States of Jersey
States Assembly

États de Jersey
Assemblée des États

Economic Affairs Scrutiny Panel

Depositor Compensation Scheme

Presented to the States on 19th October 2009

S.R.10/2009

1. PANEL MEMBERSHIP AND TERMS OF REFERENCE

1.1 The Economic Affairs Scrutiny Panel is comprised of the following members:

Deputy M.R. Higgins, Chairman

Deputy C.F. Labey, Vice-Chairman

Deputy S. Pitman

Deputy D.J.A. Wimberley

Deputy J.M. Maçon

The Panel agreed to co-opt Deputy G.P. Southern for the purpose of assisting this Review.

1.2 The following Terms of Reference were established for the Review:

1. To examine the reasons for the adoption of a Depositor Compensation Scheme.
2. To establish whether the proposed Depositor Compensation Scheme is appropriate for Jersey and constitutes the best method of achieving the objectives of the scheme. To include examination of the following:

    i. Principles;
    ii. Structure;
    iii. Development;
    iv. Coverage;
    v. Liability and risk;
    vi. Funding; and
    vii. How the proposals compare with similar measures in other jurisdictions.

3. To examine any further issues relating to the topic that may arise in the course of the Scrutiny Review and which the Panel considers relevant.

Glossary

BBA	**-**	British Bankers Association
CDIC	**-**	Canada Deposit Insurance Corporation
CDO	**-**	Centralised Debt Obligation
CIS	**-**	Collective Investment Schemes
DCS	**-**	Depositor Compensation Scheme
DGS	**-**	Deposit Guarantee Scheme
EC	**-**	European Commission
Ecofin	**-**	Ecofin is an investment firm which specialises in the global utility and infrastructure sectors
EDD	**-**	Economic Development Department
EU	**-**	European Union
FDIC	**-**	Federal Deposit Insurance Corporation
FSA	**-**	Financial Services Authority
FSSA	**-**	Financial System Stability Assessment
FOS	**-**	Financial Ombudsman Service
FRC	**-**	Financial Reporting Council
FSCS	**-**	Financial Services Compensation Scheme
FSI	**-**	Financial Soundness Indicators
GDP	**-**	Gross Domestic Product
HMT	**-**	Her Majesty's Treasury
IADI	**-**	International Association of Deposit Insurers
IMF	**-**	International Monetary Fund
IOM	**-**	Isle of Man
JBA	**-**	Jersey Bankers Association
JDCS	**-**	Jersey Depositor Compensation Scheme
JF	**-**	Jersey Finance
JFSC	**-**	Jersey Financial Services Commission
SME	**-**	Small and Medium Enterprises

2. EXECUTIVE SUMMARY

2.1 The Economic Affairs Panel recognises the importance to depositors in Jersey's banks, as in other jurisdictions, of the protection afforded by a credible depositor compensation scheme. We acknowledge that the proposed scheme in Jersey has been developed in some haste, with pressure from the States, depositors and banks. However, the Panel is concerned that because of the speed of its development, the consultation carried out has been too narrow, with too much focus on the industry and too little on taxpayers and depositors, particularly the general public and small business depositors.

2.2 With the Department's focus on the banking sector, and the pressure applied by it, the Panel has found that the drive to keep down costs for the commercial benefit of the banks has dominated the development of the scheme, to the detriment of the principle of protecting depositors. An example of this is the 5 year cap, which is unique to the Guernsey scheme and to that proposed in Jersey. It is designed in tandem with the capping of banks' liability to £65 million to minimise the costs to the banks, particularly in the case of multiple or large failures. This drive, along with the questionable continued belief by the majority of stakeholders that a Jersey bank failure is a virtually non-existent prospect, also accounts for the ex-post funding structure and lack of a permanent Board, the absence of which brings into serious question the credibility and effectiveness of Jersey's proposed scheme. The Panel considers that a real Board funded from the outset by ex-ante or hybrid funding is the minimum requirement for the scheme to be credible.

2.3 Discussion of how the elements of the proposed scheme came about revealed to the Panel that the main driver was competition; to ensure that in the eyes of a depositor the scheme matched or bettered that primarily in Guernsey and the Isle of Man. This concerns the Panel deeply because depositor compensation schemes should not be used as competitive tools. The Panel believes that Jersey should have consulted with the Isle of Man and Guernsey with a view to co-operation on developing standard approaches to the protection afforded to depositors, the core of any credible scheme.

2.4 Assessing the coverage afforded by the scheme, the Panel is in agreement with the £50,000 level of payout per eligible depositor per bank is comparable with European jurisdictions. Furthermore, the coverage of Jersey resident and international retail depositors is appropriate and consistent with international standards. Whilst it is appropriate that charities and children's trusts are covered by the scheme, the Panel can not concur with the decision to omit small businesses. It is not satisfactory that such a crucial sector of the Jersey economy was given such limited consideration, indeed to even undertake basic research to see if this would be achievable. Small businesses appear to have been simply disregarded in the initial stages simply on the grounds of minimising the cost of the scheme.

FINDINGS AND RECOMMENDATIONS

3.1 Findings

3.1.1 The Jersey authorities and other key stakeholders believe that a depositor compensation scheme is not necessary, in the sense that it will never need to be used, due to the rigour of the bank licensing policy in Jersey and the Jersey Bank Business Model. (5.2.28)

3.1.2 The world has changed since the onset of the world financial crisis and global recession. The political climate has changed markedly. Different approaches to bank failure are now under consideration, leading to an increased likelihood that a bank or banks could fail. (5.2.29)

3.1.3 The Jersey Banking Business Model is not without risk, as has been identified by the International Monetary Fund. A depositor compensation scheme is required to protect retail depositors. (5.2.30)

3.1.4 The final Oxera Report appears to have been tailored to bolster the preferred scheme of the Economic Development Department. (6.3.6)

3.1.5 The development of the scheme has been carried out in a less than transparent manner. (6.3.7)

3.1.6 There has been a lack of co-operation with the Panel during its evidence gathering from a number of key stakeholders. (6.6.3)

3.1.7 Although consultation took place with one of the main stakeholders, the Jersey Bankers Association, and with amongst others the Jersey Financial Service Commission, the Law Officers and Viscount's Department on technical issues, there was no consultation with the small business community, who were left out of the scheme, or with the General Public. (7.6.5)

3.1.8 The £50,000 payout per eligible depositor per bank is consistent with comparable jurisdictions and is a credible level of compensation. (8.2.5)

3.1.9 The coverage of Jersey resident and international retail depositors is appropriate and consistent with international standards. (8.3.12)

3.1.10 It is appropriate that charities and children's trusts are covered by the scheme. (8.3.16)

3.1.11 The scheme does not cover small businesses and insufficient consideration was given to establish if this would be achievable. (8.3.27)

3.1.12 The proposed scheme is not world class and does not comply with all of the IADI core principles. (9.2.22)

3.1.13 There is no evidence of a risk management strategy for the States' liability in the scheme. (9.3.13)

3.1.14 The drive to keep down the costs for the commercial benefit of the banks has dominated the development of the scheme to the detriment of the principles of protecting depositors and limiting the exposure of taxpayers . (9.3.25)

3.1.15 Depositor Compensation schemes should not be used as competitive tools. Jersey should have consulted with the Isle of Man and Guernsey with a view to co-operation on developing standard approaches to the protection afforded to depositors. (9.3.26)

3.1.16 The 5 year cap is unique to the Guernsey scheme and to that proposed in Jersey. It is designed to minimise the costs to the banks but this is to the potential detriment of depositor protection. (9.3.37)

3.1.17 An ex-post funded scheme lacks credibility. (9.3.44)

3.1.18 Hybrid funded schemes are becoming increasingly common. (9.3.45)

3.1.19 A permanent Board would be able to react more effectively to a bank failure than a Board established post failure. (10.3.9)

3.1.20 Public awareness of the scheme will be an important element of its credibility. It is not clear who will be responsible for promoting Public Awareness of the scheme. (10.3.10)

3.1.21 A permanent Board would be more credible to depositors and would be well placed to undertake roles including promoting Public Awareness of the scheme. (10.3.11)

3.1.22 The Board as proposed is not sufficiently independent. (10.3.21)

3.1.23 The proposed aim for a seven day payout is currently unrealistic and undermines the credibility of the scheme. (11.2.8)

3.1.24 There are significant cross border asset recovery concerns. (11.2.21)

3.1.25 There is no separate insolvency law for banks in Jersey despite the likely complexity of the liquidation of a failed bank. (11.2.22)

3.1.26 Claims of high recovery levels from of a failed Jersey bank's parent company are untested and not guaranteed. (11.2.23)

3.2 Recommendations

3.2.1 The Minister for Economic Development should make provision for coverage to be extended to small local businesses. (8.3.28)

3.2.2 A hybrid funding structure should be adopted. (9.3.46)

3.2.3 In order to raise the credibility of the scheme for depositors a real, permanent Board should be established. (10.3.12)

3.2.4 A permanent Board should be funded in advance outside of failure periods by an administration fund collected from bank levies. (10.3.13)

3.2.5 There should be a permanent Board funded by the banks and more demonstrably independent of the States and industry practitioners. Its remit should include public awareness, monitoring of international standards in depositor protection and the administration of the scheme. (10.3.22)

3.2.6 A separate insolvency law for banks should be established. (11.2.24)

4. INTRODUCTION

4.1 The Jersey Banking Sector and Business Model

4.1.1 Banking Sector

4.1.2 The finance sector dominates the Jersey economy. The main activities are banking, fund management and fiduciary services. In December 2008 the Jersey Banking Sector comprised 47 licensed institutions, with assets of £319,090 million. The Finance sector employed 13,400 people in December 2008, of which 6,040 were employed in banking.

4.1.3 The Jersey Financial Service Commission's (JFSC) licensing policy requires, inter alia, that:

- an applicant bank be a member of "a group of stature" (ie. one ranked in the top 500 by Tier 1 capital);
- systemically important in its "home" jurisdiction; and
- that the standard of consolidated supervision applied to the group by its primary regulator is judged to be of the international standard by the JFSC .

4.1.4 The 47 licensed institutions comprised 23 joint stock banks, 21 bank branches and 3 other types. Of the 23 joint stock banks, 7 were subsidiaries of UK banks and 10 were subsidiaries of other EU banks. Their combined assets amounted to £103,608 million. Of the 21 bank branches, 7 were branches of UK banks and 4 were branches of other EU banks. Their combined assets amounted to £215,481 million.

4.1.5 Among the total of 47 banks that have a licence to operate in Jersey, 31 hold deposits of natural persons. The other banks specialise in corporate deposits, serve wholesale clients only or concentrate on own-group requirements. Retail deposits represent around 18% of total banks' liabilities.

4.1.6 Number of accounts and balances of natural persons:

Accounts with less than £50,000:	
Number of accounts	516,543
Total Balance (£m)	3,676
Average Balance	7,117

4.1.7 The Island is among the larger Offshore Financial Centres in the banking sector.

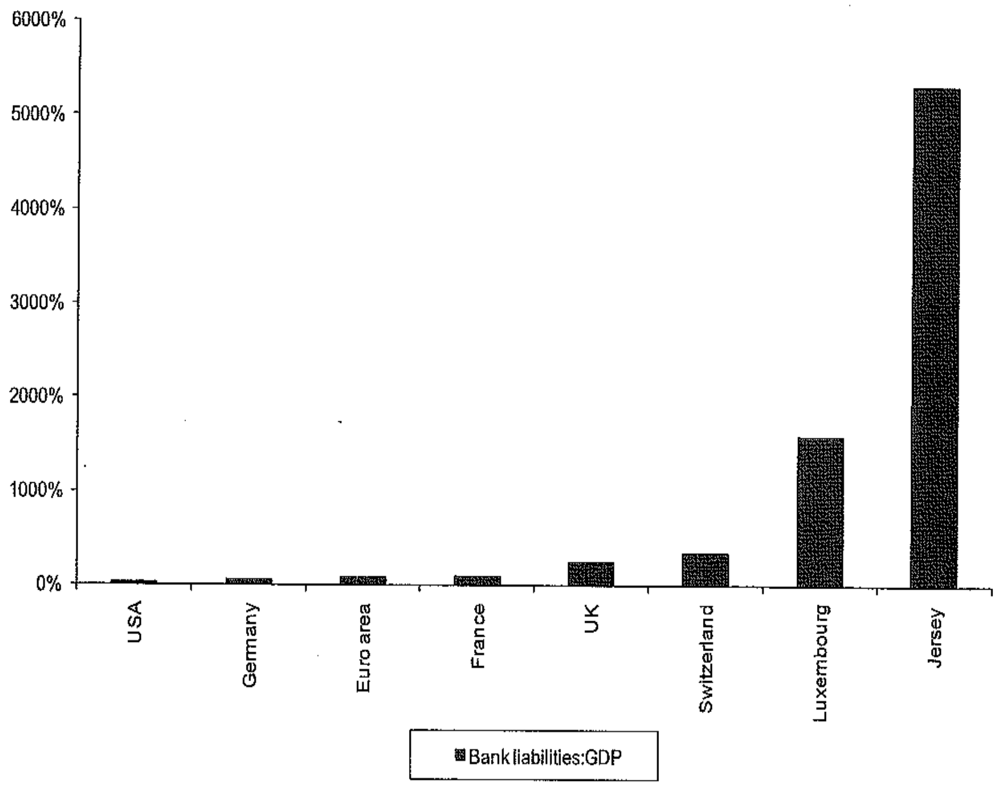
Jurisdiction	GDP	Financial Services GDP (% of total)	Financial Services Employment (% of total)
Anguila	£104m	£12m (12%)	250 (4%)
Bermuda	£2,925m	£1,207m (41%)	7,600 (19%)
British Virgin Islands	£571m	£206m (36%)	2,100 (13%)
Cayman Islands	£1,283m	£465m (36%)	7,500 (21%)
Gibraltar	£740m	£145m (20%)	2,400 (12%)
Guernsey	£1,666m	£528m (32%)	7,500 (32%)
Jersey	£4,089m	£2,117m (53%)	13,300 (23%)
Isle of Man	£1,817m	£721m (40%)	8,000 (14%)
Turks & Caicos Islands	£414m	£44m (11%)	500 (3%)

[1]

4.1.8 The ratio of bank deposits to GDP is significantly higher in Jersey than in other jurisdictions. In Jersey, bank liabilities are equal to 53 times GDP, which is significantly higher than in other jurisdictions listed, including countries that are known for hosting sizable financial centres, such as Luxembourg (where liabilities are less than 16 times GDP) and Switzerland (where liabilities are 3.4 times GDP).

[1] Michael Foot Interim Report April 2009

Figure 4.1 Bank liabilities:GDP—an international comparison



4.1.9 Banking Business Model

4.1.10 The banks' principal business is the collection of retail deposits from overseas (eg. from British expatriates or non-domiciled expatriates in the UK), and from corporate and the trusts that are managed in the Island. These funds are mainly placed with banks and in particular parent banks (ie. upstreamed).

4.1.11 Structure of total deposits by region (September 2008)

	Sterling	%	Other	%	Total	%
By residence	69,392	100	127,584		196,975	
annel Islands and UK	47,243	68.1	31,131	24.4	78,373	39.8
Jersey resident depositors	8,568	12.3	4,596	3.6	13,164	6.7
Jersey Financial Intermediaries etc	6,979	10.1	8,829	6.9	15,808	8.0
<, Guernsey and IOM	31,695	45.7	17,706	13.9	49,401	25.1
Other	22,149	31.9	96,453	75.6	118,602	60.2
Other EU members	3,749	5.4	13,754	10.8	17,503	8.9
European Non-EU	6,685	9.6	49,860	39.1	56,546	28.7
Middle East	1,551	2.2	15,573	12.2	17,125	8.7
Far East	2,732	3.9	5,006	3.9	7,738	3.9
North America	2,613	3.8	6,708	5.3	9,321	4.7
Others	4,818	6.9	5,552	4.4	10,370	5.3

[2]

4.1.12 Structure of deposits, by size and residence (end of October 2008)

	£ million	%	Number of deposits	% of total
Total Balances	33,934	100.0		
Balances <£50k	3,676	10.8	516,545	82.1
Resident	605	1.8	125,312	19.9
Non-resident	3,067	9.0	390,233	62.0
Balances > £50k	30,258	89.2	112,484	17.9
Resident	2,729	8.0	11,995	1.9
Non-resident	27,525	81.1	100,489	16.0

[3]

[2] JFSC, as contained in IMF Report on Jersey September 2009
[3] JFSC and IMF Staff Estimates, as contained in IMF Report on Jersey September 2009

4.1.13 Nature of Lending

4.1.14 Bank deposits are mainly placed with other banks and in particular with the banks' parent banks (ie. upstreamed to head office).

4.1.15 Loans to banks at the end of 2008:

	£ million	% of total bank assets
Loans to banks	266,363	83.5
Loans to parent banks	248,572	77.9
Loans to fellow banking subsidiaries	12,125	3.8
Loans to other banks	5,666	1.8

[4]

4.1.16 Non-interbank lending is mainly to individuals, property companies, and some non-bank financial institutions.

4.1.17 Loans and advances at the end of 2008:

	£m	% of total assets
Total loans and advances	34,650	10.9
Corporate lending	18,171	5.7
Retail lending	7,624	2.4
Residential mortgages	6,538	2.0
Sovereign loans	2,179	0.7
Public sector enterprises	69	0.0
Capital connected lending	48	0.0
Group non banking entities	22	0.0

[5]

[4] JFSC and IMF Staff Estimates, as contained in IMF Report on Jersey September 2009

[5] JFSC and IMF Staff Estimates, as contained in IMF Report on Jersey September 2009.

4.1.18 Structure of Non-Interbank Loans by type (end of June 2008):

	£m	% of total credit	% of total assets		£m	% of total credit	% of total assets
Total Credit	34,590	100.0	10.8	Jersey Credit	5,904	17.1	1.9
Agriculture	84	0.2	0.0	Agriculture	1	0.0	0.0
Energy	428	1.2	0.1	Energy	15	0.0	0.0
Manufacturing	4,986	14.4	1.6	Manufacturing	34	0.1	0.0
Construction	1,893	5.5	0.6	Construction	6	0.0	0.0
Garages and Tourism	194	0.6	0.1	Garages and Tourism	121	0.4	0.0
Financial	5,176	15.0	1.6	Financial	1,953	5.6	0.6
Business & other services	5,575	16.1	1.7	Business & other services	1,115	3.2	0.3
Of which Property Companies	2,868	8.3	0.9	*Of which* Property Companies	782	2.3	0.2
Persons	15,702	45.4	4.9	Persons	2,626	7.6	0.8
Of which House purchase	6,301	18.2	2.0	Of which House Purchase	2,193	6.3	0.7
Other	553	1.6	0.2	Other	33	0.1	0.0

[6]

4.1.19 Many banking groups have licences to perform other financial services, such as fiduciary services, that are ancillary to the wealth management services provided to their clients.

4.1.20 History and development of Depositor Compensation Schemes in Jersey

4.1.21 The 1998 *Edwards Review* of financial regulations in the Crown Dependencies recommended that there should be a depositor protection scheme in Jersey.

4.1.22 In 1999 the States formed an action group, undertaking in due course to ensure that depositor protection was in place. A draft scheme was prepared in 2002/3, but ultimately this scheme was never placed before the States for debate, the political and industry will for such a scheme being insufficient at the time.

[6] JFSC and IMF Staff Estimates, as contained in IMF Report on Jersey September 2009.

4.1.23 On 23rd September 2008 in a Statement to the States Assembly, the then Minister for Economic Development, Senator P.F.C. Ozouf, advised Members of a change of approach to the requirement for a Depositor Compensation Scheme in Jersey. It was outlined that, in light of the unfolding international financial market and banking crisis and to further strengthen public confidence in the Island's banking industry, a review of the arrangements for depositor protection in Jersey would be undertaken.[7]

4.1.24 In October 2008, OXERA Consulting Ltd was engaged to undertake the review entitled *'Deposit Guarantee Arrangements for the States of Jersey: A Review and Evaluation of Options'*. The subsequent report was released at the beginning of June 2009, in conjunction with the lodging of the Depositor Compensation Regulations on 2nd June 2009.

4.1.25 Following the banking crisis in October 2008, the then Chief Minister Senator Frank Walker, Treasury Minister Terry Le Sueur and Economic Development Minister Philip Ozouf gave a political guarantee to take a deposit compensation scheme to the States to give 100% compensation to all Jersey residents with retail deposits in Jersey banks in the extremely unlikely event that a bank licensed in Jersey should fail.

4.1.26 On 3rd December 2008 the States voted unanimously in support of a proposition (P150/2008) lodged by Deputy P.V.F. Le Claire:

> *'to request the Minister for Economic Development to present proposals prior to July 2009, for a Financial Compensation Scheme for Jersey, with aims and objectives along the lines of, or similar to, the U.K. Scheme known as, the Financial Services Compensation Scheme (FSCS).'*

4.1.27 On 15th July 2009 the States Assembly voted unanimously for the introduction of a depositor compensation scheme when it passed the principles of proposition P86/2009. Also on 15th July 2009 the Economic Affairs Scrutiny Panel used its powers under Standing Order 72 of the States of Jersey to call the proposition in for detailed scrutiny, giving an undertaking to the States that it would report back to members prior to the main debate on the proposition's articles on 20th October 2009.

[7] Official Record of the States, 23rd September 2008

4.1.28 Draft Depositor Compensation Scheme – P86/2009

4.1.29 In broad terms, the lodged Regulations propose a permanent, standalone depositor compensation scheme to be activated in the event that a Jersey bank failed i.e. ex post. The overall liability of the scheme including administration costs will be capped at £100 million over each 5 year period and levies on industry will also be capped with the States making up any shortfall. This shortfall funding may be repaid to the States depending on the rate of recovery in the bank liquidation. It is envisaged that short-term liquidity will be provided by the States through a loan to the scheme.

4.1.30 The scheme would provide full protection for private individuals up to a maximum of £50,000 per person, per Jersey banking group, whether or not the depositor is resident in Jersey. Up to the first £5,000 of a valid claim would be paid within 7 working days, with the balance being paid within 3 months.

4.1.31 These Regulations would establish a scheme that would ensure that most individuals and charities with money deposited with a bank in Jersey (an eligible deposit) would receive some compensation if the bank becomes bankrupt. The compensation would be the lesser of an amount equal to the eligible deposit or £50,000. Although in extreme cases the sum paid to each individual may have to be reduced to keep within the £100 million cap.

4.1.32 In response to a failure, a Board would be established to administer the compensation scheme and to pay the compensation. The scheme envisages that the Board would raise all the necessary funds to do so by imposing a levy on the banks in Jersey that held eligible deposits at the time the bank in default became bankrupt.

4.1.33 However, the amount each bank may be required to pay by way of levy in any period of 5 years is limited. So too is the amount of compensation that the Board may be required to pay by way of compensation during the same period. Where, in the case of the bankruptcy of certain banks, the amount of the levy the other banks would be required to pay would be insufficient to pay compensation, the States is required to pay the shortfall to the Board up to the overall £100 million cap.

4.1.34 Economic Affairs Scrutiny Panel

4.1.35 The Panel, including Deputy G.P. Southern who the Panel co-opted in order to draw upon his experience working in Scrutiny, has continued to work during the summer recess to carry out this review. The Panel has held a total of 7 public hearings with stakeholders, including with the Minister for Economic Development and his Officers, the Jersey Financial Services Commission and interested members of the public. The Chairman and Deputy Southern also travelled to the Isle of Man, the U.K. and Guernsey to speak to representatives of the schemes that are in place in those jurisdictions.

4.1.36 The Panel has been invaluably assisted by the advisory services of a leading international consultant on the development of depositor compensation schemes, Mr Ray Labrosse of Patterson and Labrosse Financial Consultants, Canada, a founding Member of the International Association of Deposit Insurers (IADI).

5. KEY ISSUES AND OBSERVATIONS EXPLORED

5.1 Safety of, and risk of, Jersey-based Banks

5.1.1 The proposed Depositor Compensation Scheme appears to the Panel to be built on one central premise, and that is that it is almost certain that no banks in Jersey will fail and that therefore it is highly unlikely that the scheme will ever be activated.

5.1.2 This was a recurring theme in presentations to the Panel by the Minister and his Officers and various stakeholders from within the Financial Services Industry:

> *'…. We still do not believe fundamentally that a depositor compensation scheme is needed'*[8]

5.1.3 In testimony that the proposed depositor compensation scheme was the least worst solution:

> *'Nobody wants a deposit scheme, it is something that happens in a bad set circumstances. The preference is that it does not happen and we, by means of history and regulation, have a better environment in banking terms than any jurisdiction in the world. There is no jurisdiction in the world that is in a better position in terms of the quality of the banks and the nature those risks that they undertake.'*[9]

5.1.4 The principal evidence offered by these witnesses in support of this assumption was the composition of Jersey's banking community, which had been shaped by the Island's long standing Top 500 policy and because of the Jersey banking business model, which is followed by the vast majority of banks in the Island.

5.1.5 The Top 500 licensing policy laid down by the Authorities and pursued by the Jersey Financial Services Commission requires that an applicant bank:

a. be a member of "a group of stature" (ie. One ranked in the top 500 by Tier 1 capital);

b. be systemically important in its home" jurisdiction; and

[8] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009
[9] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

c. that the standard of consolidated supervision applied to the group by its primary regulator is judged by the JFSC as meeting international standards.

5.1.6 The banking model operated by most banks in the Island is the collection of retail deposits from overseas (eg. from British expatriates or non-domiciled expatriates in the UK) and from corporate and the trusts that are managed in the Island and placing these funds with banks, particularly with their parent banks (ie. a process known as upstreaming).

5.1.7 The assumption thus appears to be based on the view that the banks in Jersey are too big, to complex, too interrelated and too systemically important to their home states and financial systems that they will never be allowed to fail.

5.1.8 'Evidence'

'. . . we, the government, the regulator in terms looking at our community of banks in Jersey, are confident that the likelihood of a bank failure is extremely remote indeed because of the portfolio of banks.'[10]

5.1.9 In an explanation of why other jurisdictions had had bank failures and why Jersey is different:

'The simple answer is that we are different and if you look at the portfolio of banks and the business model both locally and of their parents that they are different

Iceland had a series of banks that were (a) massively leveraged and (b) leveraged to the point that the jurisdiction was at risk of not being able to fund the problem. We do not have any such bank here in Jersey.'[11]

5.1.10 When discussing the political guarantee to Island residents made in October 2008 by the then Chief Minister, Treasury Minister and Economic Development Minister, which offered unlimited protection to all retail deposits:

'Our assessment is to the extent that we have even the remotest risk, it is outside the population of banks which are systemic in nature. So we have reviewed the banking population and the first twelve, thirteen banks are

[10] Public Hearing, Minister for Economic Development and Officers, 2nd July 2009
[11] Public Hearing, Minister for Economic Development and Officers, 2nd July 2009

manifestly systemic. They have all either had or their governments have already evidenced their support for their banking community to prevent them . . . [failing?].

The assessment of giving the political guarantee was to say, well, assuming that is the case, what is the slightly higher risk for a couple of reasons. One is that a couple of the banks in that population that have not had evidence that they are systemic in nature are actually financially much stronger, and others are not in the same sort of business. They have a slightly different business model where they are not basically retail deposit takers.'[12]

Mr Martin De Forest Brown, Director of International Finance

5.1.11 But are such assumptions – that Banks are too big to fail and the Jersey banking model has little of no risk - really credible in light of the recent and current global financial events?

5.1.12 In response to a statement that it is no longer valid to say that banks are too big to fail and that they may be broken up by the authorities, the following was said;

'*I struggle with that, to be honest, because I think banks are different. They are intrinsic to the economic system of any given country and, you know, it is not necessarily the case that you get better financial stability by parcelling up your banks into smaller and smaller entities.*

Maybe governments have been forced to recognise that the utility of having large banking groups with the wherewithal to do the things they do in order to oil the wheels of the economy comes with this implicit recognition, now explicit recognition, that governments are going to have to be prepared to step in.

I do not think that debate is finalised at all. Lord Turner has made it clear, for example, in his review that he does not buy the argument that banks need to split up. That is perfectly acceptable to have large banking groups which operate both the retail side of the business and also the wholesale side of the business.

[12] Public Hearing, Minister for Economic Development and Officers, 2nd July 2009

What he basically said is they just need to be better supervised and their business model needs to be tested more regularly.

So, for my money, looking at it from where I sit at the moment as a supervisor linked into the system, I think that that argument is by no means finalised and I would be surprised if we do indeed end up going down the road of a forced separation of investment and non investment banking arms.' [13]

5.1.13 The following response was given to a request to provide evidence to the claim that big banks cannot fail because there was clear evidence on the record of big banks have failed and been allowed to fail. The following was stated;

'We are making an assessment of the current position, which is the banks that we have here have either already been supported or are the nature of banks that will receive . . support as a systemic bank by their government.

So we are not saying that big banks cannot fail, but what we have been through is the worst . . . arguably one of the worst banking crises ever, and what has happened in that is the banks that did fail are not retail banks.

What has become clear is all governments have realised that politically they cannot allow retail banks to fail, They will step in, which is why suddenly in the UK you have half a trillion of government support for the banking system. So, you cannot say they will not.

All the evidence is that governments have learnt politically that you cannot have your . . . a significant proportion of your population suddenly being made bankrupt. So they have realised, and they have also learnt from experience that the cost of supporting a bank and maintaining it and keeping it going is going always turns out to be significantly less than allowing it to fail.

The hindsight now is very much that even the banks that they did let fail, the ones that were not retail, was that that was a mistake and it cost more ultimately to clear up the mess.'[14]

[13] Public Hearing, JFSC, 17th August 2009
[14] Public Hearing, Minister for Economic Development and Officers, 2nd July 2009

5.1.14 Counter view

5.1.15 Even if banks were considered to be too big to fail in the past the same is not true for the future. The global financial crisis that began in September 2007 has cost governments and taxpayers dearly. It has damaged world trade and the real economy in many nations putting millions of people out of work. The role of the banks in generating the financial crisis and global recession will not be forgotten or forgiven, especially by the taxpayers who for years to come will be paying the price of the bank bailouts as governments try to cut public debt which has ballooned and restore public finances by reducing services and raising taxes.[15]

5.1.16 According to the Panel's adviser, it is a risky assumption to make;

> *While implicitly, many of the European schemes may have been constructed with the idea that the authorities might never have to deal with a bank failure, the States of Jersey Scheme is quite explicit on that point as its aim is "to provide depositors with compensation quickly in the unlikely event of a bank failure".*
>
> *But, banks do fail and they fail in periods even when there is not a financial crisis. We have seen bank failures all around the world and even in those jurisdictions that have strict licensing regimes and structured early intervention frameworks. Some of the failures in the US recently can be attributed to the financial crisis (sub-prime loans), but others were attributed to bad management, poor risk management practices, etc.*
>
> *We know that the root of the problems surrounding Northern Rock plc was its dependence on wholesale markets for the large majority of its funding and that was what most distinguished Northern Rock from other UK banks (and a fortiori from all UK building societies). Retail deposits (and other classes of retail funds) did grow, but not nearly as rapidly as did wholesale funds. Retail funds fell as a proportion of the total liabilities and equity of Northern Rock from 62.7% at end 1997 to 22.4% at end 2006. It remained, however, a predominantly UK-based institution, with the great bulk of its business done in that country.*

[15] Patterson & Labrosse Financial Consultants, SoJ Submission 3, 9th September 2009

It is the case that Northern Rock's securitisation programme supported rapid balance sheet growth for several years. Much of that funding was short term. About half of their wholesale borrowing was at a maturity of less than one year. Even more important to their subsequent problems, the size of the Northern Rock securitisation programme meant that a large amount of mortgage-backed securities needed to be refinanced every year. It was this need to replace the funding obtained from short-term wholesale and securitisation markets, markets which were effectively closed from the summer of 2007 that forced Northern Rock to turn to the Bank of England for liquidity support.

The States of Jersey has historically only licensed banks that are in the Top 500. Thus, there is an assumption that all such banks are "too big to fail" in their home jurisdiction and therefore the operations in the States of Jersey will not fail. Globalisation of financial institutions and markets has had important spin-off benefits but it appears that that thrust has led to more financial institutions being "too big to fail", "too complicated to regulate", "too difficult to manage" and in some cases "too interconnected too fail" as a opposed to a more desirable outcome of having institutions being "too good to fail".

We also note that recent experience has shown that the capital levels that are generated to meet minimum regulatory standards are simply not enough. Indeed, Sheila Bair, the Chairman of the US Federal Deposit Insurance Corporation: "[a] strong case can be made for creating incentives that reduce the size and complexity of financial institutions as being bigger is not necessarily better. A financial system characterised by a handful of giant institutions with global reach and a single regulator is making a huge bet that those few banks and their regulator over a long period of time will always make the right decisions at the right time." She added that "unless there are clear benefits to the financial system that offset the risks created by systemically important institutions, taxpayers have a right to question how extensive their exposure should be to such entities."
Thus, it may no longer be the case that banks are "too big to fail" because governments are running out of financial capacity to allow big banks to continually expose their fiscal arrangements. The suggestion from Lord

Turner that even the largest banks should develop "living wills" is a very profound statement and may represent the new reality. [16]

5.1.17 International Monetary Fund

5.1.18 The International Monetary Fund's recent Financial System Stability Assessment Update on Jersey published on 1st September 2009 states in its main findings that:

1. The financial crisis has highlighted the vulnerability of Jersey's banks to events in major financial centres.

5.1.19 In the body of the report it states:

The current global financial crisis highlights the vulnerability of Jersey institutions to events in major financial centres.

Most banks in Jersey are branches or subsidiaries of large international groups, to which they provide financing. This close relationship reduces risk in normal times, given the group's ability to support their Jersey operations. However, it is also a powerful risk transmittal mechanism in case the health of the group deteriorates. In the event of extreme stress, a large share of Jersey's banks' balance sheets could be at risk, as well as their core business model.

Banks' intra-group claims on their parents represent the major risk to the system. However the JFSC exempts these claims from limits on exposures to related parties and large exposures. Specifically, inter-group exposures with a maturity of one year or less are exempted from risk concentration provisions.

Jersey banks are highly vulnerable to concentration risk with respect to their groups. Recent experience has demonstrated that even the largest banks can come under extreme stress, in which eventuality a Jersey affiliate could lose access to almost of its assets, at least temporarily.

If a parent is suspected to be in difficulties, the JFSC may attempt to require the Jersey subsidiary to move assets elsewhere, as would be consistent with

[16] Patterson & Labrosse Financial Consultants, SoJ Submission 3, 9th September 2009

the duties of the subsidiary's management, but such action may be damaging to the parent, to the home country's authorities, and ultimately to Jersey banks' business model.

