STATES OF JERSEY

DRAFT BANKING BUSINESS (DEPOSITORS COMPENSATION) (JERSEY) REGULATIONS 200- (P.86/2009): THIRD AMENDMENT (P.86/2009 Amd.(3)) – COMMENTS

Presented to the States on 3rd November 2009
by the Minister for Economic Development

STATES GREFFE

COMMENTS

The Minister recognises the Economic Affairs Scrutiny Panel's ("**the Panel**") wish to increase depositor protection. However, the Minister considers that the majority of the Panel's proposed amendments to the Draft Banking Business (Depositors Compensation) (Jersey) Regulations 200- ("**the DCS Regulations**") would, in reality, reduce depositor protection while increasing the costs to the public finances and risking the loss of jobs on the island.

- The scheme proposed by the Minister for Economic Development ("**the EDD Scheme**") meets the international standards of compensation for natural persons. In contrast, the amendments which effectively create a separate Scrutiny Scheme ("**the Scrutiny Scheme**") actually reduce depositor protection. There are 4 medium-sized banks where depositors would receive less compensation payments compared to the EDD Scheme.
- The Scrutiny Scheme would cost more for both the States and the banking industry. The States would lose £2 million in tax revenues even if no bank failed. The Scrutiny Scheme would cost £20 million for the banks even if there was no failure.
- The Scrutiny Scheme is uncompetitive compared to schemes in comparable jurisdictions. It potentially requires a bank to pay up to 24 times the amount levied under the EDD scheme per year and 48 times the amount levied under the Guernsey scheme per year.
- Jersey would risk losing far more tax revenues per year as a result of banks consolidating away from Jersey than the States would save by removing the States residual liability. For the avoidance of any doubt, models show that it is extremely unlikely that the States would have to contribute at all.
- The Scrutiny scheme is an "off the shelf" proposal designed for jurisdictions where banks fail on a regular basis. The EDD Scheme is designed on the advice of experts on Jersey's banking industry and insolvency procedures including the JFSC, the Viscount and Oxera who state that the risk of a failure in Jersey is extremely low.
- Jersey's strong regulatory regime coupled with the banks' lending model, and the fact that, almost without exception, the banks operating in Jersey are systemic in their home jurisdiction, means that there is an extremely low risk of bank failure in Jersey. The strength of Jersey's banks has been proven through the recent banking crisis that was one of the most severe that there has ever been.

SUMMARY

<u>A 'Jersey' Depositors Compensation Scheme</u>

Studies of Depositor Compensation Schemes in jurisdictions both small and large illustrate that there is no "one size fits all" model. Indeed, to best protect depositors, a scheme should be designed in order to meet the specific requirements of the jurisdiction.

The EDD Scheme was designed to take account of the unique circumstances of the deposit taking sector in the island. Jersey's strong regulatory regime coupled with the banks' lending model, and the fact that, almost without exception, the banks operating in Jersey are systemic in their home jurisdiction, means that there is an extremely low risk of bank failure.

This contrasts with the scheme that would result if the amendment put forward by Scrutiny Panel, which is designed to operate in a jurisdiction where bank failures are a regular occurrence.

This critical distinction shapes many of the differences in design between the EDD Scheme and the Scrutiny Scheme, including in particular with regard to the costs of operating a scheme and whether the scheme should be pre-funded.

Protection for Depositors

Clearly the scheme adopted in Jersey should match international standards for protecting depositors. The EDD Scheme meets the international standard by providing £50,000 protection to natural persons with deposits with Jersey banks.

However, the Scrutiny Scheme would offer **less** protection to depositors. Analysis of the banking data shows that the Scrutiny Scheme would not be able to pay out £50,000 immediately to depositors in several banks where quick payments could be made under the EDD Scheme. As a consequence, whilst the Scrutiny Scheme may appear, at first sight, to provide more protection to depositors, in reality it may provide less.

The reason is that Regulation 29 under the Scrutiny Scheme only permits the Board to expend £65 million on all the costs of a bank failure including the costs of administering the payments to depositors and the interest on the loan. Consequently, the Board would not be able to pay depositors the full £50,000 compensation in respect of the failure of any one of four medium-sized banks, which would all be fully covered under the EDD Scheme.

