



CONSULTATION ON THE INTRODUCTION OF PREFERRED DEBT STATUS FOR BANK DEPOSITS COMPENSATED UNDER THE GUERNSEY BANKING DEPOSIT COMPENSATION SCHEME

Purpose and Type of Consultation

This consultation paper is being issued to seek feedback from business, stakeholders, consumers, industry associations, practitioners and any other interested parties on the introduction of preferred debt status, for those qualifying deposits, covered by the Guernsey Banking Deposit Compensation Scheme (“**GBDCS**”) into Guernsey legislation. It is proposed that “**qualifying deposits**” (as defined in the Banking Deposit Compensation Scheme (Bailiwick of Guernsey) Ordinance, 2008 (the “**Ordinance**”)) which have become subrogated in accordance with the terms of the Ordinance,¹ be ranked as preferred debts (after liquidation costs, charges, expenses² and secured creditors) in the event of any bank default.³

Finance Sector Development (“**FSD**”) at the request of the Commerce and Employment Department is seeking feedback, comments and suggestions on:-

1. the introduction of preferred debt status for qualifying deposits which have become subrogated in accordance with the terms, of the Ordinance, in respect of the GBDCS and, if considered appropriate, the deposit compensation schemes operated by the other Crown Dependencies; and
2. amendments to the Preferred Debts (Guernsey) Law, 1983 (the “**PD Law**”) to allow for qualifying deposits, which have become subrogated in accordance with the terms, of the Ordinance, to be given priority over existing preferred debts, (as defined in section 1 of the PD law) in respect of the default⁴ of an entity which has been licensed by the Guernsey Financial Service Commission pursuant to section 6 of the Banking Supervision (Bailiwick of Guernsey) Law, 1994 (a “**Licensed Entity**”).⁵

Together the above referred to, in this consultation paper, as the “**Proposals**”.

The intention is that responses will be considered by the Committee for Economic Development (the “**Committee**”) when it is appointed, which will in turn produce recommendations in respect of the Proposals.

Closing date: **17th June 2016**.

¹ In accordance with section 23 of the Ordinance.

² As referred to in sections 383, 404 and 418 of the Companies (Guernsey) Law, 2008 (the “**Companies Law**”).

³ As defined in section 9 of the Ordinance. FSD notes that the EU Bank Recovery and Resolution Directive provides for equivalent treatment to be provided to the holders of qualifying deposits, though this principle is not being considered, or directly addressed, in this consultation paper. Respondents are however asked to note question 2 of this consultation paper.

⁴ In accordance with section 9 of the Ordinance.

⁵ FSD will consider whether:- (i) amending the **Ordinance** to grant preferred debt status to qualifying deposits is appropriate in the context; and (ii) any subsequent amendments to the **Companies Law** are appropriate to reflect the granting of preferred debt status to qualifying deposits.

FSD:-

1. would like to invite comments from all interested stakeholders, financial services businesses, customers and consumers about the Proposals; and
2. aims to work closely with stakeholders and industry to ensure the Bailiwick adopts the most appropriate changes to protect and enhance its economy, to ensure equitable outcomes for debtors and creditors (of a Licensed Entity in default) and to support the financial services industry.

This consultation paper is a working document and does not prejudge any final decision to be made by the Committee.

Please refer to section 5 “responding to this consultation” for full details of how to respond to this consultation paper.

Executive Summary

The financial crisis saw a number of large banks bailed out with public funds because they were considered to be “too big to fail”. While this may have been necessary to prevent widespread disruption to the financial markets (caused by the size and inter-connectedness of certain institutions), it was clearly undesirable for public funds to be used in this way at the expense of other public objectives.

First, and foremost, bank failures are prevented by their prudential supervision which is effected by national supervisory authorities.⁶ If, nevertheless, a bank fails, the GBDCS has the ability to compensate parties, who have made qualifying deposits, up to an amount of £50,000. The objective here is twofold:-

- (a) to protect a part of depositors' wealth; and
- (b) to ensure financial stability, by preventing bank runs.

This consultation paper seeks to explore the introduction of preferred debt status for qualifying deposits, which have been subrogated to the GBDCS pursuant to the Ordinance (“**Qualifying Deposits**”) by means of Bailiwick legislation.⁷ It proposes that Qualifying Deposits be ranked as preferred debts⁸ (after liquidation costs, charges, expenses and secured creditors) in the event of any Licensed Entity default.

