

**REVIEW OF THE SUPERVISORY ACTIVITIES OF THE
GIBRALTAR FINANCIAL SERVICES COMMISSION
AND THE FINANCIAL SERVICES COMMISSIONER**

**Report of a Review Team Appointed by His Excellency the Governor
of Gibraltar in accordance with Section 12A of the Gibraltar
Financial Services Commission Ordinance 1989**

January 2005

REVIEW OF THE SUPERVISORY ACTIVITIES OF THE GIBRALTAR FINANCIAL SERVICES COMMISSION AND THE FINANCIAL SERVICES COMMISSIONER

Executive Summary and Recommendations

Introduction (Chapter One of the Report)

1. His Excellency the Governor of Gibraltar has appointed a review team to evaluate the supervisory activities of the Gibraltar Financial Services Commission (FSC) and the Financial Services Commissioner as he is entitled to do under Section 12A of the Gibraltar Financial Services Commission Ordinance 1989 (FSCO). The Terms of Reference for the review (which are included at Appendix A) set out the topics to be considered by the review team. They require that the report and recommendations be addressed to the Secretary of State for Foreign and Commonwealth Affairs. This is a summary of the report of the review team. (Paragraphs 1.1 to 1.3)
2. The FSC¹ has achieved a good standard of financial services regulation in Gibraltar. The FSC has a clear commitment to meeting international standards. There is no doubt that the FSC is determined to tackle the risks it faces and is seeking to implement a high quality regulatory regime that is appropriate for the Gibraltar market. (Paragraph 1.5)
3. In addition, the Commissioner has the statutory responsibility to ensure that supervision in Gibraltar complies with European Union (EU) obligations and, where these apply, establishes and implements standards that match those required by legislation and practice in the UK. The Commission has the responsibility to monitor the extent to which supervision meets these obligations and, in particular, to advise the Governments of Gibraltar and of the United Kingdom accordingly. In giving that advice, it must have regard to the need for timely and effective implementation in Gibraltar law of EU obligations. The Commissioner, the Commission and the FSC as a whole have worked hard on fulfilling these responsibilities, although, since both UK standards and EU legislation are constantly developing, there will always be more to do. (Paragraphs 1.6 and 1.17 to 1.20)
4. The recommendations for change made by the review team should be seen in the context of a regulatory regime developed to a good standard and staffed by

¹ In this report, we have generally used the abbreviation 'FSC' to mean the Financial Services Commission and thereby refer to the Commission as a statutory body, or to the organisation as a whole, as the context demands. However, where it is necessary to distinguish between the statutory roles of the different elements of the FSC, we have used the term 'Commission' to denote the statutory body (i.e. the Board) and the 'Commissioner', to denote the Chairman of the Commission, with FSC being used to denote the organisation as a whole.

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competent regulators with a manifest determination to improve performance further. (Paragraph 1.7)

5. The Terms of Reference require that recommendations are appropriately prioritised and they are therefore categorised as being of high, medium or low priority in the summary below and in the text of the report. (Paragraph 1.8)

Overall Operation of the FSC (Chapter Two of the Report)

Management structure, organisation and decision making.

6. The legislation establishing the FSC is unusual in that it provides the Commission with virtually no specific regulatory powers or responsibilities, beyond a general duty to protect the public against financial loss as a result of action by financial services businesses and, as noted above, to monitor the extent to which supervision complies with EU obligations and matches UK standards. The Commission does not have the legal power to appoint or dismiss the Commissioner as chief executive. Moreover, it does not have specific powers to license financial services businesses, monitor their compliance with regulation or take enforcement action. These specific statutory regulatory powers have been given to the Commissioner, who is the Chairman of the Commission and is its chief executive. (In some cases, supervisory powers are given to other specified officials such as the Banking Supervisor). (Paragraphs 2.3 to 2.25)
7. While no problems have arisen with these arrangements so far, we recommend that, in order to deal with these anomalies and bring the legislation up to date, the Commission:
 - a. proposes legislative changes to the FSCO to provide for the appointment of a Commission with the statutory powers currently provided to the Commissioner in the sector-specific Ordinances, as well as the other powers already given to the Commission in the existing provisions of the FSCO (*High*);
 - b. considers proposing legislative changes to the FSCO to provide for the appointment of an independent Chairman of the Commission, with the right to be consulted by the Governor on the appointment of other members of the Commission, including the chief executive (*High*);
 - c. considers proposing legislative changes to the FSCO to provide for the separate appointment of a chief executive (*High*);
 - d. proposes legislative changes to the FSCO to provide the explicit power for the Commission to make and withdraw specific or general delegations of its powers to the chief executive (or any other person) as it sees fit (*High*);
 - e. proposes legislative changes to the FSCO to impose a specific statutory responsibility on the Commission to consider the performance of the chief executive, to determine his or her remuneration and to be responsible for the efficiency, economy and effectiveness of the FSC (*Medium*);