While some flexibility is required for banks to fulfil their business model of "upstreaming" deposits a permanent and blanket exemption from single counterparty limits is inconsistent with the Basel Banking Core Principals, which requires setting a prudent limit.

The JFSC thus faces a conundrum. It cannot feasibly analyze in depth the soundness of major international banking groups, but it should be able to detect and react to intensified spill-over risks. The JFSC also needs to further develop its capacity to look at the strength of the banking system as a whole, for example, by performing stress tests.

While Jersey supervisors cannot feasibly analyze in depth the soundness of the financial groups to which their Jersey operations provide extensive funding, it should be able to detect and react to intensified risks stemming from parent institutions.

2. Jersey has experienced some effects from the global crisis, but financial soundness indicators (FSI's) for institutions licensed on the Island have been satisfactory, and stress tests confirm that the system is resilient to a range of shocks. However, there is high concentration risk and spill-over risk from parent banks.

5.1.20 In the body of the report it states:

Jersey has felt some effects from the turmoil in global financial markets, There have been some outflows from banks and CISs (Collective Investment Schemes), and profitability is expected to decline. No bank has failed, but the crisis should reinforce awareness that even the largest parent groups are not immune to major disruption. Available FSIs for institutions licensed on the island are satisfactory. Stress tests confirm that, while the system is resilient to a range of shocks, concentration risk and spillovers from parent banks are the main potential areas of concern, and that credit risk is of significance for the local economy.

> *2. The Authorities are making contingency plans, a key element of which will be cooperation with home supervisors.* ***Experience elsewhere suggests the usefulness of a dedicated bank insolvency regime*** *(Panel's emphasis).*

5.1.20 In the body of the report it states:

> *The authorities rightly recognize the need to plan for contingencies, and preparations have begun. An essential element will be cooperation for home supervisors – and with the domestic authorities. Experience elsewhere suggests that it is useful to have a dedicated bank insolvency regime.*
>
> *4. The IMF Assessment Team found Jersey only largely compliant with Principles 10 and 11 of the Basel Core Principles, which relate to Large Exposure Limits and Exposures to Related Parties and recommended amongst other things that the general exemption given by the JFSC to inter-bank loans or placements, certificates of deposit or similar instruments issued by banks with a maturity of one year or less from concentration risk regulations should be considered.*

5.1.21 They pointed out that even short term lending to banks could provide for considerable losses as experiences eg. from the failure of Bankhaus Herstatt in 1974 (ie. the so-called "Herstatt risk") or the recent market turmoil and losses connected therewith clearly show. They also pointed out that these exposures constitute the dominant vulnerability of Jersey as a Finance Centre.

5.1.22 The IMF Main Recommendations gave a high priority to the following:

- *Continuing to develop contingency plans, including through a clear allocation of roles between the JFSC, the Treasury, and other institutions.*
- *Seeking to develop mechanisms to receive early information on financial strains, including from home supervisors.*
- *Replace the general exemption for inter-bank exposures from risk concentration provisions by a defined and transparent procedure under*

which the JFSC renews such permissions on a regular basis following a review of risks and risk mitigants.

- *Develop the capacity to assess overall financial system soundness, including through stress testing.*

5.1.23 It also gave a medium priority to the study of a possible depositor compensation scheme based on explicit objectives and recognizing constraints.[17]

5.1.24 Bank of England

5.1.25 Recent speeches by the Governor and Deputy Governor of the Bank of England have addressed: the financial crisis; whether banks are too big or too systemically important to fail; whether the retail and investment activities of large banks should be segregated or broken up; the concept of the "living will": the 2009 Banking Act which grants the Bank wide ranging special resolution powers to deal with failing banks; and state aid for failing banks:

'As far as individual banks are concerned, we face some uncomfortable choices about the structure and regulation of our banking sector.

If some banks are thought to be too big to fail, then, in the words of a distinguished American economist, they are too big. It is not sensible to allow large banks to combine high street retail banking with risky investment banking or funding strategies, and then provide an explicit state guarantee against failure. Something must give. Either those guarantees to retail depositors should be limited to banks that make a narrower range of investments, or banks which pose greater risks to taxpayers and the economy in the event of failure should face higher capital requirements, or we must develop resolution powers such that large and complex financial institutions can be wound down in an orderly manner. Or perhaps an element of all three.

Privately-owned and managed institutions that are too big to fail sit oddly with a market economy. One important practical step would be to require any regulated bank itself to produce a plan for an orderly wind down of its activities. That would provide the information to the authorities the absence of

[17] IMF Financial System Stability Assessment Update on Jersey, 1st September 2009

which made past decisions about the future of institutions difficult. Making such a will should be as much a part of good housekeeping for banks as it is for the rest of us. And it would be sensible for the various authorities to work across national boundaries to identify detailed plans for how each large cross-border financial institution could be wound up.'[18]

5.1.25 The Governor of the Bank of England:

'Whatever the ultimate shape of the structure and regulation of the banking system . . . change will be necessary.

The cost of this crisis are not to be measured simply in terms of its impact on public finances, the destruction of wealth, and the number of jobs lost. They are also to be seen in the lost trust in the financial sector among other parts of our economy.

For a generation or more, businesses and families up and down the country were told, not least by the City, that disciplines of the market economy were essential, even if painful in the short run, for the greater prosperity in the longer term. That belief in the merits of a market economy was embraced and for many years was not misplaced. But out of the blue – in this case the financial sector – came a crisis that did not stem from weaknesses in the real economy. It has wreaked havoc on those same businesses and families. Unemployment, as we saw in today's figure, is rising sharply.

And yet it is the banking system that has received financial support on an almost unimaginable scale. We who work in the financial sector have much to do to regain the trust of those who work outside it. "My word is my bond" are old worlds, but they were important. "My world is my CDO-squared" will never catch on.

There is no support in this country, and no case, for excessively bureaucratic regulation. But change to the structure, regulation and indeed culture of our banking system is necessary. Blaming individuals is not substitute for

[18] Mervyn King, Governor of the Bank of England, Mansion House Speech 17th June 2009.

acknowledging the failure of a system, of a certain type of banking. We have a real opportunity now to put that right, and regain the trust that has been lost.'[19]

5.1.26 The Deputy Governor of the Bank of England:

'Some banks and building societies have not looked distress in the eye over the past year and in earlier years endeavored to run their business safely, foregoing some of the profits of the boom. But I would urge even them to recognise that their relatively calm passage through the crisis to date owes a lot to government standing behind their peers. That support cannot go on forever, which underlines why the Social Contract for banks must be redrawn.

It must be redrawn to reflect the lessons from the crisis. And also to mark a credible shift in regime so that, as an industry, you can re-establish trust and stand on your own feet.'[20]

5.1.27 In addition to the speeches made by the Governor and Deputy Governor of the Bank of England the UK Parliament has enacted the Banking Act 2009 which gives the Bank, working with the FSA and HMT, special resolution power, among many other things, to split up a bank or building society into a number of pieces: deposits going to one buyer; some assets possibly to another; parts going into administration.

5.1.28

Key Finding:
The Jersey authorities and other key stakeholders believe that a depositor compensation scheme is not necessary, in the sense that it will never need to be used, due to the rigour of the bank licensing policy in Jersey and the Jersey Bank Business Model.

[19] Mervyn King, Governor of the Bank of England, Mansion House Speech 17th June 2009.
[20] Paul Tucker, Deputy Governor of the Bank of England, British Bankers' Association Annual International Banking Conference: Restoring Confidence – Moving Forward London 30th June 2009

5.1.29

Key Finding:

The world has changed since the onset of the world financial crisis and global recession. The political climate has changed markedly. Different approaches to bank failure are now under consideration, leading to an increased likelihood that a bank or banks could fail.

5.1.30

Key Finding:

The Jersey Banking Business Model is not without risk, as has been identified by the International Monetary Fund. A depositor compensation scheme is required to protect retail depositors.

6. OPENNESS, HONESTY AND CO-OPERATION

6.1.1 The Panel has been concerned since February 2008 at the level of co-operation it has received from a number of parties, both from the public and private sectors, and the degree to which Scrutiny has been engaged in the process of bringing such a vital scheme into being.

6.1.2 The Panel has also been concerned as to whether the process itself has been carried out in an open, transparent and co-operative manner.

6.2 Economic Development Department and Chief Ministers Department

6.2.1 Whilst the Panel is clear that it would not be within its role to actively seek to develop the scheme and Regulations, it should have been entirely apparent to the Minister from correspondence and meetings with him and his officers that it was seeking background material from the Department in order to be able to review the scheme as expeditiously as possible once they had formulated and published the scheme details and draft regulations.

6.2.2 Oxera Report and background information

6.2.3 The Panel's requests for information began in February 2009 when it decided to undertake a review of the topic.

6.2.4 Key to the Panel's understanding of depositor compensation schemes and the issues and options that could be pursued was the Oxera Report, which had been commissioned by the then Economic Development Minister in October 2008. Although the current Minister received a draft Oxera report in February 2009, which was shared for comment with the Jersey Bankers Association, the Panel was not notified that the draft had been received even though it had specifically requested a copy at its quarterly meeting with the Department in February and was advised that it had not yet been received by the Department.

6.2.5 Despite repeated requests to obtain a copy of the report the Panel did not receive a draft until the 1st June 2009, when it was provided with the final version of the report, together with a copy of the final Regulations, which were being lodged the following day for debate on 14th July 2009.

6.2.6 The Panel did receive copies of two early drafts of the Regulations. One was received in March from a member of the Jersey Bankers Association who the Chairman met in the street and said that he would be commenting on the draft proposals. This was the first that the Chairman or any member of the Panel knew of the consultation process and the fact that draft Regulations were being circulated for comment. It was at this point that the Panel became aware that an Oxera Report was in existence which had not been supplied to the Panel despite numerous requests. Another draft of the Regulations was received from Mr. J. Mews, the Finance Industry Development Manager, Chief Minister's Department on 15 May 2009. Neither drafts were considered in detail by the Panel as they were considered work in progress by the Department and meaningless without sight of the underlying information contained in the Oxera Report and other supporting documents. The Panel was also heavily engaged in reviewing another topic at the time.

6.2.7 This left the Panel with just 6 weeks before the States debate to undertake a Review of such a significant topic and the draft Regulations which had been tabled, which was not reasonable or realistic.

6.2.8 Blanket Confidentiality

6.2.9 The Panel was not provided with the background papers it had also requested and needed to effectively scrutinize the draft Regulations until 30th June, when it received four large lever arch files containing law drafts, emails and three Oxera Reports dated February, March and May and assorted papers. These papers were released to the Panel on condition that the Panel signed a confidentiality agreement, which effectively would have hampered its ability to effectively scrutinize the proposals.

6.2.10 Although the Chairman signed the agreement, in a personal capacity, to evaluate whether the information contained in the files really warranted such a restriction the rest of the Panel refused to do so as it was felt by all members that it was designed to prevent the Panel from effectively carrying out its function. The Chairman determined that with the exception of some banking data that had been provided on a confidential basis by the banks to the JFSC, and anonymied and utilized by Oxera to scope the scheme, there was nothing else that should not be in the public domain.

6.2.11 A request was therefore made to the Department to review the files and classify only genuinely confidentially documents. This request was repeated to the Minister at the Panel's first hearing with the Minister and the officers from the Chief Minister's Department on 2nd July 2009:

'Deputy M.R Higgins

The second thing I would like to say is, blanket confidentiality. Now, what we have is a situation where the 4 volumes came the other day. I signed it for myself, not for the committee, and the committee have not had sight or copies of the volumes or anything else, and I do believe a lot of the material that is in those files should … be confidential and they should be allowed to have [them] anyway.

The only thing that I could see - and correct me if I am wrong - the only thing that I would consider confidential is the tables, the breakdowns, showing the individual groups. Although the banks are anonymised, and you have all got a number and they have got the various deposits against them and so on, but where you have a group you can pretty well guess which the group might …

… So, what I am going to ask you to do is review this thing about the confidentiality, about what people have to sign up to, I think…. So, I am going to ask you to consider that and liaise with Tim on that over the coming week, if you will.

Senator A.J.H. Maclean:

... I think it is fair to say that quite an amount of the information that you were sent probably is not confidential… However, to go through all of it individually and identify what is and what is not I think, in itself, would provide some difficulty.

Mr. M. De Forrest-Brown:

We would have to provide some generic words that agree, so if we could say something like any bank numbers, or something like that, but we can discuss that, explore that.

Deputy M.R. Higgins:

As I say, from what I read of what I saw, I think they were the only things that I would consider confidential and, as I say, there is no intention on the part of anybody here to impact on the banks or the Island in any way to jeopardise the position.

Senator A.J.H. Maclean:

No, that is fine and more than happy to look at that and see if we can work out, as Martin was saying, some wording that would hopefully cover that up.' [21]

6.2.12 The confidentiality matter was never resolved and in the end the remaining Panel members agreed to be bound by the confidentiality restrictions in order to proceed with the review.

6.2.13 The net result of this lack of openness and cooperation from the Economic Development and Chief Minister's Departments was that the Panel could not review the proposals and Regulations sufficiently in time before the matter was debated in the States Assembly on 15th July 2009. This resulted in the Panel calling in the Regulations for Review under the States of Jersey Standing Orders relating to scrutiny of proposed legislation after first voting for the adoption of the principle of adopting a depositor compensation scheme.

6.2.14 This in turn led to the incredible situation where the Panel was faced with a vote of no confidence simply undertaking standard scrutiny practice. The proposition was lodged by three Assistant Ministers: Deputies Jeune, Dupré and Noel and one other member, Deputy Fox, none of whom had any experience of being part of Scrutiny,

6.2.15 Lack of file notes, minutes and working papers

[21] Public Hearing, Minister for Economic Development and Officers, 2nd July 2009

6.2.16 Except for the verbal evidence and assurances given by officers during the hearings it conducted the Panel had no means of verifying much of what it was being told by the Economic Development Department of the consultation process with the Jersey Bankers Association and others and how important aspects of the scheme were designed or were arrived at. The Panel found this situation to be unacceptable and felt that it called into question the openness, transparency and co-operation of the whole process. Although the Panel did later obtain copies of minutes of some of the meetings and discussions that took place with the Jersey Bankers Association from the Jersey Bankers Association itself on 16th September 2009 it still felt that the situation was less than satisfactory.

6.2.17 Evidence

6.2.18 When asked to be provided with the minutes or notes taken from meetings held with the J.B.A., the Panel was informed by the Director, International Finance that that no further records existed:

> ***'Deputy M.R. Higgins:***
> *…We have obviously been told there have been many meetings of the banking industry, JBA and so on.*
>
> *We have not received any information about the level of consultation they did, any notes made on the meeting, whether they had any concerns with the consultation or any decisions made or any comments that have come back from banks with the exception of one or two emails. There must have been far more information than we have had.*
>
> ***Mr. M. De Forest-Brown:***
>
> *Actually, no, there was not. We just had these open meetings where we kicked around all the issues… and the usual debates and then we have had minutes at the JBA.*
>
> ***Deputy M.R. Higgins:***
> *Can we have copies of the JBA minutes then?*

Mr. M. De Forest-Brown:
I am not sure whether you can have copies of the JBA minutes. You might be able to have a copy of the relevant minutes and it will not tell you much.

Deputy M.R. Higgins:
I would not say all. I would like to see what you have actually discussed on the scheme.

The Deputy of St. Mary:
Would there not be notes of those discussions, formal notes, nothing written down?

Mr. M. De Forest-Brown:
No, not on a formal record. Individuals may have taken their own.

Deputy M.R. Higgins:
This sounds a strange consultation exercise, I must say.

Mr. M. De Forest-Brown:
Well, it is not a formal consultation exercise. I think that is clear. We have always said that. We have gone in to debate the issues with the bankers in open forum in the JBA. If they have wanted to make their comments they have generally made them orally at the meetings.

Deputy M.R. Higgins:
I must say actually I am surprised because, again, the normal consultation thing, you would have three months, you would have people giving back their responses --

Mr. M. De Forest-Brown:
Yes, I know, but these were different circumstances. We were under pressure to try to produce a scheme as quickly as possible.' [22]

6.2.19 Ms. A. McFadyen, Chief Executive of Standard Chartered Jersey and member of the J.B.A. elaborated on the J.B.A.'s role in the consultation process, explaining that

[22] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

it was an issue on which all of the J.B.A. members were interested and had taken part in. She informed us of the nature of the consultation that had taken place:

> *'….it was a sort of iterative process ... first of all it was we want a scheme and then Martin went away and James went away and they were working on what the possibles were. Then they had the benefit of the Oxera findings and they came back and presented what they felt would be the right scheme for comment to the banks. So how much it would cost the banks, what would be the coverage, who would be covered.*
>
> *But from memory originally they needed some more information so they presented that as sort of that is the scheme but then they needed some more information from the banks which we then provided up through the J.F.S.C. (Jersey Financial Services Commission) so that we could give them some data to work with.*
>
> *Then after that they came back with what they felt would be right and then we could all work on that: "How much would it cost if there was a big bank failure? How much would it cost the banks and what sort of coverage there would be.'*
>
> ***Deputy M.R. Higgins:***
> *So were there many papers going back and forth, working papers?*
>
> ***Ms. A. McFadyen:***
> *Working papers less. I think it was more of a dialogue and so they would present ... certainly the Oxera findings I think was in a presentation format but I think it was much more of the dialogue.'*[23]

6.2.20 It should be noted here that the Panel eventually received the minutes from the JBA, in confidence, on 16th September 2009.

6.2.21 The integrity of the process

6.2.22 As part of its review of the depositor compensation scheme the Panel sought all background information relating to the scheme including all correspondence between

[23] Public Hearing, JFL and Ms A McFadyen, 7th September 2009

the parties. During its review of this correspondence the Panel came across two emails written by Mr James Mews, the Finance Industry Development Manager, and one of the two authors of the scheme, which cast doubt on the integrity of the development process and the reliance that could be placed on the Oxera Report.

6.2.23 Caps by Stealth

'Deputy M.R.Higgins

In one email, I will not say who it was to or whatever, but it was from James:

"I am interested in asking my assistant … who is a maths genius and who has an Oxbridge Double First in something like mathematics or quantum physics, the opportunity to come up with a complex formula that would impose a cap by stealth."

Mr. J. Mews:
Yes, I can explain that is very much the case. One of the things which we wondered was because when you look at the data, it seems fairly credible, to be perfectly honest. You can have a £40 million scheme that curves up to the top 5 banks in Jersey even though you have ...

The Deputy of St. Mary:
For one failure.

Mr. J. Mews:
Sorry?

The Deputy of St. Mary:
For one failure.

Mr. J. Mews:
For one failure, yes.
The Deputy of St. Mary:
Banks never fail two at a time.

Mr. J. Mews:

Yes, exactly. You look at the data which says a £200 billion on deposit and £40 million would cover all of those. Once you have caps in place in the scheme, it is blatantly apparent what your scheme can fund but the public will just equate £200 billion potentially with £40 million; they can do the maths, and for their mind it does not add up.

We have done the detailed research and it does add up. So one of the things I spoke to … about, who is far brainier than most people I know - and certainly a lot brainier than myself - was to go away and look at this very issue and say: "Look, can we come up with something which does not (clarification; this should read 'does impose') impose a cap by stealth in order to make the scheme more palatable?"

Mr. M. De Forest-Brown:

I think the word "stealth" there is confusion in it. The idea was rather than say: "We do not care how things work, there is a flat cap of £100 million."

The question was: is there a formula that works to effectively achieve the same thing? We have fixed on the word "stealth" here as though there was some attempted trickery. The idea behind the request was just to come up with a formula, it might be a tapering formula, it might be a formula that works in a certain way that once it is applied this is the outcome, rather than having to say just flatly: "There is a cap."

I am not sure that generally in a whole range of examples or situations, caps or lines in the sand are ever a good idea. Cliff-edge events always seem to create some oddity.

I am sure Mr. LaBrosse would confirm that whenever you put lines in the sand in all sorts of circumstances, all you do is then have to spend hours and hours or time trying to define exactly which side of the line you are. It is much better if you have something that is graduated and therefore that was the nature of the request; it was to try and come up with some formulae with the means of achieving the same thing rather than just imposing the flat cap.

The Deputy of St. Mary:
But what happened was you ended up with a flat cap which is puzzling because you have this super-brain who has been asked to graduate ... your argument is very sound; cliff-edges are not nice.

Mr. J. Mews:
Notwithstanding the size of his brain;… he could not come up with anything so …' [24]

6.3 Oxera Report

6.3.1 Was Oxera's report written to order?

6.3.2 During a Panel hearing with the Minister and his Officers, the following was asked of the Department:

'Deputy M.R. Higgins:
The second one I mentioned was in terms of Oxera: "In essence, we would like the report to tie in with our scheme just more. This could be done by covering off the following areas in more depth.

Firstly, explicitly providing that despite the fact that many schemes do not have State funding, if Jersey is to have a scheme that is competitive with other jurisdictions as Guernsey, State funding may be necessary to ensure the scheme is credible."

Then it also goes on to: "Secondly, thank you for removing all data we asked(?). However, we need to have a document that we can point to in public to justify the amount of the States contribution.

We also say, thirdly, the section on S.M.E.s (Small and Medium Enterprises) could be slightly more focused towards the benefits of leaving them out, as in fact our scheme provides. Issues include the fact that no data was analysed

[24] Public Hearing, Minister for Economic Development and Officers, 28th September 2009

on the size of the community and the fact that we do not know whether it is affordable to include them plus the difficulties already highlighted."

In other words, Oxera were being asked to write the report to ...

The Deputy of St. Mary:
To order.

Deputy M.R. Higgins:
Yes, to order.

Mr. M. De Forest-Brown:
I disagree.

I think that all of those are comments on the report that they can take on board. I know that you have had an in-depth session with Oxera and they will give you their responses on that.

I think all of those I am perfectly comfortable with as suggestions in terms of making the report as broad as possible or to avoid confusion.

…I am happy to go back through each of those points and explain how we understood those comments and why we thought that they were appropriate.

The Deputy of St. Mary:
Fine, let us focus on the one I wrote down as it was the most startling for me: "Slightly more focused on the benefits of leaving them out." I mean that refers to small businesses in Jersey.

Mr. M. De Forest-Brown:
I totally agree that that sounds odd. I think a better wording would have been something like let us put the balance of arguments for having them in or out. There was no deliberate intent. I think it was just felt that the report did not include the benefits of having them out as well as having them in, simple as that.

Senator A.J.H. Maclean:

Shall we just also put into perspective that we are looking to introduce a scheme in a fair timeframe. I said earlier on in this hearing that we need more data with regard to small and medium size businesses. We are going to obtain that data and we will look at the issues in more depth.

Deputy S. Pitman:
Will that include consulting with the small businesses?

The Deputy of St. Mary:
They have already said yes.' [25]

6.3.3 The Panel also sought clarification from Oxera as to why they had agreed to make these changes with its Director, Mr. F. Barnes, who explained the role of Oxera;

'Oxera are economic advisers to the States. We are retained by the Government of Jersey on a permanent retainer basis, and have been for the last 10 years, and in that role we are asked to do lots of different things and in effect we were asked to look at the design of a world class deposit guarantee scheme..... We have essentially two tests for anything that Oxera does.

The first test is an independence test which we characterise internally as being something which says if you were under an obligation to the court would this piece of work, whatever the output is, satisfy the requirements of an expert witness going to a court. We apply that to everything we do.

We also have a quality test which again we internalise by saying essentially if this was going to the Competition Commission in the U.K. (United Kingdom) or a similar kind of body would you be prepared to send this as the author or the authors of this report. We apply that to everything we do, including everything we do for the States of Jersey.' [26]

6.3.4 He explained that any decisions taken on what would be included in the scheme were political decisions, and not at all the role of Oxera.

6.3.5 The Chairman sought to clarify the matter;

[25] Public Hearing, Minister for Economic Development and Officers, 28th September 2009
[26] Public Hearing, Mr F Barnes, 25th September 2009

Deputy M.R.Higgins

'Your first report, for example, was . . . setting out the options; that was very good. Later, obviously, decisions were made that the scheme is going to take this form and the last report reflected the fact this is it. But it was not necessarily your recommendation, was it? It was a decision that was made elsewhere; you just basically tailored the report to meet the reality of the scheme that was adopted.

Mr. F. Barnes:
We are tailoring it so that the information about how it is going to work is there.

Deputy M.R. Higgins:
Yes, but you did not make the decision. It was not your recommendation that it should be in the final form that is appears, is it?

Mr. F. Barnes:
No, and it would not be appropriate.' [27]

6.3.6

Key Finding:
The final Oxera Report appears to have been tailored to bolster the preferred scheme of the Economic Development Department.

6.3.7

Key Finding:

The development of the scheme has been carried out in a less than transparent manner.

6.4 Jersey Bankers Association

[27] Public Hearing, Mr F Barnes, 25th September 2009

6.4.1 Lack of Cooperation from Jersey Bankers Association Executive Officers

6.4.2 The Panel has been disappointed at the cooperation it has received from the President and Secretary of the Jersey Bankers Association with its review. Although they did supply the Panel with the minutes of their association's meetings when the depositor compensation scheme was discussed they declined to attend any hearings with the Panel.

6.4.3 Instead, the Panel received a response outlining the broad stance of the JBA but stated that the invited representatives [Mr Martin Fricker, President and Mr Martyn Scriven, Secretary] would not be able to appear due annual leave and work commitments, and explaining that '*August is a difficult month'.* Consequently, further attempts to meet with the JBA were unsuccessful, but the Panel were informed by the JBA's Secretary:

> *'I have spoken to the President who has made it clear to me that he really does not wish the JBA to take part in any Public Hearings. Recognising that no scheme is perfect he simply feels we now have something fit for purpose which should not be unduly delayed. Sorry we will therefore decline the invitation.'* [28]

6.4.4 It was to the Panel's surprise therefore that, at its hearing with Jersey Finance Chief Executive Geoff Cook and Alison McFadyen, Chief Executive of Standard Chartered Jersey on 7th September 2009, we were advised that Ms McFadyen was attending as a representative of the JBA. Although Ms McFadyen was very helpful in the evidence she gave, the Panel had not been notified of her attendance in this capacity and therefore was not prepared to cover relevant JBA issues.

6.5 The Wider Financial Industry

[28] Email correspondence, JBA

6.5.1 Examples

6.5.2 The Panel also made other unsuccessful attempts to gather evidence. These included: a request to meet representatives from a high profile bank that had taken part in the DCS consultation process and The Society of Trust and Estate Practitioners, Jersey Branch.

6.5.3 **Key Finding:** **There has been a lack of co-operation with the Panel during its evidence gathering from a number of key stakeholders.**

7. CONSULTATION

7.1.1 Underpinning the development of the draft Regulations was the information received in the report from the consultants Oxera, engaged to advise the Minister on the options that might be considered in deciding key elements of the scheme.

7.1.2 In addition to the Oxera report, the Panel received two files of email correspondence with stakeholders that had taken place during the development phase of the Regulations from the Department of Economic Development.

7.1.3 Additionally, the Panel was provided with an outline chronology of the consultation undertaken during the development of the draft Regulations:

DCS: Schedule of Consultation [29]

Consultee	*Email date*
Law Officers' Department	*25 March 2009*
3 April 2009	
21 May 2009	
	28 May 2009
Comptroller & Auditor General	*27 May 2009*
Viscount's Department	*21 May 2009*
Jersey Financial Services Commission	*26 May 2009*
	2 April 2009
	27 March 2009
	17 March 2009
Council of Ministers	*6 May 2009*
FSCS (UK)	*22 May 2009*
States insurers (Rossborough)	*21 May 2009*

[29] Finance Industry Development Executive, DCS Schedule of Consultation

Jersey Finance	*27 March 2009*
JBA	*25 March 2009*
19 May 2009	
- HSBC	*27 May 2009*
	26 May 2009
- Barclays Wealth	*1 April 2009*
- Anglo Irish Bank	*26 March 2009*
- ING Bank	*25 March 2009*
BBA (UK)	*24 March 2009*

Meetings:

JBA	*18 March 2009*
21 May 2009	
BBA	*23 March 2009*
FSCS	*30 April 2009*

7.1.4 As context for the approach adopted to the development of the Regulations, it was stressed to the Panel by the lead Officers on the project that time was a foremost consideration, with particular reference to the decision of the States on 3rd December 2008 to agree that a scheme should be brought to the States as soon as possible, and certainly by July 2009.

7.1.5 The Finance Industry Development Executive told the Panel that:

'…we need to bear that in mind that the message we had very clearly from the States Chamber was that a scheme needed to be brought in as quickly as possible.'[30]

[30] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

7.2 Finance Industry

7.2.1 It is apparent from the Panel's hearings with industry representatives and the Minister for Economic Development that particular attention was give to consultation with Finance Industry stakeholders in the drafting of the Regulations.

7.2.2 The summarised extent of this was outlined to us in the schedule of consultation provided to the Panel by the Finance Industry Development Executive and below we present in greater detail the information that was provided to the Panel in relation to Industry consultation.

7.2.3 Jersey Bankers Association

7.2.4 The Jersey Bankers Association, representing the banking industry, is a major stakeholder in the development of a depositor compensation scheme, and as such was approached for views by way of Officers' attendance at J.B.A. monthly meetings, two additional meetings, seven rounds of email correspondence and a large number of teleconferences.

7.2.5 The depth and content of that consultation was outlined to the Panel by the Finance Industry Development Executive;

> *'… well, the J.B.A. meets on a monthly basis, Martin and I or Martin or I have been to every single meeting since October so we have met with the J.B.A. on a monthly basis, we have either reported to them how the scheme is going or discuss certain particular issues which arise during that time, such as initially it was all to do with the getting the data which Oxera needed in order for the scheme to go ahead but then it moved on into other issues such as the fact that certain banks are here in Jersey for disaster recovery purposes, for example. So talking with them about how that works, finding out more about whether those should be included in the scheme. There were other questions put to the banks as well at various times through that process.'*[31]

7.2.6 Whilst the Panel had been presented with the email correspondence that had taken place, it further requested to be provided with the minutes or notes taken from those meetings held with the J.B.A., in anticipation that the content of such consultation meetings would have been recorded in some format in order for it to be fed transparently into the scheme's development.

[31] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

7.2.7 However, the Panel was informed by the Director, International Finance that that no further records existed, apart from the J.B.A.'s own minutes (which the Panel did not receive until 16th September 2009);

> ***'Deputy M.R. Higgins:***
> *Okay, there is one that I would like to see. We have obviously been told there have been many meetings of the banking industry, JBA and so on.*
>
> *We have not received any information about the level of consultation they did, any notes made on the meeting, whether they had any concerns with the consultation or any decisions made or any comments that have come back from banks with the exception of one or two emails. There must have been far more information than we have had.*
>
> ***Mr. M. De Forest-Brown:***
>
> *Actually, no, there was not. We just had these open meetings where we kicked around all the issues. We have had them yelling at us and the usual debates and then we have had minutes at the JBA.*
>
> ***Deputy M.R. Higgins:***
> *Can we have copies of the JBA minutes then?*
>
> ***Mr. M. De Forest-Brown:***
> *I am not sure whether you can have copies of the JBA minutes. You might be able to have a copy of the relevant minutes and it will not tell you much.*
>
> ***Deputy M.R. Higgins:***
> *I would not say all. I would like to see what you have actually discussed on the scheme.*
>
> ***The Deputy of St. Mary:***
> *Would there not be notes of those discussions, formal notes, nothing written down?*
>
> ***Mr. M. De Forest-Brown:***
> *No, not on a formal record. Individuals may have taken their own.*

Deputy M.R. Higgins:
This sounds a strange consultation exercise, I must say.

Mr. M. De Forest-Brown:
Well, it is not a formal consultation exercise. I think that is clear. We have always said that. We have gone in to debate the issues with the bankers in open forum in the JBA. If they have wanted to make their comments they have generally made them orally at the meetings.

Deputy M.R. Higgins:
I must say actually I am surprised because, again, the normal consultation thing, you would have three months, you would have people giving back their responses --

Mr. M. De Forest-Brown:
Yes, I know, but these were different circumstances. We were under pressure to try to produce a scheme as quickly as possible.'[32]

7.2.8 Ms. A. McFadyen, Chief Executive of Standard Chartered Jersey and member of the J.B.A. elaborated on the J.B.A.'s role in the consultation process, explaining that it was an issue on which all of the J.B.A. members were interested and had taken part in. She informed the Panel of the nature of the consultation that had taken place;

'….it was a sort of iterative process ... first of all it was we want a scheme and then Martin went away and James went away and they were working on what the possibles were.
Then they had the benefit of the Oxera findings and they came back and presented what they felt would be the right scheme for comment to the banks. So how much it would cost the banks, what would be the coverage, who would be covered.

But from memory originally they needed some more information so they presented that as sort of that is the scheme but then they needed some more information from the banks which we then provided up through the J.F.S.C.

[32] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

(Jersey Financial Services Commission) so that we could give them some data to work with.

Then after that they came back with what they felt would be right and then we could all work on that: "How much would it cost if there was a big bank failure? How much would it cost the banks and what sort of coverage there would be."

Deputy M.R. Higgins:
So were there many papers going back and forth, working papers?

Ms. A. McFadyen:
Working papers less. I think it was more of a dialogue and so they would present ... certainly the Oxera findings I think was in a presentation format but I think it was much more of the dialogue.'[33]

7.2.9 The Panel became concerned that the development of the scheme was somewhat rushed, and driven and shaped by pressure applied from the banking industry.

7.2.10 For instance, the Panel was made aware of the speed of change of the attitude of the banking industry regarding the need for a depositor compensation scheme and the reasoning behind that change.

7.2.11 Ms. A. McFadyen advised the Panel that originally the J.B.A. did not want a depositor protection scheme, but this had changed towards the back end of 2008 when suddenly banks began to fail around the world and suddenly customers were asking for it. She explained;

'The consultation process from memory started around November, but it could have been earlier. Certainly the J.B.A. meeting in November. At that stage I would say it was kind of seen as we do need to have a depositor protection scheme and at that stage people were starting to haemorrhage a bit of money, a lot of the small accounts were going and so the more clearing banks were starting to panic about that having a big impact.

[33] Public Hearing, JFL and Ms A McFadyen, 7th September 2009

The consultation, I think at that stage the J.B.A. said: "Yes, we think we should have one." That consultation followed through, I think there was a couple of special meetings, I certainly have got minutes from a J.B.A. in March but I think there were a couple of special meetings because the world was changing quite fast at that stage.

So I think first of all the J.B.A. said: "Get one in quickly" and then various members of the J.B.A. who were also involved in the Isle of Man and Guernsey were suddenly seeing massive bills coming in for Kaupthing and suddenly said: "Oh my God, do we really want a deposit protection scheme and if we get one in here we have got to be very careful about how it is written, how we account for it, because we need to be sure that any potential losses that come of it we understand and we can account for and understand on our balance sheet.''

