Guernsey Financial Services Commission

Consultation Paper on Professional Indemnity Insurance

Fiduciary and Investment Sectors

8 December 2021

Contents

Responses to this Consultation Paper are sought by 14 February 2022.

We welcome and encourage respondents to provide feedback or comment on any section and question. Feedback may be provided via the Consultation Hub section of the Commission’s website (www.gfsc.gg).

Background

Professional indemnity insurance ("PII")

PII "covers liability for injury, damage or financial loss arising from a breach of professional duty carried out in good faith or negligent acts, errors or omissions in their professional capacity. The persons covered by the policy include the insured, any employees/partners, any agent and any predecessors" (Chartered Insurance Institute).

PII indemnifies firms in the event that they provide poor advice or are negligent when looking after other's assets. The cost of a claim combined with the legal expenses can be very large, often much greater than a firm's net assets. PII ensures primarily that clients who have suffered loss will be compensated but also that the firm can continue to service other clients. Should the loss event itself cause such reputational damage to the firm that it cannot continue, insurance to cover the financial cost of the claim will allow for an orderly wind-down of the firm; subject to the claim being covered.

The protection of the public against financial loss due to dishonesty, incompetence or malpractice by persons carrying on finance business is a statutory function of the Commission. One of the ways the Commission carries out this function is to impose a requirement on certain financial services businesses that they maintain PII. This is consistent with supervisory regimes in other jurisdictions.

Licensees must continue to meet the relevant statutory Minimum Criteria for Licensing, which among other things require that business is conducted in a prudent manner. A licensee shall not be regarded as conducting their business in a prudent manner unless it maintains an appropriate amount of insurance cover.

PII does not prevent a negative event for clients but may limit their financial loss as a result of it. It is therefore important that firms have PII that is of sufficient value and coverage to protect their customers and themselves.

Background to Changes in the PII Marketplace

The provision of PII has gone through significant changes in recent years at a market, regional and sector-specific level. This is partly as a result of general hardening of the insurance market but there have been particular issues reported for the PII sector such as historic under-pricing, significant losses in certain sectors and a reduced tolerance of loss-making by insurers. The limited number of insurers offering cover for Guernsey firms together with a unique legal system; smaller firms generating lower premiums; and business models with different risks (relative to UK) have added to the challenges in the Bailiwick's PII marketplace.

The current PII market conditions have impacted local Fiduciary and Investment licensees. Some firms reported that obtaining PII cover has become more difficult and premiums have also increased significantly. Some licensees struggled to obtain a PII policy with the level of cover required by the relevant rules. Further details on these are provided under the "Survey of firms" section below.

A review on PII

Towards the end of 2020 and the beginning of 2021, the Guernsey Financial Services Commission (the "Commission") issued questionnaires regarding PII arrangements to be completed by Full Fiduciary Licensees[1], entities licensed under the Protection of Investors (Bailiwick of Guernsey) Law ("PoI licensees") and Licensed Insurance Intermediaries. The surveys took place against a background of a hardening PII market.

The Commission has analysed data received from the completed questionnaires and consequently this Consultation Paper ("CP") now seeks views from industry on proposed changes to the current PII requirements for the Fiduciary and Investment sectors. As noted above, the Commission has engaged with the Fiduciary and Investment sectors, and the Insurance sector. The issues surrounding price and availability are relevant for all sectors, but various factors differentiate Fiduciary and Investment businesses from the Insurance industry. These factors include the exposure to retail customers; the location of customers; the nature of advice given within each sector; the average size of the firms; and each industry's claims experience. The Commission is therefore carrying out a separate consultation for the Fiduciary and Investment sectors. Where appropriate the Commission has adopted consistent approaches across all industry sectors. A separate CP making proposals in respect of PII for Insurance Intermediaries and Insurance Managers has also been published and is available on the Consultation Hub.

This CP presents key findings from the surveys and proposals concerning changes to be made to the existing rules. Proposals are driven by what is considered appropriate to a particular business model and where appropriate proposals have been aligned and are consistent between industry sectors as we are mindful some businesses hold more than one regulatory licence. All the proposed changes are summarised in the table in Appendix 2.

The Commission would like to thank the licensees which participated in the surveys for their cooperation.

[1] The licensees have now been re-categorised as Primary Fiduciary Licensees after 1 November 2021 when the Regulation of Fiduciaries, Administration Businesses and Company Directors, etc (Bailiwick of Guernsey) Law, 2020 came into effect.

Fiduciary and Investment Sectors

The Commission is aware that, owing to the hard insurance market, certain Fiduciary and Investment licensees have experienced challenges when renewing their PII policies. The Commission has also noted that the PII requirements within both the Fiduciary and PoI frameworks have been applied unchanged for many years and that the detail and level of regulatory requirements may benefit from being reviewed. These factors prompted the Commission to examine the PII requirements first through conducting a survey of licensees and then by performing a review of the regulatory policy:

- Survey - a survey was conducted of 120 licensees which represented 63% of the total Fiduciary firms and 48% of PoI licensees within scope[2] which included designated managers, designated custodians/ administrators, brokers and investment managers. Licensees were asked to provide data relating to their PII policies which included the level of cover, excess, scope of coverage and issues licensees came across when renewing a PII policy.
- Policy Review - a review of PII requirements under both the Licensees (Capital Adequacy) Rules and Guidance, 2021 ("Capital Adequacy Rules") and the Fiduciary Rules and Guidance, 2021 ("Fiduciary Rules") was performed. Comparison was made between the two sets of Rules and PII requirements applying to Fiduciary and Investment firms in other peer International Financial Centres (IFCs).

Informed by the findings of our survey and review of policy, in this CP, a number of proposals are made for revision to the minimum regulatory PII requirements within the Capital Adequacy Rules and the Fiduciary Rules. The overall aim of these proposals is to ensure that these requirements remain fit for purpose and consistent with the minimum licensing criterion to conduct business in a prudent manner, thereby helping to ensure appropriate levels of customer protection are maintained.

