of the level of the cap on total payouts, the ex ante funding of the scheme, and a risk-based assessment of banks. The latter two points are already considered by the authorities, but will take time to be implemented, especially ex ante funding. This review could also take account of developing international standards on deposit insurance.

56. **Guernsey could review its institutional arrangements for addressing financial stability issues.** The GFSC takes the lead in monitoring financial stability issues—informed by supervisory information and other resources. The States of Guernsey Policy Council, through its Fiscal and Economic Policy Group, maintains a close interest, taking reports from the GFSC. Consideration could be given to establishing a forum devoted to monitoring financial stability and coordinating policy responses (the GFSC would of course remain responsible for regulatory policy and the handling of supervisory cases). Within the GFSC, financial stability issues could continue to be addressed through normal meetings of the Board and Executive but supported by dedicated resources covering the full scope of GFSC responsibilities.

### III. FINANCIAL SECTOR OVERSIGHT

57. **The GFSC is responsible for the supervision of financial services.** The GFSC's mandate is set out in the FSC Law,<sup>21</sup> which requires it to take such steps as it considers necessary or expedient for the effective supervision of financial services, for maintaining confidence in the financial services sector and for the safety, soundness, and integrity of the regulated sector. It is also required to combat financial crime and the financing of terrorism. Governance is entrusted to (currently) six commissioners, elected by the States of Deliberation on the nomination of the Policy Council (comprising the chief minister, a deputy chief minister, and 10 departmental ministers). It is funded by industry fees and currently has 96 staff.

58. **The 2003 OFC assessment identified a high quality regulatory system with some areas for development.** The work concentrated on the assessment of observance of financial

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<sup>21</sup> Separate laws govern the regulation of each sector—banking, insurance, investments, and fiduciary services.

sector standards and codes. It noted that the regulatory and supervisory system complied well with relevant standards, but highlighted the following as areas in need of strengthening:

- (i) The functions and independence of the GFSC—the authorities were encouraged to enhance the independence of the regulator and to amend the law governing the GFSC to establish safety, soundness, and integrity of the financial system as objectives and eliminate “development” as one of its functions.
- (ii) A resource deficit identified in the GFSC’s Banking Division.
- (iii) Certain supervisory and regulatory arrangements in banking and securities, where there was a need to enhance the GFSC’s powers and procedures.

59. **Since 2003, the authorities have enhanced the regulatory framework and are responding to initial lessons of the crisis.** There have been legislative changes to strengthen the GFSC’s independence and extensive development of regulatory policy, including, for banks, the implementation of Basel II in January 2008. In addition, the financial sector has been the subject of various official reports on lessons from the crisis including (a) on the supervision of Landsbanki commissioned by the GFSC, which found no evidence of regulatory failure; (b) a review of all the British OFCs, commissioned by the U.K. government, which was generally positive about arrangements in the Crown Dependencies; and (c) a strategic review of banking in Guernsey commissioned by the government. Recommendations are being addressed. A key strategic lesson is the need to re-orientate the banking sector away from retail deposit-taking and “upstreaming” of funds to parent banks and into private banking and wealth management. The government is considering what measures can be taken in practice to encourage such a development.

#### A. Banking Sector

60. **The BCP assessment confirms the high standard of prudential regulation and supervision described in the 2003 assessment, and found that the issues identified at that time have largely been addressed.** The GFSC enjoys considerable independence, and is subject to suitable accountability provisions. The GFSC is broadly adequately resourced. As the banking supervisor, the GFSC has an array of disciplinary powers to address safety and soundness issues; there is evidence that it uses them when needed.

61. **The GFSC cooperates with the home supervisors of institutions active on the island.** Numerous memorandums of understanding (MOU) with supervisors abroad have been signed to address both on-going supervision and information exchange. Information is in fact exchanged, and regular visits to and from the home supervisors are undertaken, including for the purpose of on-site supervision. However, as experience in the recent past has shown, the asymmetry in the relationship between the GFSC and certain “home” regulators severely limits the benefit that the GFSC can draw from cooperation with them.

62. **In the recent past the authorities have faced two major challenges as a result of problems elsewhere.** These issues were being quickly transmitted to entities operating in its jurisdiction, ultimately leading to their failure. Subsequent reviews of the GFSC's performance under stress have been favorable.

63. **Several broad areas for further action have been identified (Table 9).**

- (i) Primarily, these require primary or secondary legislative changes and the latter's consequent practical application. In these regards, CP 4 "Transfer of significant ownership" requires that the GFSC be given power to review and, if necessary, rescind, transfers of significant shareholdings in licensed banks.
- (ii) A similar power for the GFSC is required by CP 5 "Major acquisitions."
- (iii) For CP 9, the GFSC should have the explicit power to require that a bank increase its level of provisioning and, if necessary, its overall financial strength.
- (iv) Given the related party lending which characterizes the business model favored by several major participants in the Guernsey banking industry, large exposure limits (CP 10) should be applied on a consolidated basis and all transactions with banks' related parties should receive prior board approval and be on market terms (CP 11).
- (v) Supervisory reporting (CP 21) to the GFSC would benefit from imposition of a requirement for senior level certification and capacity for the GFSC to impose administrative penalties for tardy reporting.
- (vi) The GFSC should consider amending its governing statute to increase the term of office of its chairman from the current one year period to a term consistent with international practice (CP 1(2)).
- (vii) The Banking Supervision (Bailiwick of Guernsey) Regulations 2010, which came into operation on April 30, 2010 (i.e., following the conclusion of the mission's on-site work team discussions with members of the GFSC's senior management) together with contemplated amendments to the GFSC's Codes of Practice, have been designed to address the areas identified in (i) through (v) above.