I think certainly the March meeting concluded that things had died down, things were quieter, there was not the same haemorrhaging, it was more of a slow leakage now and certainly if there was another banking scare it would all escalate again.

So the message from J.B.A. was while not all banks think it is absolutely necessary it is seen as a hygiene factor now and without one we are just not playing on an even playing field. So it was I think we need one, and the message was if we are going to have one let us get one in quickly. But it was very balanced and we did change our views as time progressed.'[34]

7.2.12 The issue of bank deposits being lost, and possibly attributable to the lack of a Jersey depositor compensation scheme, was also covered in a question to Mr J. Cook, Chief Executive of Jersey Finance;

'Deputy M.R. Higgins:
...we have been told that there is anecdotal evidence that there was withdrawal of funds from the Island during this period of time. Is that correct?

[34] Public Hearing, JFL and Ms A McFadyen, 7th September 2009

Mr. J. Cook:

Yes. We cannot quantify it because the problem is that some clients will tell you that they are withdrawing their funds and they will tell you that they are withdrawing it: "Because you do not have a depositor compensation scheme." A lot more will simply withdraw the funds. Where clients have disclosed it is that banks made attempts to try and persuade them to transfer the funds to alternate booking centres within the same group. So typically what would have happened is that Jersey-based depositors would have been encouraged to place their deposits in the Isle of Man or in Guernsey ... well essentially the Isle of Man, because of the presence of a longstanding scheme. Obviously history has proven that has not been quite as straightforward as perhaps people thought it might be but it certainly influenced behaviour at the time. The net consequence of that is that the international groups, that are multi-jurisdictional, have posted on their websites quite clear statements that their Jersey booking option does not have the support of a depositor compensation scheme.'[35]

7.2.13 Indeed the Minister for Economic Development also advised the Panel that;

'...Banks are reacting on a commercial basis, they are realising that there is a very real probability that business can be lost and there are examples now from some banks that Jersey banks are losing deposits and indeed depositors are saying: "We are not going to place any larger sums locally because you do not have a depositor compensation scheme." So it is an insurance policy that is important. It is important for consumers, for their confidence, both local and international depositors that we have in the Island, but it is also important from the bank's point of view to protect their businesses.'[36]

7.2.14 However, the Oxera report, as late as May 2009, advises that there is no hard evidence that money is being lost to Jersey only anecdotal, if any. When challenged about this, the Minister responded;

[35] Public Hearing, JFL and Ms A McFadyen, 7th September 2009
[36] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

'Well, the information that we are getting from the banks themselves is suggesting that bank deposits are being lost and the increase ... not in any great sums but there is still a risk there. The banks themselves are now saying to us they are worried about their deposits and they think it is a concern. They were certainly very concerned when this particular scheme was not put in place.

Deputy M.R. Higgins:
Is it not also a fact too that Jersey is pretty well getting to the extent of being totally isolated in terms of having a depositor scheme because something like 90 countries have got depositor compensation schemes, another 20 are trying to get them in at the same time. We are so out of kilter now with the rest of the world…

Senator A.J.H. Maclean:
Absolutely, and the situation has got worse. You are right, from a competitive point of view we are about the only offshore jurisdiction or only jurisdiction that does not have a deposit compensation scheme. So, yes, we are at a competitive disadvantage. When individuals are weighing up where to deposit their money or where they put additional funding, that is an issue that counts against Jersey, which is not a position we want to be in.

Deputy G.P. Southern:
You say you have hard evidence that money had been lost to Jersey.

Senator A.J.H. Maclean:
We have empirical evidence having spoken to various banks, they have fed back ... I attended a meeting with a very senior banker after this particular scheme had been pulled and he pointed out his disappointed because of the risk they were seeing with loss of deposits.

Deputy J.M. Maçon:
On that point, Minister, what evidence is there to suggest that if the deposits are going it is singly down to the fact that we do not have a depositor compensation scheme not to other issues going on globally which has made people question deposits and where they put their money.

Senator A.J.H. Maclean:

Only the view of this particular individual, this particular banker, who was clear in his opinion that it was the fact that we had, as a government, given an undertaking back in December of last year that we would be introducing a depositor compensation scheme, that we would be doing so by July of this year, and his perception was the fact that we had not done so was affecting confidence and therefore the likelihood of an increased number of depositors being uncertain.'[37]

7.2.15 It appears that in conjunction with the political pressure of the States agreement that it wished to see a scheme in place by July 2009, there was therefore also pressure on the drafting team coming from 'get one in quick' and loss of funds messages from the Industry.

7.2.16 Indeed it became apparent to the Panel as it explored the matter of consultation with other witnesses and read evidence submitted, that concern was being expressed by a number of stakeholders about the short timeframe that was being worked to in developing the Regulations in time for presentation by the end of July 2009. This matter was put to the Minister for Economic Development and his Officers;

'Mr. J. Mews:

Well, of course it was hurried. We were on a ... we were told to bring the scheme as quickly as possible. There was no other way round it. We have been through I think roughly 20 drafts in about 2 months. We have been working flat out on this...

Mr. M. De Forest-Brown:

I think I can confirm without any shadow of a doubt that everybody who has had anything to do with this process from beginning to end wished they could have had more time to deal with it.'[38]

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[37] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009
[38] Public Hearing, Minister for Economic Development and Officers, 2nd July 2009

7.2.17 Jersey Financial Services Commission

7.2.18 The Panel was informed by the Officers that the Jersey Financial Services Commission (J.F.S.C.) was consulted throughout the development process on various issues to do with the scheme, and that they had commented either on specific issues, such as disaster recovery, at various times or also on the scheme as a whole.

7.2.19 The Finance Industry Development Executive explained further the role the J.F.S.C. had played in the consultation;

> *'...back in October last year when the banking crisis hit, there was regular meetings with government, the Commission, to discuss the situation and decide what should be happening, so from the word go the Commission were very much involved in this process and there has been regular discussions with Mark Sumner, head of the banking division at the Commission, all the way through. The Commission have had chances to feed into the process and one of the things we did was look at the draft scheme which was there previously, which had not been taken through to fruition. The Commission commented on I think it is 2 drafts, an earlier draft and they also fed in their comments on where they thought the previous scheme could be improved, and what we have is a process where the Commission were given the opportunity to comment on a regular basis. Mark Sumner suggested that actually he would prefer to comment at the end of it generally, so a lot of that process went on right at the end.'*[39]

7.2.20 When the Panel spoke to the J.F.S.C. at a public hearing, its Director General, Mr J. Harris, confirmed that the Commission had taken part in the consultation process, and clarified the basis on which it had undertaken that engagement;

> *'Our role is principally an advisory role ….. Government were keen to produce a deposit protection scheme for the imperatives that they saw and we had 2 functions in this advisory role.*
>
> *One was to sense check, I suppose, what they were doing. They could ask us at any given moment whether something was, in our opinion, appropriate.*

[39] Public Hearing, Minister for Economic Development and Officers, 2nd July 2009

In particular the regulations and our experience of law drafting and financial services legislation generally. That was one area.

The second area was probably best described as data modelling. We are the repository of most of the information that they needed to give to their consultants, Oxera, in the Commission. The banking deposit numbers and who has what and who has what in terms of eligible deposits are really only centralised in the Commission. So we took the role of putting that data together in a format that could be used by a third party…. I personally attended a couple of meetings of the Government and J.B.A. (Jersey Banking Association) consultation and we gave a lot of technical input - both Mark Sumner in the banking division and also Andrew and his people in our international and policy division - and in particular to the regulations.

So where we played a role it was very much the advisory role. In terms of where we stand…. I personally see it as a role for government….we certainly were not looking to take the lead but we were looking to be useful and helpful.'[40]

7.2.21 Jersey Finance Limited

7.2.22 Jersey Finance Limited's role in this consultation was somewhat observational and back seat, feeding information to the government and to the Jersey Bankers Association about the media coverage and the gatekeeper commentary, i.e. professionals and intermediaries who might be in a position to recommend business to come to Jersey, in other parts of the world who recommend their clients to place business here.

7.2.23 The more direct consultation between government and the Finance Industry occurred via the J.B.A.

7.2.24 However, within that role it had already engaged with the Department in September, October, November of 2008 feeding information to them to express concerns about the perception issue surrounding Jersey not having a depositor compensation scheme. The Panel heard that at this time there was a lot of press coverage of the

[40] Public Hearing, JFSC, 17th August 2009

issue around banking stability, largely driven by the financial crisis and the stability issues originally initiated in the U.S. (United States), the Lehman problem, Northern Rock and the Landsbanki and Kaupthing issues. The safety of customers' deposits came into very clear focus at that time and highlighted Jersey as not having a formal compensation scheme in place.[41]

7.3 Public

7.3.1 The Panel heard that no consultation had been carried out with the public.

7.3.2 The Panel was informed by the Minister for Economic Development that the reason there was no extensive consultation or a formal consultation process with the public was because he was already aware, from sources such as letters to the Jersey Evening Post and Ministers, of overwhelming calls coming from them about this particular issue; quite simply that they wanted a depositor compensation scheme with maximum coverage but at minimum cost.

7.3.4 Asked how that complied with the code on public consultation that Ministers are supposed to follow the Minister responded;

'I think it was simply a case of feeling the mood of the jurisdiction.'[42]

7.4 Small Businesses

7.4.1 According to *Jersey In Figures, 2008*, 77% of the Island's 5,730 businesses employed five or fewer people. With that number of small businesses in the Island and the exclusion of such account types from coverage within the proposed scheme it may have been expected that small business stakeholders would be given the opportunity to comment on the draft scheme during the consultation process.

7.4.2 As outlined previously however, the Panel was informed by the responsible Officers that there was no such formal consultation process and as such there was no engagement with small business stakeholders.

[41] Public Hearing, JFL and Ms A McFadyen, 7th September 2009
[42] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

7.4.3 This was confirmed by member of the Executive Council of Jersey Chamber of Commerce Chairman of the Small Business Group Mr D. Warr;

> *'…There was nothing. No attempt was made to contact us and I do not believe there has been any contact made with the Small Business Forum either, which is a combination of government body plus private individuals.*
>
> ***The Deputy of St. Mary:***
> *Do you know if Chamber of Commerce has been approached?*
>
> ***Mr. D. Warr:***
> *I have not heard of Chamber of Commerce being approached at all, no.*
> *….*
>
> ***The Deputy of St. Mary:***
> *If I were to ask you would you prefer to have been consulted I guess it is a fairly easy answer.*
>
> ***Mr. D. Warr:***
> *Absolutely.'*[43]

7.4.4 The Panel raised this matter with the Minister for Economic Development and his Officers, asking why it was decided not to consult with the likes of the Chamber of Commerce and Institute of Directors?

7.4.5 The Director, International Finance responded;

> *'Can I just ask, if we had consulted with small businesses and asked them whether their deposits should have been covered, what do you think their answer might have been?*
>
> ***Deputy M.R. Higgins:***
> *So in other words you did not ask them because you knew what their answer was, they would want to be covered.'*

[43] Public Hearing, Mr D Warr, 10th August 2009

Mr. M. De Forest-Brown:
The answer is that they would have wanted to be covered. Yes…'[44]

7.4.6 Modelling of potential small business inclusion in the scheme was also missing from the Oxera's consultation report. The Panel raised this omission with Mr F Barnes of Oxera;

'The natural person was clearly an absolutely necessary part of this operation. We did ask at some point about whether the banks could indeed split out S.M.E. (small and medium enterprises) types and in essence it is not easy to do so which is why I think somewhere in our report we say what we have modelled is the natural person and we did not have data on either charities or S.M.E.s ...

...Deputy G.P. Southern:
But are you saying then that the fact that S.M.E.s were not included, for example, was simply a question of data because you could not access it? Because that is a side of risk that is a bit more …

Mr. F. Barnes:
We could not model it.

Deputy G.P. Southern:
… convenient to put it aside and, right, we are not going there.

Deputy M.R. Higgins:
Was that because of purely data or were you asked not to look at it?

Mr. F. Barnes:
I think we were asked to look at the practicality of modelling it. I am not sure whether … I need to go and check exactly what we were specifically asked to do or not to do. But we certainly could not get any data. Whether we were asked whether it was a good idea or not, I am not sure. I mean, I can go back and … Can I just before I stop, in a sense, again, it is not our job.

Deputy M.R. Higgins:
We are not criticising; we are trying to understand the process.'[45]

[44] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

7.5 External

7.5.1 The Panel heard that schemes in other jurisdictions such as Guernsey, Isle of Man and the U.K. had been examined during the development of the proposed Jersey Regulations, and that direct consultation had been carried out with representatives of the Financial Services Compensation Scheme (F.S.C.S.) in the U.K.

7.5.2 The purpose of that consultation was to raise awareness of what developments may be taking place in the U.K. scheme in order to be able to incorporate any relevant changes into the Jersey scheme somewhat ahead of the game.

7.5.3 Other issues discussed with the F.S.C.S. were the matter of asset recovery, who might determine the failure of a bank and the definition of group banks, a result of which is the definition as presented in the draft Regulations.[46]

7.6 Other

7.6.1 Whilst the Ministers and his Officers have confirmed that there was no wholesale, formal consultation for reasons previously outlined, they did maintain that there was nevertheless considerable consultation undertaken throughout the process.

7.6.2 Indeed, in addition to key Finance Industry stakeholders the Panel was informed of the consultation that had taken place with a number of other stakeholders, including Public Sector stakeholders. The Comptroller and Auditor General and the Viscount's Department were consulted, and there was engagement with the Treasury regarding governance and other matters relating to the funding perspective.

7.6.3 The draft regulations were also referred to the Law Officers Department for further input on a legal basis and if there were any improvements for the process, and there was input from the Law Draftsmen from the point of view of their requirements and expertise.

7.6.4 In additional to those public sector stakeholders, the Association of Jersey Charities was also requested to feed into the development, specifically on the matter of the definition of a charity to ensure that it was acceptable to them as well. The Finance Industry Development Executive explained further;

[45] Public Hearing, Mr F Barnes, 25th September 2009
[46] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

'…they basically very much wanted to be in the scheme, which was not surprising, and we made sure that they were in the scheme. We changed the definition of charity to make sure that it did cover all charities because the definition we had first come up with apparently did miss out certain charities.

Deputy S. Pitman:
….You did not consult the charities on the limits of £50,000?

Mr. J. Mews:
No, we did not consult the charities on the limit of £50,000. Putting charities in was very much an exception to the general rule. It is something which most jurisdictions do not do, if a charity is covered under the rules of the scheme anyway then a charity is covered, but to make sure that all charities are covered by the scheme is something which is unique to Jersey, I believe.'[47]

7.6.5

Key Finding:
Although consultation took place with one of the main stakeholders, the Jersey Bankers Association, and with amongst others the Jersey Financial Service Commission, the Law Officers and Viscount's Department on technical issues, there was no consultation with the small business community, who were left out of the scheme, or with the general public.

[47] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

8. COVERAGE

8.1 What is proposed for Jersey?

8.1.1 The scheme would provide protection for retail deposits (i.e. private individuals), children's Trust accounts and charities, up to a maximum of £50,000 per person, per Jersey banking group, whether or not the depositor is resident in Jersey.

8.2 International Practice

8.2.1 The coverage proposals for the scheme in Jersey are comparable to those in Guernsey. The Guernsey scheme covers only individual retail depositors, but not corporate depositors or deposits by trusts, except in certain defined circumstances (e.g. executorships or bank accounts held by parents on trust for their children). Coverage, as in Jersey, is limited to £50,000 per depositor, per licensed bank.

8.2.2 The Isle of Man scheme does offer rather more generous breadth of coverage. In addition to the coverage it matches in Jersey of up to £50,000 for retail deposits and international savers, the scheme also extends to companies and trusts, up to a maximum of £20,000 per depositor, per licensed bank.

8.2.3 In the UK, the Financial Services Compensation Scheme is perhaps more comparable in its coverage to the Isle of Man than Jersey. It too matches Jersey with up to £50,000 for retail deposits and international savers, but the scheme also extends to small companies, as defined in the Companies Act 2006, up to a maximum of £20,000 per depositor, per licensed bank.

8.2.4 The Panel's adviser evaluated the Jersey Depositor Compensation Scheme against all of the Core Principles for Effective Deposit Insurance Systems (see Annex 3 for full evaluation), the Panel having been informed on a number of occasions by the Minister and scheme's Officers that it was consistent with international standards. His assessment regarding Coverage is presented below;

Principle 9, Coverage:

Policymakers should define clearly in law or by private contract what is an insurable deposit. The level of coverage can be set through an examination of relevant data. Whatever coverage level is selected, it must be credible and internally consistent with other deposit insurance system design features, and cover adequately the large majority of depositors in order to meet the public policy objectives of the system. Coverage limits may need to be adjusted periodically because of inflation and other factors.

Is a covered deposit clearly defined in law or by private contracts? ***Unclear***

Was the level of coverage set through an examination of relevant data? ***Yes***

Is the coverage limit adjusted periodically because of inflation or other factors? ***Will depend on changes in EU***

Does JDCS comply with Principle 9? ***Yes***

The coverage level of £50,000 appears credible and is consistent with the other deposit compensation schemes in the region. It also appears that coverage level cover 'adequately' the large majority of depositors in order to meet the public policy objectives as determinable by the scheme of looking after the 'ordinary' retail depositor.[48]

8.2.5

Key Finding:
The £50,000 payout per eligible depositor per bank is consistent with comparable jurisdictions and is a credible level of compensation.

8.3 Coverage: Key Issues Explored

8.3.1 Included: Retail (Jersey and International):

[48] Patterson & Labrosse Financial Consultants, SoJ Submission 3, 9th September 2009

8.3.2 The extent of coverage provided by a scheme is very much a political decision, influenced by a range of factors, from local to international, commercial to social. It was outlined to the Panel that the essence of the proposed Jersey scheme, as indeed with most others, is compensating the man in the street; those people who have most to lose as a result of placing deposits in banks, every day, normal retail depositors. It does not cover a variety of other depositors for that very reason.

8.3.4 It does not cover investments or pensions, trusts (other than those eligible as children's trusts or commercial accounts. This approach was summarised by the Minister for Economic Development;

> *'The basis of depositor compensation schemes are quite simply to protect the vulnerable; they are to protect those much smaller deposits and you can get small deposits from international depositors who deposit from elsewhere; small amounts, life savings, and that is the key and basis from the scheme itself.'*[49]

8.3.5 In addition, the scheme is also designed to strike the best possible balance behind the principle of achieving maximum coverage for minimum cost.

8.3.6 With regard to international depositors being covered in exactly the same manner as local savers, the Panel heard from the Minister that not protecting international investors in Jersey would not be sensible from a business and reputational perspective. We need to be protecting all retail depositors, local as well as international, in order to help maintain depositor confidence in Jersey.[50]

8.3.7 In context, the total retail deposits, domestic and international, is £33 billion, with £3.3 billion of the total being domestic. The following table demonstrates how those deposits can be broken down against the full £50,000 coverage:

[49] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009
[50] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

	£ million	%	Number of deposits	% of total
Total Balances	33,934	100.0		
Balances <£50k	3,676	10.8	516,545	82.1
Resident	605	1.8	125,312	19.9
Non-resident	3,067	9.0	390,233	62.0
Balances > £50k	30,258	89.2	112,484	17.9
Resident	2,729	8.0	11,995	1.9
Non-resident	27,525	81.1	100,489	16.0

[51]

8.3.8 It is also the case that coverage of international and local savers is standard international practice. The case for following international practice and including both local and international depositors in Jersey was further clarified by the Director, International Finance;

> *'We looked at that very closely in terms of whether we should simply limit the scheme to residents. The case for that would have been that those who are choosing to deposit their money in Jersey from outside will be doing it knowingly with their eyes open and so on. But all of the advice we had, both from Oxera and elsewhere, was that it is part of the impression you are creating as a jurisdiction. Here you are trying to be an international financial jurisdiction and you are saying you cannot give any support to external depositors, and I think in terms of our proposition and in terms of the experience of foreign depositors or, sorry, depositors from outside of Jersey, their activity with the banks, all the evidence was that we did need to extend the scheme to international depositors.'*[52]

8.3.9 The reputational risk in differentiating between local and non-local savers was highlighted to the Panel by the Chief Executive of Jersey Finance. He informed the Panel that it would be difficult to implement a scheme that differentiates between a resident and a non-resident.

[51] JFSC and IMF Staff Estimates, as contained in IMF Report on Jersey September 2009
[52] Public Hearing, Minister for Economic Development and Officers, 2nd July 2009

'I think you start inviting all sorts of trouble in terms of the types of issues we have had with people like Ecofin about having preferential treatment for your resident customer base as opposed to your international customer base. So I do not think it is feasible to have a differentiated scheme or you have special treatment for your local population.'[53]

8.3.10 The case for not differentiating between local and international depositors is not however, accepted by all parties. Speaking to Mr D. Warr of the Jersey Chamber of Commerce, the Panel asked his opinion about non-local investors, individuals, being protected by the scheme and not local businesses. He replied;

'Obviously that is pretty appalling, simple as that. The first people you want to protect are your own kind, are they not? I think that is quite simple.'[54]

8.3.11 This sentiment was echoed in a submission received from Mrs A Richardson, who argued that non-residents should not be covered by the scheme. Instead;

'any funds should be reserved to support our local businesses, who are of a greater value to our Island than 'off Island savers'[55]

8.3.12

Key Finding:
The coverage of Jersey resident and international retail depositors is appropriate and consistent with international standards.

8.3.13 Included: Charities

8.3.14 The coverage of the proposed Jersey scheme is extended to the charities and Children's trusts. The inclusion of charities is one way in which the Jersey scheme differentiates from the Guernsey scheme, and the Finance Industry Development Executive explained to the Panel that putting charities in to the scheme was very

[53] Public Hearing, JFL and Ms A McFadyen, 7th September 2009
[54] Public Hearing, Mr D Warr, 10th August 2009
[55] Written submission, Mrs A Richardson

much an exception to the general practice of most jurisdictions. Indeed making sure that all charities are covered by the scheme is something which is unique to Jersey.

8.3.15 The reasoning behind this specific inclusion relates to the reason given **not** to include small businesses. The Panel was told that as charities cannot put the cash in their charity into the name of an individual, a different scenario from a small business owner, they do not have the options of mitigating their risk that a small business does. Hence, it is important to protect them.[56]

8.3.16

Key Finding:
It is appropriate that charities and children's trusts are covered by the scheme.

8.3.17 Excluded: Small Businesses

8.3.18 According to *Jersey In Figures 2008*, 77% of the Island's 5,730 businesses employ 5 people or less. The decision to exclude small businesses from the scheme is therefore a very significant one, with the potential to affect a significant portion of Island businesses and consequently local people.

8.3.19 The Panel has already highlighted a key principle behind the coverage scheme, that of achieving maximum coverage for minimum cost. Is it therefore the case that small, local businesses have been excluded to keep costs down for the banks? If so, is this justifiable?

8.3.20 The Panel explored the matter with a number of the key stakeholders. The Chief Executive of Jersey Finance Ltd backed the coverage proposed by the scheme, including the exclusion of small businesses.

8.3.21 He told the Panel that once coverage moves away from the simple structure proposed of covering private retail accounts you quickly move into a complex structure, which it makes it more difficult to manage a scheme and potentially makes it significantly more costly. He further explained;

[56] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

' I think the main problem is that you have ... we have got 33,000 companies on our companies register. A lot of those are international companies and some of them ... how will you measure them if they are securitisation vehicles or special purposes vehicles and they are holding cash elements, would that cash element be caught and protected by a compensation scheme? So I think you quickly move into quite a complicated set of questions that would make your scheme a lot less straightforward, a lot more difficult to manage and potentially more expensive.'[57]

8.3.22 The potential complexity that extending the scheme to small businesses was further outlined to the Panel by the Chief Executive of Standard Chartered Jersey, Ms. A. McFadyen:

'I think it is going to be quite complex and it is not something that can be done in a month or 2 months because if you have got a small business, do you protect the owners of that business individually and again in the business. Definition of turnover, who is covered who is not? Do you look at any non-Jersey businesses that are covered? Is it the shell businesses or is it the actual functioning businesses in Jersey? I think the definition of that will be incredibly complex.'[58]

8.3.23 The case for including small businesses within the coverage of the scheme was presented to the Panel by Mr D. Warr. Understandably, he was adamant that small businesses should be included in the scheme, arguing that it is fundamental that businesses keep running.

'People forget that business drives this economy. If we do not have an economy we do not have business, full stop.'[59]

8.3.24 Ms. A. McFadyen also suggested that there may be some merit in examining how the scheme may be extended to cover small businesses, although it was an issue that would need time to develop as a lot of work would need to be undertaken to define a small business, to understand what coverage would be required and to understand what would be needed to support that.[60]

[57] Public Hearing, JFL and Ms A McFadyen, 7th September 2009
[58] Public Hearing, JFL and Ms A McFadyen, 7th September 2009
[59] Public Hearing, Mr D Warr, 10th August 2009
[60] Public Hearing, JFL and Ms A McFadyen, 7th September 2009

8.3.25 The Minister for Economic Development and his Officers explained to the Panel that during consideration of including small businesses in the scheme, the decision to exclude them had been influenced by a solution that they believed would allow small business owners to protect their deposits. This solution was explained to the Panel by the Minister for Economic Development;

> *'Quite simply that is to ensure that large deposits are not held or they are moved into directors' personal names'*[61]

8.3.26 The Panel notes, however, that this proposed solution for small incorporated companies is contrary to law. The company has a separate legal personality from its shareholders and directors, and company money should not be placed in director's personal accounts. It does, however, recognize that it could provide a less than satisfactory solution to two or more persons operating a partnership as it does not have a separate legal personality to its owners. It could also result in the persons concerned having more than £50,000 in their personal bank accounts and losing protection for any money in the account above that sum.

8.3.27

Key Finding:
The scheme does not cover small businesses and insufficient consideration was given to establish if this would be achievable.

8.3.28

Recommendation:
The Minister for Economic Development should make provision for coverage to be extended to small local businesses.

[61] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

9. FUNDING

9.1 What is proposed for Jersey?

9.1.1 The proposed scheme would have its overall liability, including administration costs, capped at £100 million over each 5 year period, and levies on industry also capped with the States making up any shortfall. This shortfall funding may be repaid to the States depending on the rate of recovery in the bank liquidation. It is envisaged that short-term liquidity will be provided by the States through a loan to the JDCS.

9.1.2 Essentially, the maximum liability to the industry is capped at a maximum of £65 million once the calculations prescribed by the Regulations are undertaken. The shortfall, and therefore the capped States exposure to the scheme is at least £35 million.

9.1.3 It is an ex-post scheme as opposed to an ex-ante scheme or a hybrid of the two. An ex-ante funding type is a scheme where the regulator has decided to create up front a cash fund, whereas this proposed scheme would see funds collected only after the failure of a bank.

9.2 International Practice

9.2.1 Guernsey

9.2.2 In broad terms, the scheme is funded in three ways:

- An annual fee payable by all licensed banks to pay for the administration costs of the scheme.
- An upfront insurance premium paid by the industry to insure against a portion of the risk. That premium is apportioned among the participating banks on the basis of each bank's respective risk.
- In the event of a bank failure, a levy on the banks to raise funds to pay compensation.[62]

9.2.3 In essence the administration and insurance is ex-ante (pre-funded), but the compensation ex-post (post-funded).

[62] Key Features of Guernsey DCS, EDD report

9.2.4 The finer details of the Scheme are as follows:

- The Scheme is funded by the banks up to a maximum of £100 million over a five year period, with the States of Guernsey giving an initial guarantee of the first £20 million to a captive insurance company (who in theory would insure against part of the risk) plus provide £1 million in initial capital. The monies are raised partly by a pre-funded element - an annual insurance premium - and a post-funded levy should a bank fail

- The annual insurance premium is designed to raise approximately £2 million paid for by the participating banks on the basis of a calculation of each bank's respective risk of failure using factors such as the banking groups' credit rating, price of banking groups' credit default swaps, existence of a credible home government guarantee, steps taken by local management to reduce risk profile, and the total compensation payment likely to occur in event of failure. The premium will be paid to a captive insurance company which will continue to build its total funds to £20 million through an annual insurance premium paid by the banking industry. The details of this calculation have not yet been finalised and are not yet known.

- In the event of a bank failure there would be a levy on the banks to raise the remaining funds required. Each year each bank would contribute the lower sum of £1 million, or 50% of their average profits over the 3 preceding years. The first £10 million of any post funded compensation will be paid by all licensed banks equally, the second tier of up to £70 million would be based on a complex calculation not yet known based on a risk analysis. The legislation also permits the Scheme to negotiate a different amount to be paid by each bank from the amount fixed to be paid under the calculations prescribed in Regulations.

- There is a relatively small annual administration fee to be paid equally by all licensed banks to pay for the administration costs of the scheme (which is estimated to be around £4,000 per bank).

- If total liability exceeds £100 million, then the amount of compensation paid to depositors would be reduced proportionately.

9.2.5 Isle of Man

- The Isle of Man has had a deposit protection scheme, the 'depositors' compensation scheme (DCS)' since 1991. However, following international scrutiny of their scheme and the failure of the Isle of Man subsidiary of Kaupthing Singer & Friedlander ("Kaupthing"), Tynwald amended their Compensation Scheme in the Compensation of Depositors Regulations 2008 on 23 October 2008.

- If a bank defaults a post-funded Scheme will be set up funded by contributions made by other banks in the Isle of Man. There is no "standing fund" of compensation (i.e. money is not collected before a bank failure). The Scheme has discretion to determine the date of default.

- The Scheme will compensate resident and non-resident persons who have money in current and deposit accounts up to £50,000 of net deposits per individual depositor (or £20,000 for most other categories of depositor, such as companies and trusts). Cover is calculated per depositor, per deposit taker. However, after 23 October 2009 the maximum compensation per depositor will revert to the previous limit of £20,000 (although this date may be extended to April 2010 under current proposals before the Tynwald).

- All licensed banks in the Isle of Man are members of the Scheme, except those who do not take deposits from the public. Building Societies subsidiaries are covered but Building Societies parents with branches are not.

- To receive compensation depositors must transfer their rights in respect of an eligible protected deposit to the Scheme.

- Until 23 October 2009 the Scheme will be made up of a mixture of levies imposed on banks and Government funding, although this date may be extended to April 2010 under current proposals before the Tynwald. After that date, Treasury funding will cease under the current scheme regulations. In addition, the Scheme has the power to borrow money for the purposes of the Scheme.

- The maximum sum that can be levied on banks until 23/10/09 is £200 million. The amount which may be levied in any one financial year is subject to limits from £35,000 up to a maximum of the lesser of £350,000 and 0.125% of the bank's average sterling and foreign currency deposit base as calculated in accordance with the Regulations.

- Up until 23rd October 2009 (or possibly extended to April 2010 as mentioned above), if further sums are needed in addition to the levies imposed on banks, the IOM Treasury will pay the Scheme up to £150 million.[63]

9.2.6 U.K.

9.2.7 The FSCS is effectively a pay as you go ex-post scheme, funded by levies on firms authorised by the FSA. FSCS's costs are made up of management expenses and compensation payments.

9.2.8 Under a new funding system that started on 1 April 2008, for the purposes of funding FSCS compensation costs, the FSCS levy is split into five broad classes:

- deposits,
- life and pensions,
- general insurance,
- investments, and
- home finance.

9.2.9 With the exception of the deposits class, each broad class is divided into two sub-classes based on provider/intermediation activities. Each of the "sub-classes" is made up of firms which are providers or intermediaries and engage in similar styles of business with similar types of customer.

9.2.10 The sub-classes are based on the activities a firm undertakes (and are aligned to their FSA permissions). A firm could be allocated to one or more sub-classes according to the activities that it undertakes.

[63] International/Economic Affairs Sub-Group, Update Report, January 2009

9.2.11 Thresholds

9.2.12 Each firm's contribution is calculated on the tariff base applicable to the relevant sub-class. Each firm contributes proportionally. A threshold for each sub-class is set by the FSA by reference to what a particular sub-class or class (taken as a whole) can be expected to afford in a year. The threshold sets the maximum that FSCS can levy for compensation in any one year. The model operates on the basis that a sub-class will meet the compensation claims from defaults in that sub-class up to the threshold. Once a sub-class reaches its annual threshold, the other sub-class in that broad class will be required to contribute to any further compensation costs up the threshold for the class as a whole. A layer of cross-subsidy is then available from the general retail pool, through which firms in the other broad classes support any other broad class which has reached its overall threshold, up to the overall limit of £4.03bn

9.2.13 General retail pool

9.2.14 The general retail pool is above the broad classes. The total levy on all classes under the general retail pool provides an annual capacity of about £4.03bn to FSCS unless defaults arise in the home finance intermediation sub-class, in which case the total capacity is £4.10bn. This is due to the fact that the £70m contribution from home finance providers can be levied only for defaults in the home finance intermediaries' sub-class.

9.2.15 Transitional arrangements for the new system

9.2.16 As part of the 'clean break' transitional arrangements for the new system, at the close of business on 31 March 2008 FSCS confirmed the fund balances (credit and debit as appropriate) for each of the former contribution groups and identified how much each qualifying firm was owed by, or owed to, FSCS. FSA, acting as agents for FSCS, will then include this firm-specific credit or debit with that firm's 2008/09 consolidated fees and levies invoice, in a way that is clearly identifiable.

9.2.17 Beginning in June 2008 during the normal fees and levies billing cycle, each firm will receive:

- a credit or debit note for their 2007/08 FSCS balance;
- a single invoice for regulatory fees and levies (FSA, FOS, FSCS and FRC) for 2008/09; and
- a letter that will state the total net amount to be collected or refunded by the FSA.

9.2.18 The 2008/09 levy amount for individual firms will depend on what credit (or debit) they receive, based on 2007/08 tariff data in their previous contribution group(s), combined with their share of the funding requirement under the new sub-class(es), based on 2008/09 tariff data.

9.2.19 Any claims paid or levies raised after 1 April 2008 will be based on the new model.[64]

9.2.20 IADI Core Principles:

9.2.21 The Panel's Adviser assessed the proposed JDCS against Principle 11: Funding

The Principle states:
Sound funding arrangements are critical to the effectiveness of a deposit insurance system. A deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors claims. Ex-ante funding requires the accumulation and maintenance of a fund to cover deposit insurance claims and related expenses prior to a member bank failure. In an ex-post system funds are obtained only once a bank has failed; banks are assessed and contribute at this time. Member banks should pay the cost of deposit insurance since they and their clients directly benefit from having an effective deposit insurance system.

Recent IADI research indicates that ex-ante funding has many more advantages than disadvantages particularly with respect to ensuring prompt reimbursement to insured depositors, the maintenance of public confidence and as a means to avoid the pro-cyclical effects of deposit insurance assessments.