It is acknowledged that the respective risk profiles of the Fiduciary and Investment sectors are not identical and that the requirements for each sector therefore need not be the same. This is reflected in the differing proposals in respect of level and scope of cover. Nevertheless, the two regimes have been reviewed and considered together in this paper because there are common elements in the design of an effective regulatory framework, irrespective of the industry sector, and it is useful to draw on the strengths of each current framework to identify a common, effective approach. Moreover, joint consideration is important to create an appropriate alignment and avoid potential conflicting obligations for PoI licensees which also hold a Fiduciary licence (around 30%)[3]. Where appropriate, this paper presents the analysis and proposals separately for each sector and for ease of reference proposals are clearly labelled with FIDUCIARY and/or INVESTMENT as applicable.

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[2] PoI licensees with staff and premises in the Bailiwick.

[3] Excluding certain licensees subject to Rule 2.1(1)(d) of the Capital Adequacy Rules which require PII cover of a level which their directors deem sufficient to meet the licensees' commitments and business risk.

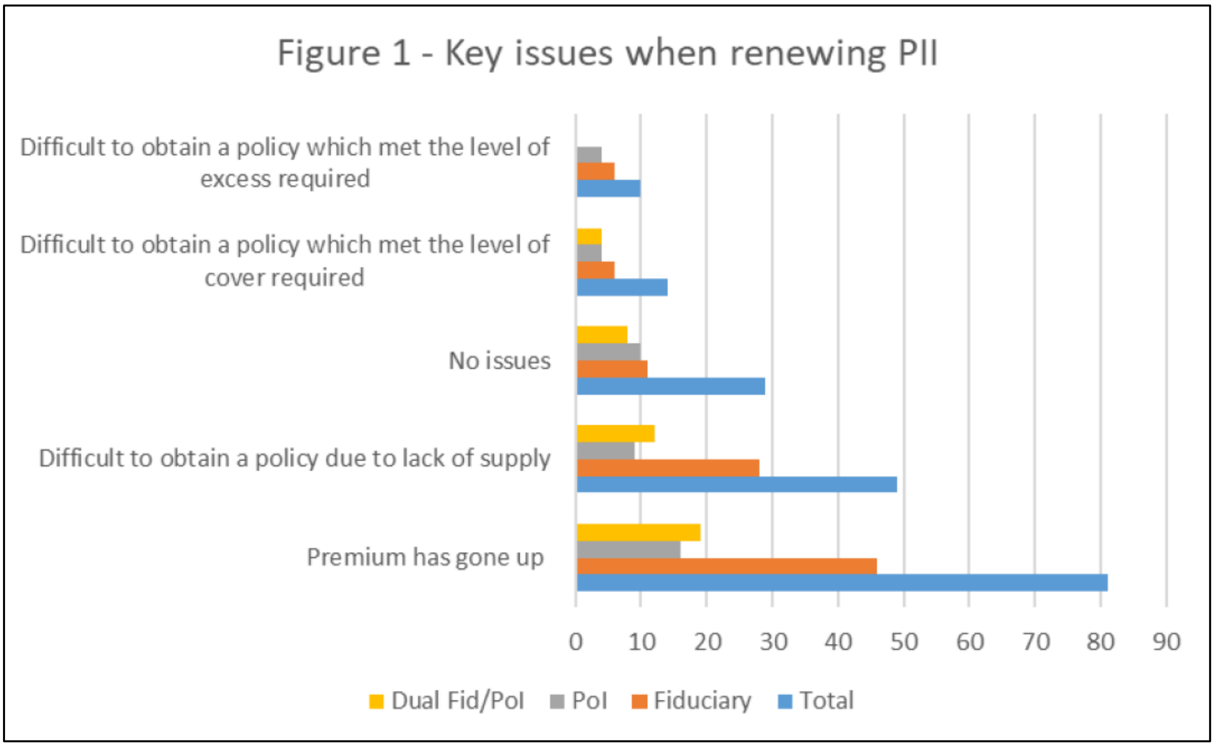
Overall, perhaps unsurprisingly, the survey found that premiums have increased significantly for most licensees and there have been difficulties for some at time of renewal, although the overwhelming majority have been able to find cover in line with the regulatory requirements, if at a price. The Commission is proposing one significant change that will reduce the aggregate cover requirements for a number of firms and align our framework more closely with peer jurisdictions. At the same time in reviewing the rules we have identified certain weaknesses that need to be addressed to ensure continued protection of customers and also some changes which can be made to remove inconsistencies for dual licensees.

1. Survey of firms

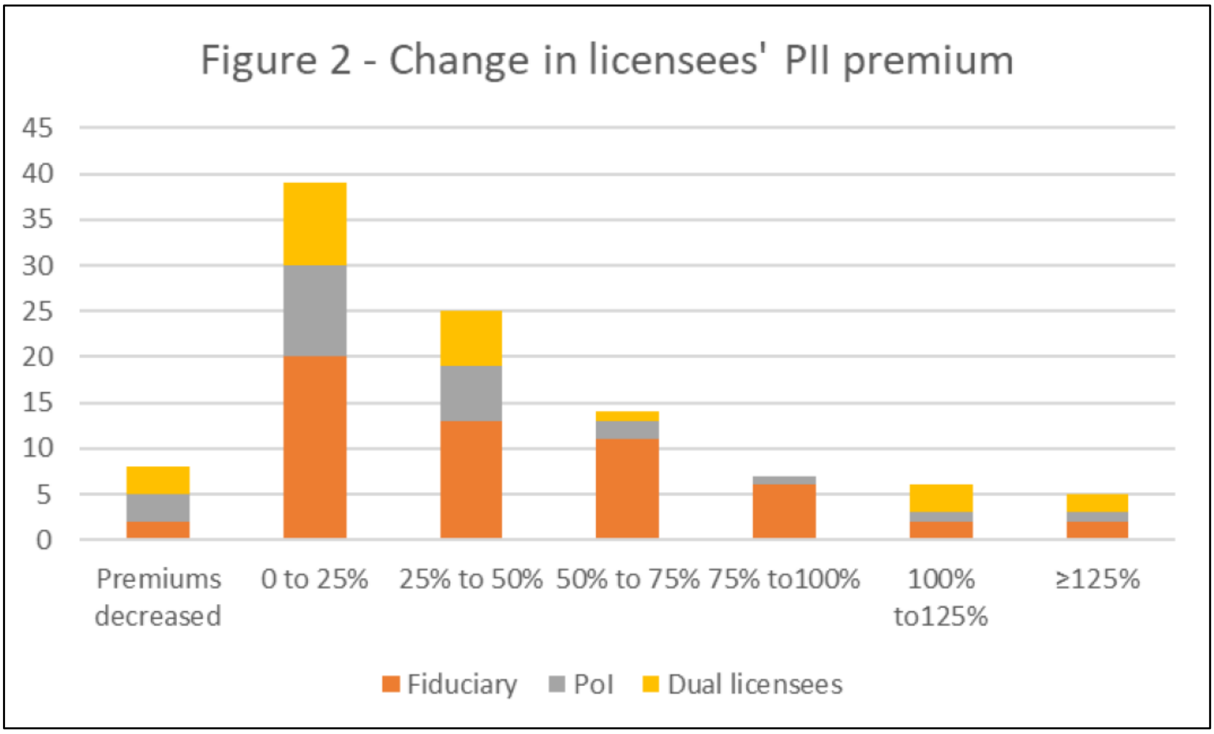
The questionnaire asked whether firms had experienced difficulties when renewing their PII policy. Figure 1 below presents a summary of the responses received from the 115 licensees which responded to this part of the questionnaire[4], 59 of which are Fiduciary licensees, 28 PoI licensees and 28 dual licensed firms.