## **B. Insurance Sector**

64. **Guernsey updates its regulatory regime continually and has implemented all the recommendations arising from the 2003 OFC assessment.** The GFSC adopts a risk-based and proportionate approach in supervising its large population of insurers, which promotes efficient allocation of regulatory resources. The GFSC gives licenses to captive insurers individually and adopts consistent prudential regulation for both captive and commercial insurers. Ongoing supervision of captives is exercised through insurance managers. The GFSC has adequate powers and well-documented policies, procedures, and customized



checklists to ensure consistency in supervisory decisions. The introduction of the OSCA by insurers has been well received by the industry. The regulatory frameworks for corporate governance, risk management, and AML/CFT are comprehensive and robust.

65. **The GFSC responded proactively to the global financial crisis.** The GFSC worked with the relevant insurance managers to resolve issues that arose from the crisis and assessed the financial condition of the parent companies of some captives. The relevant insurers affected by the crisis were closely monitored. The GFSC also required insurers who relied on loans to parent companies to meet solvency requirements to reapply for such loans to qualify as approved assets and GFSC imposed restrictions in some cases. As at March 3, 2010, insurers' loans to parents totaled £5.8 billion of which £5.2 billion was approved for solvency purposes, representing 33 percent of net assets.<sup>22</sup>

66. **The GFSC is mindful of the implications of global market and regulatory developments for Guernsey as an international financial centre.**<sup>23</sup> The GFSC is committed to following international standards in enhancing its risk-based solvency regime. The GFSC is currently assessing the impact on the Guernsey insurance sector in the event that Guernsey decides to implement a risk-based solvency regime. An independent review of the implications of Guernsey seeking recognition of Solvency II equivalence has been commissioned by the commerce and employment department (CED). The GFSC is fully involved in that review and is working with the CED on investigating the implications of Solvency II.

67. **While the updated regulatory framework has a high level of observance with the ICPs, there is scope for enhancements.** Given the dominance of the international sector, the GFSC has a keen interest in establishing effective cooperation arrangements with relevant home/host supervisors in respect of recognized insurers without a physical presence, and to protect foreign policyholders of international life insurers. The GFSC should also consider expanding its range of enforcement powers and how best to implement the public disclosure standards established by the IAIS. The mission advised the GFSC to continually assess the practical implementation of OSCA, including establishing criteria on the use of internal models.

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<sup>22</sup> These figures are skewed by two large captive insurers. If the loans by these two captives are excluded, loans to parents amounting to £1.1 billion of which £392 million (or 2.2 percent of net assets) was approved for solvency purpose.

<sup>23</sup> In particular, the EU Solvency II Directive may have an impact on some captive reinsurers, such as those who use EU fronting insurers. This is because reinsurance cessions to reinsurers subject to a solvency regime that is not Solvency II equivalent may not be fully admissible for the purpose of solvency requirements applied to the ceding insurers.

### C. Investment Business

68. **The GFSC has substantially implemented the recommendations of the 2003 OFC assessment of IOSCO Objectives and Principles of Securities Regulation.**<sup>24</sup> Key changes include legislative reform to reflect IOSCO objectives of securities regulation in those of the GFSC and to equip the GFSC with powers in respect of onsite work. New conduct of business rules has recently been introduced and a proposed GFSC code of corporate governance will apply to funds and fund services providers. Otherwise, the GFSC continues to carry out regulation and close supervision of licensees, taking a risk-based approach.

69. **The framework governing funds that may be established in Guernsey has been reformed.** Legislative changes have substantially aligned the requirements applying to closed-ended funds previously regulated under control of borrowing laws with the regime for open-ended funds. Funds aimed at broadly professional investors or offered only to investors outside Guernsey now qualify for fast track approval (within three days) by the GFSC. Funds may now be established in the full range of legal forms (companies, trusts, partnerships, and as PCCs or ICCs—as originally developed for insurance). The fast track procedures rely on warranties by the fund administrator that it has done due diligence to establish that regulatory requirements are met. The GFSC also looks closely at the quality of the fund sponsor.

70. **These changes have supported a reorientation of the funds sector away from retail to professional investors.** While there continues to be retail funds, including those eligible for marketing in the UK, the sector is increasingly focused on specialist funds and international investors. The GFSC is responding to the resulting change in risk profile in the sector, including assessing whether administrators have the expertise to manage more complex funds such as funds of hedge funds. Such funds may not be especially leveraged or high risk but may have relatively illiquid or otherwise hard to value investments.

