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Financial System Stability Assessment Update
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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

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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.