The changes to the preferred debts regime would place Qualifying Deposits ahead of existing Bailiwick preferred debts, unsecured debts, postponed debts⁹, winding up or liquidation (together referred to as the “**Unsecured Creditors**”).

It is also proposed that, in limited circumstances, equal priority should be given to Qualifying Deposits and those covered by the deposit guarantee schemes of the other jurisdictions (if they are deemed to be similar)¹⁰ to ensure that the depositors covered by other deposit guarantee schemes receive the same treatment, in the event of a Licensed Entity failure which affects depositors in that other jurisdiction. The intention is that this would only be granted on a reciprocal basis.

FSD asks that recipients note that the above will be a significant project which will require the commitment of significant resources by the Committee and the Law Officers.

FSD also asks recipients to note that this consultation is not intended to elicit responses which affect the operation and current financial thresholds operated by the GBDCS.

⁶ In the case of banks, within the Bailiwick, the Guernsey Financial Services Commission (the “**Commission**”).

⁷ FSD intends to take advice from the Law Officers as to the most appropriate route with regard to legislative amendments. Please refer to footnote 4 in this regard.

⁸ This reflects the requirements set out in Article 108(b) of the Bank Recovery and Resolution Directive.

⁹ As set out in section 3 of the Partnership (Guernsey) Law, 1995.

¹⁰ The current intention is that this will be limited to the other Crown Dependencies. The details of how this will be affected are yet to be considered.

The consultation closes on 17th June 2016.

1. Background

One of the fundamental responsibilities of the GBDCS is that it must ensure that, in the event of a Licensed Entity default, the parties who made qualifying deposits are compensated on a timely basis. The GBDCS will, in such circumstances, provide that qualifying deposits are paid out in accordance with this principle.

Under the terms of the Ordinance, Licensed Entities are obliged to provide funding to the GBDCS in order to make payments to those parties covered by the scheme.¹¹ The payments, to be made by the GBDCS, are funded by payments from the participating Licensed Entities not in default. Under the current scheme, the GBDCS will not pay out more than £100,000,000 in any 5 year period. The liability of Licensed Entities is similarly capped. If this cap is reached, depositors may not receive the maximum amount of £50,000 each.

It is an established principle of insolvency law, in the Bailiwick, that when a corporate entity fails in such a manner so as to leave a shortfall in assets, in relation to its liabilities, the relevant loss must be allocated amongst its creditors. These same principles also dictate that all unsecured creditors should share in the shortfall. However, there has been broad agreement amongst international policymakers that some creditors (generally depositors) should be given special protection in such situations.¹²

There are ongoing discussions between the GBDCS and Treasury and Resources to establish facilities (the “**Facilities**”) to assist in accelerating the compensation payments, to be made by the GBDCS, in the event of a Licensed Entity going into default. The purpose of these Facilities are to assist in reducing the period between the Licensed Entity going into default and the GBDCS effecting payment to claimants. The ability to effect payments in a shorter time period will:-

- (a) reduce the potential hardship suffered, by claimants, if payments were to be delayed; and
- (b) increase public confidence in the GBDCS as a body.

In light of international developments, FSD wishes to explore the concept of Qualifying Deposits ranking as preferred debts ahead of Unsecured Creditors on the default of a Licensed Entity. This would put the GBDCS in a better position to recover monies from a Licensed Entity in default and repay any monies drawn down via the Facilities and from the Licensed Entities (not in default) and may also assist the GBDCS in responding to another default in the 5 year period.

¹¹ Under section 18 of the Ordinance as part of the overall payment profile a participating bank contribution, in any calendar year, is capped at the lesser of £1,000,000 or 50% of the participant’s average profits over the 3 years proceeding that year.

¹² This will generally be affected by local depositor compensation schemes.

2. The International Perspective

The EU Bank Recovery and Resolution Directive (the “**BRRD**”) was formally adopted by the European Council in May 2014 with the purpose of establishing a common framework for the recovery and resolution of credit institutions and certain investment firms throughout the EU. It also introduced a new hierarchy of creditors in respect of a bank which became insolvent.