The JDCS:

- *Do member banks pay for the cost of deposit compensation?* ***Yes***

- *Is the system able to levy banks ex-ante, before the occurrence of a payout event? No – Only* ***After a payout***

[64] www.fsa.gov.uk

- *Does JDCS comply with Principle 11? (Fully/mainly/partly/do not comply)* ***Partly***

  Funding is provided in many ways for deposit insurance systems such as through government appropriations, levies, premiums assessed against member banks, government/market borrowing or a combination thereof. The majority of systems charged premiums (ex ante) as a way to build-up a fund but retained the authority to charge levies or other charges on their members if required. Other country systems preferred to rely on ex-post levies.

  While flat rate premiums are the most common form of application, differential premium systems are becoming increasingly prevalent. In a large number of cases, the deposit insurer was provided with the ability to secure funding for liquidity purposes from governments, its members or directly from capital markets.

  A fund is to be established once a bank is declared in default. It is not clear if JDCS has available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims. There is a plan to pay-out some deposit balances with 7 days and the remainder in 90 days or some longer period. It is not clear if the plan is credible.

  Differential premiums
  For deposit insurance systems utilizing ex-ante funding, policymakers have a choice between a flat-rate premium system and a premium system that is differentiated on the basis of individual bank risk profiles. The bases and criteria used in a risk-adjusted differential premium system should be transparent to all participants. As well, policymakers who adopt risk-adjusted differential premium systems should ensure that necessary resources are in place to administer the system appropriately.

- *Will JDCS employ differential premiums, are the bases and criteria used in a risk-adjusted differential premium system transparent to all participants (so that information on the assessment process is in the public domain)?* ***No***

- *Does the JDCS comply with Principle 11? (Fully/mainly/partly/do not comply)*
  Does not comply [65]

9.2.22
Key Finding: **The proposed scheme is not world class and does not comply with all of the IADI core principles.**

9.3 Funding: Key Issues Explored

9.3.1 Too big to fail – a credible assumption?

9.3.2 There was a recurring assumption presented to the Panel by the Minister and his Officers and various stakeholders within the Financial Services Industry that it is almost certain that no banks in Jersey will fail. Principle evidence offered for this assumption is that Jersey only licenses banks within the Top 500, and as such these banks are assumed to be too big to fail. The resulting attitude that we encountered from those stakeholders was that most did not believe that this scheme will ever be needed. The Mister himself told the Panel;

> *'….We still do not believe fundamentally that a depositor compensation scheme is needed.'*[66]

9.3.3 Is such an assumption really credible in light of the recent and current global financial events? It certainly raises a number of other questions also; Is it demonstrative of a complacent attitude and a contributing factor to the apparent lack of development of details of the scheme, as none of the funding stakeholders appear to believe it will ever be needed? Has government relied on this assumption when offering up its share of funding?

9.3.4 According to the Panel's adviser, it is a risky assumption make;

[65] Patterson & Labrosse Financial Consultants, SoJ Submission 3, 9th September 2009
[66] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

While implicitly, many of the European schemes may have been constructed with the idea that the authorities might never have to deal with a bank failure, the States of Jersey Scheme is quite explicit on that point as its aim is "to provide depositors with compensation quickly in the unlikely event of a bank failure". But, banks do fail and they fail in periods even when there is not a financial crisis. We have seen bank failures all around the world and even in those jurisdictions that have strict licensing regimes and structured early intervention frameworks. Some of the failures in the US recently can be attributed to the financial crisis (sub-prime loans), but others were attributed to bad management, poor risk management practices, etc.

We know that the root of the problems surrounding Northern Rock plc was its dependence on wholesale markets for the large majority of its funding and that was what most distinguished Northern Rock from other UK banks (and a fortiori from all UK building societies). Retail deposits (and other classes of retail funds) did grow, but not nearly as rapidly as did wholesale funds. Retail funds fell as a proportion of the total liabilities and equity of Northern Rock from 62.7% at end 1997 to 22.4% at end 2006. It remained, however, a predominantly UK-based institution, with the great bulk of its business done in that country.

It is the case that Northern Rock's securitisation programme supported rapid balance sheet growth for several years. Much of that funding was short term. About half of their wholesale borrowing was at a maturity of less than one year. Even more important to their subsequent problems, the size of the Northern Rock securitisation programme meant that a large amount of mortgage-backed securities needed to be refinanced every year. It was this need to replace the funding obtained from short-term wholesale and securitisation markets, markets which were effectively closed from the summer of 2007 that forced Northern Rock to turn to the Bank of England for liquidity support.

The States of Jersey has historically only licensed banks that are in the Top 500. Thus, there is an assumption that all such banks are "too big to fail" in their home jurisdiction and therefore the operations in the States of Jersey will not fail. Globalisation of financial institutions and markets has had important spin-off benefits but it appears that that thrust has led to more financial *institutions being "too big to fail", "too complicated to regulate", "too difficult to manage" and in some cases "too interconnected too fail" as a opposed to a more desirable outcome of having institutions being "too good to fail".*

We also note that recent experience has shown that the capital levels that are generated to meet minimum regulatory standards are simply not enough. Indeed, Sheila Bair, the Chairman of the US Federal Deposit Insurance Corporation: "[a] strong case can be made for creating incentives that reduce the size and complexity of financial institutions as being bigger is not necessarily better. A financial system characterised by a handful of giant institutions with global reach and a single regulator is making a huge bet that those few banks and their regulator over a long period of time will always make the right decisions at the right time." She added that "unless there are clear benefits to the financial system that offset the risks created by systemically important institutions, taxpayers have a right to question how extensive their exposure should be to such entities." Thus, it may no longer be the case that banks are "too big to fail" because governments are running out of financial capacity to allow big banks to continually expose their fiscal arrangements. The suggestion from Lord Turner that even the largest banks should develop "living wills" is a very profound statement and may represent the new reality.[67]

9.3.5 The Director General, Jersey Financial Services Commission, explained to the Panel the Regulator's position on the argument that the assumption of the banks being too big to fail is no longer valid. He proposed to the Panel that in fact, that argument was by no means concluded, explaining;

'*I struggle with that, to be honest, because I think banks are different. They are intrinsic to the economic system of any given country and, you know, it is not necessarily the case that you get better financial stability by parcelling up your banks into smaller and smaller entities. Maybe governments have been forced to recognise that the utility of having large banking groups with the wherewithal to do the things they do in order to oil the wheels of the economy comes with this implicit recognition, now explicit recognition, that governments are going to have to be prepared to step in. I do not think that debate is finalised at all. Lord Turner has made it clear, for example, in his review that he does not buy*

[67] Patterson & Labrosse Financial Consultants, SoJ Submission 3, 9th September 2009

the argument hat banks need to split up. That is perfectly acceptable to have large banking groups which operate both the retail side of the business and also the wholesale side of the business. What he basically said is they just need to be better supervised and their business model needs to be tested more regularly. So, for my money, looking at it from where I sit at the moment as a supervisor linked into the system, I think that that argument is by no means finalised and I would be surprised if we do indeed end up going down the road of a forced separation of investment and non investment banking arms.'[68]

9.3.6 The strong belief in the Regulatory system and strength of the banking sector was summed up by the Director, International Finance who told the Panel;

> *'What we are trying to achieve is the least worst solution. Let us be clear that that is what you are trying to achieve, the least worst solution. Nobody wants a deposit scheme, it is something that happens in a bad set circumstances. The preference is that it does not happen and we, by means of history and regulation, have a better environment in banking terms than any jurisdiction in the world. There is no jurisdiction in the world that is in a better position in terms of the quality of the banks and the nature those risks that they undertake.'*[69]

9.3.7 Who Pays? Government v Industry

9.3.8 Using the funding mechanism as prescribed by the Regulations to calculate the banks' contributions when levied (equivalent to 0.3% of eligible deposits held by a bank on the day of a given failure, and no more than the cap of £10 million maximum to nay one bank), the first approximately £65 million required by the scheme would be the liability of the banks. Any subsequent money required to fund the scheme, up to a maximum of approximately £35 million to take the fund to the £100 million cap, would be the liability of the States. It emerged to the Panel from the evidence gathered that Jersey would be operating somewhat distant from the international normal by its explicit contribution to the proposed scheme. This point was confirmed by the Director, International Finance who responded to the question of how many other schemes have explicit government funding in such a scheme by confirming that

[68] Public Hearing, JFSC, 17th August 2009
[69] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

very few did. However, the Finance Industry Development Executive explained why the proposed Jersey scheme was structured in such a way;

> *'We discussed with Oxera and Oxera confirmed to us very few have explicit up front government funding in the legislation. However, when push comes to shove governments do have to put in, so the Isle of Man contributed £150 million into the scheme to support Kaupthing. They do not expect to get that back. They have also given £120 million up from liquidity to fund payment being made out to people quickly. There you can see something which, although the figures are larger than what we would have to pay out in the Jersey Government in the worst possible case scenario, you can see something which is very similar to what Jersey is doing but the difference is we tend to examine our navel a bit more. We like to get things up front and explicit for the world to see. So what we are doing there increases the credibility of our scheme rather than lessens it and is a very important part of it.'*[70]

9.3.9 The Director, International Finance elaborated further, outlining that in their estimation the government funding was a safe option given the systemic nature of most banks in Jersey, and therefore their unlikely failure. Indeed, this confidence allowed the government to perhaps go that little bit further and provide the confidence to Industry and depositors of their explicit financial backing, and to use that backing to add weight to the utilisation of the Jersey scheme as a competitive marketing tool. As he explained;

> *'So what we suggested was, given that we think that this is very remote, given that this is a competitive time when we are trying to compete with other jurisdictions for consolidation activity by the banks, that we, to make that work, should put in government as a lender of last resort effectively for that last £35 million, should that eventuality arise. Then having run many of the scenarios and numbers on banks that result in a problem, is the likelihood of us requiring on that is even more remote in that that many small banks here, if they were to have a problem, would be covered by the £65 million. So that is how we arrived at the solution. The key point is that there is no up front funding, this is only obviously funded in the event that there is a failure and in*

[70] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

the event that there is a failure that takes you into an area that results in £100 million being required.'[71]

9.3.10 The Panel discussed with the Minister and his Officers how the split of funding levels in the scheme had been arrived at. The Panel was taken through the process in some detail by the Director, International Finance;

> *'The reason you arrive at £65 million is because we have chosen to put in a cap with an eye on the competing jurisdictions. So we looked across the water and saw Guernsey had £5 million cap, we thought we could live with a greater cap, the industry were not happy with it but we though we could get to a negotiated level where there was an acceptable gap but a reduced imposition on government and gave a fair charge to industry. So we introduced at £10 million. Now, when you run all of those numbers you come up with a figure of £65 million. Again, looking across the water, Guernsey have got a £100 million scheme. So starting from scratch in terms of credibility, could we have a scheme that offered cover that was less than Guernsey. We did not think so. So our starting point was we must have at least the same cover as Guernsey does, £100 million. So that was one we thought: "Okay, which of these pieces in the jigsaw can we move?" So we thought that was a minimum. We thought there were many arguments for having a higher figure but we thought: "£100 million, that is the minimum, let us run that through the numbers." We have ticked that box, we have ticked the £50,000 per depositor, because that is the current standard.'*

9.3.11 He continued;

> *'... and then we have thought: "What is an acceptable charging rate?" Then we looked around and saw that the standard charging rate used in the U.K. used to be - but is not any longer, they are changing their scheme - the current standard of .3 per cent. So that is something which our major banks were familiar with.'*

9.3.12 Addressing the shortfall between the £65 million and the £100 million, he explained further how that decision had been taken:

[71] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

'Then the last bit, as I have mentioned, was the cap. You run all of those numbers together and that results in a £100 million scheme, £65 million of funded. That leaves the shortfall. So what we suggested was, given that we think that this is very remote, given that this is a competitive time when we are trying to compete with other jurisdictions for consolidation activity by the banks, that we, to make that work, should put in government as a lender of last resort effectively for that last £35 million, should that eventuality arise. Then having run many of the scenarios and numbers on banks that result in a problem, is the likelihood of us requiring on that is even more remote in that that many small banks here, if they were to have a problem, would be covered by the £65 million. So that is how we arrived at the solution. The key point is that there is no up front funding, this is only obviously funded in the event that there is a failure and in the event that there is a failure that takes you into an area that results in £100 million being required, and it takes you into that area post the recoveries from a liquidation or a receivership. If one looks at the evidence around in the industry elsewhere, and a very good example is the Isle of Man situation currently, the level of recoveries are extremely high for a bank and therefore in almost all circumstances, even if there was an initial pay out under the government's obligation, there is a very high chance that that money would be refunded in due course under the liquidation and receivership. So the reason we have ended up with the funding is we cannot see another part of that jigsaw to move without damaging either credibility or our competitive position. The number pops out of itself. It is not where we started from. We were not thinking: "There should be this much funding."'[72]

9.3.13

Key Finding:
There is no evidence of a risk management strategy for the States' liability in the scheme.

9.3.14 No scheme - loss of banking customers?

9.3.15 The Panel can accept that there are multi dimensional drivers behind the scheme. But what balance was struck? Evidence from key stakeholders from the banking

[72] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

industry gave greater weight to the argument that this scheme has been strongly commercially driven to its benefit, and perhaps by extension the Island's, notably in respect of the speed of its development in reaction to the recent significant withdrawal of funds from the Island's banks which, it was argued, was itself a reaction of worried depositors (as the world banking crisis took hold) to the island not having a scheme. The Chief Executive of Jersey Finance outlined the concern to the Panel;

> *'We cannot quantify it because the problem is that some clients will tell you that they are withdrawing their funds and they will tell you that they are withdrawing it: "Because you do not have a depositor compensation scheme." A lot more will simply withdraw the funds. Where clients have disclosed it is that banks made attempts to try and persuade them to transfer the funds to alternate booking centres within the same group. So typically what would have happened is that Jersey-based depositors would have been encouraged to place their deposits in the Isle of Man or in Guernsey ... well essentially the Isle of Man, because of the presence of a longstanding scheme. Obviously history has proven that has not been quite as straightforward as perhaps people thought it might be but it certainly influenced behaviour at the time. The net consequence of that is that the international groups, that are multi-jurisdictional, have posted on their websites quite clear statements that their Jersey booking option does not have the support of a depositor compensation scheme.'*[73]

9.3.16 The Panel challenged the Minister on this assumption, referring him to the OXERA report that argued as late as May 2009 that there was no hard evidence that money is being lost to Jersey, only anecdotal. The Minister responded that he was getting a clear message from the banks that this was the case;

> *'Well, the information that we are getting from the banks themselves is suggesting that bank deposits are being lost and the increase ... not in any great sums but there is still a risk there. The banks themselves are now saying to us they are worried about their deposits and they think it is a concern. They were certainly very concerned when this particular scheme was not put in place.'*[74]

[73] Public Hearing, JFL and Ms A McFadyen, 7th September 2009
[74] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

9.3.17 When challenged about the credibility of that evidence, the Minister explained its source;

> *'We have empirical evidence having spoken to various banks, they have fed back ... I attended a meeting with a very senior banker after this particular scheme had been pulled and he pointed out his disappointed because of the risk they were seeing with loss of deposits.*
>
> ***Deputy J.M. Maçon:***
> *On that point, Minister, what evidence is there to suggest that if the deposits are going it is singly down to the fact that we do not have a depositor compensation scheme not to other issues going on globally which has made people question deposits and where they put their money.*
>
> ***Senator A.J.H. Maclean:***
> *Only the view of this particular individual, this particular banker, who was clear in his opinion that it was the fact that we had, as a government, given an undertaking back in December of last year that we would be introducing a depositor compensation scheme, that we would be doing so by July of this year, and his perception was the fact that we had not done so was affecting confidence and therefore the likelihood of an increased number of depositors being uncertain.'*[75]

9.3.18 Additionally, as previously mentioned, a picture built up from the Panel's communications with a number of stakeholders that the Minister was not alone in believing that this scheme is not at all likely to be needed. It appears from the information that the Panel gathered that the scheme is seen by some stakeholders as something of a necessary evil, a means of not only reassuring concerned depositors in order to counter any possible out flow of funds from existing depositors with the Island's banks, and to be used as a marketing tool in the competition for new ones.

9.3.19 The Minister did tell the Panel about how circumstances had changed with regard to the expectations of consumers. He argued that with the fear of what is going on globally consumers are now feeling that this is something that they would like. But he also emphasised that it was important to weigh up all considerations, that the

[75] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

commercial aspects are important when one considers the value of the finance industry to the Island. In that respect, it had been necessary for him to balance out the commercial aspects with political considerations. He explained;

> *'I suppose you have got to put together a deal and a scheme that is going to satisfy all parties. If you start losing business ... if the scheme is not commercial, you do run the risk of losing business.'*[76]

9.3.20 No scheme - loss of banking business?

9.3.21 The theory behind the argument that banks may consider pulling out of Jersey is presented as relatively simple; Particularly in this financial climate, banks are looking to minimise costs. Many banks operating in Jersey also do so in our most direct competitor jurisdictions of Guernsey and the Isle of Man. If, as the Panel understands, Head Offices of those banks may be looking at the scale of their operations with an eye on consolidation, then introducing any additional cost to operating in Jersey is risky, and certainly any cost above a level 'acceptable' to the banks, and may tip the balance of any consolidation considerations that may be taking place. As the Minister told the Panel;

> *'If you change the scheme and you want to deliver a scheme that is funded solely, solely, by the banks then you are going to run the very real risk of the banks leaving the Island.'*

9.3.22 However with the scheme as proposed, he felt this possibility had been minimised;

> *'The risk of losing the banking industry, as such, is small provided we have a competitive scheme. The scheme we have put together is very competitive; it has been agreed by the banks, they do not like it, but they have agreed to it and I think the balance is right in terms of what it is going to deliver.'*[77]

9.3.23 The Panel can certainly understand and accept that in the highly international and commercial world of banking such risk exits, although it is very difficult to quantify just how real this threat is. There is a bigger issue of just what influence the Island's Finance Industry is able to exert on Government, but what is perhaps more important

[76] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009
[77] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

in the context of this scheme is how far the pressure of this 'risk of withdrawal' argument that we had witnessed from industry stakeholders, the Minister and OXERA, was able to influence the shape of the scheme – the level of caps, the type of funding mechanism and so on.

9.3.24 The Panel raised this matter with the Minister, who told the Panel;

> *'The economy and the Island relies very heavily upon the revenues that are delivered by the finance industry. The industry itself has diversified in terms of products geographically and so on. There is a great deal of other things being done to diversify the economy, if that is what you are ...*
>
> ***Deputy M.R. Higgins:***
> *But we are dependent upon this industry and therefore we need to protect the industry.*
>
> ***Senator A.J.H. Maclean:***
> *We get the majority of our tax receipts from the financial services industry in one shape or form, as you will be well aware. So, clearly it is an important part of the economy.*
>
> ***Deputy M.R. Higgins:***
> *Therefore we need to protect it and therefore we need to do anything to keep it here.*
>
> ***Senator A.J.H. Maclean:***
> *Well, naturally we need to do all we can to protect it. It would be the sensible thing to do, would it not?'*[78]

9.3.25

Key Finding:
The drive to keep down the costs for the commercial benefit of the banks has dominated the development of the scheme to the detriment of the principle of protecting depositors and limiting the exposure of taxpayers.

[78] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

9.3.26

Key Finding:
Depositor Compensation schemes should not be used as competitive tools. Jersey should have consulted with the Isle of Man and Guernsey with a view to co-operation on developing standard approaches to the protection afforded to depositors.

9.3.27 The £100 Million and 5 Year Caps

9.3.28 Within the proposed Regulations, the total cover provided by the scheme is limited to £100 million in any five year period. It is very unusual for schemes around the world to have such a form of cap to the fund, and the Panel wanted to be clear therefore why Jersey was proposing such a cap, and how the levels of capping were arrived at to establish whether they had been based on sound principles. In the case of the 5 year cap this is again highly unusual, as indeed is any such time cap, and as far as the Panel has been able to establish is the preserve of only the Guernsey and proposed Jersey schemes.

9.3.29 The Panel explored these issues further, asking the Minister and his Officers to outline to the Panel how the tandem caps had been arrived at. The Director, International Finance explained to the Panel that the initial starting point was the Guernsey scheme, which has the same caps, and so in terms of credibility, Jersey has to have a scheme that at least matches that of one of its main competitors, hence the £100 million cap. He told the Panel;

> *'There are 2 things here; one is again 5 years is just like £100 million, we could make it £200 million, we could make it £500 million, we could make it 3 years, we could make it 10 years. What we have done is we have come up with something that we think meets as many criteria as possible. So, there is no categorical answer to it, but we think that £100 million over 5 years, given that Guernsey out there have £100 million over 5 years, sets a competitive benchmark for us. In the U.K. it is unlimited.'*[79]

[79] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

9.3.30 The Minister confirmed this approach to the Panel, saying in relation to the 5 year cap;

> *'Well, it is five years to be competitive effectively with Guernsey, so we have come in line with them.'*[80]

9.3.31 But is simply picking up the level of a competitor and making sure it matches that from a commercial point of view really a credible basis for the scheme's funding cap? This is surely questionable, given for instance the different profiles of banking industries in Jersey and Guernsey, and the different levels of deposits in each Island?

9.3.32 Furthermore, is this capping realistic, for instance in view of the possible need to re-assess the assumption on the likelihood of banks failing in Jersey? The Panel's adviser informed the Panel that the cap for the JDCS should be viewed as a financing mechanism to cover the expected losses to the compensation scheme when a bank fails. But, that statement assumes that the liquidator can gain control of the assets of a failed bank and that the assets are of quality that will result in a high level of recovery once they are sold or they mature.

9.3.33 There are also questions that must be asked about the calculation rate for the bank contributions to the scheme of 0.3% of the eligible deposits held by a bank at the time of a bank failure. This figure has been adopted from the UK scheme but is this really so easily transported to Jersey? Asked how much serious thought went into this figure, the Director, International Finance responded;

> *'A lot of serious thought and the pressure that we do find from the banks here all the time, and you see this in many formats, is a desire to try and keep things as simple as possible recognising they are multi jurisdictional schemes, they are U.K. businesses or they U.K./Guernsey/Jersey businesses. So they are always trying to get us to do thing that are the same between Jersey and Guernsey or the same between Jersey and U.K. Now, the 0.3 per cent is what operated in the U.K. We could have had a 0.5 scheme, we could have had a 0.7 scheme, we could have had a 0.1 scheme. We looked at the options and it was one that we had operating in the U.K., it came to a number that we thought - having looked at the data - covered, and I will keep*

[80] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

repeating this, every single bank up to and including bank 6. So any other number would not really have changed much. To the extent that any other number would have been different it would have simply given you additional bank funded monies that are not required in most eventualities.'[81]

9.3.34 In addition to the caps outlined above, the banks' contributions are also to be capped by way of maximum levels of contribution per bank, either £5 million or £10 million depending on size. This was explained to the Panel by the Director, International Finance;

'The banking contribution is calculated at 0.3 per cent of their deposit base, their retail deposit base, and that their contribution is capped at £10 million if .... that would calculate an amount that is over £10 million, and at £5 million if the amount they would pay is over £5 million but less £10 million.'[82]

9.3.35 How this was arrived at was outlined by the Director, International Finance at a subsequent hearing, who told the Panel;

'...we looked across the water and saw Guernsey had £5 million cap, we thought we could live with a greater cap, the industry were not happy with it but we thought we could get to a negotiated level where there was an acceptable gap but a reduced imposition on government and gave a fair charge to industry. So we introduced at £10 million.'[83]

9.3.36 The Panel's adviser advised the Panel that addressing the specific question of the size of the cap on banks' contribution to the JDCS there is no international standard. However, it is instructive to examine the range of arrangements that exist in other systems.

IADI found that there are a number of methods available to calculate the appropriate size for a targeted reserve. A common element of all of them is the need to determine the potential losses of the deposit insurance fund. The most common approach is to consider the country's historical experience with bank failures and associated losses. The majority of countries that have a target reserve ratio use this approach. The advantages of this approach are

[81] Public Hearing, Minister for Economic Development and Officers, 28th September 2009
[82] Public Hearing, Minister for Economic Development and Officers, 2nd July 2009
[83] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

relatively straightforward and easily understandable and it relies on existing information. A shortcoming, of course, is that the past may not be a good guide to the future. It does not take into account the current risk profile of member institutions and other information which may be useful in assessing potential losses to the deposit insurer.

The credit portfolio approach is a more analytical method to determine a suitable reserve ratio and is used, for example, in Hong Kong, Singapore, the US and Canada. Under those systems the deposit reserve is viewed as being subject to a portfolio of credit risks similar to a bank loan portfolio. The portfolio consists of individual exposures to insured banks, each of which has the potential (some greater than others) of causing a loss to the fund. In most cases there will be a relatively high probability of small losses and a much lower probability of very large losses. The probable large losses would tend to be associated with the presence of large banks.

Targeted Reserve Ratios of Selected Countries
(as a %of total or insured deposits as of end 2007)

Venezuela 10.11%
Argentina 0.50%
Colombia 5.00%
Canada 0.40-0.50%
Jordan 3.00%
Taiwan 0.30% of insured deposits (since January 2007, a target ratio of 2% of insured deposits has been stipulated by the Deposit Insurance Act)
Tanzania 2.70%
Singapore 0.30%
Indonesia 2.50%
Bahamas 0.20%
Jamaica 2.00 – 2.25%
Honduras 0.10%
Brazil 2.00% India 0.05%
US 1.25%
Average (ex. Venezuela) 1.45%

*Sources: CDIC International Deposit Insurance Survey (2003), World Bank and Garcia
(1999).*

The table above shows that there is considerable variation in targeted reserve ratios; however, the appropriateness of a reserve ratio will be affected by such characteristics as the assessment base as well as the effectiveness of regulatory oversight.

Adopting a credit portfolio approach to reserve targeting requires an insurer to consider: (1) developing a specific provision for each member bank taking into account the risk of loss and the range of losses that could occur over a specified period of time; and (2) setting aside additional funds (or surpluses) to cover situations where actual losses, as a result of unexpected factors, may exceed reserves. Another explanation is that a deposit insurance fund is exposed to both expected and unexpected losses and these need to be taken into account in determining the target size of the fund. Based on international experience and practice, a cap of 0.3% of the eligible deposits held by the bank for the JDCS is far too low to be considered credible.

There are two basic approaches in creating an insurance fund or reserve. A steady premium can be levied over an extended period; alternatively, a premium system can be designed to achieve and maintain a target reserve level or range. In the case of a target reserve it is necessary to establish how large a reserve is appropriate. The target level should be adequate to at least cover the potential losses of the insurer under normal circumstances. A large number of factors need to be taken into account including: the composition of member banks (number, size, lines of business), the liabilities of members and the exposure of the insurer to them, the probability of failures and the characteristics of losses that the insurer can expect. Deposit insurers and the member institutions can be exposed to a wide range of factors that are difficult to identify in advance. Potential losses can also be affected by the activities of the insuring agency itself and other members of the financial safety net, such as the supervisory authorities. For example, an effective supervisory regime can reduce the probability of bank failures and, by extension, the risk exposure of the deposit insurer.

Policymakers need to balance the requirements of the insurer to cover potential losses with the ability of the industry to fund the system. It should be borne in mind that an excessive reserve ratio could have a negative impact on profitability and hamper the development of the financial system. On the other hand a very small fund, designed to minimize the burden on contributing members, would probably be too limited to absorb significant losses and would likely require large ex post contributions by members at potentially awkward times.

We have seen that even in the US where the FDIC has a tremendous range of powers and unparalleled practical experience in dealing with bank failures that a deposit insurance system, by itself, cannot contend with a large scale financial crisis. Even in a non-systemic situation the deposit insurance system may find itself without adequate funds in reserve to meet its commitments. A gap between resources and financial obligations can be covered by giving the insurer access to additional or backup financing either from the government or the market. The backup funding would allow the prompt reimbursement of insured deposits and could be repaid through special assessments of the surviving institutions and/or proceeds from the liquidation. The terms and conditions of the financing must be carefully considered but it is most unusual to set a term limit on the ability to tap back-up government financing.

As a financial system grows it can only be expected that the size of the back-up facility will need to grow along with it. In the early 1990s, the direct Government of Canada support to CDIC was increased to C$6 billion and then earlier this year it was raised to C$15 billion. It is important to note access to funds must be gained quickly and the existence of a financial recourse mechanism to the Government substantially improves the credibility and increases confidence in the system. It may facilitate the timelier closure and resolution of failed banks and help contain the costs associated with a failure. In the case of a new system such as JDCS that has not had the time to accumulate sufficient resources, a backup system is essential.[84]

[84] Patterson & Labrosse Financial Consultants, SoJ Submission 3, 9th September 2009

9.3.37

Key Finding:
The 5 year cap is unique to the Guernsey scheme and to that proposed in Jersey. It is designed to minimise the costs to the banks but this is to the potential detriment depositor protection.

9.3.38 Ex-Post v Ex Ante

9.3.39 The proposed Jersey Scheme, if agreed, would see the adoption of an ex-post scheme, i.e. money would only be levied in the event of a confirmed bank failure, not beforehand. The Panel sought to establish the reasons as to why the Minister was pursuing this form of funding. He informed the Panel that in part it was to do with costs, with the Director, International Finance adding that;

> *'The primary reason is because we are so confident there will be no claim it would be pointless setting up a scheme; it would just be a waste of time as much as money.'*[85]

9.3.40 When asked what consideration was given to ex-ante and hybrid schemes, the Finance Industry Development Executive outlined to the Panel what consideration had taken place;

> *'...quite categorically we considered all the variety of options and we decided that the one which we came up with was the best possible scheme for Jersey because of the nature of our banking community and all the different factors which we would have here in Jersey. So, you cannot just say: "Well, another scheme is perfect so we are going to take that" because you always have to play around with it to some degree to make sure it is right for you. So, we looked at the different possibilities, and this was part of the research which Oxera did for us, and our resounding conclusion was that the scheme which we came up with was the best for Jersey.'*[86]

9.3.41 It was put to the Minister and his Officers by the Panel that Guernsey, by way of an example, has part ex-ante, part ex-post. Furthermore, the U.K. scheme is part ex-

[85] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009
[86] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

ante, part ex-post, moving even more towards an ex-ante scheme. In fact the vast majority of depositor compensation schemes are ex-ante schemes, including in Europe. Asked what consideration was given to those trends, the Director, International Finance reasoned that all those other jurisdictions have regular failures, in particular small deposit takers fail in large jurisdictions. Jersey does not have the same business model and has not had a failure and that is why, he explained, on the basis of the advice from Oxera that Jersey did not need an ex-ante scheme. Challenged about the potential for bi banks to fail, such as Lehman's, he continued;

> *'The whole point is governments are almost incapable of allowing a retail bank to go down because of the political risk and that is why you have exactly nailed it by saying the only example that one has been allowed to fail is Lehman's which is not a retail bank.'*[87]

9.3.42 The Panel received detailed advice from the Panel's adviser about the types of funding applied by such schemes. In short, the IADI Core Principle on Funding, Principle 11, states that a deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims including a means of obtaining supplementary back-up funding for liquidity purposes when required. Primary responsibility for paying the cost of deposit insurance should be borne by the banks since they and their clients directly benefit from the stability that an effective deposit insurance system promotes. For deposit insurance systems (whether *ex-ante*, *ex-post* or hybrid) utilising risk-adjusted differential premium systems, the criteria used in constructing such arrangements should be transparent to all participants. As well, all necessary resources should be in place to administer the risk-adjusted differential premium system appropriately.

> *Experience has shown that not all types of funding arrangements for deposit insurers are effective. Indeed, as implied above, the least effective arrangements are ex post compensation schemes. While there is a belief that ex post schemes are inexpensive to operate the fact of the matter is that they rely almost exclusively on government support, are less equitable for the surviving institutions, they play no role whatsoever in controlling moral hazard and governments are most likely to have to step in to provide a blanket guarantee or nationalise parts of the banking system at a great cost and exposure to taxpayers when there is a perception of a crisis.*

[87] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

The recent financial crisis provides some very important lessons learned for deposit guarantee systems that rely on ex post funding. For example, at the October 2008 IADI Conference, Loretta Minghella, Chief Executive of the FSCS, noted that the FSCS was "fully funded" by the industry and can impose a maximum deposit levy of £1.8 billion per year. It was also noted that the obligations of the FSCS at that time were £17 billion and current fees were about £5 million, a fair long way away from the maximum and unless the fees are raised substantially then the term of the mortgage will be extremely long and certainly beyond the end of this century. On top of that liability will be the additional costs on the banks to modify their IT systems (estimated at £892 million over the next 5 years – Financial Times, 7 January 2009) so that payouts can be made as per the new EC Directive. Certainly, paying for the compensation scheme in the UK is beginning to look like a potentially debilitating charge on the UK banking system and the UK government is not a very good position to afford the failure of another bank.

As well, the Associated Press on 29 August 2009 reported that Iceland has decided to repay Britain and The Netherlands the $5.7 billion it borrowed to compensate savers in those countries who lost funds in the collapse of an Icelandic Internet Bank last year. The Icelandic government overcame heavy opposition to the compensation plan, securing backing from the majority of lawmakers by pledging to link the pace of debt repayment to the rate of growth of the country. Iceland will begin repaying £2.3 billion to Britain and £1.3 billion to the Netherlands from 2016 with payments spread over the following nine years.

As noted, ex ante funding of deposit insurance systems requires the accumulation and maintenance of a fund to cover deposit insurance claims and related expenses prior to a failure actually occurring. It is funded by its members through contributions, insurance premiums and other means. An ex ante system is more rules-based and offers greater certainty than other systems because the funds are intended to be in place before they are needed. The knowledge that funds have been raised in advance and that the fund is well managed can reassure depositors that their insured deposit balances are safe. This helps minimise the risk of sudden withdrawals and the escalation of withdrawals that can lead to a bank run.

An ex ante funding system spreads the cost of insurance losses over time, since premiums should be set and collected taking into account expected losses over the long run. In addition, they should contain an anti-cyclical feature and buffer for the industry; the fund continues to accumulate premiums during stronger economic conditions, when losses may be low, as a hedge against future needs when economic circumstances may be less favourable and losses higher. It thus avoids further weakening of the overall banking industry at the time of a failure.

From the perspective of a member institution, compared to an ex post system, an ex ante system may at first sight appear to be more expensive, since it involves an explicit up-front business expense as opposed to an uncertain one and the ex ante payments required from the institution may reduce the resources it has available to absorb losses on its own. Additionally there is an opportunity cost to the premium paying banks and the overall economy, if one takes into account how the resources represented by the insurance premiums might otherwise have been employed. The cost of a bank failure of any size to taxpayers, however, can certainly be much higher than the opportunity cost to the premiums paid by banking systems.