Comparison was made between premiums paid by licensees for the previous PII policy and the current PII policy. Expiry dates of the "current policies" (at the time of the survey) ranged from December 2020 to December 2021 and expiry dates for the previous policies varied from December 2019 to December 2020 accordingly. From the chart, it is noted that 81 licensees out of the total of 115 (c.70%) identified that their premium had gone up significantly. The next most significant issue identified by respondents was that firms experienced challenges in obtaining a policy due to the lack of supply (43%). Fourteen (12%) and ten licensees (8%) responded that they had difficulties obtaining a policy which met the required level of cover and excess, respectively. 25% of licensees responded that they had no problem obtaining PII cover.

[4] Five respondents noted that they were unable to respond.



The questionnaire gathered data on the premiums paid by licensees for the current policy and the previous year's policy. Figure 2 below presents a summary of the findings. Almost 90% of respondents experienced an increase in premium. As seen from the chart, approximately 30% of respondents experienced a premium increase of greater than 50% with five licensees' premiums increasing by more than 125%. Where licensees reported a decrease in premiums year on year this was explained by a reduction in the amount of cover required in the second year. The ratio of premium to total expenditures ranges from approximately 1% - 10% and on average the increase in premium represents around a 2% increase in total expenses.



Further reference is made to the results of the survey in the following sections of this paper.

2. Level of cover – the current requirements

Current PII requirements for Fiduciary and Investment licensees

Overall, PII requirements for Fiduciary and Investment firms apply a similar approach in that the level of policy cover and maximum excess are linked to the firm's turnover. In most cases the minimum aggregate cover required is based on three times turnover with floors and exceptions applied in some cases:

Fiduciary Rules:
"The minimum indemnity limit for any one claim, or for aggregate claims, must be the greater of –
(a) three times turnover from regulated activities; or
(b) £1,000,000
where the turnover from regulated activities shall be taken from the previous year's audited financial statements or, for new businesses, estimated turnover for the first year."

The Capital Adequacy Rules (applicable to PoI licensees):
"...minimum professional indemnity insurance cover of either £300,000 or three times the total revenue, whichever is greater...."*

* The floor of £300,000 applies to a designated trustee, designated custodian or designated administrator of a Collective Investment Scheme but for other licensees a floor of £250,000 applies. There is no prescriptive PII coverage requirement for a PoI Licensee that is

administered by another licensee and that falls under Rule 2.1(1)(d) of the Capital Adequacy Rules, whereby it is required to hold "cover which is, in the opinion of its directors, sufficient to meet its commitments and to withstand the risks to its business".

3. Cap on the level of PII cover required under the Capital Adequacy Rules and the Fiduciary Rules (together "the Rules").

As a part of the regulatory review, the Commission carried out comparison of the PII requirements between Guernsey and other comparable jurisdictions. Additionally, the Commission also reviewed the claims record of licensees, including the number and value of potential claims and the actual claims made.

It is noted that unlike the other peer jurisdictions, the Guernsey regime does not cap the required minimum level of PII cover.

FIDUCIARY and INVESTMENT

Following review, the Commission proposes that the requirement for licensees to have a PII cover of three times the total revenue should be maintained. However, a cap (on the required minimum level of PII cover) should be introduced. In this regard, where three times total revenue of the PoI or Fiduciary licensee exceeds £10,000,000:

1) For licensees which rely on a Group PII policy, the level of cover provided by the Group would be considered acceptable to meet the Rules if it is at least £10,000,000 and the board of the licensee has appropriately assessed the Group PII policy and considered that the cover is appropriate for its local business.
2) For licensees which do not rely on a Group PII policy, a level of cover of at least £10,000,000 would be accepted provided that the board of directors of the firm has considered and decided that such level of cover is appropriate and sufficient for its business.

Where a licensee considers and decides to obtain a PII policy with a level of cover less than three times total revenue as per 1) or 2) above, the licensee must be able to evidence the required board assessment if requested by the Commission.

The cap on PII cover is proposed because:

- The cap allows more licensees to consider the level of PII cover appropriate to their business while still creating a minimum protection level for investors across the board. This is in line with the minimum criteria for licensing where licensees are required to maintain a level of PII cover which is commensurate with the size and nature of their business[5];
- It was observed in some cases that where a licensee is a part of a group and where the local entity generates high turnover, the licensee might have to seek to obtain a "top

[5] Paragraph 5(2)(a)(ii) and (4) of Schedule 4 of the Protection of Investors (Bailiwick of Guernsey) Law, 2020 and paragraph 5(2)(a)(ii) and (4) of Schedule 1 of The Regulation of Fiduciaries, Administration Businesses and Company Directors, etc (Bailiwick of Guernsey) Law, 2020.

up" policy to meet the local regulatory requirements. In some cases, this created required minimum cover significantly in excess of any potential claim and which might not be easily available in the market. The introduction of the cap would mean that such licensees would not be required to seek an excess layer of PII cover in addition to that provided by the Group policy if the local board is satisfied with the Group PII policy;

- Whilst historic claims performance is not necessarily an accurate predictor of future claims, the claims histories reviewed provides some indication and a level of comfort for the proposed cap; and
- This proposal is broadly in line with other peer jurisdictions where the required minimum level of PI cover for regulatory purposes is capped.

