New Era of Banking Supervision Awaits

by Michael Sproule

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As we live through the impact of the credit crunch Michael Sproule foresees a tougher regime of performance standards for Banks and their Boards in meeting the requirements of best practice.

A new era of 'enhanced' banking supervision is upon us. Issues raised by the GFSC's Consultation Paper (August 2008) ("CP") and the Promontory Financial Group Report on Northern Rock (Guernsey) Limited and Landsbanki Guernsey Limited (January 2009) ("Promontory") are likely now to inform the approach which banks will be required to take to cross-jurisdictional supervisory issues in complying with the Code of Practice (November 2003) under section 36A of The Banking Supervision (Bailiwick of Guernsey) Law, 1994 ("the Code").

In this short article I have highlighted a number of areas of the Code where we may expect fresh or updated provisions to be proposed. These issues should be of particular interest to local non-executive and executive Directors:

1. **"Banks should have a policy statement on ethics and professional behaviour which is clearly communicated to all staff". (the Code - para. 4).**
   I refer to this first since that is the order in which it appears in the Code. Logically, when all else is in place, banks should be minded to revisit their policy statements as a concluding step so as to ensure that staff at all relevant levels meet their "responsibilities to their depositors" as newly formulated. The parameters of such responsibilities will of necessity pervade all the issues touched on in this article and many others besides. As a matter of promoting the culture of ethics and professionalism from the top down, the appointment of local, independent non-executive directors should do much to foster and encourage the climate of best practice throughout each institution (see Promontory - paras. 79 and 80).

2. **"Banks should ... ensure that [credit] policies, practices and procedures include a sound and well documented credit granting ... process ...". (the Code - para. 5).**
   Generally, of course, one of the pillars of sound credit is sound valuation, a topic of truly global dimensions too extensive to be explored here and one which has caused huge disruption to credit lines the world over. In any event, we can expect much new focus on safer lending by local banks to their onshore parent institutions ("upstreaming") and other "related counterparties". The CP proposes a percentage cap on upstreaming in order to keep back and ring-fence a balance of assets available to invest in a lower-risk, more diversified range (CP - para. 2.11). CP makes other supporting proposals with a view to achieving a fair balance of risks in this area. Promontory also alludes to the risks of "centralisation of treasury functions" and the disadvantages faced by local banks in assessing risk (Promontory - paras. 21 and 23).

3. **"Banks should ... have procedures in place to prevent persons benefitting from loans ... being part of the loan assessment or decision process ...". (the Code - para. 5).**
   In deciding to upstream, local boards of directors with their non-executive element will demonstrably need to exercise a proper level of independence so that conflicts of interest are avoided.

4. **"Banks should have in place comprehensive risk management processes ... periodically adjusted in light of the changing risk profile of the bank and external market developments". (the Code - para. 7).**
   CP reminds us that "recent events have demonstrated that management of risk must include the consideration of extreme and unusual circumstances" (CP - para. 2.4). It instances the perils for the healthy local subsidiary from the weakened parent. Accordingly, to the "changing risk profile of the bank" there should logically be added that of the parent.

   Promontory puts it starkly: "In time of need it is .... likely to be difficult to get liquidity back to the subsidiary and – even where possible – may be very evident, with consequent risks that adverse conclusions will be drawn in the market or by depositors". (Promontory - para. 22).

On any view, risk management is likely to require an altogether more sceptical and probing view of the parent's position and status in the market as demonstrated by reliable rating assessments and other sources.

5. **"Consideration should be given to diversification of funding sources, stress testing and contingency planning". (the Code - para. 7).**
   In the context of upstreaming it is arguable that this provision should be extended to funding placements, including loans to parent institutions. We have touched already on CP's proposals to limit such lending (CP - paras. 2.1, 2.11). This is mirrored by the close oversight role of the Commission in upstreaming cases (Promontory - paras. 34 to 37 and 58 to 61).

6. **"The board of directors of banks are responsible for banks having in place internal controls that are adequate for the nature and scale of the banks' business". (the Code - para. 8).**
   We may now expect the responsibility of directors to be extended to ensure that any parent institution to which the bank's assets are upstreamed has similar controls which satisfy its home regulator, and, through it, the Commission as host regulator.

7. **"The internal audit function should report direct to a parent undertaking with a demonstrable level of independence from local senior management or to an audit committee which can provide the requisite independence and experience ...". (the Code - para. 9).**
   In the light of recent upstreaming failures it is certainly arguable that, so far as possible, the reverse position should also now be adopted – that the internal audit function of the parent should also report direct to the subsidiary undertaking with a demonstrable level of independence from parental senior management or to a local audit committee which can provide the requisite independence and experience.

Conclusion

The Director General of the Commission has expressed pleasure that Promontory found that its "actions were wholly justifiable having regard to the facts known at the time and what could reasonably be foreseen". That was then. Our collective appreciation of the foreseeable has moved on markedly even since Promontory was commissioned to report.

It remains to be seen how and to what extent the Commission will expect banks to monitor the integrity of parental accounts and processes. Where, for example, there is a significant upstreamed loan on the local balance sheet, it may be appropriate for a Note to state whether the parent debtor's auditors have raised any issues concerning going concern risk and liquidity risk at that level.

Today we observe that in the light of the risks associated with cross-border banking the prudential concerns of the Commission as 'host supervisor' are bound, firstly, to be heightened and require effective translation into the models and plans of individual banks and, secondly, to be reflected in the controls it may reasonably expect of 'home supervisors' with direct charge over the parent institutions. Open and consistent co-operation between supervisors will be vital if banks are to emerge from the current crisis fit for purpose in the new era. It is clear that the seeds have been sown for a more rigorous climate of due diligence, audit and compliance in the days ahead.

It is obviously important that Boards of Directors address their minds to these on-going developments in supervision. We await the outcome of the IMF visit to Guernsey now scheduled for later in 2009.

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