There are few, if any, true examples of a pure ex ante deposit insurance system. As a result, the most common set of funding arrangements particularly outside of the EC are hybrid systems. Hybrid funding combines features of both ex ante and ex post funding. They incorporate an ex ante fund financed by premiums and contributions and includes a mechanism to obtain funds ex post from member institutions, through special premiums, levies or loans, should they be needed. An ex ante deposit fund may be established and the insurer be empowered to levy ex post contributions to make up for any fund shortfall. With ex ante funding, under very adverse circumstances, such as a large failure or a systemic crisis, losses may exceed the fund's reserves and a temporary increase in premiums or access to emergency (e.g. government) lines of credit may be appropriate. Thus, in practice, the real choice may not be between pure ex ante and ex post funding, but the relative extent to which the deposit insurance system relies on each.

Based on experience, the deposit protection arrangements in Canada, the US and Malaysia are the best examples of well-funded hybrid systems. But, each of those systems has had their special challenges. During the recent financial crisis Canada, for example, found it necessary to increase the coverage of inter bank deposits fully for six months. In the US, the FDIC is in the process of implementing a special levy to reinforce the deposit insurance fund and in Malaysia, the government found it necessary to institute a blanket guarantee which is being administered by the Malaysia Deposit Insurance Corporation.

Despite those measures, and due to the extraordinary circumstances, there is no doubt that hybrid systems are the best set of arrangements.

However, as explained earlier, a deposit insurance system, by itself, will not be able to contend with a large scale financial crisis. Even in a non-systemic crisis the deposit insurance system may find itself without adequate funds in reserve to meet its commitments. A gap between available resources and financial obligations can be covered by giving the insurer access to additional or backup financing either from the government or the market. The backup funding would allow the prompt reimbursement of insured deposits and could be repaid through special assessments on the surviving institutions and/or proceeds from the liquidation of bank assets. If a backup funding mechanism is in place, it is important that there be clearly defined rules on its use so that public funds will not be excessively relied on or otherwise used inappropriately.

Backup financing can be either improvised at the time or pre-arranged. Having a mechanism in place is highly advantageous as the terms and conditions of the financing can be more carefully considered. Access to funds can be gained quicker and the existence of a financial recourse mechanism may increase confidence in the system. It may facilitate the timelier closure and resolution of failed banks and help contain the costs associated with a failure. In the case of a new system that has not accumulated sufficient resources, a backup system can be particularly important.[88]

[88] Patterson & Labrosse Financial Consultants, SoJ Submission 3, 9th September 2009

9.3.43 The Panel's Adviser concluded that the search is on to implement measures to create a safer and more stable financial sector. The good news is that States of Jersey has seen the need to implement an explicit depositor compensation scheme. The bad news is that it contains many elements that undermine the credibility of the scheme. The funding measures are particularly weak. Starting from the assumption that banks can and do fail, depositors in Jersey banks will not be comforted to know that access to their funds may not be available for a considerable length of time and this will be particularly troublesome if the memories of *Northern Rock* have not faded.

9.3.44

Key Finding:

An ex-post funded scheme lacks credibility.

9.3.45

Key Finding:

Hybrid funded schemes are becoming increasingly common.

9.3.46

Recommendation:

A hybrid funding structure should be adopted.

10. STRUCTURE

10.1 What is proposed for Jersey?

10.1.1 The proposal is for a permanent, standalone DCS that will be activated in the event of a bank failure in Jersey. The Regulations establish a Board to administer the compensation scheme and to pay the compensation. In keeping with the ex-post funding structure of the scheme, the Board would be activated on instruction of the Minister for Economic Development, with the membership appointed by the Minister, solely in the event of a failure and would not be operational at any other time. During the time that the Board would be in the process of being constituted, the Minister would carry out its functions.

10.1.2 The Board would raise the funds to undertake compensation of depositors in the event of a failure by imposing a levy on the banks in Jersey that held eligible deposits at the time the bank in default became bankrupt. Where the amount of the levy the banks would be required to pay would be more than approximately £66 million, the States would be required to pay the shortfall to the Board up to the £100 million cap.

10.1.3 The Board itself would be funded from within the levies be raised to compensate depositors, and it is anticipated that this cost would be up to £2.5 million per failure. It was estimated that annual running costs of a permanent Board had that been proposed would have been in the region of £100,000 to £250,000.

10.2 International Practice

10.2.1 In the scheme in Guernsey there is a permanent Board structure. This Board is independent of the Guernsey Financial Services Commission and the States of Guernsey. There are four members of the Guernsey Banking Deposit Compensation Scheme.

10.2.2 The Scheme is administered by Aon Services (Guernsey) Limited. Since the introduction of the scheme the Board has met on a fortnightly basis and its remit includes working closely with Banks to ensure that clients are made aware of the protection that is afforded to depositors banking in Guernsey, and it is also responsible for maintaining its website to ensure the public and businesses are kept up to date.

10.2.3 The Board advised the Panel that the Guernsey scheme required banks to contribute annually to the administrative costs for operating the scheme. All banks are charged an annual fee of £5,000, which is completely separate to the compensation fund. The administrative element of the scheme does not receive any funding from the government. The annual total cost for administration is £220,000. The Board's remit includes a requirement to report back to the States annually.

10.2.4 Board members are selected by the Minister and the proposal is ratified by the States of Guernsey. The Memorandum of Articles is drawn up by the Minister, but the Board is not subject to any instructions from the Minister.[89]

10.2.5 In the Isle of Man the Financial Supervision Commission, established in 1983 as an independent statutory body, has as part of its broader regulatory remit, responsibility as the designated scheme manager for the administration of its depositor compensation scheme. The scheme manager's role is permanent, part of which includes preparation in respect of each financial year a report to the Treasury on the discharge of its functions and on the operation of the Scheme generally. This report shall include a balance sheet and an income and expenditure account for the Scheme.

10.2.6 In preparing this report the Scheme Manager is required to:

- Select suitable accounting policies and then apply them consistently; and,
- Make judgements and estimates that are reasonable and prudent.

10.2.7 The Scheme Manager is responsible for keeping proper accounting records, which disclose with reasonable accuracy at any time the financial position of the scheme and to enable the Scheme Manager to make reports required by the Compensation of Depositors Regulations 2008 - 2009, made under the Financial Services Act 2008. The Scheme Manager is also responsible for safeguarding the assets of the Scheme and for taking reasonable steps for the prevention and detection of fraud and other irregularities.[90]

10.2.8 In view of the propensity of hybrid ex-ante/ex-post schemes in existence internationally, most schemes incorporate a permanently active Board.

[89] Panel report, Visit to Guernsey Board, August 2009
[90] www.fsc.gov.im

10.3 Structure: Key Issues Explored

10.3.1 Is an Ex-post, Reactionary Board Appropriate?

10.3.2 As identified, the Board of the proposed JDCS would be activated in the event of a bank failure in Jersey – an ex-post, reactionary Board to match the pure ex-post funding arrangements proposed. The reasoning presented to the Panel by the Minister and his Officers for this structure again centred around the argument that this scheme is very unlikely to be needed due to the suggested unlikely event of a bank failure here. The opportunity therefore again presents itself to minimise costs by way of a Board that requires funding only in the event of a failure. By not being active during all other times it does not require funding when it is effectively not needed. The Director, International Finance explained this argument to the Panel;

> *'Shall we talk about some concept here in the first instance, which is that what we are trying to do here is that, given that we think the likelihood of this scheme ever being called is very, very remote, one of the key requirements up front was to try and avoid any cost, which is why we have gone through a post-event scheme rather than a pre-event scheme. So the principle that we started with was to try and avoid having to establish an independent board before the event, because once you have established them you have to pay them, you have all the costs that go along with it. So the concept behind this was to come up with a construct that allows us to ensure that the matters that need to be dealt with can be dealt outwith a board, in which case we have endowed those abilities with the Minister.'*[91]

10.3.3 The Finance Industry Development Executive told the Panel that individuals of quite a high skill set would be required to sit on that board, including a lawyer, an accountant and somebody with a lot of senior experience in the banking industry for the board to have credibility. To have such people would lead to costs broadly equivalent by way of example to what the JFSC pays its Commissioners and Chairman. He explained to the Panel that the standing cost to the States of such a permanently activated Board would be in the region of £100,000 to 150,000 a year, and that it appeared sensible to not encounter such costs if possible.[92]

[91] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009
[92] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

10.3.4 Additionally, the Minister is confident that the necessary expertise to establish a Board quickly, post failure, would be available, although it was admitted that the details of who would need to be worked on;

> *'Well, we believe there would be the availability to find suitable people to fulfil the role of the board and … the structure proposed effectively from a cost saving perspective is the one that we believe is the most appropriate and that the expertise will be available should we require it in a timely fashion to fulfil the obligations required.*
>
> ***Deputy G.P. Southern:***
> *The evidence you have for having the experience available, experienced hand just sitting there waiting to be called up should the need arise?*
>
> ***Mr. M. De Forest-Brown:***
> *As you note, this is not written down yet. This point ... the details of this have not been documented anywhere and that is recognised as a piece of work to do, but the principle behind it was we would appoint representatives from a firm of accountants and lawyers. So that is why we are confident that they will be available immediately because they would step in as a paid agent. So it is not looking around for somebody from the great and good who seems to meet all the criteria in the first instance, it would be an appointed paid professional from a professional firm…But the basis behind all of this is simply to try and keep costs down.'*[93]

10.3.5 It appears from what the Panel has heard that this approach is based on certain assumptions; again that banks in Jersey are very unlikely to fail; that a Board would have nothing to do without there being a failure; that a team of experts could be parachuted in virtually overnight to begin the work of the Board.

10.3.6 As already highlighted, the assumption that a Jersey Bank is unlikely to ever fail is being challenged. Furthermore, the Panel received advice from the Panel's adviser and has seen from Boards operating around the world, and including Guernsey, that there are a number of functions that Boards might be expected to carry out in addition to the administration of compensating depositors in the event of a failure. Not least of these would be preparing to be fully up to speed on the potential for any

[93] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

failures in order to maximise the efficiency and effectiveness of response to failure. Also of vital importance is the role of ensuring high levels of public awareness to the existence and details of the scheme. A Board that is permanently active is also able to evolve the scheme to ensure that it reaches international standards and reacts to constantly emerging external or internal factors.

10.3.7 With the Panel's adviser's advice and the international evidence about the multi dimensional role a Board may be expected to fulfil, is it really credible for Jersey to proceed without such a key structure in place? Who else is going to undertake that work? The Panel spoke to the Minister and his Officers about this matter at the Panel's final hearing on 28th September 2009. The Panel was told that it was accepted that there was significant further work to do on the details, but that the priority had to be to get a scheme in place and then work out that detail. The Chairman asked;

'Who is going to work on our scheme, because we will not have a chair and we will not have a board?

Mr. M. De Forest-Brown:
There is a Project Officer that is going to focus on doing exactly this and to put forward proposals on whether it remains a board that would be appointed in the extreme event of a failure, or alternative models, but that is still to be debated.

Deputy M.R. Higgins:
Would it not be more credible if the board was there and doing the work?

Mr. M. De Forest-Brown:
That is the debate to be had, the point is, we are just simply trying to get a scheme out, and we are getting ... the cost of not having a scheme, we are continuing to debate all of these issues, and we are putting off getting a scheme in place. If we could get the scheme in place we could get on and focus our resources on that second part of the element.'[94]

10.3.8 Specifically referring to who would raise public awareness of the scheme, the Director, International Finance explained that it would be the banks' responsibility;

[94] Public Hearing, Minister for Economic Development and Officers, 28th September 2009

'Obviously, once we get to the position of having a scheme, then we will look very clearly at what we can do in the way of communicating that, but fundamentally that is down to the banks to communicate what level of coverage their scheme has. But we will obviously look, where appropriate, to … best practice in that area.'[95]

10.3.9 **Key Finding:** **A permanent Board would be able to react more effectively to a bank failure than a Board established post failure.**

10.3.10 **Key Finding:** **Public awareness of the scheme will be an important element of its credibility. It is not clear who will be responsible for promoting Public Awareness of the scheme.**

10.3.11 **Key Finding:** **A permanent Board would be more credible to depositors and would be well placed to undertake roles including promoting Public Awareness of the scheme.**

10.3.12 **Recommendation:** **In order to raise the credibility of the scheme for depositors a real, permanent Board should be established.**

[95] Public Hearing, Minister for Economic Development and Officers, 28th September 2009

10.3.13

Recommendation:
A permanent Board should be funded in advance outside of failure periods by an administration fund collected from bank levies.

10.3.14 Independence of the Board

10.3.15 IADI Principle 5 – Governance

The sound governance of agencies comprising the financial system safety net strengthens the financial system's architecture and contributes directly to system stability. Operationally independent and accountable safety net organizations with clear mandates and which are insulated from undue political and industry influence provide greater integrity, credibility and legitimacy than entities lacking such independence.

The deposit insurance system should have a governing body and the governing body should be held accountable to the authority from which the deposit insurance system receives its mandate. The deposit insurance system should be structured such that the potential for undue political and industry influence and conflicts of interest respecting members of the governing body and management is minimized.

10.3.16 The Panel's adviser assessed the proposed scheme against the IADI Principle:

Is the JDCS operationally independent? Qualified ***No***

Does JDCS have a governing body? Qualified ***Yes***

Is the governing body accountable to the authority from which JDCS receives its mandate? ***Yes***

Does JDCS comply with Principle 5? (Fully/mainly/partly/do notcomply) ***Partly*** [96]

[96] Patterson & Labrosse Financial Consultants, SoJ Submission 3, 9th September 2009

10.3.17 Under the proposed scheme the Minister has a considerable number of responsibilities relating to the Board. The extent of the Minister's relationship to the Board is set out in the following Regulations;

9 Independence of Board

(1) The Board is independent of the Minister and of the States.

(2) Accordingly, neither a Minister nor the States are liable for –

(a) an act or an omission of the Board; or

(b) a debt or other obligation of the Board.

10 Constitution of the Board

(1) The Minister shall appoint the members of the Board.

(2) The Board must have at least 3 members.

(3) The Minister may, in appointing a member of the Board, seek nominations from –

(a) the Commission; and

(b) the Jersey Bankers Association.

(4) The Minister may not appoint as a member of the Board a person who is –

(a) a member of the States;

(b) subject to a disqualification order under Article 78 of the Companies (Jersey) Law 1991 or Article 24(7) of the Bankruptcy (Désastre) (Jersey) Law 19907; or

(c) bankrupt.

(5) The appointment of a person as a member of the Board ceases if the person becomes a person who may not be appointed to be a member of the Board.

(6) The rights and obligations of the Board, and the performance of its functions, shall not be affected by –

(a) any vacancy in its membership; or

(b) any defect in the appointment of a member.

(7) Despite paragraphs (1) and (2) the Board shall not assume its functions until such time as the Minister may determine.

(8) In the meantime the Minister shall carry out the functions of the Board.

11 Terms and conditions of appointment of members of the Board

(1) A person appointed to be a member of the Board –

(a) holds the appointment on terms and conditions agreed between the person and the Minister; and

(b) may be reappointed.

(2) The terms and conditions must include terms and conditions in respect of –

(a) the term of the appointment of the member, being a term not exceeding 5 years;

(b) the manner in which the member may resign during that term;

(c) the grounds upon which the appointment of the member may be terminated during that term;

(d) the remuneration (if any) of the member,

and may contain such other terms and conditions as the Minister may consider appropriate or necessary.

(3) The grounds mentioned in paragraph (2)(c) must include –

(a) the member being mentally or physically incapable of carrying out his or her functions as a member; and

(b) the member being convicted of an offence that carries a penalty of imprisonment for a term of 2 years or longer.

12 Procedures of the Board

(1) The quorum for a meeting of the Board is half the number of members appointed to be members of the Board at the time of the meeting.

(2) The Board must keep a record of its decisions.

(3) The Minister may determine the procedures of the Board.

(4) Except as otherwise provided by this Regulation or the Minister, the Board may determine its own procedures.

(5) The Board must ensure –

(a) that Board and the scheme are administered in a prudent and economical manner; and

(b) that the resources of the Board are used efficiently and effectively.

***15** Accounts and report*

(1) This Regulation applies if during a financial year the Board receives, holds or expends money.

(2) The Board must keep accounts prepared in accordance with generally accepted accounting principles that show a true and fair view –

(a) of the profit or loss of the Board for the financial year; and

(b) of the state of the Board's affairs at the end of the financial year.

(3) The Board must, within 3 months after the end of the financial year, have its accounts audited by an auditor qualified for appointment as an auditor of a company by virtue of Article 113 of the Companies (Jersey) Law 1991.

(4) The Board must, within 3 months after its accounts have been audited, provide the Minister with –

(a) its audited accounts; and

(b) a report.

(5) The report must contain –

(a) details of the Board's activities during the financial year; and

(b) such other information as the Minister may direct the Board to provide.

(6) The Minister must lay the accounts and report before the States as soon as practicable after receiving them.

(7) The Board must keep records that permit its financial position to be ascertained with reasonable accuracy at any time.

(8) The Comptroller and Auditor General may audit the accounts of the Board.

(9) When requested to do so by the Comptroller and Auditor General the Board must make its records and accounts available to the Comptroller and Auditor General.

(10) In addition, the Board is an independently audited States body for the purposes of the Public Finances (Jersey) Law 2005.

16 Board to publish "relevant date" in respect of bank in default

(1) The Board must, as soon as practicable after a bank becomes bankrupt –

(a) publish a notice, in a manner that is likely to bring it to the attention of those affected by it, specifying the date on which, in the Board's opinion, the bank became a bank in default in Jersey; and

(b) inform the Minister of the date specified in the notice and the name of the bank in default.

(2) The date specified in the notice is the relevant date in respect of the bank in default.

(3) The Minister must inform the States as soon as practicable of the

20 Board must pay compensation

(1) This Regulation applies where the Board receives a valid application for compensation.

(2) The Board must, within 3 months of receiving the application pay to the applicant the compensation due to the applicant under the bank depositors compensation scheme.

(3) The Minister may –

(a) extend the period mentioned in Regulation 19(2) or paragraph (2) of this Regulation; or

(b) permit compensation to be paid by instalments over a specified period, if the Minister is satisfied that it is necessary to do so for the better administration of the scheme.

(4) The Minister may do so by notice published in a manner that, in the opinion of the Minister, is likely to bring the notice to the attention of those affected by it.

(5) Paragraph (2) is subject to Regulations 21, 32 and 34.

10.3.18 Taking, amongst other international practice, the expectations of IADI Core Principle 5 that undue political and industry influence and conflicts of interest respecting members of the governing body and management should be minimised, the Panel explored the possibility that, in part at least, this scheme may be challenged on these grounds. The Panel raised the matter of political independence with the Minister and his Officers, with particular concern for the provision in the Regulations that it is the Minister's decision to determine when the Board will assume its functions, and that the Minister may carry out the functions of the Board until that point.

10.3.19 The Panel heard from the Minister and his Officers that the logic for this provision lay in the cost saving measures of establishing a Board after a failure, and therefore not having a permanent Board in operation. This was explained to the Panel by the Director, International Finance;

> *'…the principle that we started with was to try and avoid having to establish an independent board before the event, because once you have established them you have to pay them, you have all the costs that go along with it. So the concept behind this was to come up with a construct that allows us to ensure that the matters that need to be dealt with can be dealt outwith a board, in which case we have endowed those abilities with the Minister. But with the understanding the way that would operate in practice is the second that a scheme needed to be called upon that we would be in a position to immediately put in place an independent board. So it is to try and balance those 2 elements. So clearly in terms of policy definition part of the scheme,*

the run up, that would all be dealt with under the powers of the Minister. But the second a board gets created then that would move away from government into the hands of the independent board.'[97]

10.3.20 Whilst the Director, International Finance did advise the Panel that one of the options that was considered was to establish an independent Board from the outset, he had concluded that the;

'…balance of the argument is there is nothing for them to do. Therefore all you would have is a cost of people sitting around with nothing to do.'[98]

10.3.21

Key Finding:
The Board as proposed is not sufficiently independent.

10.3.22

Recommendation:
There should be a permanent Board funded by the banks and more demonstrably independent of the States and industry practitioners. Its remit should include public awareness, monitoring of international standards in depositor protection and the administration of the scheme.

[97] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009
[98] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

11. MECHANICS

11.1 What is proposed for Jersey?

11.1.1 The Panel has focused its attention on two specific key mechanisms of the scheme that it agreed required particular examination, 7 day payouts and cross border asset recovery.

11.1.2 7 Day Payouts

11.1.3 Regulation 19 sets out the provision for an interim payment of up to £5000 within 7 days of receipt by the Board of a valid claim;

> ***19 Board must make interim payment of compensation***
>
> *(1) This Regulation applies where –*
>
> *(a) the Board receives a valid application for compensation; and*
>
> *(b) the application includes a request for an interim payment of compensation.*
>
> *(2) The Board must, within 7 working days of receiving the application, pay to the applicant, by way of compensation the lesser of –*
>
> *(a) £5000; or*
>
> *(b) an amount equal to the eligible deposit of the applicant on the relevant date.*
>
> *(3) Paragraph (2) is subject to Regulations 21, 32 and 34.*

11.1.4 In addition, it should be noted that Regulation 20 (3) (a) does allow the Minister to extend this period:

> ***20 Board must pay compensation***
>
> *(1) This Regulation applies where the Board receives a valid application for compensation.*
>
> *(2) The Board must, within 3 months of receiving the application pay to the applicant the compensation due to the applicant under the bank depositors compensation scheme.*
>
> *(3) The Minister may –*

(a) extend the period mentioned in Regulation 19(2) or paragraph (2) of this Regulation; or

(b) permit compensation to be paid by instalments over a specified period,

if the Minister is satisfied that it is necessary to do so for the better administration of the scheme.

(4) The Minister may do so by notice published in a manner that, in the opinion of the Minister, is likely to bring the notice to the attention of those affected by it.

(5) Paragraph (2) is subject to Regulations 21, 32 and 34.

11.1.5 Cross Border Asset Recovery

11.1.6 Asset recovery will be a key factor in determining the final States liability in the scenario of a bank failure. As previously covered, the banks will effectively be responsible for the first (at most) £65 million of any depositor compensation in the event of a bank failure, with the States liable for any additional funding required up to the £100 million cap. The more money recovered, the less exposure the States, and potentially the banks, will face. Also, in practice with the scheme set up with an ex-post funding structure, the States will almost inevitably have to step in with initial liquidity to fund the scheme until bank levies are realised.

11.1.7 Under the scheme, depositors wishing to claim from the scheme will have to sign over their legal claim as creditors of the failed bank to the Board (subrogation), who will subsequently act as creditor on behalf of all such depositors. However, given the broad banking industry business model in Jersey of subsidiaries or branches upstreaming funds to parent companies in other jurisdictions, the complex cross border issue of how to recover locally deposited funds that are no longer held locally becomes a significant challenge, and one that would be led under current legislation by the Viscount.

11.2 Mechanics: Key Issues Explored

11.2.1 Seven Day Payouts

11.2.2 Jersey's aim to achieve interim payouts of £5,000 within 7 days of receipt by the Board of a valid claim appears to be ambitious when compared to others schemes and international standards. In Guernsey, its Board aims to achieve payouts within 3 months, but only an interim proportion if there is a prudent reason for paying out less than the full amount. In the Isle of Man, the scheme manager aims simply to pay out all or a proportion of the compensation as soon as possible. And in the UK, the Financial Services Compensation Scheme aims to process all claims with in 6 months of a default, and although it has been considering the possible adoption of a 7 day payout, it is unlikely to progress this until after 2011, and indeed may opt to pursue a 20 day payout.

11.2.3 As outlined in the Oxera report, recent EU policy discussions have focused on the speed at which depositors can access their funds and obtain compensation from the DGS. Under the 1994 EU Directive on DGS, the requirement was for the DGS to pay compensation within a three month period, with a possible further extension if the circumstances require it. As part of the wider measures to enhance the confidence of consumers, proposals have been passed to amend the Directive and shorten the payout period—payment of compensation for duly verified claims is required within 20 working days of the determination of default, with an extension of the time limit by no more than ten working days (to be implemented by end 2010).[99]

11.2.4 The Panel explored with the Minister and his Officers how the 7 payout was arrived at. The background to the decision was provided to the Panel by the Finance Industry Development Executive**;**

> *'Well, one of the big issues in the U.K. is about payment out. One of the things you will see is that the international principle says that you should be able to have a substantial payout to people under the scheme within a short period of time and you will notice that we have incorporated in our scheme, which is different to Guernsey, different to the Isle of Man, different to the U.K., as it was, a provision whereby you can make sure that the first £5,000 of a claim is paid out early, within 7 days, and that is something which the U.K. was looking at bringing forward and now it has announced that it is going to do that as a result of its latest consultation, so that is a good example*

[99] Oxera Report, *'Deposit Guarantee Arrangements for the States of Jersey: A Review and Evaluation of Options'*. May 2009

where we have looked at things and thought: "That is a really good idea." In the U.K. it is almost certainly going to come in.'[100]

11.2.5 The principle of an early interim payout appears reasonable, but what the Panel endeavoured to establish was whether the 7 day payout was realistic given the elements that would have to be undertaken to enable this to happen. And if it isn't realistic, does it undermine the credibility of the scheme to include it?

11.2.6 One apparent stumbling block achieving the 7 day payout is the absence of a permanent Board, which doesn't help to give it the opportunity to lay the groundwork in advance of a failure to administer such a payout. Furthermore, early payout will require efficient receipt of depositor information from the failed bank, and it is unclear that there is any guarantee of such information being readily available, as the Panel discussed with the Officers, who outlined to the Panel why they envisaged that the 7 day payout was achievable in a scheme on the scale of Jersey's ;

'Deputy M.R. Higgins:
….What research have you done into the bank systems to enable you to be absolutely confident that it can deliver on the 7 days, which is the expectation we are putting out to the people?

Mr. J. Mews:
I think the key thing here is very much to look at the difference between our scheme and the U.K. scheme and you are trying to compare like with like and we are not comparing like with like here.

Deputy M.R. Higgins:
For example, can you tell me: do the banks here have separate systems, computer systems, gathering the data and having a single customer view compared to what their parents have in the U.K.?

Mr. M. De Forest-Brown:
In practice, one might envisage a process whereby an individual has made his submission and that the point that was made - this is 7 days from the submission of a claim - is the person makes submission of a claim and the

[100] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

process would be probably: look at the balance on the system; has over the amount? Yes. Sorted. There would be a smaller number of circumstances where individuals may have multiple holdings and a single item of those would not cover the amount. So somebody might have 3 accounts with, you know, 500 or 1,000 or something in multiple accounts. In terms of the form that the individual would be required to submit, they would typically put in a form that says: "This is their accounts and these are their balances that they are aware of." It may be that they have not had a recent statement so it might be a sort of estimated balance, or it may be supported by a last bank statement or something. Those are details that we need to work up. In practice there would be a team that will then take that application, they will look on the system to see if they can verify that and that would be immediately past the payment. So, knowing what their exact balance is as a single customer is in most cases probably not necessary to make this first initial payment on a ...

Deputy M.R. Higgins:
I hear what you are saying, but what research have you done? …

Mr. M. De Forest-Brown:
Well, we have not done any ...

Deputy M.R. Higgins:
You have not done any, have you?

Mr. M. De Forest-Brown:
No, no, of course we would not do that research. I have to say, with due respect, it is well-understood that this government in its desire to keep costs down has a certain level of resources to deal with a very large number of projects. We need to use that resource as effectively as possible for all the priority claims. This is one very, very small element of this scheme; it is the key element, I agree, but I think that I can see, in my own mind, clearly ways in which we could, as the project officer fleshes this out, come up with a system that says: "Form, claim. I have these balances. Quick check. Yes, okay. I can see that is okay. Tick. Pass for payment over there. Payment

made out." It is not necessary to spend hours, days, weeks, months of officer time investigating bank systems to come up with that conclusion.'[101]

11.2.7 When the Panel spoke to the JFSC, its Director General explained to the Panel that he saw a distinction that might need to be drawn between the likelihood of achieving identification of depositors and the validation of their claims. He told the Panel;

'It is certainly possible to identify the claims, yes. Verification, it depends how many layers you want to verify. Obviously if you want it triple-checked, then no. But the systems are capable of giving you the identification of the £50,000 or less depositors eligible….

Deputy M.R. Higgins:
Can I tell you that other regulators, others deposit protection schemes, have told us it is absolutely dotty, that is how they refer to it.

Deputy G.P. Southern:
The F.S.C.S. …. One of the things they said was, and we got information, that it was not compatible with our system. So the first thing you have got to say is: "You need to present us with data that is compatible with our systems, in order to do that we have to negotiate a suitable system." Again, that comes back to this: "And if you have not got a body set up to do that negotiation you are making life difficult for yourself in setting up of the whole thing." Again, it comes down to the detail. We appear to have built in some difficulties.

Mr. J. Harris:
I think the banks can produce that detail. The degree of verification I think is an open question, I agree with that… banks should be capable of doing that already. They should be capable of producing a software package or a software…data mining capability at the press of a button where they can take their eligible deposits out and produce them at any given moment. That can be replicated and reproduced at any given time and I do think a Jersey bank would be capable of doing that and should be capable of doing that. That is not the same, however - I fully acknowledge - as giving that to a third party and saying: "Right, now we need that to be verified in order to pay out £5,000

[101] Public Hearing, Minister for Economic Development and Officers, 28th September 2009

of claims." I do not think the funding is a problem; the verification may be the issue.'[102]

11.2.8

Key Finding:
The proposed aim for a seven day payout is currently unrealistic and undermines the credibility of the scheme.

11.2.9 Cross Border Asset Recovery

11.2.10 The Panel examined one of the key issues relating to the potential liability of the Jersey taxpayer within the proposed scheme, the issue of cross border asset recovery. The business model of the overwhelming majority of banks based in Jersey is that of a collector of funds to be upstreamed to an off island parent company. It is almost inconceivable that a bank failure in Jersey will occur in any other fashion than as a consequence of the failure of its parent company. As such, the recovery of deposits made locally is complicated by not only the upstreaming factor, in that a very low percentage of actual deposits may be left on island, but also by the sheer scale and complexity of a 'Top 500' parent bank failing in its home country.

11.2.11 The task of recovering the Jersey bank's upstreamed assets from the failed parent falls to the Viscount. The Panel spoke to the Viscount who explained to the Panel what his role would be in such circumstances and the planning that was in place for the scenario of a bank insolvency;

'...perhaps I ought to first say that conceptually this applies in Jersey as well, in most countries if you become an officeholder in insolvency the domestic law of the country concerned purports to give the officeholder universal title to the assets. So that if an insolvency is instigated in country A and there is a branch in Jersey, in normal circumstances - there are one or 2 exceptions - the officeholder would be authorised by his or her domestic law to recover all of the assets wherever they may be. Quite often that is a very sensible thing to do but there are lots of advantages of having one officeholder to protect the assets and the interests of creditors wherever they may be. One often sees

[102] Public Hearing, JFSC, 17th August 2009

protocols worked out to deal with different pockets of assets that are outside the mainstream.'[103]

11.2.12 He explained that in the insolvency field he has been advised on cross-border issues for 30 years by a leading firm of London lawyers who would back up local legal advice here and bring people over to ensure that he understood the issues arising from a banking law perspective. In addition, financial accounting expertise would be immediately parachuted in from larger firms. All of those necessary arrangements would be feasibly completed virtually immediately following notification of a failure, or indeed in advance as the Viscount anticipated prior warning of such a major failure, which would be absolutely crucial because of the way the financial markets are structured and time differences across the world.

11.2.13 Having established what expertise would be put in place and when in the vent of a bank failure the Viscount explained what duties would be fulfilled;

'In some ways every désastre is the same, it all requires certain things to happen. One has to advertise for creditors, there is essentially a moratorium on activity, the assets vest in the Viscount, one would have to deal with the bank P.R. (Public Relations) issues, media management and so on. All of that we would expect to take in. So what one would be attempting to do is to assess the asset situation to protect the assets, would be one of the first steps obviously, because there are no assets, there are creditors. One would be dealing with creditors, requesting them to submit their claims and one would begin to assess the international ramifications and to what extent there are cross-border issues, conflict of laws, points which would need to be resolved. I would be supported by local law firms as well, because there will be Jersey law issues as well as foreign law issues.'[104]

11.2.14 The Viscount was asked about the time that it may take to recover local assets from a bank failure and the rates of recovery that might be expected, and that the complexity of such issues with a bank failure may put the States liability at increased risk. The Viscount agreed that it may take years to recover the assets, and with

[103] Public Hearing, Viscount, 7th September 2009
[104] Public Hearing, Viscount, 7th September 2009

regard to asset recovery levels explained that this would be difficult to predict, but that this problem would apply to the failure of a bank in any jurisdiction.[105]

11.2.15 These matters were also raised with the Minister and his Officers, who discussed with the Panel the levels of expected recovery and how such rates mitigated against the possible risk of the States liability. It was acknowledged that it might be expected to take many years to complete the asset recovery process from a bank failure, but that this would be the case anywhere in the world faced with a large bank failure. The Finance Industry Development Executive explained how Oxera had estimated a 60% recovery rate;

> *'...which is lower than Landsbanki can expect to recover back and is considered to be quite a low estimate, actually, because banks, generally recover most of the assets …. if the sixth largest banking group went down and the total cost of the scheme after recoveries would be around £37 million, so the States would not even have to put anything in. After that, it would have ... if it was a larger banking group, it would be capped at £100 million. But that just goes to show that up to number 6 in terms of banking groups under normal recovery regime, the States would not have to pay out anything at all.'*[106]

11.2.16 The Minister also advised the Panel that a rate of over 60% recovery might be expected;

> *'With bank failures you tend to find reasonably high recoverable levels. Even Landsbanki, they are looking at 70% plus payout now.'*[107]

11.2.17 The Panel's adviser informed the Panel that there is no real science in recoveries on banks that fail around the world, and recovery rates vary considerably from one case to the other.