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- f. proposes the removal of the legislative requirement that members of the Commission should have specified areas of expertise or be from the UK (*Low*).

(Paragraph 2.26)

Independence, funding and fees.

8. The FSC acts in an independent manner and is seen by the financial services industry and Government as doing so. This is commendable. Independence is reinforced by statute. Once appointed, members of the Commission can only be dismissed under circumstances specified in the statute. The members of the Commission, the Commissioner and the staff have appropriate legal immunities. This is in line with best practice. However, the present budget process could potentially undermine this independence, since fees are not set by the Commission. The Government is consulted over the annual budget and that budget is supported by regular funding from the Government. The Annual Report is presented to the House of Assembly which also votes the level of funding that appears in the estimates. While this appears not to have compromised independence in practice hitherto, this outcome has depended largely on the personalities of those currently operating the process and the choices they have made. These personalities and choices could change in the future and it would therefore be better to have arrangements that were more robust. (Paragraphs 2.27 to 2.40)
9. We conclude that there would be advantage in adopting a new budgetary model, which would reinforce independence and yet provide some safeguard for the Government, on the lines of that set out below.
 - a. The Commission would set its own fees and budget subject to an industry consultation process. The fees should be set according to criteria set and published by the Commission. The budget would be set according to the Commission's assessment of the level necessary to undertake its statutory duties, subject to its overall statutory responsibility to operate economically, efficiently and effectively.
 - b. The Government would have no general right to influence the level of the FSC's budget but there would be no restriction on its ability to exercise its right, if it wished, to pay an amount equivalent to a proportion of the fees.
 - c. If the Government considered that the FSC was behaving in a disproportionate or extravagant manner, it would have the statutory right to appoint an independent assessor to conduct a value for money review.
 - d. If that review revealed any wasteful or unnecessary expenditure, the Government would be able to require the FSC to take appropriate action (provided that such action did not interfere with the FSC's ability to perform its regulatory duties) or to require the FSC to explain why action was inappropriate.

(Paragraphs 2.41.1 to 2.41.4)

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10. We believe that the independence that this arrangement would provide should be accompanied by more transparent accountability arrangements. There is at present considerable informal accountability to the Government and the financial services industry. This is to be commended. However, further accountability arrangements could be put in place. The FSC could hold an Annual General Meeting. It would be helpful if the FSC, the Government of Gibraltar and the Governor were to draw up a Memorandum of Understanding (MoU) to cover the relations between them, including the kind of information and briefing the FSC should provide and the way particular events (such as financial collapses) should be handled. Members of the Assembly could, if they wished, question the members of the Commission, in public or private, on their policies (and funding if they chose), as is the case now. (Paragraphs 2.41.5 to 2.43 and 2.44.2 to 2.44.3)
11. We recommend that the Commission proposes legislative changes that would have the following result:
- a. the FSCO should provide explicitly for fixed terms of appointment for members of the Commission and the Commissioner (*Medium*);
 - b. the FSCO should be amended to give the Commission the power to set its own fees, with the safeguards outlined in paragraph 9 (*High*);
 - c. the FSCO should be amended to remove the restriction that the FSC can only borrow from the Government (*Low*).
- (Paragraph 2.44.1)
12. We also recommend that:
- a. the FSC seeks to agree a MoU to set out the lines of accountability and cover other matters discussed in paragraph 10 (*Low*);
 - b. the Commission continues to publish an Annual Report but includes a statement on how it has met its responsibilities and holds an Annual General Meeting in order to enhance accountability (*Medium*).
- (Paragraphs 2.44.2 to 2.44.3)