Data showed that 46% of all PoI licensees and 22% of all Fiduciary licensees are required to hold PII cover of higher than £10m and therefore may have a reduced minimum PII cover requirement if the cap is introduced.

FIDUCIARY and INVESTMENT

Q1: Do you have any comments on the proposal to introduce a cap of £10,000,000 on the required minimum level of PII cover under the Capital Adequacy Rules and the Fiduciary Rules?

4. Cover per claim

The Fiduciary Rules specifically provide that the minimum level of PII cover applies to both the aggregate cover and the limit for any one claim. Unlike the Fiduciary Rules, the Capital Adequacy Rules are silent on this point. This lack of clarity has caused inconsistencies in how PoI licensees interpret the rule. It was noted from the responses to the questionnaire that of the 60 PoI licensees which submitted their response, 10 licensees have PII policies with a limit on each and every loss less than the total aggregate cover. Six of these licensees hold a PII policy with a limit on each and every loss less than 3 times turnover.

INVESTMENT

It is therefore proposed that the Capital Adequacy Rules are amended as follows:
<u>current requirement</u>
"...minimum professional indemnity insurance cover of either £300,000 or three times the total revenue, whichever is greater…."
<u>proposed new rule</u>
"...the minimum indemnity limit for any one claim, and for aggregate claims of either £300,000 or three times the total revenue, whichever is greater…."

Without the proposed change, a PoI licensee may obtain a policy which meets the level of cover required by the rules through the aggregate limit, but with a very low level of cover for each and every loss, thus it provides a lower level of protection to customers. The proposed change will increase clarity, promote a level playing field for licensees and help to ensure a greater level of investor protection. The proposal would also bring the requirement for PoI licensees in line with that of the Fiduciary regime and peer jurisdictions.

INVESTMENT

Q2: Do you have any comments on the proposal to provide greater clarity regarding the level of aggregate and limit for each and every loss?

5. Total revenue/ income

5.1 Level of cover: Three times total revenue/ income

The Capital Adequacy Rules require PoI licensees to hold a PII policy offering cover equivalent to three times total revenue, with *"total revenue"* defined as *"revenue of any type, which shall include commissions, investment management fees, advisory fees, interest and dividends".* This differs from the Fiduciary Rules where *"income from fiduciary regulated activities"* is used instead of total revenue.

The requirement for a PoI licensee to include revenue of all types toward the calculation of the PII cover ensures that the level of cover takes into account other (non-regulated) activities carried out by the firm given that it is possible that a claim is made against the licensee in relation to such activities. Conversely, in calculating the level of PII cover, the Fiduciary Rules only include income from regulated fiduciary activities. The Commission considers that the same rationale should also apply to Fiduciary licensees as a claim can be made against a Fiduciary licensee in relation to non-regulated fiduciary activities and our analysis indicates that the impact of this change would be minimal. The Commission, therefore, proposes that the discrepancy between the two sets of rules is removed by amending Rule 4.1(2) of the Fiduciary Rules as follows:

FIDUCIARY

The minimum indemnity limit for any one claim, or for aggregate claims, must be the greater of –

(a) three times turnover ~~from regulated activities~~; or

(b) £1,000,000,

where the turnover ~~from regulated activities~~ shall be taken from the previous year's audited financial statements or, for new businesses, estimated turnover for the first year.

5.2 Gains from proprietary portfolio trading

Currently, the definition of “total revenue” in the Capital Adequacy Rules captures gains and losses from proprietary portfolio trading. There is an argument to be made that such gains and losses should be excluded from the calculation of PII cover because these do not correspond to the level of ongoing operational activity and therefore the risk of a claim made by a client. Gains and losses may also be relatively significant in relation to turnover leading to large fluctuations in the required PII cover. The same principle should also apply to the requirement under the Fiduciary Rules. The Commission, therefore, proposes changes to “total revenue” in the Capital Adequacy Rules and adding a guidance note to Rule 4.1(2) of the Fiduciary Rules as follows:

INVESTMENT

The Capital Adequacy Rules

Change the definition of “total revenue” from *“revenue of any type which will include commissions, investment management fees, advisory fees, interest and dividends”* to *“revenue of any type which will include commissions, investment management fees and advisory fees. <u>Total revenue does not include gains or other investment income from a licensee’s proprietary investment portfolio”.</u>*

FIDUCIARY

The Fiduciary Rules

Guidance Note:

<u>Turnover does not include gains or other investment income from a licensee’s proprietary investment portfolio.</u>

FIDUCIARY

Q3: Do you have any comments on the proposal to include income received from non-regulated activities within “turnover” when calculating the level of PII cover under the Fiduciary Rules?

FIDUCIARY and INVESTMENT

Q4: Do you have any comments on the proposal to exclude gains or other investment income from a licensee’s proprietary investment portfolio when calculating the level of PII cover under the Capital Adequacy Rules and the Fiduciary Rules?

6. The minimum PII cover for PoI licensees

The Capital Adequacy Rules require that the minimum PII cover for a designated trustee ("DT") or a designated custodian ("DC") of an open-ended Collective Investment Scheme ("CIS") and a designated administrator ("DA") of a CIS is the greater of £300,000[6] or three times total revenue. It was noted as a part of the regulatory review that the fixed minimum PII cover of £300,000 ("the floor") is considerably lower than in the Fiduciary sector and other offshore financial centres[7].

INVESTMENT

It is recognised that the PoI licensees acting as DT, DC or DA carry on a core function in respect of funds businesses and, having reviewed the relevant claims history of PoI licensees, the Commission considers that the current floor of £300,000 may be inadequate. The Commission, therefore, proposes amending the Capital Adequacy Rules to require that the level of PII cover for PoI licensees which are DT, DC or DA is the greater of £1,000,000 or 3 times total revenue. It is not proposed that a similar change is made in respect of other categories of licensee for which the floor of £250,000 would continue to apply. According to the data from the latest Investment Returns and the responses to the survey, it is anticipated that the impact of the proposed change would be minimal as the majority of the DTs, DCs or DAs would already hold cover in excess of the proposed floor.