11.2.18 The complexity of the liquidation of a failed bank does raise a question as to whether or not it might be appropriate to explore a separate insolvency law for banks? The Viscount, for example, was asked whether in the case of a very large

[105] Public Hearing, Viscount, 7th September 2009
[106] Public Hearing, Minister for Economic Development and Officers, 2nd July 2009
[107] Public Hearing, Minister for Economic Development and Officers, 3rd August 2009

bank going down, as per the top 500 banks in Jersey, it would be difficult dealing with an insolvency of that type of bank. He acknowledged;

> *'It would be extremely difficult dealing with the insolvency of that type of bank.'* [108]

11.2.19 As outlined by the Panel's adviser, the factors that are working against a high level of recoveries by the JDCS are as follows:

1. *The JFCS is the host regulator for all but one of the banks licensed to operate in Jersey.*

2. *Banks licensed in the States of Jersey are often just collectors of deposits which are passed upstream to a parent. The loans to parents may be difficult to recover.*

3. *Addressing cross-border resolution issues remains one of the greatest challenges for deposit protection organisations as with no agreements on how to solve conflicts across borders, the risk of national interests being put ahead of the greater global good increases significantly.*

4. *The JDCS has no tools to minimise its exposure to losses. The JDCS will only become operational once a failure occurs. If the public becomes concerned about delays in accessing their deposits this will undermine financial stability and may bring down other banks.*

5. *At the time when Canada Deposit Insurance Corporation was a "pay-box" deposit insurer the losses they had were, on average, 51 cents on the dollar (when the mandate for CDIC was altered so that it became a loss minimiser their losses were 11 cents on the dollar).*

6. *The JFSC may not have enough tools to intervene in dealing with a problem bank.*

7. *Canada, the US, Malaysia and a number of other effective deposit insurers have early, structured supervisory frameworks.*

[108] Public Hearing, Viscount, 7th September 2009

8. *The cost of liquidating a failed bank is quite expensive. Based on experience in Canada, liquidation costs for a failed bank amount to at least 5% of the value of assets left in the estate of a bank.*

Based on the factors noted above it is quite possible that the £100 million cap will only be sufficient if the States of Jersey banking regulators have strong (Treaty-type) agreements with offshore banking supervisors, are able to stop the passing of funds upstream to a parent or offshore creditor, and they close the problem bank very quickly after they become aware that a bank is in danger of failing.

IADI Principle 7: Cross-Border

The recent credit crisis has shown that close coordination and information sharing among deposit insurers and other financial system safety-net participants is very significant from a cross-border perspective. Provided confidentiality is ensured, all relevant information should be exchanged between deposit insurers in different jurisdictions and possibly between deposit insurers and other foreign safety-net participants when appropriate.

11.2.20 The Panel's adviser also assessed the proposed scheme against the IADI Principle 7:

- *Are there any formal information-sharing agreements between JDCS and affiliated schemes in different jurisdictions?* ***No***

- *Are multiple reimbursements avoided in cases where both home and host countries provide coverage for foreign branches?* ***Unknown***

- *Are bilateral or multilateral agreements in place on the process by which depositors insured by two schemes in different jurisdictions will be reimbursed?* ***No*** [109]

[109] Patterson & Labrosse Financial Consultants, SoJ Submission 3, 9th September 2009

11.2.21

Key Finding:

There are significant cross border asset recovery concerns.

11.2.22

Key Finding:

There is no separate insolvency law for banks despite the likely complexity of the liquidation of a failed bank.

11.2.23

Key Finding:

Claims of high recovery levels from of a failed Jersey bank's parent company are untested and not guaranteed.

11.2.24

Recommendation:

A separate insolvency law for banks should be established.

12. APPENDIX 1 – EVIDENCE CONSIDERED

12.1 The following documents are available to read on the Scrutiny website (www.scrutiny.gov.je) unless received under a confidential agreement.

Documents

1. P87-2009 - DRAFT BANKING (DEPOSITORS COMPENSATION) (JERSEY) REGULATIONS 200- 2nd June 2009
2. P86-2009 DRAFT BANKING BUSINESS (DEPOSITORS COMPENSATION) (JERSEY) REGULATIONS 200- 2nd June 2009
3. P85-2009 - DRAFT PUBLIC FINANCES (DEPOSITORS COMPENSATION) (JERSEY) REGULATIONS 200- 2nd June 2009
4. P84-2009 - STRATEGIC RESERVE FUND- USE FOR BANK DEPOSITORS' COMPENSATION SCHEME - 2nd June 2009
5. P81-2009 Draft Income Tax (Amendment No 32) (Jersey) Law 200 - 2nd June 2009
6. Oxera Report - May 2009
7. Draft Financial Services (Banking Depositors Compensation Scheme) (Jersey) Order 200- (2003)
8. IADI - Core Principles for Deposit Insurance Systems- June 2009
9. Paul Tucker DCS Speech- June 2009
10. Illustration of DGS cost implications
11. Data re payout following insolvency – email – 1st July 2009
12. Isle of Man (IOM) – DCS
13. IOM - DCS guidance notes
14. Guernsey DCS (Ordinance) 2008
15. Guernsey DCS regulations 2008
16. Guernsey general guidance notes
17. Guernsey advisory leaflet
18. EDD Note on Guernsey DCS
19. UK Financial Services and Markets Act 2000 - Part 15 – FSCS
20. EDD notes FSCS rules (netting off assignment)

21. EDD notes amended FSCS rules
22. EDD DCS comparison table
23. EDD Report on Guernsey and IoM Depositors Compensation Schemes
24. Directive 9419EC of European Parliament & Council - 30 May 1994 on DCS's
25. EC DCS Amendment proposal - 08.10.15
26. EC DCS Amendment summary - 08.10.15
27. Jersey Banking Business Licensing Policy June 2009
28. Jersey banking sector – list
29. Jersey bank deposit data 2009
30. Jersey top 500 banks policy - source of data
31. FSCS Payout Reform – 27th July 2009
32. Press Release FSCS Payout Reform - ps09-11 – 27th July 2009
33. Oxera report - Feb vs. May 2009
34. IOM - guidance con DCS
35. Responsibilities of Minister re Board
36. Small business sector Jersey- 2008
37. Financial Directive 5.1 - engagement and use of consultants
38. DCS Schedule of Consultation 20th July 2009
39. British Bankers Association (BBA) minutes 23rd March 2009
40. FSCS minutes 30th April 2009
41. JBA minutes 18th March 2009
42. JBA minutes 21st May 2009
43. Email regarding consultation minutes – 28th August 2009
44. JBA Minutes 10th September 2008 AM
45. JBA Minutes 8th October 2008
46. JBA Minutes 12th November 2008
47. JBA Minutes 10th December 2008
48. JBA Minutes 21st January 2009

49. JBA Minutes 18th February 2009
50. JBA Minutes 18th March 2009 (2)
51. JBA Minutes 15th April 2009
52. JBA Action Log Sept 2009
53. JBA Email from secretary regarding minutes
54. JBA Minutes 21st May 2009
55. JBA Minutes 15th June 2009
56. Slides for JBA 9th April 2009
57. DCS - Bank thoughts regarding DCS November 2008
58. DCS - Deposits Data October 2008
59. DCS - Deposits September 2008
60. DCS – Monthly Statistics 0908
61. DCS - Balance Summary 0908
62. DCS – Profit and Loss Summary 09055 -8

12.2 Public Hearings held by the Economic Affairs Panel during the Depositor Compensation Scheme Review.

1. Witnesses:

Senator A.J.H. Maclean (The Minister for Economic Development)
Mr. M. de Forest-Brown (Director of International Finance)
Mr. J. Mews (Finance Industry Development Executive)

2nd July 2009

2. Witnesses:

Senator A.J.H Maclean (Minister for Economic Development)
Mr. J. Mews (Finance Industry Development Executive)
Mr. M. De Forest-Brown (Director of International Finance)

3rd August 2009

3. Witness:

Mr. D. Warr (Jersey Chamber of Commerce)

10th August 2009

4. Witnesses:

Mr. J. Harris (Director General, Jersey Financial Services Commission)

Mr. A. Le Brun (Director of International and Policy, Jersey Financial Services Commission)

17th August 2009

5. Witnesses:

Mr. J. Cook (Chief Executive, Jersey Finance Limited)

Ms. A. McFadyen (Chief Executive, Standard Chartered)

7th September 2009

6. Witness:

Mr. M. Wilkins (Viscount)

7th September 2009

7. Witness:

Mr. F. Barnes (Oxera)

25th September 2009

8. Witnesses:

Senator A.J.H. Maclean (Minister for Economic Affairs)

Mr. J. Mews (Finance Industry Development Executive)

Mr. M. De Forest-Brown (Director of International Finance)

28th September 2009

9. Witnesses:

Mr. M. Dun (Member of the public)

The Maha Chohan (Member of the public)

28th September 2009

12.3 Public Written Submissions:

1. Mr D. O'Neil	20th May 2009
2. Mr J. Conlon	10th September 2009
3. Mrs A. Richardson	16th September 2009
4. The Maha Cohan	28th September 2009

13. APPENDIX 2 – ADVISER SUBMISSIONS

13.1 The Panel engaged the following adviser to assist with the review:-

Mr John Raymond LaBrosse of Patterson and LaBrosse Financial Consultants Ltd, Canada

Professional Curriculum Vitae

John Raymond LaBrosse
Honorary Visiting Fellow
School of Law
University of Warwick
and
Partner
Patterson & LaBrosse Financial Consultants Ltd.
ray.labrosse@rogers.com

John Raymond LaBrosse is an international expert and advisor in the field of financial services with a principal focus on deposit protection. He was the founding Secretary General of the International Association of Deposit Insurers (IADI), housed in the Bank for International Settlements, and served in that role until 30 April 2008. The objects of IADI are to contribute to the stability of financial systems by promoting international cooperation and to encourage wide international contact among deposit insurers and other interested parties.

Mr. LaBrosse began his career at the Bank of Canada where he worked on banking and financial sector issues including the development of flow of funds data. During a 25-year career with the Government of Canada, Mr. LaBrosse served as a senior policy advisor on financial institution and markets issues in the federal Department of Finance, was a member of the team that negotiated the Canada-USA Free Trade Agreement and served in two postings as the Department's representative in New York. He was the Director of the Financial Institutions Division of the Department of Finance from 1988 to 1995 where he led several revisions of Canadian banking and payment system legislation (was the author of numerous Government of Canada

Cabinet Documents, White Papers and several policy position papers on financial sector issues, led the reform for two major revisions of the Bank Act and several other pieces of financial sector legislation (Trust Companies Act, Canadian Payments Association Act, the Winding Up Act, Canada Deposit Insurance Corporation Act, Office of the Superintendent of Financial Institutions Act, etc.).

In 1995-96, he was responsible for the Canada Savings Bond campaign which raised $3.2 billion. Prior to his appointment as the founding Secretary General of IADI, Mr. LaBrosse was Director, International Affairs, Canada Deposit Insurance Corporation and at the same time he was the Executive Director of the Financial Stability Forum's Study and Working Groups on Deposit Insurance which finalized its report in September 2001. Mr. LaBrosse has provided policy advice on the design of deposit insurance systems for a number of countries including Malaysia, Hong Kong (SAR), South Africa, Ukraine, Mexico, the Western Balkans, the UK, several countries in central Asia and China. Mr. LaBrosse is a member of the IADI Guidance Group Advisory Panel, a contributor and member of the Editorial Board of the Journal of Banking Regulation, an Honorary Visiting Fellow at the University of Warwick Law School and Partner in a financial consulting firm.

Publications:

Bank Insolvency, an International Guide for Deposit Insurers, Insol International, January 2005.

Guest Editor of the October 2006 Special Issue on Deposit Insurance of the Journal of Banking Regulation.

"Contingency Planning: A Practitioner's Guide Drawing from Lessons Learned in Dealing with Banking Failures" Journal of Banking Regulation, October 2006.

Co-author of Deposit Insurance published by Palgrave in June 2007.

Editor of the proceedings from the Federal Reserve Bank of Chicago Ninth Annual Conference.

Co-author of International Financial Instability: Global Banking & National Regulation published by World Scientific in October 2007.

"Time to Fix the Plumbing: Improving the UK Framework following the Collapse of Northern Rock", Journal of Banking Regulation, August 2008.

"International Experience with Deposit Protection Guarantees: A review of practices and recommendations by international organisations", prepared for The Consumer Panel, Financial Services Authority, United Kingdom, September, 2008.

Co-author of “A new Standard for deposit insurance and government guarantees after the crisis”, with Andrew Campbell, David G Mayes and Dalvinder Singh, Journal of Financial Regulation and Compliance, June 2009.

Co-author of “Northern Rock, Depositors and Deposit Insurance Coverage: Some Critical Reflections”, with Dalvinder Singh, Journal of Banking Law and Finance Review (forthcoming).

“International Experience and Policy Issues in the Growing Use of Bridge Banks”, *(forthcoming)*

Mr. LaBrosse organized a Symposium on “Banking Crises and Resolution” that was held on 16-17 April 2009 at the University of Warwick. The papers from the Symposium will be included in a book entitled Banking Crisis and Resolution that will be available in October 2009.

From May 2008 to April 2009, Mr. LaBrosse was engaged by one of the world’s leading professional firms and provided advice to a number of countries on deposit protection, bank restructuring and other financial sector issues.

Mr. LaBrosse has a BA and MA (Economics), both from the University of Calgary.

13.2 Document One was submitted by Mr J. R. LaBrosse on 25th August 2009:

DOCUMENT ONE

Considerations on Using Deposit Guarantees to Provide Depositor Protection

Introduction

The Great Recession of 2008-XX was preceded by a substantial period of financial turmoil which saw losses on US-originated bank assets amount to over US$2 trillion[1] in what could be termed The Great Financial Crisis of 2007-XX. The economies of the advanced countries and most trade-dependent emerging economies went into a deep recession. The US, some major European countries, the UK, Japan and China have together undertaken stimulus packages totalling close to US$2 trillion. Although it is still reverberating through the world, the extent of the problems has underscored how the business of intermediation has changed. All of this has provided some sobering lessons about the implications for financial stability which financial safety net players, including deposit insurers, must address in order to strengthen regulatory and supervisory practices, going forward.

Deposit insurance systems (sometimes called deposit protection, depositor protection or deposit guarantee schemes) have become an integral part of the apparatus of prudential regulation and supervision across many parts of the globe. There is considerable debate in the literature as to the usefulness of such measures especially when it comes to matters like moral hazard, the potential exposures of taxpayers and the degree of consumer protection that such arrangements can provide. However, when properly designed, appropriately implemented and well run, effective deposit insurance systems contribute to financial stability. Unfortunately, not all deposit insurance systems fall into that category. The purpose of this paper is to explore how deposit guarantee systems in Europe have generally worked in mitigating systemic risk and protecting individual depositors and their prospects in assisting the creation and operation of the single markets. As noted in a recent paper, a cynical colleague pointed out that the European Deposit Insurance Directive merely spells out the minimum characteristics that a deposit insurance regime should have. He noted that there is no requirement that it should actually work nor, indeed, any requirement that it should be constructed so that people believe it will work. Our colleague added that no one would have believed that the Icelandic scheme could cope with failures of its major banks yet their schemes were fully compliant with the Directive before the failures of October 2008.[2]

This paper is organised as follows. In Section 1, we look at the financial system safely net and its role in promoting financial stability. Next, consideration is given to the role of deposit insurance in contributing to financial sector stability by drawing on international work in the area before we examine important design features of effective deposit insurance systems in Section 3. In Section 4, we examine deposit insurance systems and their track record in dealing with the financial crisis. In Section 5, there is a focus on deposit guarantee systems that are prevalent in Europe by first looking at the EC Directive and then some specifics regarding the handling of *Northern Rock plc*. Some conclusions are reached in the final section of the paper.

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[1] Sabourin, JP, Keynote Address at the University of Warwick, Symposium on Financial Crisis Management and Bank Resolution, April 2009. More details on the crisis can be found in International Monetary Fund, "World Economic Outlook Financial Stress, Downturns, and Recoveries" (2008).

[2] Campbell, A, J R LaBrosse, D G Mayes and D Singh, "A new Standard for Deposit Insurance and Government Guarantees, *Journal of Financial Regulation and Compliance*, V.17, N.3, 2009.

Section 1 – The Financial System Safety Net

Public confidence in a banking system's soundness plays an important role in financial system stability. In normal times, tools such as deposit insurance[3], the promotion and use of appropriate standards of sound business and financial practices, and an effective bank closure mechanism help reduce the adverse consequences of a failed bank. It is understood that banks[4], like other firms, will fail and the likelihood of this happening is higher when risks in a banking concern are not managed appropriately or when financial markets are very fragile. The orderly resolution of weak or failing banks plays an important role in maintaining public confidence and minimising the risk of contagion. While it is preferable that private sector solutions, such as mergers, be pursued to deal with problem or failing banks, at the same time, there is a clear need for explicit deposit protection, coherent contingency planning, risk assessment and crisis management within a sound and transparent bank resolution and restructuring framework. These matters are important as the public needs to know the benefits and limitations of the guarantee of the funds that they entrust with banks.

As LaBrosse and Mayes (2007) explain, bank regulation in most countries encompasses a lender of last resort, deposit insurance and supervision.[5] Governments also play a very important role most often seen in a political context by setting the framework, mandates, roles and responsibilities of the financial system safety net players through advice provided by staff of the Treasury/Ministry of Finance. These four functions are interrelated and, therefore, each in their own way contributes to the moral hazard created by the financial safety net. In support of strong prudential regulation and supervision there needs to be a clear and transparent closure regime. Some countries, notably Canada, have done this by developing and promoting appropriate standards of sound business and financial practices that acknowledge the need to allow institutions to compete effectively and take reasonable risks.[6] Those standards note that management and boards of directors are ultimately responsible and that financial institutions can fail. The Canadian authorities have taken an additional step in publishing a *Guide to Intervention* [7]which outlines in detail the steps that the supervisor and the deposit insurer will take through the 'life cycle' of a bank. The *Guide*, supported by the standards of sound business and financial practice makes it explicit that one of the functions of the supervisor is to close a 'troubled' bank. The existence of such policies is a key factor in providing incentives to bank management so that they operate prudently.

Deposit insurers need to be able to act to minimise losses even when the supervisor would be prepared to allow a problem bank to continue to operate. In plain and simple terms someone has to be able to make the judgment at that point. And, there is more than one way to do this; by executive action for example, with the banking licence being revoked or by application to the courts for power to appoint a firm or an individual to oversee a fair liquidation or resolution process. Whichever way it is done, the action has to be immediate

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[3] From this point onward, the term "deposit insurance" means "an effective limited-coverage deposit insurance system".

[4] The term bank or banks in this paper means any deposit-accepting financial institution.

[5] LaBrosse, J R and D G Mayes, *Promoting Financial System Stability through Effective Depositor Protection: The Case for Explicit Limited Deposit Insurance,* in Campbell, LaBrosse, Mayes and Singh (eds.) Deposit Insurance, Palgrave Macmillan, Houndmills, Hampshire, 2007.

[6] The legislation governing the Office of the Superintendent of Financial Institutions in Canada recognizes that management, boards of directors, and plan administrators are ultimately responsible and that financial institutions can fail. Please see the Report of the Superintendent Management Framework located at: http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?ArticleID=2923.

[7] Please see: http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?ArticleID=537@criteria=guide%20to%20intervention&templateID=2.

benefit of countries considering the adoption or the reform of an explicit, limited-coverage deposit insurance system. It first presents the contextual issues related to different forms of depositor protection and identifies the issues that need to be addressed when adopting or reforming a deposit insurance system. It then sketches out the design features that help to ensure the effectiveness and credibility of a system, and finally outlines the key issues and considerations involved in resolution options, the reimbursement of depositors, and claims and recoveries. It is the conviction of the FSF that this report, with such a pragmatic approach, will serve its role as a useful tool for policy makers who want to design deposit insurance systems that preserve the benefits of heightened financial stability and small depositors' protection, without at the same time increasing moral hazard or reducing market discipline."[12]

Section 3 – Important Design Features of Effective Deposit Insurance Systems

There is a wide spectrum of deposit insurance systems ranging from narrow systems, such as "pay-box" systems, to those with broader powers and responsibilities, such as "risk-minimisation" systems and the individual features are discussed at length in *The Sabourin Report* and related documentation.[13] It is clear, therefore, that deposit insurers can perform a range of functions depending on their mandates. Pay-box systems, like the UK Financial Services Compensation Scheme (FSCS), largely confine themselves to paying claims of depositors well after a bank is closed. Deposit insurers in risk-minimisation systems, by contrast, have much broader mandates which may have features, such as the power to control entry into and exit from the system, the ability to assess and monitor risk, the authority to impose risk-based premiums and to conduct examinations of banks or request that their affairs be examined. Risk-minimisation systems may also have the power to provide limited financial assistance to problem banks and may have intervention powers that can influence decisions on how to treat the symptoms of a problem bank. Indeed, some risk- or loss-minimisation systems may be charged with resolving bank failures, including finding least-cost solutions in resolving a bank failure or creating a bridge bank.

The most common policy objectives of deposit insurance systems are to protect and reassure depositors and thereby contribute to financial system stability.[14] A survey undertaken by Canada Deposit Insurance Corporation (CDIC) revealed many different types of governance structures among deposit insurers.[15] Legally separate organisations, relying on a board of directors or governing committee, are quite numerous, although a number of countries have opted for establishing their insurer as a department of the central bank, banking supervisor or government. Government administered systems, like the Federal Deposit Insurance Corporation (FDIC) tend to be the most common of those surveyed, followed by those which combine characteristics of public and private systems.

Most jurisdictions require compulsory membership in the deposit insurance system to avoid adverse selection and include only institutions subject to effective supervision and regulation. In general, most systems cover demand and savings deposit products and exclude certain non-deposit products and accounts owned by so-called sophisticated

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[12] FSF Working Group on Deposit Insurance, 2001, Forward to the Final Report.

[13] See Financial Stability Forum Working Group on Deposit Insurance, Guidance for Developing Effective Deposit Insurance Systems: Final Report of the Working Group on Deposit Insurance, Basel, 2001, plus Volume II compiled by J R LaBrosse as Executive Director of Study and Working Groups published in CD format and available on the CDIC Web site www.cdic.ca

[14] Other objectives include: enhancing the orderly resolution of financial institution failures, protecting payment systems, and contributing to the reduction of financial crime.

[15] The survey was devised by J P Sabourin, J R LaBrosse and D K Walker at Canada Deposit Insurance Corporation and is available at www.cdic.ca .

depositors; those individuals who are deemed capable of ascertaining the financial condition of a bank or who have the resources to purchase such information.

Funding is provided in many ways for deposit insurance systems through government appropriations, premiums, levies, government/market borrowing or a combination thereof. The majority of systems charge *ex ante* premiums as a way to build-up a fund, but retain the authority to charge levies or impose other charges on their members if required. A "best practise" identified by the Financial Stability Forum is to target fund or target fund ratio.[16] Constructed appropriately, *ex ante* systems offer a much higher degree of credibility than systems that rely on *ex-post* levies.

Section 4 – Deposit Insurance Systems – What Has Been Their Track Record in Dealing with the Financial Crisis?

Deposit insurance systems are not the "mother of all evils" nor are they the "father of all solutions". We know that deposit insurance systems are not designed, and therefore should not be expected, to deal with a financial crisis. Those situations are the responsibility of governments but deposit insurers that have the authority to act can play an important role in calming the public in the midst of bank failures. Let's examine this area in some detail.

In financial mathematics and financial risk management, Value at Risk (VaR) is a widely used measure of the risk of loss on a specific portfolio of financial assets. For a given portfolio, probability and time horizon, VaR is defined as a threshold value such that the probability that the mark-to-market loss on the portfolio over the given time horizon exceeds this value (assuming normal markets and no trading in the portfolio) is the given probability level. For example, if a portfolio of stocks has a one-day 5% VaR of $1 million, there is a 5% probability that the portfolio will fall in value by more than $1 million over a one-day period, assuming markets are normal and there is no trading. Informally, a loss of $1 million or more on this portfolio is expected on one day in 20.

Deposit insurance systems should be designed to operate effectively in normal times in the same way that airbags in automobiles are expected to operate at better than 95% of the time. It would not be useful, for example, to have a VaR measure for a passenger airbag that works 95% of the time; unfortunately the other 5% includes the time when the driver has an accident.

The Great Financial Crisis of 2007-XX is teaching us some lessons in the area of depositor protection and systems that support it. According to Sabourin (2009) there are two lessons that are very important.[17] First, the financial exposure for deposit insurers is much larger than ever before. He notes that, "interconnectivity, globalisation, the size of the non-traditional banking system as well as supervisory capacity over a dynamic and modern banking system are some of the drivers of this change". Yet, Sabourin adds that deposit insurers remain largely passive players in most regulatory frameworks. Many are pay-box systems and as such issues like funding for deposit insurers and credibly remain major concerns; the ability of deposit insurers to meet payout obligations in a short period is dependent on ready access to appropriate levels of funding. Unless it can be demonstrated clearly that deposit insurers have access to sufficient funds in the event of a payout, the credibility and the role of the deposit insurers to maintain confidence is seriously affected.

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16 Report of the FSF Report of the Working Group on Deposit Insurance. Please see n. 13.

17 Sabourin, J P, Keynote Remarks at the Warwick Symposium on Financial Crisis Management and Bank Resolution, April 2009 and available in Financial Crisis Management and Bank Resolution, John Raymond LaBrosse, Rodrigo Olivares-Caminal and Dalvider Singh, Informa Law, 2009.

Secondly, Sabourin maintains that deposit insurance operational readiness to address issues, such as how and when depositors can be reimbursed has to be greatly enhanced and publicised. During the crisis, promises were made that payouts would be conducted speedily within days. Depositors would, therefore, expect deposit insurers to deliver on those promises to maintain public confidence. Unfortunately, he notes that many deposit insurance systems cannot be relied upon to meet their depositor's obligations if they are ill-conceived, lack contingency planning to do so, and lack funding. This, Sabourin notes, is a major risk to any financial system.

Section 5 – How have European Guarantee Schemes Faired in the Recent Past?

To answer this question we will look first at the EC Directive and then to the FSCS particularly in its dealing with *Northern Rock plc*.

(i) The EC Directive

Singh and Walker (2009)[18] note that the EU model is based on guarantee arrangements, rather than an insurance model as adopted by the North Americans and a number of other jurisdictions. The EC Directive provides certain assurances that will protect the interests of depositors up to a certain limit and make a payout within a designated period of time. The lack of rules to guide Member States on how such guarantees should be funded, for instance, means that how it will achieve them is left to the individual Member States. European systems are therefore distinct from insurance systems found in many other parts of the world where *ex ante* premiums through contingency planning are set and calculated according to the risk posed to the deposit insurer.

The authors further note that schemes in the EU model will not be sufficiently funded and attempts to fund such arrangements *ex post* run the risk of banks being unable to make the appropriate contributions. This would inevitably mean the state would have to intervene to cover the losses of depositors with taxpayers' money. In light of these issues, insurance systems such as the one operating in Canada have sought to also include in their toolkit the capability to manage bank risk by having the powers to construct differentiated *ex ante* premiums and to apply a surcharge to incentivise banks to rein in their risks. The EU arrangements run the risk of significant political interference once confronted with a bank failure by having in place a guarantee scheme rather than an insurance system. They conclude that the EU deposit protection schemes lack sufficient standards on funding so need to go *via* political bodies to get the appropriate funding agreed rather than exercise their own administrative powers to access funds.

The Council of the European Union agreed on 7 October 2008 that its priority was to restore confidence and the proper functioning of the financial sector by reforming, *inter alia*, deposit protection. It committed itself to take all necessary measures in light of the magnitude of the crisis to protect the deposits of individual savers and supported the intention of the Commission to bring forward urgently an appropriate proposal to promote convergence of deposit guarantee schemes. The three areas that were addressed were: an increase in the minimum coverage level; a reduction of the payout delay to a maximum of three days; and termination of co-insurance. So far, only two of those three points have been addressed in a constructive way.

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[18] Singh, D and D K Walker, "The EU Deposit Guarantee Scheme: An Appraisal of the Reforms", in Financial Crisis Management and Bank Resolution, Ibid.

Walker and Singh also note that cross-border issues have also risen to the forefront in the EU as a result of the financial crisis. The EU deposit guarantee schemes not only cover depositors in the Member State where the bank is authorised (home country), but also depositors at the bank's branch in another Member State (host country). If the host country's scheme offers a higher level of coverage than the home country's scheme, the branch may also join the host country's scheme to offer the same coverage as the banks that are authorised in the host country. Whether or not the bank joins the host country's scheme, it is essential in this home and host state relationship for both schemes to cooperate with each other to ensure effective depositor reimbursement.

A lack of coordination during the recent financial crisis clearly undermined financial stability and contributed to capital flight in some regions. In addition, in certain jurisdictions issues arose when it was not clear which deposit insurer should be responsible for the reimbursement process. These problems exposed the branching rights under the single passport regime that place responsibility on the Home State for supervision. The adoption of risk-based premiums is one technique to reduce the risks the single passport regime gives rise to in the host state. If properly implemented, the risk-based premium system could reduce cross-border exposure if the premium is calculated on a consolidated basis to give a more accurate measurement of the risk a bank poses to not only the home but also the host member state. This could go some way to avoid decoupling the EU single passport regime. Another measure would be to ensure that deposit guarantee funds are risk proofed. My recent thinking in this area is that the fund should be large enough to cover the losses from the failure of two small banks or one medium-sized bank. The resources to support risk proofing can be obtain through a combination of *ex ante* premiums and government-supported borrowings.

(ii) The FSCS – Inadequate Coverage or Poor Public awareness, or Both?

These questions are addressed in detail in Singh and LaBrosse (2009) where we note that the FSCS does not have a mandate to participate in crisis resolution in any meaningful way.[19] The overall management of the compensation scheme is complex and somewhat curious. The Financial Services Authority (FSA) was required to set up the scheme but is not responsible for its administration.[20] Responsibility for operating and administering compensation is placed on the shoulders of a separate corporate body, the Financial Services Compensation Scheme Ltd, which has deemed itself a 'fund of last resort'.[21] It handles compensation claims relating to accepting deposits, designated investment and insurance business, insurance mediation and mortgage advice/arranging, all regulated by the FSA.[22] However, the FSCS, although it has separate legal personality, is not an independent body as it lacks its own rule-making powers, nor is it placed on an equal

[19] D Singh and J R LaBrosse, "Northern Rock, Depositors and Deposit Insurance Coverage: Some Critical Reflections", *Journal of Business Law*, forthcoming. The role of the FSCS in dealing with a bank run contrasts sharply with deposit protection agencies in other countries. In Taiwan, for example, Central Deposit Insurance Corporation has developed a standard operating procedure to control bank runs based on their experience with 58 runs. According to Ray B. Dawn, former chairman of CDIC, in his remarks at the Sixth Annual IADI Conference in Kuala Lumpur, Malaysia, bank runs usually last for three days. In terms of demographics, the depositors were females, 30–50 years old, and had funds in the bank below the coverage limits.

[20] COMP 1.1.5G.

[21] See www.fscs.org.uk/.

footing to the FSA in terms of dealing with issues that may arise.[23] It is for all intents and purposes reliant on the FSA to confer responsibilities that it can effectively exercise, and not to place an undue constraint on the FSCS to raise sufficient funds to meet the costs incurred in discharging its duties.[24]

The FSA and FSCS are required to cooperate with one another in such matters as sharing information and dealing with issues that will give rise to public scrutiny.[25] But, we note in our article that the *Northern Rock* episode brought to the fore the inadequacy of the coverage of the compensation system operating in the UK. It also highlighted the lack of a clear public profile for the FSCS and the UK compensation scheme, albeit the FSA did attempt to calm the situation. Nevertheless, it needed to be more proactive on the issue of consumer awareness regarding depositor compensation matters, rather than simply posting pieces of news on its website and dealing with individual enquiries. It also brought to the attention of the authorities the unwillingness of bank customers to take any loss to their savings if they could help it, highlighting the fragility of co-insurance, especially when the maximum limit is so inadequate, as the UK coverage was before Northern Rock. The news coverage on this subject was to say the least ambiguous at times, again resulting in the public not really knowing the extent of the protection scheme.

The extended coverage to £35,000 maximum is to some extent a step in the right direction.[26] However, the initial proposal by the government of a limit of £100,000 was simply a political move to assure depositors and indeed voters that it was willing to take all necessary steps to avert such a crisis happening again.[27] The sceptical view is aptly highlighted by Campbell: 'A government which is perceived as having taken no action to prevent the failure of a bank may find that its popularity with voters has diminished and this could, of course, have an adverse effect on its chances of re-election.'[28] What *The Times* interview with the Chancellor of the Exchequer did highlight is the inadequacy of consumers' perception of the risk to deposited money in a bank. This in stark contrast to the level of awareness of such risks in other jurisdictions: in the US the system of consumer education is much more ingrained and systemic, and high profile when it comes to deposit insurance.[29] Indeed, other jurisdictions that experienced financial crisis in the late 1990s have even gone so far as producing television commercials to explain the existence of deposit insurance – for example Malaysia. The move towards a maximum of £50,000, was certainly necessary to reduce the likelihood of consumers queuing outside a bank. However, it can only work if the right systems are in place to ensure payments are made as quickly as possible, otherwise no maximum limit will really be effective.

As LaBrosse (2008) notes there are compelling reasons for establishing an operationally independent FSCS with an explicit mandate to provide depositor protection.[30] First, and foremost, the public believes that the funds that they entrust to a bank are as safe as

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[22] FSCS sub-schemes, available at: www.fscs.org.uk/industry/sub-schemes/.

[23] The exception noted is its powers under company law to raise finance; see COMP 1.2.1G and 1.2.2G.

[24] Memorandum of Understanding between the Financial Services Authority and the Financial Services Compensation Scheme, available at http://www.fsa.gov.uk/pubs/mou/fsafscs.pdf.

[25] Ibid., para. 12.

[26] FSA (2007) 'Compensation scheme to cover 100 % of depositors' claims up to £35,000', press release FSA/PN/105/2007, 1 October, available at: www.fsa.gov.uk/pages/Library/Communication/PR/2007/105.shtml.

[27] *The Times*, '£100,000 guarantee to cover all savers', 22 September (2007), at p. 1.

[28] A. Campbell, 'Bank insolvency and the interests of creditors', *Journal of Banking Regulation*, 7, (2004) p. 133, at p. 133.

[29] Federal Deposit Insurance Corporation (FDIC) consumer information about deposit insurance is available at www.fdic.gov/consumers/consumer/index.html.

[30] LaBrosse, J R, "Time to Fix the Plumbing", *Journal of Banking Regulation*, 2008.

money in their wallets[i]. In practice, current accounts and non-term deposits are clear substitutes for cash. As a result, depositors have a clear expectation to be reimbursed within defined limits when a bank fails. But, in the UK, the Authorities have chosen to provide depositors with a system of compensation. As demonstrated in the *Northern Rock plc* case, the run was caused by the withdrawal of large deposits which caused heightened media coverage which soon led to retail depositors lining up to get at their funds. Most certainly, the power of the media cannot be discounted.