The FSC's approach to its statutory duties

13. The Commission has, during the period in which the review was carried out, adopted a publicly declared position on the meaning of the requirement in the legislation to match UK standards and the way in which members of the Commission judge how this requirement is met. It has published this position in the 2004 Annual Report. At the same time, the Commission also decided that, in future, regular briefings, given to members of the Commission, will routinely include an analysis of developments in the UK and the need, if any, for consequential changes to regulation in Gibraltar. Prior to these decisions, there was no formal assessment of the meaning of the duties set out in the legislation, nor any formal guidelines to staff to ensure that policy papers discussed the implications, for the Gibraltar regime, of changes in the UK. There were no standing instructions to ensure that all policy papers discussed the implications of

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any policy changes suggested for Gibraltar on the statutory duty to match UK standards. There was no formal analysis, for example, conducted at the time of its implementation, of the changes brought about in the UK by the Financial Services and Markets Act 2000 (FSMA) and the objectives they were intended to meet. However, a comparison of provisions in the FSMA and the Gibraltar legislation was conducted late in 2003. (Paragraphs 2.45 to 2.55)

14. The review team has considered what the requirement to match UK standards means in practice. We have concluded that UK standards should be regarded as matched when the risks arising from Gibraltar's financial services business (whether to customers, to reputation, or to the financial system) are mitigated by Gibraltar's regulatory regime to the same extent that equivalent risks are mitigated in the UK. We believe this is a workable interpretation and recommend it to the Commission. The Commission has stated, in the Annual Report, that 'matching' will be achieved if its regulatory objectives are met to the same extent as the FSA's equivalent regulatory objectives are met in the UK. We are not entirely convinced that a definition at the high level of overall objectives is sufficient to meet what we believe is the intention of the Ordinance and consider that the judgement should be at the level of specific risks. Nevertheless, we support the decision of the Commission to publish its position in the Annual Report and believe that it should also include an assessment of performance. The Commission's policy position would then be open for public debate. We also support the decision to include an analysis, in the regular briefings given to members of the Commission, of the extent to which developments in the UK require changes in Gibraltar in order to meet the matching requirement. In addition, we conclude that all relevant internal policy submissions and public consultation papers should include an assessment of the effect of any proposals on the requirement that UK standards be matched. (Paragraphs 1.22 to 1.29 and 2.56 to 2.57)
15. The FSC gives much support to the Government in implementing EU Directives relating to financial services. Much of the current body of EU financial services legislation has been implemented by the Government, even though, in some cases, there has been some delay. The delays are often for understandable reasons relating to the requirement to match UK standards and other factors. Moreover, some of the delayed Directives have little practical impact on Gibraltar. Responsibility for the implementation does not rest with the FSC. However, the Commission has the statutory duty to advise the Governments of Gibraltar and of the United Kingdom on matters concerning financial services, "having regard... to the need for timely and effective implementation in Gibraltar law of Community obligations"² and the Commissioner has the statutory duty to ensure that supervision complies with those obligations. He may not be able to fulfil that duty if the necessary legislation necessary is not in place. (Paragraphs 2.58 and 2.61 to 2.62)

² FSCO Article 6 (2) (d).