As there is no proposal for increased liquidity funding by the States the Scrutiny Scheme would not be able to compensate more depositors in accordance with international standards in the event of multiple failures than under the EDD Scheme.

A competitive DCS maximises the benefits for Jersey

Tax revenues generated by Jersey banks make a significant contribution to the public finances and employment in the Island. The EDD Scheme is designed to balance the need to meet international standards on depositor protection with the potential cost to the public finances and the employment consequences of banks consolidating out of Jersey.

Consolidation of international banks is a clear and present threat to the sustainability of Jersey's public finances and the employment prospects of 6,000 Jersey residents and their dependents.

In a letter to all States members, the Jersey Banking Association stated –

> "In 1997 there were 82 banks in Jersey. At the end of 2008 there were 47. This has already reduced in 2009 to 45. A number of banks have more than one licence, so there are actually only 25 banking groups in Jersey. In the current climate, where profits are declining and unlikely to recover in the next

> two to three years, most banks are scrutinising their costs to find savings, and this will inevitably lead to consolidations and cutbacks."

Furthermore, in a letter to the Minister, dated 23rd October 2009, the Director-General of the Jersey Financial Services Commission stated –

> "I can confirm that in the past three months the Commission has been officially notified of the withdrawal of four banking institutions from the Jersey banking sector, one of which is already in the public domain and three of which are not, which will be implemented over the next several months. The reason behind the withdrawal of these four medium size banks is in every case group rationalisation, whereby continuing representation in Jersey is not considered sufficiently important to the future of the wider group for these institutions to retain their licence here. The underlying driver is the management of costs, although one case is also linked to an EU competition ruling. In addition, there are a possible two further institutions where similar considerations may move from the theoretical to the actual in the next 12-18 months."

The cost of a depositor compensation scheme is one of the critical factors that govern consolidation decisions.

The EDD Scheme aims to reduce the risk of banks consolidating out of Jersey with associated office closures, job losses for Jersey workers and the loss of tax revenues that pay for essential services such as the hospital and schools.

Indeed, the EDD Scheme could encourage banks to consolidate into Jersey with increased jobs for Jersey residents and increased tax revenues for the States of Jersey, which is vital at a time when structural deficits are forecast.

<u>EDD Scheme developed through consultation</u>

The EDD Scheme is supported by the banks in Jersey following consultation with the Jersey Bankers Association ("**JBA**"). As a result of this process, the JBA is fully supportive of the implementation of depositor compensation in Jersey and considers that the EDD Scheme provides depositor protection in line with international standards while appropriately minimising the costs in accordance with the specific risks faced in Jersey.

In contrast, the Scrutiny Scheme, designed to operate in an environment where bank failures are a regular occurrence, would impose potentially unlimited charges on each bank. The JBA has indicated that there is a real risk that implementation of the Scrutiny Scheme would lead to existing banks giving up banking licences.

It must not be forgotten that Jersey operates in a highly competitive market place where both capital and banking institutions are highly mobile. Given this, it is vital that whilst providing high quality protection for depositors any DCS implemented in Jersey recognises the need to retain the Island's competitive position.

It would be inappropriate for the States to agree to the Scrutiny Scheme without full consultation with the proposed persons who would be taxed and who would pay the major costs of any scheme.

DCS should minimise the cost to the public finances

The EDD Scheme reduces the potential loss of tax revenues to the Jersey government by proposing a post-funded scheme. If no bank fails in Jersey then no bank has to pay a levy and there would be no loss in tax revenue for the States. This contrasts with the Scrutiny Scheme's incorporation of pre-funding which would result in the **loss of £2 million to the States of Jersey's tax revenues** as the £20 million reserve is built up.

Credibility rests on States liquidity not pre-funding

Financial stability is fundamental to the credibility of any depositor compensation scheme. In Jersey this credibility depends on Government support providing upfront liquidity funding. Government support reassures depositors that the EDD Scheme can pay out quickly and has real substance.

It is not the case that a £20 million pre-funded reserve would make the scheme more credible as the Scrutiny Report suggests, because there are many banks where £20 million would not be sufficient to make a quick payment out in the event of failure. The credibility of the scheme is based on the credibility of the Government support.