Second, financial system safety nets operate better when there are a number of "checks and balances" in place. There are many excellent examples of effective financial safety net arrangements and the situation that exists in Canada is a good example. Trying to balance different objectives within one organization (as now exists in the UK in the way in which the FSCS effectively reports to the FSA) is difficult and oftentimes counterproductive. The decisions to be made are likely to be better, and more acceptable to the public, and to those directly affected, if they reflect two independent assessments rather than one. How and when to intervene in dealing with a troubled institution is a matter of judgement and such difficult decisions have a substantial impact on the cost of depositor protection (and potentially on taxpayers). The "cost of getting it wrong" will far exceed the routine reporting and administrative costs associated with regulatory or depositor protection services.

Third, by establishing an independent FSCS there will be important benefits for the Government. With an "arms length" relationship the Chancellor would be insulated in matters such as premium settings, the timing of interventions, how depositors and other creditors are treated, and issues arising from the disposition of assets.

Fourth, organisations such as the IMF view separate, independent depositor protection agencies that are accountable and transparent with more integrity and credibility.

Section 6 - Conclusions

Central bankers are learning that the pursuit of price stability does not guarantee financial stability.[31] As such, many central banks are looking to add financial stability as one of their objectives. Prudential regulatory agencies are finding that their first line of defence must be better regulation. Accordingly, attention needs to focus on better capital rules with earlier and measured intervention strategies. The Great Financial Crisis of 2007-XX has shown that some deposit protection agencies have better deployed the tools in their toolkits. Therefore, it is timely to rethink the role of deposit insurance.

When properly designed, appropriately implemented and well managed, effective deposit insurance systems contribute to financial stability. Experience has shown that deposit insurance and financial stability are more tightly bound than what may have been appreciated. Effective deposit insurers have met expectations almost all the time in most jurisdictions around the world. But, the track record for the European deposit guarantee arrangements is much less impressive. Most of those systems are not credible as they lack funding arrangements that allow the deposit protection agency to institute an incentive-based *ex ante* premium system. Most of the European deposit guarantee agencies are not integral parts of the financial system safety net as they lack the authority to act independently. In many European jurisdictions the agencies are not funded in a way to handle a bank failure of almost any size, the public is unaware of the benefits and limitations of the protection of their bank deposits and many of the Member States rely on foreign supervisors to do their job for them.

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31 Remarks of Mark Carney, Governor of the Bank of Canada to the Jackson Hole Symposium organised by the Kansas City Federal Reserve Bank, 22 August 2009.

Cross-border issues are growing in importance in all parts of the globe and most particularly in Europe in the context of the growing single market. Consistent with the view that the best line of defence is better regulation then deposit protection agencies particularly those in Europe need to: revamp their funding arrangements to include *ex ante* premiums; institute formal government back-stop arrangements to promote their credibility; institute public awareness programmes so that the public understands the benefits, and limitations, of deposit protection; and, improve the coordination of the responsible agencies to avoid decoupling the EU single passport regime.

Campbell, LaBrosse, Mayes and Singh (2009) point out that blanket guarantees were instituted in many countries and government participation[32] in banks reached a very high level during The Great Financial Crisis of 2007-XX.[33] We note that it is time for deposit insurers to adopt standards respecting membership, coverage and funding. Considerable work also needs to be done to promote public awareness of deposit protection in virtually all jurisdictions and especially in the case of the guarantee systems in Europe. From recent experience we have seen that the European guarantee systems don't seem to work especially when accidents happen. It is time to make some important changes and re-think the role of deposit insurance and the key features of deposit guarantee systems.

32 It was reported in the *Financial Times* on 23 August 2009 that Governments around the world are still sitting on multi-billion dollar losses from their direct shareholdings in banks, in spite of a strong rebound in equity markets in recent months. In contrast to Switzerland which sold its 9% UBS stake for a SFr1.2bn ($1.1bn) gain last week, the world's other large economies – except the US – are sitting on combined losses of $10.8bn relating to their holdings in the equity of listed banks they bailed out over the past 12 months.

33 Campbell, A *et al. op cit.*

12.3 Document Two was submitted by Mr J. R. LaBrosse on 27th August 2009:

DOCUMENT TWO

Issue

By way of an email from Charlie Ahier received on 25 August 2009 I was asked to take a look at the funding mechanism for the proposed scheme and assess: the *ex-ante* basis; the capping; and the effective underwriting of the scheme by the Jersey government.

I Background Considerations

Sound funding arrangements are critical to the effectiveness of a deposit insurance system and to the maintenance of public confidence in it as well as confidence in the banking system itself. Inadequate funding can lead to costly delays in resolving failed banks and to the loss of credibility of the deposit insurance system. To that end the International Association of Deposit Insurers (IADI) produced in May 2009 a Guidance Paper that examines various approaches to funding used by deposit insures and suggested guidance on the design of funding mechanisms and closely related features of deposit insurance systems.[1]

(i) IADI Guidance

The following guidance points set out IADI Core Principles and Supporting Guidance for the funding of deposit insurance systems.

Sound funding arrangements are critical to the effectiveness of a deposit insurance system. A deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims. *Ex-ante* funding requires the accumulation and maintenance of a fund to cover deposit insurance claims and related expenses prior to a member bank failure. In an *ex-post* system funds are obtained only once a bank has failed; banks are assessed and contribute at that time.

Member banks should pay the cost of deposit insurance since they and their clients directly benefit from having an effective deposit insurance system. Recent IADI research indicates that *ex-ante* funding has many more advantages than disadvantages particularly with respect to ensuring prompt reimbursement to insured depositors, the maintenance of public confidence and as a means to avoid the pro-cyclical effects of deposit insurance assessments.1.

Supporting IADI Guidance Points

1. Policymakers can choose among *ex-ante*, *ex-post* and combined (i.e. hybrid) approaches to funding, but *ex ante* and hybrid approaches are recommended in most circumstances and in particular for newly established systems.

2. In assessing premiums, the assessment base and the assessment criteria must be clear to all participants.

[1] The full text of the IADI Guidance Paper on Funding is available at: http://www.iadi.org/docs/Funding%20Final%20Guidance%20Paper%206_May_2009.pdf

3. When considering adopting a differential (risk-adjusted) premium system, measures should be taken to ensure that the necessary sources of information are available to fully support the operations of the system.
4. A deposit insurance reserve fund can be built-up and maintained in at least two ways. One approach is to employ a steady premium rate over a long period. Alternatively, the premium system can be designed to maintain a target reserve ratio or range. In cases where a target reserve ratio is used, it is an effective practice to ensure that the target reserve ratio is sufficient to cover the potential losses of the insurer under normal circumstances and reduce the probability of the fund's insolvency to an acceptable minimum.
5. A wide range of factors need to be taken into account for the target reserve ratio approach. These include: characteristics of the banking sector such as the number and size of banks, the liabilities of member banks and the insurer's risk exposure to them, the likelihood of failures and the characteristics of losses typically experienced by the insurer.
Deposit insurers can find themselves exposed to unexpected developments that can have a bearing on funding adequacy.
6. In cases where funds are accumulated in excess of targeted reserve requirements, the deposit insurer should consider developing a disbursement mechanism for surplus funds. Such a mechanism should take into account factors such as the assessment base of each bank, past contributions to the fund and the risk profiles of member institutions.
7. Should there be more than one type of financial institution that accepts deposits, it is an effective practice to consider having either one overall fund for all institutions or a separate fund for each category of institution. In the latter case it is necessary to ensure that the system does not introduce competitive distortions.
8. A deposit insurer should ensure that its funds are well managed and readily available to cover losses as they arise. This can be accomplished by implementing appropriate investment policies and procedures, and by instituting sound internal controls, risk mitigating practices, disclosure and reporting systems.
9. A deposit insurance system should have a means of obtaining supplementary back-up funding.

(ii) IADI Recommended Approach

IADI is not in the practice of making recommendations but the Funding Guidance Paper is highly suggestive of a preferred approach. The paper notes that hybrid funding combines features of both *ex ante* and *ex post* funding. It incorporates an *ex ante* fund financed by premiums and contributions and includes a mechanism to obtain funds *ex post* from member institutions, through special premiums, levies or loans, should they be needed.

Hybrid funding systems are, in fact, relatively common. An *ex ante* deposit fund may be established and the insurer be empowered to levy *ex post* contributions to make up for any fund shortfall. With *ex ante* funding, under very adverse circumstances, such as a large failure or a systemic crisis, losses may exceed the fund's reserves and a temporary increase in premiums or access to emergency (e.g. government) lines of credit may be appropriate. Thus, in practice, the real choice may not be between pure *ex ante* and *ex post* funding, but the relative extent to which the deposit insurance system relies on each.

(iii) Trade-offs Regarding *Ex ante* and *Ex Post* Funding

IADI guidance notes that *ex ante* funding has several advantages. Firstly, it ensures a readily available pool of funds enabling prompt disbursement to insured depositors. Secondly, it is fairer to collect premiums before a failure rather than after since all members, including failed institutions, would have helped cover the costs of the system.

Thirdly, *ex ante* funding avoids the pro-cyclical effect of *ex post* funding. Finally, the existence of a fund that can reimburse depositors reinforces public confidence in the deposit insurance and banking systems. On balance IADI notes that *ex ante* funding seems to be a better mechanism for achieving the goals of a deposit insurance system.[2]

(iv) Sources of Funds for Deposit Protection Agencies

The sources of funds for a deposit insurance system, especially for those covering depositor reimbursements, resolution costs and current expenses can come from the public sector, the private sector or both. Most countries operate a system that relies on private funding to a large extent.

(a) Private Sources

IADI notes that member institutions should be the main source of funding. As such, institutions usually pay mandatory premiums as one of the conditions of membership. Premium amounts are typically determined relative to either the insured deposit base or the total deposit base. Policymakers in countries which use insured deposits as a basis for determining premiums are usually of the view than others. On the other hand some claim that using total deposits has the advantage of ease of operation and can prevent speculative switches by banks between insured and uninsured deposits. To top up a fund following a failure, it may be necessary to introduce special assessments or levies.

(b) Public Sources (Underwriting the Deposit Protection System by the Government)

In addition to premiums collected from members, most deposit insurance systems have facilities in place that can access public sector funds if needed. These can take the form of initial contributions when the system is established, government or central bank loans to cover special circumstances and grants to cover losses.

A number of countries have relied on government funds for an initial capital injection to establish the system, for example, the US, Russia, and Chile among others. Since the promotion of financial system stability and the operation of a financial safety net are important government objectives which benefit the country as a whole, it can be argued that it is appropriate for the public sector to give the system some financial support by providing some initial capital to establish a fund and/or by providing supplementary funding or going even further in in crisis situations. The government can provide contingent financing even for systems which are financed *ex ante*. Some deposit insurers have a line of credit with central bank or with the government directly. In some cases the government may play an indirect role by guaranteeing private sector borrowing by the deposit insurer.

Generally speaking, it is less expensive for the insurer to obtain funds from the public sector than from the private sector, since given its credit rating, the public sector can usually raise funds at lower cost. In addition, it may be difficult to raise funds directly in the private sector during crisis situations. Supplementary financing from the public sector or borrowings with government guarantees should be repaid in full as the fund recovers. If needed, special levies on members can be introduced as the financial system strengthens. Procedures for accessing public sources of funds, should these be required, need to be considered at the

[2] See Annex 1 for a summary of the trade-offs between *ex ante* and *ex post* funding.

time the deposit insurance system is designed. The system should not be designed in such a way that the expected recourse to public support is frequent, since this can undermine public confidence in the system and encourage unnecessary risk-taking by member institutions.

II An Evaluation of the Approach Being Taken by the States of Jersey

(i) Regulations 1 and 2

Under these regulations the Minister may lend out of the consolidated fund to the Jersey Bank Compensation Board up to a maximum of £100 million on terms and conditions to be specified to meet the obligations set under the regulations.

The expressed ability of the *Jersey Bank Compensation Board* to borrow from the Government adds to the credibility of the system. What is not known are the terms and conditions for the borrowings. For example, the Canada Deposit insurance Corporation may borrow up to C$15 billion and the borrowings require the approval of the Minister of Finance which sets the terms and conditions for all the borrowings of crown agencies. In most circumstances the rate of interest applied is the crown corporation borrowing rate plus 25 basis points. In the early 1990s, the Minister of Finance announced that the Government of Canada may also impose a credit enhancement fee. The credit enhancement fee[3] is to be determined by the difference between the rating of the Government of Canada (AAA) and the rating of CDIC-member institutions (likely a rating below A and perhaps as low as B+).

The five-year term limit on borrowings seems reasonable on the surface but an extension of the limit might be advisable as it can taken several years to wind-up the estate of a failed bank particularly when there is litigation involved.

For added flexibility, it would be advisable to allow the *Jersey Bank Compensation Board* to borrow from the private markets.

If the Jersey Bank Depositors Compensation Scheme is to operate with *ex post* levies rather than *ex ante* premiums then consideration should be given to charging a standby-fee, the borrowing rate, and a credit enhancement fee as part of the terms and conditions for any loans advanced by the States of Jersey.

(i) Regulations 26 to 29

The purpose of these provisions is to limit the amount a bank may be required to pay by way of a levy and sets an overall cap based on a proportion of their eligible deposits.

The interpretation of these provisions is that the levies will be imposed only after the point that a bank has failed and then after that point the *Jersey Bank Compensation Board* will levy the industry but the maximum that can be levied in a 5-year period is £100 million. According to the Consultants report a figure of £100 million would be sufficient to pay the claims in all but the failure of the largest banks in Jersey but would be sufficient to cover he claims of multiple small banks. State funding is to be used to provide upfront liquidity.

[3] An actual credit enhancement fee has never been applied.

The regulations stipulate that each member bank must pay a levy no later than 6 months after the relevant date that a bank has become bankrupt.

By not charging *ex ante* premiums no reserve fund will be built-up and compensation payments to depositors will be subject to the States of Jersey`s ability to borrow funds.

These kind of provisions are consistent with many of the European deposit guarantee schemes and therefore underscore the weakness of the system and its credibility. The following points should be noted:

1. Depending on the size of the bank failure, the set limit of £100 million on borrowings may not be sufficient. In such cases, decisions will need to be made as to what claims will be paid and when shall they be paid.
2. The *Jersey Bank Compensation Board* does not appear to have a role in deciding when a bank is to be closed. As such, it has no apparent means at its disposable to minimise its exposure to losses. In Canada, CDIC received its loss-minimisation mandate in 1987. Prior to that losses averaged 51 cents on the dollar; after the change in mandate losses were 11 cents on the dollar.
3. Early and measured intervention by the supervisor can limit the exposure and losses of the compensation fund.
4. Liquidation costs are likely to be in the order of 5 cents on the dollar (Canadian experience).
5. Levies on the surviving banks penalise banks that follow less risky strategies and favour those banks that bring more risk into the system.
6. *Ex ante* premium systems provide a basis for risk-adjusted or differential premiums as well as premium surcharges that can be used to incentivise banks to reduce risk.

As pointed out in a study by Jean Roy, the existence of *ex ante* premiums would be of more interest to governments in funding a deposit protection scheme rather than one that relies on *ex post* assessments (see Annex 1). This is because there would be considerable uncertainty that the surviving banks would have the capacity to repay the funds lent by the government to compensate depositors of a failed bank.

With *ex ante* premiums banks would be able to budget each year based on the premium rates set by the deposit protection fund. In the event that the protection fund results in a substantial surplus for a prolonged period, then a rebate system could be instituted to return premiums paid by the highest-rated banks, if a risk-based system were in place.

In an *ex post* system the levies needed to fund a failure or series of failures might need to be imposed at a time when the banking industry is less able to pay the levies.

Premiums should also be related to the level of coverage. During the recent financial crisis in order to restore financial stability, governments raised coverage limits to historically high levels and in some jurisdictions extended coverage to areas where it had not even existed before. Fifteen European countries increased bank deposit coverage limits with almost one-half of them now providing unlimited coverage. Hong Kong, Malaysia, Taiwan and Singapore instituted blanket/government guarantees, the FDIC limit was raised from US$100,000 to $250,000 and coverage of non-interest bearing accounts was included for the first time. Australia and New Zealand, which until recently had felt that explicit deposit protection was not needed, now cover all bank deposits through government backing.

(ii) Regulation 30

The maximum amount the Board may require a bank to pay is set to equal 0.3% of the eligible deposits held by a bank on the relevant date of the bank in default.

IADI has reviewed aspects of this question in its Guidance Paper on Funding. The found that there are a number of methods available to policymakers to calculate the appropriate size for a targeted reserve. A common element of all of them is the need to determine the potential losses of the deposit insurance fund. The most common approach is to consider the country's historical experience with bank failures and associated losses. The majority of countries that have a target reserve ratio use this approach.

The advantages of this approach are relatively straightforward and easily understandable and it relies on existing information. A shortcoming, of course, is that the past may not be a good guide to the future. It does not take into account the current risk profile of member institutions and other information which may be useful in assessing potential losses to the deposit insurer.

Another way to address the area is through a credit portfolio approach as it is a more analytical method to determine a suitable reserve ratio and is used, for example, in Hong Kong, Singapore, the US and Canada. Under those systems the deposit reserve is viewed as being subject to a portfolio of credit risks similar to a bank loan portfolio. The portfolio consists of individual exposures to member banks, each of which has the potential (some greater than others) of causing a loss to the fund. In most cases there will be a relatively high probability of small losses and a much lower probability of very large losses. The probable large losses would tend to be associated with the presence of large banks.

IADI found that there is considerable variation in targeted reserve ratios; however, the appropriateness of a reserve ratio will be affected by such characteristics as the assessment base as well as the effectiveness of regulatory oversight. Adopting the credit portfolio approach to reserve targeting requires an insurer to consider: (1) developing a specific provision for each member bank taking into account the risk of loss and the range of losses that could occur over a specified period of time; and (2) setting aside additional funds (or surpluses) to cover situations where actual losses, as a result of unexpected factors, may exceed reserves. Another explanation is that a deposit insurance fund is exposed to both expected and unexpected losses and these need to be taken into account in determining the target size of the fund.

It is the case that a number of deposit protection systems have adopted rules or methodologies to limit the size or place caps on the premiums or levies on member institutions. However, it is difficult to know if a system developed in one country will have merits and be practical for use in another country. The US and Canada have similar systems but the FDIC is mandated to operate with a target fund ratio while CDIC operates without one. Both systems, however, have hybrid funding arrangements.

III Concluding Comments

There is limited evidence to suggest that *ex post* funded deposit protection systems work terribly well particularly when there are failures. Could Northern Rock have been handled by the Financial Services Compensation Scheme if it had had a fund built-up through ex ante premiums? That question is, of course, theoretical. The UK had not had a bank failure of any appreciable size since the reign of Queen Victoria. As Wood (2009) points out two features of Northern Rock make it stand out – it was big enough for its failure to be noticed, but not so big that its closure was damaging to the economy as a whole; and it had no international business of any significance, so could, indeed had to be, handled by the government and authorities of one nation only.[4]

[4] Wood, G, *Towards a Coherent Crisis Resolution Mandate*, Financial Crisis Management and Bank Resolution, LaBrosse, Olivares-Cam and Singh (eds.), Informa Law, 2009.

Annex 1

Relative Evaluation of *Ex ante* Funding Versus *Ex post* Assessments

	Ex ante Premiums	Ex post assessments
Effectiveness		
Deposit insurer`s liquidity	X	
Deposit insurer`s solvency	X	
Transparency and information sharing	X	
Conducive to supervision allowing for risk measurement and control	X	
Fairness and Incentives	X	
Smoothing of Premiums	X	
Potential for Government Backing (as most systems are public)	X	
Confidence of Depositors	X	
Efficiency		
Operating cost		X
Issues related to funds management - Optimising quantity target level - Optimising quality risk-return		 X X
X=Superiority Source: Jean Roy (2000)		

12.4 Document three was submitted by Mr J.R. LaBrosse on the 9th September 2009:

Issue

I was asked to evaluate the States of Jersey's proposed deposit compensation scheme in terms of where it sits against other jurisdictions, specifically the funding methods of the proposed scheme. In particular, I was asked to compare and contrast with "best practices" elsewhere as the Panel is particularly concerned with the funding basis of the proposals.

Methodology

This paper focuses on the States of Jersey Deposit Compensation Scheme (JDCS) with a particular emphasis on funding issues which are vitally important in establishing and maintaining the credibility of deposit protection arrangements. It draws heavily on the guidance developed by the International Association of Deposit Insurers (IADI) but also includes points that are beyond the scope of the Core Principles for Effective Deposit Insurance Systems that were released by the Bank Supervisors Committee and IADI in June 2009.

Introduction

The IADI guidance is based on practitioner's experiences and it is designed to assist policymakers in the establishment and reform of deposit protection arrangements. But, the guidance is of a very general nature and it has been structured to address a broad range of circumstances, settings and structures. Accordingly, the guidance should be looked at as a point of departure as to what are in fact "best practices" that can be formulated into the development of an effective deposit insurance system. Experience has shown that certain types of arrangements in the design of a deposit protection system are better than others. This is particularly evident in the area of funding.

This paper is structured as follows. Section I outlined the Core Principles that have been developed by IADI. Section II examines the issue of funding and analyses the arrangements being proposed by the States of Jersey for a deposit compensation scheme. Section III considers in detail the key assumptions surrounding the proposed funding for the JDCS. The final section of the paper offers some conclusions. Annex I contains a full evaluation of the JDCS against the Core principles.

I Core Principles for Effective Deposit Insurance Systems

In July 2008, the Basel Committee on Banking Supervision (BCBS) and IADI decided to collaborate to develop an internationally agreed set of Core Principles using the IADI Core Principles for Effective Deposit Insurance Systems as a basis.[1]

In the preamble to the Core Principles it is noted that policymakers have choices regarding how they can protect depositors and contribute to financial system stability. Explicit deposit insurance has become the preferred choice compared to other alternatives such as reliance on implicit protection. It is noted that a deposit insurance system should clarify the authority's obligations to depositors (or if it is a private system, its members), limit the

[1] A joint working group was established to develop Core Principles to be submitted to the BCBS and IADI for their respective review and approval. This joint working group was comprised of representatives from the BCBS's Cross-Border Bank Resolution Group (CBRG) and IADI's Guidance Group. The Core Principles for Effective Deposit Insurance Systems represent the work of the joint working group in developing Core Principles.

scope for discretionary decisions, promote public confidence, help to contain the costs of resolving failed banks, provide countries with an orderly process for dealing with bank failures and a mechanism for banks to fund the cost of failures. It should be noted that while such goals are laudable, it is in fact very difficult to follow through with the implementation of all such arrangements except over a lengthy period.

The introduction or the reform of a deposit insurance system can be more successful when a country's banking system is healthy and its institutional environment is sound. In order to be credible, and to avoid distortions that may result in moral hazard, a deposit insurance system needs to be part of a financial system safety net, properly designed and well implemented. A financial system safety net usually includes prudential regulation and supervision, a lender of last resort and explicit deposit insurance. The distribution of powers and responsibilities between the financial safety-net participants is a matter of public policy choice and individual country circumstances.

It is well-understood that a deposit insurance system or deposit compensation scheme cannot, by itself, deal with systemically significant bank failures or a "systemic crisis". In such cases all financial system safety-net participants must work together effectively. In addition, the costs of dealing with systemic failures should not be borne solely by the deposit insurance system but dealt with through other means such as an intervention and support of the state government.

As pointed out in Submission II, there are important differences between deposit insurance systems and deposit compensation schemes particularly when it comes to the matter of funding. Deposit insurance systems found in most parts of the world operate with explicit, up-front premiums collected from the member institutions (*ex ante* premiums). Many of them have funding sources over and above the premiums they collect. For example, the premiums charged are not always charged at one flat rate and therefore some are differentiated by way of the risk that the deposit-taking institution poses to the deposit insurer or fund established to cover losses. Those insurers may also have the power use the funds accumulated to make depositor pay outs and/or cover losses resulting from a failed member bank[2], impose conditions on financial institutions that want to join the system, impose premium surcharges, impose levies on the surviving members after a failure, and borrow from the market with or without a formal government guarantee. In some cases the deposit insurer may have the power to cancel a policy of deposit insurance which will almost most certainly bring about the demise of a member financial institution.

By contrast, deposit compensation schemes have much less flexibility and most often are funded only after a failure has occurred (*ex post*). In such schemes, there are no advance contributions and the organisation that operates the compensation scheme does not have explicit responsibilities regarding the sharing of costs for reimbursing depositors. In this sense, *ex post* schemes are less equitable for the surviving institutions because a failed institution will not have contributed to the cost of reimbursing its depositors as this cost is borne by the surviving institutions. On the plus side, it is argued that an *ex post* schemes are less onerous during periods when there are no or very few failures because premiums are not being collected continually. Supporters of *ex post* funding argue that this approach is less expensive than *ex ante* funding over the long run, since it avoids the administrative costs associated with the ongoing collection of premiums and portfolio management of a fund.

[2] In the 1990s the Polish deposit protection had assets to deal with failures in the form of government bonds but they were told by the Ministry of Finance that the market conditions were not appropriate and they were not able to sell those securities.

To be at all useful, *ex post* compensation schemes require highly effective bank supervision and operate best in a relatively stable financial environment with no or very few failures. A number of European countries that did not experience banking crises in the 1980s and 1990s, such as Austria, The Netherlands, Switzerland and the UK decided to adopt *ex post* systems and they do not maintain a fund to compensate for bank failures.[3]

While the up-front costs to the members of an *ex post* system are lower than an *ex ante* system, the overall costs to the economy and/or government fiscal positions are higher. As the experiences of several countries have demonstrated, inadequate funding can lead to delays in resolving failed institutions and to significant increases in overall costs in terms of disruption of the financial system.[4] Countries with unfunded systems include: Austria, Bahrain, Chile, Gibraltar, Guernsey, Isle of Man, Italy (in Italy banks pay annual contributions for operating expenses of the insurer), Liechtenstein, Luxembourg, the Netherlands, Slovenia, Switzerland and the UK. Given that many European schemes have been superseded by full government guarantees during the financial crisis it will be interesting to see how they plan to transition to lower coverage limits and whether ex post funding will still be their preferred means of financial support. It would be unfortunate if that were the case as it will demonstrate that policymakers have learned very few lessons from the events of the past few years.

II Funding of Deposit Protection Arrangements

This section addresses the Core Principle on Funding and its usefulness. In short, Principle 11 states that a deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims including a means of obtaining supplementary back-up funding for liquidity purposes when required. Primary responsibility for paying the cost of deposit insurance should be borne by the banks since they and their clients directly benefit from the stability that an effective deposit insurance system promotes. For deposit insurance systems (whether *ex-ante*, *ex-post* or hybrid) utilising risk-adjusted differential premium systems, the criteria used in constructing such arrangements should be transparent to all participants. As well, all necessary resources should be in place to administer the risk-adjusted differential premium system appropriately.

Experience has shown that not all types of funding arrangements for deposit insurers are effective. Indeed, as implied above, the least effective arrangements are *ex post* compensation schemes. While there is a belief that *ex post* schemes are inexpensive to operate the fact of the matter is that they rely almost exclusively on government support, are less equitable for the surviving institutions, they play no role whatsoever in controlling moral hazard and governments are most likely to have to step in to provide a blanket guarantee or nationalise parts of the banking system at a great cost and exposure to taxpayers when there is a perception of a crisis.

The recent financial crisis provides some very important lessons learned for deposit guarantee systems that rely on *ex post* funding. For example, at the October 2008 IADI

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[3] The "Study of deposit guarantee systems in credit institutions in Europe", prepared for the European Commission in 2002, identified 9 European countries with having an ex ante system, three with an ex post system and six with a mixed system. The study examined the 15 EU countries plus Liechtenstein, Iceland and Norway.

[4] The experience of the US in resolving the savings and loan crisis during the 1980s and early 1990s provides such an example (Financial Stability Forum, 2001).

Conference, Loretta Minghella, Chief Executive of the FSCS, noted that the FSCS was "fully funded" by the industry and can impose a maximum deposit levy of £1.8 billion per year. It was also noted that the obligations of the FSCS at that time were £17 billion and current fees were about £5 million, a fair long way away from the maximum and unless the fees are raised substantially then the term of the mortgage will be extremely long and certainly beyond the end of this century. On top of that liability will be the additional costs on the banks to modify their IT systems (estimated at £892 million over the next 5 years – *Financial Times*, 7 January 2009) so that payouts can be made as per the new EC Directive. Certainly, paying for the compensation scheme in the UK is beginning to look like a potentially debilitating charge on the UK banking system and the UK government is not a very good position to afford the failure of another bank.

As well, the Associated Press on 29 August 2009 reported that Iceland has decided to repay Britain and The Netherlands the $5.7 billion it borrowed to compensate savers in those countries who lost funds in the collapse of an Icelandic Internet Bank last year. The Icelandic government overcame heavy opposition to the compensation plan, securing backing from the majority of lawmakers by pledging to link the pace of debt repayment to the rate of growth of the country. Iceland will begin repaying £2.3 billion to Britain and £1.3 billion to the Netherlands from 2016 with payments spread over the following nine years.

As noted, *ex ante* funding of deposit insurance systems requires the accumulation and maintenance of a fund to cover deposit insurance claims and related expenses prior to a failure actually occurring. It is funded by its members through contributions, insurance premiums and other means. An *ex ante* system is more rules-based and offers greater certainty than other systems because the funds are intended to be in place before they are needed. The knowledge that funds have been raised in advance and that the fund is well-managed can reassure depositors that their insured deposit balances are safe. This helps minimise the risk of sudden withdrawals and the escalation of withdrawals that can lead to a bank run.

An *ex ante* funding system spreads the cost of insurance losses over time, since premiums should be set and collected taking into account expected losses over the long run. In addition, they should contain an anti-cyclical feature and buffer for the industry; the fund continues to accumulate premiums during stronger economic conditions, when losses may be low, as a hedge against future needs when economic circumstances may be less favourable and losses higher. It thus avoids further weakening of the overall banking industry at the time of a failure.

From the perspective of a member institution, compared to an *ex post* system, an *ex ante* system may at first sight appear to be more expensive, since it involves an explicit up-front business expense as opposed to an uncertain one and the *ex ante* payments required from the institution may reduce the resources it has available to absorb losses on its own. Additionally there is an opportunity cost to the premium paying banks and the overall economy, if one takes into account how the resources represented by the insurance premiums might otherwise have been employed. The cost of a bank failure of any size to taxpayers, however, can certainly be much higher than the opportunity cost to the premiums paid by banking systems.

There are few, if any, true examples of a pure *ex ante* deposit insurance system. As a result, the most common set of funding arrangements particularly outside of the EC are hybrid systems. Hybrid funding combines features of both *ex ante* and *ex post* funding. They incorporate an ex *ante* fund financed by premiums and contributions and includes a mechanism to obtain funds *ex post* from member institutions, through special premiums, levies or loans, should they be needed. An *ex ante* deposit fund may be established and the insurer be empowered to levy *ex post* contributions to make up for any fund shortfall. With *ex ante* funding, under very adverse circumstances, such as a large failure or a systemic crisis, losses may exceed the fund's reserves and a temporary increase in premiums or access to emergency (e.g. government) lines of credit may be appropriate. Thus, in practice, the real choice may not be between pure *ex ante* and *ex post* funding, but the relative extent to which the deposit insurance system relies on each.

Based on experience, the deposit protection arrangements in Canada, the US and Malaysia are the best examples of well-funded hybrid systems. But, each of those systems has had their special challenges. During the recent financial crisis Canada, for example, found it necessary to increase the coverage of interbank deposits fully for six months. In the US, the FDIC is in the process of implementing a special levy to reinforce the deposit insurance fund and in Malaysia, the government found it necessary to institute a blanket guarantee which is being administered by the Malaysia Deposit Insurance Corporation. Despite those measures, and due to the extraordinary circumstances, there is no doubt that hybrid systems are the best set of arrangements.

However, as explained earlier, a deposit insurance system, by itself, will not be able to contend with a large scale financial crisis. Even in a non-systemic crisis the deposit insurance system may find itself without adequate funds in reserve to meet its commitments[5]. A gap between available resources and financial obligations can be covered by giving the insurer access to additional or backup financing either from the government or the market. The backup funding would allow the prompt reimbursement of insured deposits and could be repaid through special assessments on the surviving institutions and/or proceeds from the liquidation of bank assets. If a backup funding mechanism is in place, it is important that there be clearly defined rules on its use so that public funds will not be excessively relied on or otherwise used inappropriately.

Backup financing can be either improvised at the time or pre-arranged. Having a mechanism in place is highly advantageous as the terms and conditions of the financing can be more carefully considered. Access to funds can be gained quicker and the existence of a financial recourse mechanism may increase confidence in the system. It may facilitate the timelier closure and resolution of failed banks and help contain the costs associated with a failure. In the case of a new system that has not accumulated sufficient resources, a backup system can be particularly important.

III An Evaluation of the Funding Arrangements States of Jersey Deposit Compensation Scheme

The JDCS is modelled after the schemes found in many parts of Europe that were designed to conform to the EC Directive on Deposit Guarantees. The funding parameters contained within the scheme are based on the following assumptions:

1. There will be no failures of a bank in Jersey;
2. The overall liability of the JDCS including administration costs will be capped at £100 million;
3. There will be caps on levies on the industry equal to 0.3% of the eligible deposits held by the bank;
4. The maximum amount that that the JDCS may require a bank to pay by way of a levy is 5 years is £100 million; and

[5] The FDIC appears to be in that position presently due to the "premium holiday" that was granted to the member institutions just a few years ago.

5. The States of Jersey is responsible to make up any shortfall.

Assumption 1 – Banks Will Not Fail

While implicitly, many of the European schemes may have been constructed with the idea that the authorities might never have to deal with a bank failure, the States of Jersey Scheme is quite explicit on that point as its aim is "to provide depositors with compensation quickly in the unlikely event of a bank failure".[6] But, banks do fail and they fail in periods even when there is not a financial crisis. We have seen bank failures all around the world and even in those jurisdictions that have strict licensing regimes and structured early intervention frameworks. Some of the failures in the US recently can be attributed to the financial crisis (sub-prime loans), but others were attributed to bad management, poor risk-management practices, etc.

We know that the root of the problems surrounding *Northern Rock plc* was its dependence on wholesale markets for the large majority of its funding and that was what most distinguished *Northern Rock* from other UK banks (and *a fortiori* from all UK building societies). Retail deposits (and other classes of retail funds) did grow, but not nearly as rapidly as did wholesale funds. Retail funds fell as a proportion of the total liabilities and equity of *Northern Rock* from 62.7% at end 1997 to 22.4% at end 2006. It remained, however, a predominantly UK-based institution, with the great bulk of its business done in that country.