INVESTMENT

Q5: Do you have any comments on the proposal to amend the Capital Adequacy Rules to require DT, DC or DA to hold minimum aggregate PII cover of £1,000,000 or three times turnover, whichever is greater?

[6] For other licensees which are not DT, DC or DA, other than those subject to Rule 2.1(1)(d), a floor of £250,000 applies instead of £300,000.

[7] The Fiduciary Rules require £1,000,000. As for the investment sector, one peer IFC requires £1,000,000 while another applies £1,500,000.

7. Excess and Regulatory Resources

FIDUCIARY and INVESTMENT

7.1 Excess

Theoretically a maximum level of PII excess is set to minimise instances where claims or parts of claims below PII coverage levels cannot be paid. It is noted that there are differences in excess requirements for Investment and Fiduciary licensees. The maximum excess permitted by the Capital Adequacy Rules is considerably higher than that under the Fiduciary Rules. The 20% of the total insured as required by the Capital Adequacy Rules equates to an excess of 60% of total revenue (20% x 3 x total revenue) in most cases.

7.2 Regulatory resources - deductions

Separately, the calculation of the Fiduciary Financial Resources Requirement ("FRR") also takes into account PII excess. Theoretically, requiring a Fiduciary to deduct one excess from the calculation of liquid assets required to be held, ensures that these licensees should be able to fund the excess in the event that a claim is made on the PII policy. The Investment Capital Adequacy Rules currently do not contain an equivalent provision.

7.3 Comparison

The table below compares the regulatory requirements on PII excess and regulatory resources between Fiduciaries and Investment licensees in Guernsey and two peer IFCs.

Table 1 – Regulatory mapping comparing the excess and regulatory resources deductions for Investment and Fiduciary firms in Guernsey and other IFCs.

	Investment	Fiduciaries
Excess		
Guernsey	Must not exceed 20% of the total insured	No more than 3% of turnover (from fiduciaries regulated activities)
IFC1	Must not exceed £5,000 or 3% of the annual relevant fees and commissions, whichever is greater	Must not exceed £20,000 or 3% of the annual relevant fees and commissions, whichever is greater
IFC2	No requirement	No requirement
Regulatory resources requirements		
Guernsey	Excess not deducted from the Financial Resources Requirement ("FRR") calculation	At least one excess is deducted from the FRR calculation
IFC1	The amount of the excess on a registered person's PII policy should be treated as an additional liability within the calculation of the FRR or the Adjusted NET Liquid Assets (ANLA) in all cases.	
IFC2	Excess on PII forms a part of the total liquid capital requirement.	

7.4 Proposals

Having analysed data from regulatory returns and responses to the PII survey and reviewed Guernsey's current regulatory regime compared to other jurisdictions, the Commission proposes the following changes:

(1) FIDUCIARY

Amend rule 4.1(3) of the Fiduciary Rules from "Any excess must not exceed 3% of turnover from regulated activities." to "Any excess must not exceed 3% of turnover."

This proposed change is in line with the proposal set out in 5.1 above. It is expected that the impact of the proposed change will be minimal.

(2) INVESTMENT

Deduct the PII policy excess when calculating "net assets" for the financial resources requirements under the Capital Adequacy Rules applicable to PoI licensees.

As noted above, licensees must be able to pay out the excess amount should a claim be made. It is observed that a common measure applied by other regulators is to treat a PII excess as additional liability when calculating the resources requirement. Capital resources are held by a licensee to allow for an orderly wind down, at least over a 3-month period and should not be set aside to meet any excess pay out. It is logical therefore to deduct the excess in the calculation of the resources requirement. This practice also currently applies to the Fiduciary sector.

FIDUCIARY and INVESTMENT

Q6: Do you have any comments on the following proposals: (1) to amend rule 4.1(3) of the Fiduciary Rules from "Any excess must not exceed 3% of turnover from regulated activities." to "Any excess must not exceed 3% of turnover". (2) to deduct a PII excess when calculating "net assets" for the financial resources requirements under the Capital Adequacy Rules.

(3) FIDUCIARY and INVESTMENT

The Commission is mindful of the hard PII market and has very carefully considered where it could make requirements easier whilst not damaging its objectives, including investor protection.

An argument could be made, if the proposal under 7.4(2) is implemented (PoI licensees required to deduct the minimum of one excess when calculating "net assets" for the financial resources requirements under the Capital Adequacy Rules that there is no need to also have an absolute minimum excess requirement (i.e. the PoI 20% of total insured and 3% of turnover for Fiduciaries). However, sole reliance on excess deduction when calculating FRR under the Fiduciary Rules or the net assets under the Capital Adequacy Rules requires that the resources retained to meet the excess are truly liquid and readily available in the event of a claim.

The Commission is therefore open to considering removal of the absolute excess minimum requirements under the PoI and Fiduciaries frameworks provided that such consideration would be accompanied by a review of the applicable financial resources requirements under the respective Rules to ensure that adequate resources are held, and are sufficiently liquid, to meet the excess.

Put colloquially, A case could be constructed that regulatory capital deductions (7.2) provides a belt, and excess (7.1) provides braces. We could remove the braces if we were confident the belt worked.

FIDUCIARY and INVESTMENT

Q7: Are you supportive of consideration of the removal of the absolute excess minimum requirements under the PoI and Fiduciaries frameworks and accompanying review of the applicable financial resources requirements under the respective Rules?

8. Dual or multiple licensees

FIDUCIARY and INVESTMENT

8.1 Fiduciary licensees and PoI licensees which also hold a licence under the Banking Supervision (Bailiwick of Guernsey) Law 2020 ("Banking Law"), The Insurance Managers and Insurance Intermediaries (Bailiwick of Guernsey) Law, 2002 ("IMIIL") or The Insurance Business (Bailiwick of Guernsey) Law ("IBL"), 2002, referred to as "dual licensees"

It is recognised that there are a number of Primary Fiduciary Licensees and PoI licensees which are also licensed under another regulatory law. There are currently 17 PoI licensees and one Primary Fiduciary Licensee which also hold a Banking licence. The main business or core functions of these 18 licensees are banking (Fiduciary or Investment are ancillary to their business). Data also showed that 12 PoI licensees and 4 Primary Fiduciary Licensees are also licensed under the IMIIL or the IBL. The 16 licensees, with the exception of one, are also licensees whose core functions are either insurance business or banking.

