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THE LICENSEES (CAPITAL ADEQUACY) RULES 2010**EXPLANATORY NOTE AND FEEDBACK ON CONSULTATION**

The Commission has been preparing new Capital Adequacy Rules mandatory for all entities licensed under the Protection of Investors (Bailiwick of Guernsey) Law, 1987 as amended (“the Law”). In November 2009 the Investment Business Division posted on the Commission website the draft Licensees (Capital Adequacy) Rules 2010 (“the Capital Adequacy Rules”) for consultation. All responses were reviewed by the senior management team of the Investment Business Division.

I would like to thank everyone who took the opportunity to respond to this consultation. The Rules have, today, been placed on the web site in final form. The Capital Adequacy Rules will become effective on 16 April 2010, but contain transitional rules that allow licensees until 30 June 2010 to meet the requirements.

Before I discuss some of the key themes arising from the consultation, I should like to make clear that the Capital Adequacy Rules have been designed as a framework upon which further, more sector-specific computation and analysis may be applied. The “Legislative Framework and Principles of Capital Adequacy” segment not only anticipates an extension to the computations at Rule 5 in the future but also that the Board of a licensee is more able to assess and manage the risks its business is subject to, and the capital adequacy requirement thereon. Accordingly the Commission is more than willing to entertain enquiries from licensees that believe their specific risk measurement tools point to a more appropriate level of capital adequacy required. Such an approach is consistent with the international regulatory trend and, indeed, other Divisions in the Commission.

This is particularly important in the light of the global economic conditions in which licensees are operating. Global events have highlighted the need for robust and sophisticated tools to assess capital adequacy. Licensees should not be surprised that these Rules display a more prudent approach to capital adequacy. Point 3 below is one such example.

Given the volume of responses to the consultation it has not been possible to provide a line by line response on each comment and the changes made from the draft Capital Adequacy Rules. The purpose of this document is to outline the main themes raised from the consultation and in particular provide our reasoning where we have not incorporated comments from the consultation.

1. Capital Adequacy Requirements for Designated Managers administered by another firm

Several respondents asked whether, for designated managers administered by another licensee, the Capital Adequacy Rules should be relaxed. The respondents were concerned about barriers to entry. The Commission no longer has the power, or the duty, under section 4 of the Law to consider economic benefit for licence applicants.

The Commission, in arriving at these Capital Adequacy Rules, has considered the general risks that it considers licensees are exposed to. The risk for such licensees is in being a

designated manager; the Commission does not recognise a distinction between an administered designated manager and one with its own staff and premises.

2. Use of Carry Value for adjustments at Rule 5

The Commission has been made aware that the concept of carry value is more appropriate than market value. This is because, under certain GAAP provisions, some assets are carried at cost in the balance sheet. The Commission does not wish to force companies to apply market value or fair value where they are not required to under GAAP. Therefore we have accepted this point.

3. Inter-Company Group Loans

The Commission received significant feedback about the disallowing of inter-company group loan debtors. Some respondents have suggested to us that this might be appropriate in cases where capital is then placed outside the Bailiwick of Guernsey but should not apply where the debtor is another company domiciled in Guernsey. We do not consider this an appropriate principle on which to negotiate. It has been regulators' experience that such arrangements lead to a recycling of capital that disguises, maybe unintentionally, insufficient cover to the group as a whole.

4. Counterparty Risk

The absence of a definition of counterparty risk provided a major problem for respondents. Whilst the Capital Adequacy Rules have been designed to protect licensees from an over-exposure to any single counterparty they were not designed to capture balances with counterparties for every outstanding bargain or trade. Consequently, the Capital Adequacy Rules now exclude outstanding trades unsettled for 15 days or less from the Counterparty Risk computation.

In addition, respondents were concerned that cash held at bank would also be captured under counterparty risk. The Commission has accepted this concern: any cash held at bank with a term of less than 90 days should be excluded from the Counterparty Risk computation.

5. Matching of Fees Payable and Receivable

Respondents expressed concern at the inclusion of fees payable (which were directly attributable to fees receivable) in expenditure for the purposes of calculating the Financial Resources Requirement. The Commission has accepted this inclusion did not reflect the behaviour of such businesses and therefore the risks of undercapitalisation. Such fees payable are now excluded from the Financial Resources Requirement (and Liquidity Requirement) calculation.

Peter Moffatt
Director of Investment Business
 13 April 2010