It is the case that *Northern Rock's* securitisation programme supported rapid balance sheet growth for several years. Much of that funding was short term. About half of their wholesale borrowing was at a maturity of less than one year. Even more important to their subsequent problems, the size of the *Northern Rock* securitisation programme meant that a large amount of mortgage-backed securities needed to be refinanced every year. It was this need to replace the funding obtained from short-term wholesale and securitisation markets, markets which were effectively closed from the summer of 2007that forced *Northern Rock* to turn to the Bank of England for liquidity support.[7]

The States of Jersey only licenses banks that are in the Top 500. Thus, there is an assumption that all such banks are "too big to fail" in their home jurisdiction and therefore the operations in the States of Jersey will not fail. As we explain in my forthcoming book globalisation of financial institutions and markets has had important spin-off benefits but it appears that that thrust has led to more financial institutions being "too big to fail", "too complicated to regulate", "too difficult to manage" and in some cases "too interconnected too fail" as a opposed to a more desirable outcome of having institutions being "too good to fail".

We also note that recent experience has shown that the capital levels that are generated to meet minimum regulatory standards are simply not enough. Indeed, Sheila Bair, the Chairman of the US Federal Deposit Insurance Corporation: "[a] strong case can be made for creating incentives that reduce the size and complexity of financial institutions as being

[6] If a bank were to fail, the DCS would provide full protection for private individuals (residents or non-residents) up to a maximum of £50,000. Up to the first £5,000 of a valid claim would be paid within 7 working days with the balance being paid within three months.

[7] Wood, G, "Toward a Coherent Crisis Resolution Mandate", Financial Crisis and Bank Resolution, J R LaBrosse, Rodrigo Olivares-Caminal, Dalvinder Singh (eds.), Informa Law, 2009, forthcoming.

bigger is not necessarily better. A financial system characterised by a handful of giant institutions with global reach and a single regulator is making a huge bet that those few banks and their regulator over a long period of time will always make the right decisions at the right time."[8] She added that "[u]nless there are clear benefits to the financial system that offset the risks created by systemically important institutions, taxpayers have a right to question how extensive their exposure should be to such entities." Thus, it may no longer be the case that banks are "too big to fail" because governments are running out of financial capacity to allow big banks to continually expose their fiscal arrangements. The suggestion from Lord Turner that even the largest banks should develop "living wills" is a very profound statement and may represent the new reality.

Assumption 2 – The £100 million cap

Given the need to relax the assumption of "no banks failing", we address the question as to whether the £100 million cap is, therefore, realistic.

The cap for the JDCS should be viewed as a financing mechanism to cover the expected losses to the compensation scheme when a bank fails. But, that statement assumes that the liquidator can gain control of the assets of a failed bank and that the assets are of quality that will result in a high level of recovery once they are sold or they mature.

The factors that are working against a high level of recoveries by the JDCS are as follows:

The JFCS is the host regulator for all but one of the banks licensed to operate in Jersey.

Banks licensed in the States of Jersey are often just collectors of deposits which are passed upstream to a parent. The loans to parents may be difficult to recover.[9]

Addressing cross-border resolution issues remains one of the greatest challenges for deposit protection organisations as with no agreements on how to solve conflicts across borders, the risk of national interests being put ahead of the greater global good increases significantly.

The DJCS has no tools to minimise its exposure to losses. The DJSC will only become operational once a failure occurs. If the public becomes concerned about delays in accessing their deposits this will undermine financial stability and may bring down other banks.

At the time when Canada Deposit Insurance Corporation was a "pay-box" deposit insurer the losses they had were, on average, 51 cents on the dollar (when the mandate for CDIC was altered so that it became a loss minimiser their losses were 11 cents on the dollar).

The JFSC may not have enough tools to intervene in dealing with a problem bank. Canada, the US, Malaysia and a number of other effective deposit insurers have early, structured supervisory frameworks.

The cost of liquidating a failed bank is quite expensive. Based on experience in Canada, liquidation costs for a failed bank amount to at least 5% of the value of assets left in the estate of a bank.

Based on the factors noted above it is quite possible that the £100 million cap will only be sufficient if the States of Jersey banking regulators have strong (Treaty-type) agreements with offshore banking supervisors, are able to stop the passing of funds upstream to a parent or offshore creditor, and they close the problem bank very quickly after they become aware that a bank is in danger of failing.

Assumption 3 – A cap of 0.3% of the eligible deposits held by the bank

Financial system safety nets have a cost because they insulate financial institutions from the full consequences of their actions and that can diminish market discipline. Governments around the world have sought to contain this moral hazard through regulation. They have done so by requiring banks to maintain reserves and capital buffers in proportion to their risk so that they can absorb losses at their own expense, not at the taxpayer's.

It has been pointed out on many occasions that the banking regulatory framework failed last year. Before the crisis, supervisors and rating agencies underestimated risks building in the system. In fact, despite the work that went into Basel II, banks maintained capital levels that were too low, relied too heavily on unstable short-term funding, and their compensation plans rewarded excessive risk-taking. Larger banks often held less capital relative to their risks and used more leverage than smaller banks.

To address the problems, G20 Finance ministers have proposed a new international accord on capital standards. The fundamental principle is that capital and other regulatory requirements should be designed to ensure the stability of the system, not just the solvency of individual institutions. They have determined that such an approach requires a broad shift in the way capital and related regulations are designed.

To address the specific question of the size of the cap on banks' contribution to the JDCS there is no international standard. However, it is instructive to examine the range of arrangements that exist in other systems.[10]

IADI found that there are a number of methods available to calculate the appropriate size for a targeted reserve. A common element of all of them is the need to determine the potential losses of the deposit insurance fund. The most common approach is to consider the country's historical experience with bank failures and associated losses. The majority of countries that have a target reserve ratio use this approach. The advantages of this approach are relatively straightforward and easily understandable and it relies on existing information. A shortcoming, of course, is that the past may not be a good guide to the future. It does not take into account the current risk profile of member institutions and other information which may be useful in assessing potential losses to the deposit insurer.

The credit portfolio approach is a more analytical method to determine a suitable reserve ratio and is used, for example, in Hong Kong, Singapore, the US and Canada. Under those systems the deposit reserve is viewed as being subject to a portfolio of credit risks similar to a bank loan portfolio. The portfolio consists of individual exposures to insured banks, each of which has the potential (some greater than others) of causing a loss to the fund. In most cases there will be a relatively high probability of small losses and a much lower probability of very large losses. The probable large losses would tend to be associated with the presence of large banks.

8 The speech is available on www.fdic.gov.

9 The Economist reported on 3 September 2009 Lehman Brothers International (Europe)—LBIE, the London subsidiary of Lehman Brothers Holdings, New York—closed for business on 15 September 2008 leaving 839,000 failed transactions totalling billions of dollars hanging in the air. PricewaterhouseCoopers (PWC), the administrator, is still trying to sort out most of them, which relate to over 100 separate units of LBIE. It has managed to pay claims of around $13 billion (£8 billion) but wants the American parent to settle up to $100 billion more. In the global Lehman debacle, the British authorities and claimants on the London entity drew the short straw. Lehman Brothers Inc, the broker-dealer in New York, was a relatively simple company. It siphoned billions from the global group days before it went bust. The American authorities then gave it until 19 September to settle its trades. Many of its clients' assets were insured. Barclays, a British bank, bought the business and took over its customer positions, ensuring continuity.

LBIE, a complex investment bank, offered no such comfort. Its trades included huge off-exchange dealings in securities and derivatives. Many of its clients' assets had been lent or pledged to third parties by the bank itself, in some cases without clients' knowledge and perhaps without their permission: sloppy records leave plenty of room for doubt. Administrators have had to fight for access to information from Lehman New York, and from securities depositories worldwide. Clearing this mess up will take years.

10 IADI, Guidance Paper on Funding, 2008.

Targeted Reserve Ratios of Selected Countries

(as a %of total or insured deposits as of end 2007)

Venezuela 10.11%	Argentina 0.50%
Colombia 5.00%	Canada 0.40-0.50%
Jordan 3.00%	Taiwan 0.30% of insured deposits (since January 2007, a target ratio of 2% of insured deposits has been stipulated by the Deposit Insurance Act)
Tanzania 2.70%	Singapore 0.30%
Indonesia 2.50%	Bahamas 0.20%
Jamaica 2.00 – 2.25%	Honduras 0.10%
Brazil 2.00%	India 0.05%
US 1.25%	
Average (ex. Venezuela) 1.45%	

Sources: CDIC International Deposit Insurance Survey (2003), World Bank and Garcia (1999).

The table above shows that there is considerable variation in targeted reserve ratios; however, the appropriateness of a reserve ratio will be affected by such characteristics as the assessment base as well as the effectiveness of regulatory oversight.

Adopting a credit portfolio approach to reserve targeting requires an insurer to consider: (1) developing a specific provision for each member bank taking into account the risk of loss and the range of losses that could occur over a specified period of time; and (2) setting aside additional funds (or surpluses) to cover situations where actual losses, as a result of unexpected factors, may exceed reserves. Another explanation is that a deposit insurance fund is exposed to both expected and unexpected losses and these need to be taken into account in determining the target size of the fund. Based on international experience and practice, a cap of 0.3% of the eligible deposits held by the bank for the JDCS is far too low to be considered credible.

Assumption 4 - The maximum amount that that the JDCS may require a bank to pay by way of a levy is 5 years

There are two basic approaches in creating an insurance fund or reserve. A steady premium can be levied over an extended period; alternatively, a premium system can be designed to achieve and maintain a target reserve level or range. In the case of a target reserve it is necessary to establish how large a reserve is appropriate. The target level should be adequate to at least cover the potential losses of the insurer under normal circumstances. A large number of factors need to be taken into account including: the composition of member banks (number, size, lines of business), the liabilities of members and the exposure of the insurer to them, the probability of failures and the characteristics of losses that the insurer can expect. Deposit insurers and the member institutions can be exposed to a wide range of factors that are difficult to identify in advance. Potential losses can also be affected by the activities of the insuring agency itself and other members of the financial safety net, such as the supervisory authorities. For example, an effective supervisory regime can reduce the probability of bank failures and, by extension, the risk exposure of the deposit insurer.

Policymakers need to balance the requirements of the insurer to cover potential losses with the ability of the industry to fund the system. It should be borne in mind that an excessive reserve ratio could have a negative impact on profitability and hamper the development of the financial system. On the other hand a very small fund, designed to minimize the burden on contributing members, would probably be too limited to absorb significant losses and would likely require large *ex post* contributions by members at potentially awkward times.

We have seen that even in the US where the FDIC has a tremendous range of powers and unparalleled practical experience in dealing with bank failures that a deposit insurance system, by itself, cannot contend with a large scale financial crisis. Even in a non-systemic situation the deposit insurance system may find itself without adequate funds in reserve to meet its commitments. A gap between resources and financial obligations can be covered by giving the insurer access to additional or backup financing either from the government or the market. The backup funding would allow the prompt reimbursement of insured deposits and could be repaid through special assessments of the surviving institutions and/or proceeds from the liquidation. The terms and conditions of the financing must be carefully considered but it is most unusual to set a term limit on the ability to tap back-up government financing.

As a financial system grows it can only be expected that the size of the back-up facility will need to grow along with it. In the early 1990s, the direct Government of Canada support to CDIC was increased to C$6 billion and then earlier this year it was raised to C$15 billion. It is important to note access to funds must be gained quickly and the existence of a financial recourse mechanism to the Government substantially improves the credibility and increases confidence in the system. It may facilitate the timelier closure and resolution of failed banks and help contain the costs associated with a failure. In the case of a new system such as JDCS that has not had the time to accumulate sufficient resources, a backup system is essential.

Assumption 5 - The States of Jersey is responsible to make up any shortfall.

There are a number of potential sources from which to obtain contingency funding. These include the private sector (loans or bonds, with or without a government guarantee), the government treasury, the central bank or another government agency. The treasury or central banks are the most common sources. If the government is unable to mobilise financial resources quickly enough, because of legal or other constraints, the deposit insurer may need to borrow from the central bank or an international organisation. Borrowing from the central bank may later be replaced by borrowing from the government or by the issuance of government guaranteed bonds.

In extremely rare cases a deposit insurer could consider private sources such as obtaining one or several lines of credit with sound banks. The issuance of bonds or buying put options to place bonds or debentures if needed are other possibilities. Although the deposit insurer is typically a government agency, a government guarantee may nevertheless lower the cost of borrowing from the private sector since it can enhance the credit rating of the financial instrument used. In some cases the lack of a government guarantee may even prevent access to private sector credit.

In non-crisis situations, the JDCS may have access to backup financing from financial markets. Some investors might be willing to lend money to it or buy bonds issued by it. In the extreme, large international banks might be willing to provide funds if the arrangements are guaranteed by a major international financial organisation. But, in the end the States of Jersey will be responsible for funding the system.

IV Conclusions

The search is on to implement measures to create a safer and more stable financial sector. The good news is that States of Jersey has seen the need to implement an explicit depositor compensation scheme. The bad news is that it contains many elements that undermine the credibility of the scheme. The funding measures are particularly weak. Starting from the assumption that banks can and do fail, depositors in Jersey banks will not be comforted to know that access to their funds may not be available for a considerable length of time and this will be particularly troublesome if the memories of *Northern Rock* have not faded.

To be sure, implementing an effective deposit protection scheme is no simple task: the measures must be sufficiently forward-looking to anticipate tomorrow's problems, yet not so restrictive that they cost too much and retard the growth in the financial sector in Jersey. Some progress has already been made on the international level by strengthening micro-prudential regulation. For example, the Basel Committee has made recommendations for strengthening the regulatory capital framework and Finance Ministers want those measures implemented.

A key lesson of the financial crisis is that capital requirements cannot be lenient. They must therefore not only be increased, but also made more variable in order to prevent excessive risk taking. Since banks in Jersey are largely regulated offshore and fall into the Top 500 it will be important for the JSFC to stay inform of those developments as they are largely relying on other jurisdictions to do their jobs appropriately. Certainly, putting in place strong agreements with other jurisdictions would be an important step forward.

All deposit protection organisations face risks and it is important that they be managed appropriately. These risks include but are not limited to:

> Insurance Risk: the risk of loss, including costs incurred in the event of an intervention, associated with insuring deposits;
> Financial Risk: The risk associated with managing assets and liabilities, both on- and off-balance sheet;
> Operational Risk: CDIC's risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events;

Reputation Risk: The risk of an event significantly affecting stakeholders' perceived trust and confidence in the system, and which could result in financial or other losses.

The JDCS will not have any tools to manage its risks. It could, however, be strengthened in some important ways. First, a Board should be put in place now or at least well ahead of an actual failure. Second, a system of *ex ante* premiums needs to be developed and implemented. Third, a small staff (3 to 5 people) would be needed to handle the collection of premiums, handle public awareness activities so that depositors understand the benefits and limitations of the compensation scheme, work with other jurisdictions and negotiate agreements to minimise the financial exposure of the States of Jersey.

The financial crisis has exposed weaknesses in many deposit protection arrangements. In light of the lessons learned more standardisation needs to take place and better systems need to be developed to evaluate the effectiveness[11] of current arrangements. While it is stated in the consultant's report that the deposit protection arrangements being proposed for the States of Jersey are consistent with "international practices" it is clear from the evaluation of the system as per Annex I that the parameters of the proposed JDCS fall well short of many of the Core Principles that are being adopted or have been already been implemented in many jurisdictions. A similar conclusion can be reached for many of the European compensation schemes that exist today.

There are few parameters of the JDSC that meet "best practices" and the scheme will not meet its stated goal of being able to provide depositors with compensation quickly once a bank fails in the States of Jersey. In my view, it would be preferable not to implement the JDCS in its present form as it will raise expectations that it is not capable of fulfilling and do more harm than good.

[11] Campbell, A, J R LaBrosse, DG Mayes, D Singh, "A New Standard for Deposit Insurance and Government Guarantees after the Crisis", *Journal of Financial Regulation and Compliance*, Vol 17, number 3, 2009.

Annex 1

This Annex provides an evaluation of the States of Jersey deposit compensation scheme against the IADI Core Principles for Effective Deposit Insurance Systems.[12]

Legal Underpinnings
What are the relevant authorities that support the JDCS?

The JDCS is established as a deposit protection scheme under the Banking Business (Depositors Compensation (Jersey) Regulations 200-

Principle 1 – Public Policy Objectives

The first step in establishing a system is to specify appropriate public-policy objectives that it is expected to achieve and these objectives must be well understood. The principal objective for most deposit insurance systems is to contribute to the stability of the financial system and to protect less-financially-sophisticated depositors. A continuous-improvement process should exist for reviewing the extent to which a deposit insurance system is meeting its public-policy objectives and its mandate.

Does the JDCS specify public policy objectives that it is expected to achieve?	Yes
Do these objectives include contributing to the stability of the financial system?	No
Do these objectives include protecting less financially sophisticated depositors?	Yes

The most common policy objectives of the deposit insurance systems are to protect depositors and contribute to financial system stability. Other objectives include: enhancing the orderly resolution of financial institution failures, protecting payment systems, ensuring that all banks contribute to resolving the cost of failures and financial crisis, and to contribute to the reduction of financial crime. Report on the Regulation' s state that the aim of JDCS is to provide depositors with compensation quickly in the unlikely event of a bank failure, thus minimizing hardship by enabling depositors to carry on with everyday economic activity.

Principle 2 – Mitigating Moral Hazard

Moral hazard should be mitigated by ensuring that the explicit deposit protection arrangements contain appropriate design features which are consistent with other elements of the financial system safety net.

[12] In June 2009, the Basel Committee on Bank Supervision and the International association of Deposit Insurers released a paper entitled: "Core Principles for Effective Deposit Insurance Systems". The full document is available on : www.iadi.org

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

Ensuring that a deposit insurance system contains certain design features can also mitigate moral hazard. These features may include: placing limits on the amounts insured; excluding certain categories of depositors from coverage; implementing differential or risk-adjusted premium systems; minimizing the risk of loss through early closure of troubled banks; and demonstrating a willingness to take legal action, where warranted, against directors and others for improper acts (FSF, pages 8-9).

Does JDCS contain the following design features that can mitigate moral hazard:

- placing limits on the amounts insured?	Yes
- exclude certain categories of depositors from coverage?	Yes
– implement a differential or risk-adjusted *ex ante* premium system?	No
- minimise the risk of loss through early closure of troubled banks?	No
-demonstrate a willingness to take legal action, where warranted, against directors and others for improper acts?	No

Principle 3: Mandate

There is no single mandate or set of mandates suitable for all deposit insurers. Existing deposit insurers typically have mandates ranging from narrow, so-called pay-box systems to those with broader powers and responsibilities, such as risk or loss minimization with a variety of combinations in between. Whatever the mandate selected, it is critical that there be consistency between the stated objectives and the powers and responsibilities given to the deposit insurer. Formally specifying the mandate of a deposit protection agency clarifies the role that it can play within the financial system safety net (FSF, page 17).

Is the mandate of the JDCS formally specified?	Qualified Yes

Deposit insurer mandates varied significantly from country to country. They range from relatively narrow "paybox" mandates concentrating on the reimbursement of depositors of failed institutions to systems with broader mandates including risk assessment, risk management, failure resolution and direct regulation and supervision.

The ability of JDCS to carry out its mandate will only be known once the arrangement has been activated and this will only happen once there is a bank failure which the Authorities judge to be unlikely.

Principle 4: Powers

A deposit insurer should have all the powers necessary to fulfil its mandate. All deposit insurers require the ability to enter into contracts, set appropriate requirements, and access timely and accurate information to ensure that they can meet their obligations to depositors promptly (FSF, page 18).

Does JDCS have the ability to:	
- enter into contracts?	No
- set appropriate requirements?	No
- access timely and accurate information?	No

Does JDCS comply with Principle 4? (Fully/mainly/partly/do not comply)	No

The Regulations empower the Minister to lend money out of the consolidated fund up to £100 million on terms and conditions, not yet specified.

The maximum amount that can be lent is £100 million and the term of the loan is a maximum of 5 years.

The regulations only come into effect if a bank is declared bankrupt and the effective date is set.

Principle 5 – Governance

The sound governance of agencies comprising the financial system safety net strengthens the financial system's architecture and contributes directly to system stability. Operationally independent and accountable safety net organizations with clear mandates and which are insulated from undue political and industry influence provide greater integrity, credibility and legitimacy than entities lacking such independence (APEC, page 3).

The deposit insurance system should have a governing body and the governing body should be held accountable to the authority from which the deposit insurance system receives its mandate. The deposit insurance system should be structured such that the potential for undue political and industry influence and conflicts of interest respecting members of the governing body and management is minimized (IADI Discussion Paper on Governance of Deposit Insurance Systems, pages 3-4).

Is the JDCS operationally independent?	Qualified No
Does JDCS have a governing body?	Qualified Yes
Is the governing body accountable to the authority from which JDCS receives its mandate?	Yes

Does JDCS comply with Principle 5? (Fully/mainly/partly/do not comply)	Partly

There are many different types of governance structures among deposit insurers. Legally separate organizations, relying on a board of directors or governing committee, are quite numerous, although a number of countries have opted for setting up their insurer as a department of the central bank, supervisor or government.

There are many variations of private and publicly administered deposit insurance systems in place. Government administered schemes tend to be the most common of those surveyed, followed by systems which combine public and private characteristics.

The JDCS is not operational and will only become operational when there is a bank failure. Once that happens, the Minister will appoint a Board and it will be up to the Board to determine how the compensation scheme will be implemented.

Principle 6: Relationships with other safety-net participants
A deposit insurer's interrelationship management needs to vary according to its mandate and powers, but the need for close coordination and information sharing among home financial system safety-net participants is essential in all cases. Such information should be timely, accurate, and relevant with due respect given to maintaining confidentiality when required. It is highly desirable to formalize information-sharing arrangements either through legislation, memoranda of understanding, legal agreements or a combination of these techniques. These arrangements also may be helpful in providing a general framework for safety-net participants to coordinate their related activities (FSF, 19-20).

Are formal codes of practice in place to facilitate close coordination, and in particular information sharing, among financial safety-net participants?	No
Are formal information-sharing agreements, such as legislation, memoranda of understanding, legal agreements, in place to provide a general framework for safety-net participants to coordinate?	No
Does JDCS comply with Principle 6? (Fully/mainly/partly/do not comply)	Does not comply

Principle 7: Cross-Border

The recent credit crisis has shown that close coordination and information sharing among deposit insurers and other financial system safety-net participants is very significant from a cross-border perspective. Provided confidentiality is ensured, all relevant information should be exchanged between deposit insurers in different jurisdictions and possibly between deposit insurers and other foreign safety-net participants when appropriate.

Are there any formal information-sharing agreements between JDCS and affiliated schemes in different jurisdictions?	No

Are multiple reimbursements avoided in cases where both home and host countries provide coverage for foreign branches?	Unknown
Are bilateral or multilateral agreements in place on the process by which depositors insured by two schemes in different jurisdictions will be reimbursed?	No

Information sharing and coordination of the activities of the deposit insurer and other safety-net players was a high priority for the majority of deposit insurers. Depending on country circumstances, insurers reported using both formal and informal mechanisms to exchange information and coordinate their activities.

The JFSC relies on home regulators and is the host regular for one subsidiary of an international bank.

Principle 8: Compulsory membership
Membership should be compulsory for banks meeting membership criteria to avoid adverse selection. Banks that are to be included in a deposit insurance system should be subject to strong prudential regulation and supervision (FSF, pages 20-21).

Is membership compulsory for banks meeting certain membership criteria to avoid adverse selection?	Yes
Do banks have to be supervised in order to be covered by your DIS?	Yes
Does JDCS comply with Principle 8?(Fully/mainly/partly/do not comply)	Fully

Principle 9 Coverage
Policymakers should define clearly in law or by private contract what is an insurable deposit. The level of coverage can be set through an examination of relevant data. Whatever coverage level is selected, it must be credible and internally consistent with other deposit insurance system design features, and cover adequately the large majority of depositors in order to meet the public-policy objectives of the system. Coverage limits may need to be adjusted periodically because of inflation and other factors (FSF, pages 23-25).

Is a covered deposit clearly defined in law or by private contracts?	Unclear
Was the level of coverage set through an examination of relevant data?	Yes
Is the coverage limit adjusted periodically because of inflation or other factors?	Will depend on changes in EU

Data appears to have been drawn out in a review and evaluations of the options in a report prepared by Oxera.

Does JDCS comply with Principle 9? (Fully/mainly/partly/do not comply)	Yes

The coverage level appears credible and is consistent with the other deposit compensation schemes in the region. It also appears that coverage level cover 'adequately' the large majority of depositors in order to meet the public policy objectives of the system

Principle 10: Transitioning from a blanket guarantee

In transitioning from a blanket guarantee to a deposit insurance system, the transition should be as rapid as a country's circumstances permit. Policymakers should pay particular attention to public attitudes and expectations during the transition period (FSF, pages 14-15).

Does your JDCS comply with Principle 10? (Fully/mainly/partly/do not comply)	Partly

There was a political statement that deposits in Jersey banks were protected.

Principle 11: Funding

Sound funding arrangements are critical to the effectiveness of a deposit insurance system. A deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors claims. Ex-ante funding requires the accumulation and maintenance of a fund to cover deposit insurance claims and related expenses prior to a member bank failure. In an ex-post system funds are obtained only once a bank has failed; banks are assessed and contribute at this time. Member banks should pay the cost of deposit insurance since they and their clients directly benefit from having an effective deposit insurance system. Recent IADI research indicates that ex-ante funding has many more advantages than disadvantages particularly with respect to ensuring prompt reimbursement to insured depositors, the maintenance of public confidence and as a means to avoid the pro-cyclical effects of deposit insurance assessments (FSF, page 2, IADI draft paper on Funding of Deposit Insurance Systems, pages 3, 7).

(i) Do member banks pay for the cost of deposit compensation?	Yes
(ii) Is the system able to levy banks ex-ante, before the occurrence of a payout event?	After a payout
Does JDCS comply with Principle 11? (Fully/mainly/partly/do not comply)	Partly

Funding is provided in many ways for deposit insurance systems such as through government appropriations, levies, premiums assessed against member banks, government/market borrowing or a combination thereof. The majority of systems charged premiums (ex ante) as a way to build-up a fund but retained the authority to charge levies or other charges on their members if required. Other country systems preferred to rely on ex-post levies.

While flat rate premiums are the most common form of application, differential premium systems are becoming increasingly prevalent. In a large number of cases, the deposit insurer was provided with the ability to secure funding for liquidity purposes from

governments, its members or directly from capital markets. A fund is to be established once a bank is declared in default. It is not clear if JDCS has available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims. There is a plan to pay-out some deposit balances with 7 days and the remainder in 90 days or some longer period. It is not clear if the plan is credible.

Differential premiums

For deposit insurance systems utilizing *ex-ante* funding, policymakers have a choice between a flat-rate premium system and a premium system that is differentiated on the basis of individual bank risk profiles. The bases and criteria used in a risk-adjusted differential premium system should be transparent to all participants. As well, policymakers who adopt risk-adjusted differential premium systems should ensure that necessary resources are in place to administer the system appropriately (FSF, page 28, IADI General Guidance for Developing Differential Premium Systems, pages 3-5).

Will JDCS employ differential premiums, are the bases and criteria used in a risk-adjusted differential premium system transparent to all participants (so that information on the assessment process is in the public domain)?	No
Does your DIS comply with Principle 11? (Fully/mainly/partly/do not comply)	Does not comply

Principle 12 Public Awareness

In order for a deposit insurance system to be effective it is essential that the public be informed about the benefits and limitations of the deposit insurance system. The characteristics of a deposit insurance system should be publicized regularly to maintain and strengthen public confidence (FSF, page 29).

All deposit insurers should promote public awareness about the deposit insurance system on an ongoing basis. The major goals of a public awareness program are for the deposit insurer to accomplish its public policy objectives and enhance the effectiveness of a deposit insurance system through public education to promote the stability of the financial system. The objectives of the public awareness program should be clearly set out and consistent with the public policy objectives and mandate of a deposit insurer (see the IADI Discussion Paper on Public Awareness of Deposit Insurance Systems, page 3).

Are there arrangements to regularly publicise the characteristics of JDCS to maintain and strengthen public confidence?	No
Is public awareness of about the deposit insurance system promoted on an ongoing basis?	No
Are objectives of the public awareness programme clearly set out?	No
Are objectives of the public awareness programme consistent with the public policy objectives and mandate of JDCS?	N/A

Does JDCS comply with Principle 12? (Fully/mainly/partly/do not comply)	Does not comply

A feature common to many insurers was the requirement that member institutions be responsible for providing information provided by deposit insurers to the general public. A number of deposit insurers took additional steps to directly communicate to the public through public awareness campaigns and other initiatives.

There is no evidence of a programme to inform the general public informed about the benefits and limitations of the deposit insurance system.

Principle 13 – Legal Protection

Individuals working for deposit insurers and other financial system safety-net participants should be protected against lawsuits for their decisions and actions taken in good faith while discharging their mandates. However, legal protection must coexist in an environment where there is clear accountability. This means that while individuals should be legally protected, they must be required to follow appropriate oaths of office, conflict-of-interest rules and codes of conduct to ensure they remain accountable. Legal protection should be codified in legislation and administrative procedures, and under appropriate circumstances, cover legal costs for those indemnified (APEC, pages 2-3).

Will individuals working for JDCS be protected against lawsuits for their decisions and actions taken in 'good faith' while discharging their mandates?	Yes for Board members
Is such legal protection codified in legislation and administrative procedures, and under appropriate circumstances, cover legal costs for those indemnified?	Yes
Will individuals working for JDCS explicitly required to follow appropriate oaths of office, conflicts-of-interest rules and codes of conduct to ensure they remain accountable?	Unknown
Does JDCS comply with Principle 13? (Fully/mainly/partly/do not comply)	Mainly

Principle 14: Dealing with parties at fault in a bank failure

A deposit insurer, or other relevant safety-net participant, should be provided with the power to investigate and if necessary litigate against those parties at fault in a bank failure. The power of investigation into officers, directors, managers, auditors and related parties of the failing/ failed bank can help improve recoveries for an insurer and can mitigate moral hazard problems by providing strong incentives against malfeasance (IADI Guidance on the Resolution of Failed Banks, page 45).

Will JDCS be provided with the power to investigate, and if necessary litigate against, those parties at fault in a bank failure?	Unknown

Does JDCS comply with Principle 15? (Fully/mainly/partly/do not comply)	May not comply

Principle 15: Early detection and timely intervention and resolution

Trigger mechanisms to support prompt corrective action in dealing with failing banks

Financial-system safety-net participants must ensure that a framework exists for the prompt detection and resolution of troubled banks. The determination and recognition of when a bank is or is expected to be in serious financial difficulty should be made early and on the basis of well defined and transparent trigger mechanisms by safety net participants with the operational independence and legal authority to act. These arrangements need to be supported by strong regulation and supervision, sound accounting and disclosure regimes, and an effective legal regime (APEC, page 4).

Does a framework exist for the prompt detection and resolution of troubled banks?	Unknown
Is the determination and recognition of when a bank is or is expected to be in serious financial difficulty made on the basis of well defined and transparent trigger mechanisms?	Unknown

Does JDCS comply with Principle 15? (Fully/mainly/partly/do not comply)	May not comply as it is a host

The determination and recognition of when a bank is or is expected to be in serious financial difficulty made 'early'. The determination and recognition of when a bank is or is expected to be in serious financial difficulty should be made by safety net participants with the operational independence and legal authority to act. The trigger mechanisms for prompt corrective action supported by strong regulation and supervision, sound accounting and disclosure regimes and an effective legal regime.

No information has been provided to fully evaluate this principle for JDCS.

IADI Principle 16: Effective failure resolution processes

Is there a failure-resolution process and does it:

- ensure that depositors are reimbursed promptly and accurately?
- minimise resolution costs and disruption of markets?
- maximise recoveries on assets?
- settle bona-fide claims on a timely and equitable basis?

The deposit insurer or other relevant safety-net participant should have the authority to establish a bridge-bank (or related resolution mechanism) to help preserve critical banking functions by acquiring the assets and assuming the liabilities of a failed bank until a final resolution can be accomplished (FSF, page 32 and IADI General Guidance for the Resolution of Bank Failures, page 22).

Does JDCS (or other relevant safety-net participant) have the authority to establish a bridge-bank (or related resolution mechanism) to help preserve critical banking functions by acquiring the assets and assuming the liabilities of a failed bank until a final resolution can be accomplished?	No

Does JDCS comply with Principle 16? (Fully/mainly/partly/do not comply)	No

Principle 17 Reimbursing Depositors: Reimbursing depositors

The deposit insurer should be notified or informed sufficiently in advance of a bank closure to be able to prepare for timely payment of insured deposits. Systems and processes should be developed in order to undertake preparatory reviews of deposit liabilities held by troubled banks (FSF, page 34).

Determining who should be reimbursed and ensuring that deposit insurance limits are respected are crucial steps in the reimbursement process. Depositors need to know when and under what conditions the deposit insurer will start the reimbursement process, as well as the applicable coverage limits. Depositors should be told the time frame over which reimbursement will take place and whether any advance or interim payments will be made. Access to the necessary deposit data before the bank is closed lessens the risk of record manipulation, shortens the time for completing the reimbursement process and helps preserve public confidence (FSF, page 35).

Are systems and processes developed in order to undertake preparatory reviews of deposits liabilities held by troubled banks?	No
Is it transparent to depositors when and under what conditions the deposit insurer will start the reimbursement process?	No
Is the applicable coverage limits transparent to depositors?	Unknown
Are depositors told the time frame over which reimbursement will take place?	Unknown
Are depositors told whether any advance or interim payments will be made?	Unknown

Does JDCS comply with Principle 17? (Fully/mainly/partly/do not comply)	No

Most systems attempted to reimburse depositors as quickly as possible. Reimbursement periods vary considerably depending on the quality and security of bank deposit records.

Principle 18 – Recoveries

Asset-management, claims and disposition strategies should be guided by commercial considerations and their economic merits, the quality of the assets, the depth and condition of markets, the availability of expertise in asset management and disposition, legal requirements relating to the disposition of assets, and public-policy objectives (FSF, pages 34 and 36).

Are JDCS asset management, claims and disposition strategies guided by:

commercial considerations and their economic merits?	Unknown
the quality of the assets?	Unknown
the depth and condition of markets?	Unknown
(iii) - the availability of expertise in asset management and disposition?	Unknown
(iv) - legal requirements relating to the disposition of assets?	Unknown
(v) - public policy objectives?	Unknown

Does JDCS comply with Principle 18? (Fully/mainly/partly/do not comply)	No

Reflecting differing mandates and powers, the deposit insurers surveyed had varying roles in risk assessment and intervention. These ranged from highly developed risk assessment and intervention regimes to systems relying on other safety-net players for these services.

An important function of some deposit insurers, particularly those with risk minimizing mandates and associated powers, was a direct role in resolving problem institutions and failures. The extent to which deposit insurers can intervene and resolve failures satisfactorily depended on the objectives of the deposit insurance system and the powers accorded to the insurer and other financial system safety net players.