FIDUCIARY and INVESTMENT

8.2 PII requirements –carve-out for certain dual licensees

The Fiduciary Rules currently do not provide for a carve-out for Fiduciary licensees which are also licensed under another supervisory law. This means that Fiduciary licensees must comply with the PII requirements under the Fiduciary Rules and those issued under another supervisory law. In contrast, the Capital Adequacy Rules provide a carve-out for a PoI licensee which is also licensed under another supervisory law. However, this carve-out is only applicable to a PoI licensee which is not a DT, DC or DA and where the licensee has received a written confirmation from the Commission that the insurance requirements under the other law take precedence.

The Commission proposes that the Fiduciary Rules are amended to disapply the PII requirements set out in the Rules where a Fiduciary Licensee[8] is also licensed under the Banking Law, IMIIL or IBL and has obtained a PII policy which meets the requirements as set out under the relevant supervisory law. The carve-out would be contingent on the licensee representing to the Commission that it has undertaken analysis that the insurance requirements under the Banking Law, IMIIL or IBL, as the case may be, are adequate for their business and receipt of the Commission's confirmation of agreement to the disapplication of the PII requirements under the Fiduciary Rules.

It is also proposed that the Capital Adequacy Rules are amended to provide for a carve-out for PoI licensees which are DT, DC or DA.

FIDUCIARY and INVESTMENT

Q8: Do you have any comments on the proposal to provide for a carve out for a fiduciary licensee or a PoI licensee (DT, DC or DA) which is also a bank or a licensed insurer whereby the licensee would only have to comply with the requirements issued under the banking law, IMIIL or IBL as applicable?

8.3 Dual licensees - Fiduciary and Investment

FIDUCIARY and INVESTMENT

Due to differences between the Capital Adequacy Rules and the Fiduciary Rules in the calculation of the minimum required level of PII cover and excess, licensees which hold both a Fiduciary licence and a PoI licence currently have to calculate the levels of PII cover as

[8] To include both Primary Fiduciary Licensees and Secondary Fiduciary Licensees since the PII requirements apply to both categories.

required by both sets of rules and follow the most stringent requirements. Going forward, if the proposed changes under 5.1 (regarding the use of "total revenue" for Fiduciary licensees) and 7.2 (the excess is deducted from the regulatory capital requirement) are implemented, both sets of rules will be much more closely aligned and there will be fewer differences. The Commission is therefore not proposing to include a carve-out in the Fiduciary Rules or a Capital Adequacy Rules for dual licensees which hold both a Fiduciary licence and a PoI licence.

9. Self-insurance

9.1 Fiduciary and Investment sectors

Currently, it is possible for a Fiduciary licensee to rely on self-insurance where "*its parent or ultimate parent is of sufficient stature*", as stipulated under rule 4.1(4) of the Fiduciary Rules[9]. This position is different for the Investment sector as self-insurance is not recognised within the Capital Adequacy Rules. Therefore, in meeting three times total revenue, if a PoI licensee relies on a combination of insurance which includes self-insurance, the element of self-insurance is not taken into account.

Data gathered from the Fiduciary Annual Returns showed that there are only a few licensees which specified that they are relying on self-insurance. However, further investigations and review of their submitted response to the PII survey revealed that all of these licensees were in fact relying on a captive or a group policy which has a high level of excess.

The Fiduciary Rules do not currently offer a definition of "self-insurance". The Commission takes the view that self-insurance differs from commercial insurance in that with self-insurance, risk is retained by the firm whereas risk is transferred to an insurer in the case of a commercial insurance arrangement. For the avoidance of doubt and for the purposes of the application of the Fiduciary Rules, the Commission does not deem that captive insurance is regarded as "self-insurance".

9.2 Proposal

FIDUCIARY

The Commission proposes that the reference to self-insurance from the Fiduciary Rules be removed. The proposal will also bring the Fiduciary regime in line with the Investment regime.

FIDUCIARY

[9] This rule has been incorporated unchanged from the previous Codes (Codes of Conduct for TSP, CSP and FSP).

Q9: Do you have any comments on the proposal to no longer accept the use of self-insurance for Fiduciary licensees?

10. Scope of cover

FIDUCIARY and INVESTMENT

It is proposed that certain compulsory terms and conditions for PII policies are introduced. There are already some minimum requirements on the scope of PII coverage currently prescribed in the Fiduciary Rules. The Capital Adequacy Rules are, however, currently silent on scope of PII cover.

Increasing the level of prescription on the terms and conditions would improve the quality of coverage and customer protection. It is proposed that the following terms and conditions are made compulsory in PII policies for Fiduciary licensees and PoI licensees:

1. PII policies must include cover for –
   (a) negligence, errors or omissions by the licensee or its employees;
   (b) any liability for the dishonest or fraudulent acts of employees which may fall on the licensee;
   (c) liabilities of its employees who, in the course of their duties to the licensee, perform functions in their own names;
   (d) liabilities which the licensee might incur in any jurisdiction in which it carries on business;
   (e) ombudsman awards; and
   (f) legal defence costs.
2. Defence costs must not contribute to the individual loss or aggregate limit.
3. In the event that a claim is made on the PII policy and causes the aggregate level of PII cover to deplete, the licensee must take actions to reinstate the level of cover.
4. The licensee must notify the Commission as soon as it becomes aware that there is a retroactive date applied to their PII policy and the retroactive date is after the date the firm was licensed.

Appendix 1 provides further detail and rationale for the proposed changes.

FIDUCIARY

Q10: Do you have any comments on the additional terms and conditions proposed to the Fiduciary Rules?

INVESTMENT

Q11: Do you have any comments on the proposed requirements concerning scope of PII for the Investment sector?