The new hierarchy now includes a mandatory ‘**super preference**’ for deposits protected by EU deposit guarantee schemes and the schemes themselves, such as the financial services compensation scheme (the “**FSCS**”), for amounts below €100,000 (£75,000). This means that, on the insolvency of a UK bank, the FSCS will be the most senior class of unsecured creditor and is likely to recover more of its costs than under the previous creditor hierarchy.¹³

This new hierarchy has implications for the Bailiwick, the GBDCS and Bailiwick resident parties who hold accounts with EU banks which operate branches and/or subsidiaries in the Bailiwick.

The new order of creditor priorities means that depositors with deposits, placed in an EU bank (including EU branches of that bank) and covered by an EU deposit guarantee scheme (“**covered deposits**”) now rank ahead of other creditors. Other depositors with deposits including, those which exceed the EU deposit guarantee scheme threshold and deposits **in non-EU branches** (including those covered by the GBDCS) (“**eligible deposits**”), **are ranked below these “covered deposits”,** but above other debts effectively existing as a ‘**secondary preference**’.¹⁴

Deposits from a Guernsey subsidiary placed with its EU parent bank (i.e. deposit monies which are currently “up streamed” to the EU parent bank) are treated as unsecured debts and **will rank below a super preference and a secondary preference** on a bank insolvency as indicated above.

FSD has noted that the legislative changes in the UK and EU referred to above, have prioritised the claims of EU covered deposits¹⁵ over qualifying deposits (i.e. those held in a Guernsey branch of a UK/EU bank covered by the GBDCS) and over other unsecured deposits (such as “up-streamed” funds from a Guernsey subsidiary to an EU parent as indicated above).

Given the exposure of the Bailiwick and its domestic depositors, as set out above, FSD is of the opinion that the domestic regime needs to be amended to protect, as far as is possible, the interests of the Bailiwick’s depositors and the GBDCS. In addition to the proposals in this consultation paper, other measures will be brought forward for consideration in due course, such as the creation of a bank resolution authority.

¹³ This reflects the requirement of Article 108 of the BRRD which, as an EU Directive, will be implemented across EU member States.

¹⁴ Article 108(a)(ii) of the BRRD.

¹⁵ As defined in Article 2 of Directive 2014/49/EU on Deposit Guarantee Schemes.

3. Debt Preference in respect of Guernsey Entities¹⁶

There are five Licensed Entities whose activities are viewed by the Commission as material in respect of retail deposit taking. Of these only one operates as a subsidiary in Guernsey and thus would be directly affected by the Proposals on the failure of such a Licensed Entity.

Three of the remaining Licensed Entities operate as branches of banks incorporated as subsidiaries in the other Crown Dependencies (“CDs”). If, and to the extent that, reciprocal debt preference regimes were adopted across all the CDs then the GBDCS would benefit, in this regard, should such a Licensed Entity fail. As previously stated the details as to how this process would be effected are yet to be agreed between the CDs.

Finally the last Licensed Entity, of this group, operates as a branch of a UK bank and the introduction of the Proposals would have no effect on the treatment of the GBDCS under the UK insolvency regime, the relevant details of which have been set out in section 2 of this consultation paper.

Question 1

Do you believe it is appropriate for the creation of a preferred debts regime that would rank qualifying deposits, which have been subrogated to the GBDCS, as preferred debts after liquidation costs, charges, expenses and secured creditors? If your response is yes, please explain why?

Question 2

Do you believe that if the preferred debts regime, referred to in question 1, were to be established that all qualifying deposits, which are not subrogated to the GBDCS, should be given a secondary preference below the GBDCS but above Unsecured Creditors? If your response is yes, please explain why?

Question 3

Do you believe that further consideration should be given to the impact of the creation of such a preferred debt regime in respect of preferred debts under the PD Law, such as the subordination of employee salaries/remuneration pursuant to the PD law? ¹⁷ If your response is yes, please explain any concerns you may have?

Question 4

¹⁶ It should be noted that this section focuses on the main clearing banks and further consideration will need to be given to the status of local banks which are branches of banks in non EU countries.

¹⁷ FSD requests that stakeholders note, that this would place the GBDCS in respect of qualifying deposits above salaries, remuneration and holiday pay owed to employees as well as income tax and social insurance contributions deducted by employers from employees earnings. FSD invites responses as to whether stakeholders believe this is appropriate, particularly in light of situations where a liquidator may require staff with particular expertise to assist in a liquidation and the impact that such a change might have in respect of the retention of the same.

Do you have any issues/concerns with this proposed amended debt hierarchy? If so please give details of those issues/concerns.