The fact that Jersey has no government debt and that the Treasury holds significant reserves gives both the EDD and Scrutiny Schemes credibility by providing immediate liquidity enabling quick payment in the event of bank failure.

Government support for banks and schemes is common in all jurisdictions. This may be explicit as in Guernsey and the proposed amendments in the Isle of Man. It is more often explicitly seen in the actions of nations when there is the possibility that a systemic bank may fail as demonstrated by the recent actions taken in many jurisdictions across the world.

'YELLOW AMENDMENTS'

The Scrutiny Panel's 'Yellow Amendments' are principally designed to establish a standing Board to administer the DCS straight away, paid for by levies on Jersey's banking industry. Further amendments provide for Board members to be appointed by the States (rather than by the Minister) and for the States to approve each Board member's terms and conditions.

Need to establish DCS Board immediately

The Minister has been persuaded by the Panel's arguments to accept the principle that there should be a standing board appointed immediately. The Minister also considers that it is an improvement for the States to appoint the members of the Board rather than the Minister.

However, there are improvements that need to be made to some of the Panel's amendments in this area. For example the proposed functions do not include acting in the best interests of the island, there are potential overlaps with the role of the JFSC, and the Board would be given an unfettered power to impose unlimited charges on the bank industry without any consultation. It is not appropriate for the States to get involved in the detail of the terms and conditions of the appointments of Board members and this would sit more comfortably with the Minister. The Minister undertakes to consider these areas, set out clearly the responsibilities of the Board and those of other organisations in this area, and feed these changes into the first annual review of the DCS made within 12 months of the DCS debate.

The Minister undertakes to provide for the administration costs of the standing Board for the first year in order to permit consultation with a view to passing the costs of administering the standing Board to the banks.

'GREEN AMENDMENTS'

The Scrutiny Panel's 'Green Amendments' propose to establish a £20 million pre-fund, paid for by levies on Jersey banks.

Pre-funding the Board

The Minister does not advocate pre-funding for a scheme that is tailored to the specific requirements of Jersey as the Panel's amendment would impose unnecessary costs on the public finances and the banking industry.

The amendments are based on rejecting the evidence of the Jersey experts that the risk of a bank failure in Jersey is very low.

It would result in a loss to the Treasury of £2 million in tax revenues even if a bank doesn't fail. It would result in the banking industry losing £20 million even if a bank does not fail in Jersey.

It would not lead to any increased benefits for the scheme. While the Panel state that pre-funding is essential for credibility, this view is not accepted. The ability to give depositors immediate payment out if a bank fails comes from the Government providing liquidity funding. This provides credibility to the scheme, not the proposal for pre-funding.

Finally, it would be entirely inappropriate for the States to agree to a charge on the banking industry without consultation. The Panel has not consulted with the proposed payer – the banks.

'BLUE AMENDMENTS'

The Scrutiny Panel's 'Blue Amendments' amount to an entirely new proposal. They would change the proposed DCS from a £100 million scheme for all bank failures over a 5 year period, into a £65 million scheme for each bank failure, remove provision for States shortfall funding and place an unlimited liability on Jersey banks.

Less Protection

This proposal is rejected because it would protect less depositors. The reduction of the cap from £100 million to £65 million would result in depositors in any one of the 4 medium-sized banks not being fully covered in contrast to the EDD Scheme. It therefore does not comply with the international standards for the coverage of a DCS.

In practice, it would not offer significant benefits, even if there is more than one failure. It would not be able to compensate more depositors quickly (as the international standards require) because there is no additional liquidity funding proposed on top of the States £100 million.

As well as failing to meet international standards, it imposes unlimited liability on the banks each year in contrast to other comparable jurisdictions (Guernsey scheme and Isle of Man proposals). Banks would face a potential liability of 24 times the previous U.K. levy rate and the suggested rate under the EDD Scheme (a fair rate when compared to other schemes).

Finally, there has been no consultation over the adoption of this proposal with the banks. The consequence is that the JBA have stated in a letter to the Minister that the Panel's proposal would lead to additional consolidation away from Jersey. If this amendment causes further consolidation away, the cost to the revenue as well as the effect on employment would be significant.