11. Notification relating to PII

Rule 5.2(1)(j) of the Fiduciary Rules requires that a Fiduciary licensee must notify the Commission (i) when a notification under a PII policy is made to its insurer; or (ii) if there is any payment made, by the insurers, under the PII cover. The Capital Adequacy Rules do not contain such specific notification requirements and therefore it is proposed that requirements similar to Rule 5.2(1)(j) are added to the Capital Adequacy Rules.

INVESTMENT

Q12: Do you have any comments on the proposal to add notification requirements relating to PII to the Capital Adequacy Rules?

12. Run-off PII cover

FIDUCIARY and INVESTMENT

The Fiduciary Rules and the Capital Adequacy Rules are currently silent on run-off PII cover. International standards require that regulators should give consideration to imposing requirements for the licensees to have in place run-off PII where a licence is surrendered or revoked[10]. In this regard, the Commission has considered whether it would be appropriate to add a run-off PII cover requirement to the relevant Rules. Taking the view that the circumstances of each run-off scenario may be quite different, however, it is proposed that the current practice should continue. A decision on whether to direct that run-off PII cover is obtained would be made on a case-by-case basis upon surrender or revocation of a licence. It is expected that in most cases, a licensee would need to have cover in place[11].

[10] The Standard on the Regulation of Trust and Corporate Service Providers – Group of International Finance.

[11] The requirement may be made by giving a direction issued under s.9 (Power to issue directions) of the Fiduciaries Law, 2020 or s.30 of PoI Law, 2020.

Q13: Do you have any other comments on the regulatory requirements concerning PII for the Investment or Fiduciary sectors?

Next steps

Feedback to this CP is welcomed and will be considered by the Commission with a view to issuing a revised draft of the Fiduciary Rules and Capital Adequacy Rules by H1, 2022. It is envisaged that, for practical reasons, new rules relating to PII as proposed above, if implemented, will not apply to existing PII policies, but will apply from the next renewal date.

Appendix 1 – Scope of cover

FIDUCIARY

Comparison between the proposed terms and conditions in the current Fiduciary Rules is presented below. Text in green below shows areas of cover not currently addressed in the Fiduciary Rules.

1. PII policies must include cover for –
   (a) negligence, errors or omissions by the licensee or its employees;
   (b) any liability for the dishonest or fraudulent acts of employees which may fall on the licensee;
   (c) liabilities of its employees who, in the course of their duties to the licensee, perform functions in their own names;
   (d) liabilities which the licensee might incur in any jurisdiction in which it carries on business;
   (e) ombudsman awards; and
   (f) legal defence costs.
2. Defence costs must not contribute to the individual loss or aggregate limit.
3. In the event that a claim is made on the PII policy and causes the aggregate level of PII cover to deplete, the licensee must take actions to reinstate the level of cover.
4. The licensee must notify the Commission as soon as it becomes aware that there is a retroactive date applied to their PII policy and the retroactive date is after the date the firm was licensed.

In order to incorporate the additional requirements, the following changes would be made to the Fiduciary Rules, if the proposals are adopted:

1) Amend Rule 4.1(5)(b) to read "any liability for the dishonest <u>or fraudulent</u> acts of employees which may fall on Primary or Secondary Fiduciary Licensees".*
   This change will not only provide more clarity on the scope of the PII policy, but also bring Guernsey in line with other IFCs and the insurance sector. From the review of PII survey, the majority of the licensees obtained a PII policy which covered fraudulent acts. As a result, it is expected that there will be minimal impact from this change.
   * proposed additional text is underlined
2) Add to Rule 4.1(5) "(f) for PSPs, ombudsman awards".
   This change will bring Guernsey in line with the insurance sector and the other IFCs.
3) Legal defence costs
   3.1) Add to Rule 4.1(5) "(e) legal defence costs"
   We have observed a number of disputes which led to litigation within the Fiduciary sector. Some cases involved legal costs arising from multi-jurisdictions. This change is recommended to ensure that legal defence costs will be covered under a PII policy obtained by licensees. It was noted from the PII survey that almost all of the Fiduciary respondents obtained PII policies which specifically included legal defence costs and therefore it is expected that the impact from implementation of this change would be minimal.

3.2) Add Rule 4.1(2)(A) which reads "Defence costs must not contribute to the individual loss or aggregate limit."
As noted above, the Fiduciary sector is more susceptible to large legal defence costs. It is important that the clients/ investors who have suffered loss will be compensated and therefore this proposal is to ensure that the aggregate limit is not depleted during the litigation process.

4) Add Rule 4.1(2)(B) which reads "In the event that a claim is made on the PII policy and causes the aggregate level of PII cover to deplete, the licensee must take actions to reinstate the level of cover to ensure compliance with Rule 4.1(2)."
5) Add to Rule 5.2 (Notification by a Licensed Fiduciary), a requirement for the licensee to notify the Commission as soon as it becomes aware that there is a retroactive date applied to their PII policy and the retroactive date is after the date the firm was licensed.
Retroactive date is the date after which acts, errors or omissions of the insured are covered. If the policy contains a retroactive date, the licensee is only covered for their acts, errors or omissions arising from work carried out after the retroactive date. From the PII survey, around one third of the Fiduciary respondents obtained a policy with a retroactive date. Where the retroactive date is after the licensing date, the licensee is exposed to a risk that they are not protected from a claim arising from work undertaken in the past.
The proposal takes into account the survey results whereby the retroactive dates mostly are the same date as when the licensees were incorporated and therefore it is expected that the impact on this change would be minimal.

INVESTMENT

As noted above, the Capital Adequacy Rules are currently silent on scope of PII cover. Taking into account customer protection and the risk that Investment firms may be exposed to claims outside the scope of coverage, it is proposed that the following requirements are added to the Capital Adequacy Rules, making them in line with the Fiduciary Rules and the Insurance sector:

1. PII policies must include cover against –
   (a) negligence, errors or omissions by the [PoI] licensee;
   The proposed requirements under (a) and (b) will bring the PII regulatory regime for Investment sector in line with that of other IFCs, the Fiduciary sector and the Insurance sector. It is expected that the impact of the introduction of the requirements under (a) and (b) would be minimal as these are standard terms for a PII policy.
   (b) any liability for the dishonest or fraudulent acts of employees which may fall on the [PoI] licensee;
   (c) liabilities of its employees who, in the course of their duties to the [PoI] licensee, perform functions in their own names;
   (d) liabilities which the [PoI] licensee might incur in any jurisdiction in which it carries on business;
   The PII policy should provide cover which extends to all territories from which the licensee conducts business. Adopting the required scope of PII policy set out

in (d) and (e) will bring the Investment sector in line with other IFCs, the Fiduciary sector and Insurance sector.