4. The status of the other Crown Dependencies

The States of Jersey approved the establishment of the Jersey Bank Depositors Compensation Scheme (the “**Jersey DCS**”) in 2009. Pursuant to Article 32 of the Bankruptcy (Désastre) (Jersey) Law 1990 preferred creditor status was given to the Jersey DCS where the rights of an eligible depositor,¹⁸ in respect of an eligible deposit, have vested in the Jersey DCS board. At this point in time no other depositor compensation schemes are recognised as having the same rights as the Jersey DCS and the intention is for discussions to be had in this regard.

On the 11 September 2015, the Isle of Man Department of Economic Development (the “**Economic Department**”) issued a consultation paper on the introduction of preferred creditor status for bank deposits compensated under the Isle of Man Depositors Compensation Scheme (“**IoMDCS**”). The consultation closed on the 23rd October 2015 and the responses are being considered in the larger context of implementation of equivalent elements of the BRRD and the creation of a bank resolution authority. The Economic Department is considering recognising qualifying deposits subrogated to the depositor compensation schemes of Jersey and Guernsey in its legislation.

FSD is of the view that it is in the interests of the Bailiwick that equal priority should be given to each of the GBDCS, the Jersey DCS and the IoMDCS in respect of qualifying deposits, which have been subrogated to them, in relation to a bank which has become insolvent in another CD. This would only be considered where there is equivalence between the regimes.

FSD’s view is that it is unlikely that a branch of a CD clearing bank will be declared in default without the subsidiary also being declared in default in its home jurisdiction. In the event of a mutual default, both in the Bailiwick (in respect of a branch) and in another CD (in respect of the relevant subsidiary), the intention is that the mutual recognition of each CD’s depositor compensation schemes (in respect of subrogated qualifying deposits) would take effect providing equivalent protection, though the detail on how this would work has not yet been agreed.

In the case of a UK subsidiary (with a Guernsey branch) going into default, whilst the GBDCS would pay out to parties who made Qualifying Deposits in accordance with the terms of the Ordinance, the GBDCS would potentially rank as a party with a secondary preference as referred to in page 7 of this consultation paper.

In the unlikely event that a branch did go into default but the relevant subsidiary did not, then again the GBDCS would pay out to parties whom made qualifying deposits, but would then

¹⁸ As defined in the Banking Business (Depositors Compensation) (Jersey) Regulations 2009.

need to assess what actions would need to be taken in respect of rights which have been subrogated in accordance with the terms of the Ordinance and how they would be enforced.

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Question 5

Do you believe it is appropriate that preferred debt status should be available, under Bailiwick legislation, for a CD equivalent deposit compensation scheme (if approved by the GBDCS) to ensure reciprocal preferred debt status for each CD deposit compensation scheme.²⁰

If you do not agree with the above, please provide an explanation as to your reasoning?

Question 6

Please give any other comments which you consider are relevant to the Proposals.

5. Responding to the Consultation

Please provide your comments by 17th June 2016, in writing and preferably in a format that can be read by Microsoft Word. FSD requests responses to be made by email to the following address:

Email: financesectordevelopment@gov.gg

Alternatively they may be posted to:

Finance Sector Development – GBDCS Preferred Debt Consultation

Raymond Falla House

PO Box 459

Longue Rue

St Martin

Guernsey

GY1 6AF

The consultation closes on 17th June 2016.

¹⁹ FSD intends to take advice from the Law Officers to understand if, and to what extent, Bailiwick legislation would allow the GBDCS to seize assets of a bank branch.

²⁰ FSD notes that the Isle of Man Depositors' Compensation Scheme includes protection for corporates up to a maximum amount of £20,000 and this would need to be addressed before considering granting equivalence under Bailiwick legislation to this scheme.

1. When submitting your views please indicate whether you are responding on behalf of an organisation.
2. FSD is also interested in receiving general comments and feedback on the Proposals. Please feel free to respond to all, or some, of the questions.
3. Unless specifically requested otherwise, any responses received may be published either in part or in their entirety. Please mark your response clearly if you wish your response and name to be kept confidential. Confidential responses will be included in any summary of comments received.
4. The purpose of the consultation is to gather information, views and evidence which will allow an informed decision to be made regarding the Proposals. As in any consultation exercise the responses received do not guarantee changes will be made in accordance with what has been proposed.

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