71. **Guernsey has not gone as far as to introduce unregulated funds.** In some other jurisdictions, funds may be launched without formal approval. The GFSC's approach balances the need to accommodate innovation and new sources of demand for Guernsey funds with the importance of retaining some regulatory control over all funds. It also facilitates collection of data. Full quarterly statistics are published on Guernsey funds.

72. **Investor compensation arrangements may be extended from their currently limited scope.** Only in the case of retail funds eligible for marketing in the UK is compensation available to investors. It provides maximum compensation of GBP 60,000, where losses arise from defaults by a fund administrator or trustee/custodian. No payment has ever been made. A review is under way to consider a possible extension of cover to other

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<sup>24</sup> See Appendix I for a more detailed account of responses to the 2003 recommendations.

investors.<sup>25</sup> While careful analysis of costs and benefits is required, and compensation should clearly not be made available to professional investors, such an extension would seem to offer greater consistency in the protection afforded to investors across different types of funds.

**73. EU developments may pose the most significant challenges for investment regulation.** The EU is considering the future regulation of managers of hedge funds and other alternative investment firms (the draft directive on alternative investment fund managers (AIFM)). Only AIFMs based in the EU will be able to manage and distribute relevant funds to EU investors. Much of Guernsey business is directed to the EU, so Guernsey faces choices on whether and how to change its requirements, if it decides to meet conditions likely to be placed on third country AIFMs. The GFSC, industry, and government are cooperating to monitor developments and consider their approach.

#### **D. Trust and Company Service Providers**

**74. The GFSC licenses only the service providers and not trusts themselves or companies, on which statistical information is too limited.** Guernsey companies are registered by the Guernsey Companies Registry, which is not part of the GFSC (but after a 2008 reform, only a service provider licensed by the GFSC can form such a company at the registry). There are nearly 200 licensed trust and company service providers, including trust companies owned by banks and a number of independently owned private trust companies. Numbers of trusts and companies are large (1,500 new companies are registered on average each year) but no data are collected on the value of their assets, which have been estimated at hundreds of billions of pounds. Given the significance of trusts and companies to the wider Guernsey financial sector, the GFSC should consider reinstating the regular collection of data on asset values that was discontinued some years ago.

**75. Service providers have been subject to full regulation in Guernsey since 2001.** Anti-money laundering requirements have been applied since 2000 and remain a focus of the regulation of the business—although supervisors also address fitness and propriety of service providers and the adequacy of financial resources (capital equal to three months expenditure and professional indemnity insurance must be held). Regular reports to the GFSC are required and onsite supervision is undertaken on a risk-based cycle.

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<sup>25</sup> This discussion also addresses the question whether the system should be pre-funded. At present, the system is not funded, but has government guaranteed liquidity back-up.

## **E. AML/CFT Provisions and Implementation**

76. **Guernsey’s AML/CFT legal framework is comprehensive and provides a sound basis for an effective AML/CFT regime.**<sup>26</sup> It criminalizes money laundering (ML) and terrorism financing (TF) fully in line with the international standard. While no shortcomings have been identified in the legal framework, concerns remain with respect to the implementation of the ML provisions. The Financial Intelligence Service (FIS), the financial intelligence unit for Guernsey is adequately performing its role as a key player in the AML/CFT system. The preventive measures, applicable to financial institutions and the designated non financial businesses and professions (DNFBPs) are largely in line with the FATF Recommendations. Competent authorities have adequate supervisory powers, and financial institutions and DNFBPs receive adequate supervision of AML/CFT matters. However, the sanctioning regime for applying discretionary financial penalties for non compliance with the AML/CFT requirements is not considered dissuasive and proportionate.

77. **There are sound measures established to ensure that legal entities and legal arrangements are transparent and that accurate, adequate and current information concerning beneficial ownership and control of all legal persons is available to law enforcement and other competent authorities.** Guernsey also has effective mechanisms for coordination and cooperation among all domestic AML/CFT stakeholders including an active policy coordination committee. The legal framework for mutual legal assistance (MLA) and extradition is sound and the majority of requests seem to be processed in a timely and constructive manner.

## **F. Other Issues**

78. **Arrangements are being made to strengthen the oversight of audit work of listed companies on the island.** There is currently no official oversight of the quality of the audits by Guernsey companies, although auditors are subject to reviews by their relevant professional body such as the practice assurance review scheme operated by the Institute of Chartered Accountants in England and Wales (ICAEW). However, companies’ law amendments were due to take effect in April 2010 to provide that, in respect of companies whose shares are admitted to trading on an EU regulated market, Guernsey audit firms will have to register with the Guernsey Company Registry. There will be audit regulations based on those of the UK and regular inspection to look at the quality of the audit work carried out for listed entities. These inspections will be carried out by either the U.K.’s Audit Inspection Unit or the ICAEW on a similar basis as those currently carried out in the UK.

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<sup>26</sup> A separate Fund mission was conducted in May 2010 to assess Guernsey’s compliance with the FATF AML/CFT standard. A detailed assessment report is nearing completion, following which an AML/CFT ROSC will be circulated to the Executive Board for information.