(e) Ombudsman awards; and

(f) legal defence costs.

Although the Investment sector is less inclined to litigation, compared to Fiduciary, it is crucial to ensure that the PII policy provides for cover which includes legal defence costs. From the review of PII survey, the majority of PoI licensees obtained a PII policy which covered legal defence costs.

2. Defence costs must not contribute to the individual loss or aggregate limit.
   It is important that the clients/ investors who have suffered loss will be compensated and this proposal ensures that the aggregate limit is not depleted during the litigation process.
3. In the event that a claim is made on the PII policy and causes the aggregate level of PII cover to deplete, the licensee must take actions to reinstate the level of cover to ensure compliance with Rule 2.1 [of the Capital Adequacy Rules].
4. The licensee must notify the Commission as soon as it becomes aware that there is a retroactive date applied to their PII policy and the retroactive date is after date the firm was licensed.
   Retroactive date is the date after which acts, errors or omissions of the insured are covered. If the policy contains a retroactive date, the licensee is only covered for their acts, errors or omissions arising from work carried out after the licensing date. From the PII survey, around 20% of the PoI respondents obtained a policy with a retroactive date. Where the retroactive date is after the licensing date, the licensee is exposed to a risk that they are not protected from a claim arising from work undertaken in the past.
   The proposal takes into account the survey results whereby the retroactive dates mostly are the same date as when the licensees were incorporated and therefore it is expected that the impact from this change would be minimal.

The proposals will broadly align the requirements concerning scope of PII policy between the Capital Adequacy Rules and the Fiduciary Rules.

Appendix 2 – Summary of the proposals

	FIDUCIARY		INVESTMENT	
	Current requirements under the Fiduciary Rules	Proposed change	Current requirements under the Capital Adequacy Rules	Proposed change
1) A cap on PII cover required by the relevant Rules	No requirement	A cap of £10,000,000 to be introduced.	No requirement	A cap of £10,000,000 to be introduced.
2) Cover per claim	The minimum level of PII cover under the Rules applies to both aggregate cover and the limit for any one claim.	No change	No requirement	To require that the minimum level of PII cover under the Rules applies to both aggregate cover and the limit for any one claim.
3) The definition of "turnover" or "total revenue"	In calculating "three times turnover", only turnover from regulated activities is included.	To include income received from non-regulated activities within "turnover".	"Total revenue" includes revenue of any type.	No change
4) Gains from proprietary portfolio trading	The level of PII cover only takes into account regulated activities and therefore, gains from proprietary portfolio trading is excluded.	If the proposal under 3) is adopted, gains from proprietary portfolio trading will be captured under the definition of "turnover". Consequently, it is proposed that gains or other investment income from a licensee's proprietary investment portfolio is excluded from the calculation of three times turnover.	"Total revenue" captures gains and losses from proprietary portfolio trading.	Total revenue excludes gains or other investment income from a licensee's proprietary investment portfolio.
5) The minimum PII cover	The greater of three times turnover or £1,000,000.	No change	For a DT, DC or DA, the greater of £300,000 or three times total revenue.	For a DT, DC or DA, the greater of £1,000,000 or three times total revenue.

	FIDUCIARY		INVESTMENT	
	Current requirements under the Fiduciary Rules	Proposed change	Current requirements under the Capital Adequacy Rules	Proposed change
6) Excess	Any excess must not exceed 3% of turnover from regulated activities.	Any excess must not exceed 3% of turnover. Alternative: Consider removal of absolute excess subject to compensating FRR provisions.	Must not exceed 20% of the total insured.	No change Alternative: Consider removal of absolute excess subject to compensating FRR provisions.
7) FRR	At least one excess is deducted from the FRR calculation.	No change	Excess is not deducted from calculation.	To deduct one PII excess when calculating "net assets" for the FRR.
8) Carve out for dual licensees	Fiduciary licensees which are also licensed under the Banking Law, IMIIL or IBL have to comply with both the PII requirements under the Fiduciary Rules and those required under another regulatory law.	To disapply the PII requirements set out in the Rules where a fiduciary licensee is also licensed under the Banking Law, IMIIL or IBL and has obtained a PII policy which meets the requirements as set out under another regulatory law. The licensee must undertake analysis that the PII requirements under that regulatory law are adequate for their business and receive the Commission's confirmation of agreement to the disapplication of the PII requirements under the Rules.	PII requirements under the Rules are disapplied to PoI licensees which are not DT, DC or DA, if the licensees also hold a licence under the Banking Law, IMIIL or IBL and have been granted with a confirmation from the Commission that the insurance requirements under another law take precedence.	DT, DC or DA are also eligible for the carve-out.
9) Self-insurance	A Fiduciary licensee can rely on self-insurance where "*its parent*	To no longer accept the use of self-insurance for Fiduciary licensees.	The use of self-insurance is not recognised within the Rules.	No change

	FIDUCIARY		INVESTMENT	
	Current requirements under the Fiduciary Rules	Proposed change	Current requirements under the Capital Adequacy Rules	Proposed change
	or ultimate parent is of sufficient stature".			
10) Scope of cover	There are already some minimum requirements on the scope of PII coverage currently prescribed in the Fiduciary Rules.	To include additional terms and conditions as presented in Appendix 1.	No requirement.	To apply the proposed minimum policy terms and conditions, in line with the Fiduciary sector.
11) PII notification	Fiduciary licensees must notify the Commission (i) when a notification under a PII policy is made to its insurer; or (ii) if there is any payment made, by the insurers, under the PII cover.	No change	No specific requirement.	To require that PoI licensees notify the Commission (i) when a notification under a PII policy is made to its insurer; or (ii) if there is any payment made, by the insurers, under the PII cover.