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16. While all Directives are important, in that there is an obligation to implement them, some are more important than others in the impact they have on the ability of the Commissioner to fulfil his statutory duty to ensure that supervision meets EU obligations and that standards are implemented which match those required by legislation and supervisory practice in the UK. We consider that the statutory requirement to give advice requires the Commission to give regular and formal reports to the Governments of Gibraltar and of the United Kingdom, not only on the current state of implementation (as it has done until recently) but also on the effect of any delay in implementing legislation on the Commissioner's ability to carry out his supervisory responsibilities. We are pleased to note that the FSC has substantially amended and improved its working papers to achieve this but consider that, in addition, the Commission should also formally give the Government its assessment of the extent to which EU legislation relating to the financial services sector has been transposed in a way which allows the Commissioner to fulfil his responsibilities. (Paragraphs 2.63 to 2.64)
17. The FSC has worked hard to develop relations with HM Treasury and the Financial Services Authority (FSA) in order to improve its ability to understand the UK approach to the implementation of Directives (and indeed other matters) and the consequent development of FSA supervisory practices, thereby minimising delays in future. Nevertheless, there is scope for greater assistance from the Government of the UK and the FSA to the Gibraltar authorities to help them implement legislation in a way that enables the FSC to meet its statutory supervisory objectives. The FSC has recently concluded a MoU with the FSA. This is a positive step and it would be helpful if the MoU were to cover the provision of assistance to the FSC in meeting its supervisory responsibilities with respect to EU obligations. (Paragraphs 2.59 to 2.60)
18. We recommend that:
 - a. the Commission reviews its interpretation of the matching requirement and reconsiders adopting that recommended by the review team, as well as publishing, in the Annual Report, an assessment of the extent to which it regards the requirement as being met (*High*);
 - b. the FSC assesses whether that interpretation is applied at present in its supervisory approach and activities, taking account of the observations in this report (*High*);
 - c. the FSC includes an assessment of the consistency of any new policy proposal with its interpretation of the matching requirement in internal submissions and external consultation and policy papers (*High*);
 - d. the FSC develops the tracking mechanism for EU Directives so that, in addition to the useful and improved working document now used, the Commission makes a formal submission to the Government on a regular basis that includes an assessment not only of the relative priority of outstanding EU Directives for the FSC but also of the extent to which proposed implementing legislative instruments would allow the Commissioner to fulfil his statutory duties to supervise financial institutions in line with EU obligations (*High*);

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- e. the FSC asks the UK Government, through the relevant sponsoring department, to undertake to keep the FSC advised at all stages of UK drafting and implementation of relevant EU legislation and advises the Government of Gibraltar to do the same (*Medium*);
- f. the FSC continues to develop relations with HM Treasury and the FSA so as to keep in touch with developments in emerging EU legislation (*Medium*);
- g. the FSC invites HM Treasury and the FSA to circulate relevant papers to the FSC as a matter of routine, so that it can comment on proposals where they are of particular significance to Gibraltar, and asks (or, where appropriate, advises the Government of Gibraltar to ask) the UK authorities to invite Gibraltar representatives, as appropriate, to join the UK representatives in discussions of emerging EU legislation (*Medium*);
- h. the FSC seeks to add these measures, designed to assist the FSC in meeting its responsibilities, to the MoU that the FSC has recently concluded with the FSA (*Low*);
- i. the FSC seeks to ensure that other relevant parties be included in formal working arrangements for trilateral meetings between the FSC, FSA and HM Treasury, that the FSC advises us are now in place (*Medium*);
- j. the FSC includes a high level analysis of the implementation of EU Directives and a description of the action it has taken to monitor implementation, in its Annual Report, drawing attention to those Directives that will require action during the following year (*High*).

(Paragraph 2.65)

Corporate governance and decision making

19. There is a substantial policy-making burden on the FSC, given the constantly developing international regulatory standards, the development of UK standards and the development of EU legislation. At the time of the review, the main policy-making resource was the Commissioner who prepares the Commission's agenda and submits a Chairman's report of action and developments. We are not convinced that there are sufficient resources to enable policy submissions to include an adequate analysis of alternative policy options and the consequences of each. Moreover, the FSC will need to devote substantial policy-making resources to implementing its own proposed plans and the recommendations in this report. In addition, there is a substantial amount of EU financial services legislation that is currently being drafted or recently adopted and a number of new developments in international and UK supervisory practice that are currently under way. These developments include the new Basel capital regime (Basel II), a new investment services Directive, the UK insurance capital regime and the forthcoming 'Solvency 2' Directive. The FSC is to be commended for deciding, during the course of the review, to allocate part of the time of one member of staff to assist the Commissioner in his policy-making function. However, we do not believe that this will be sufficient. (Paragraphs 2.66 to 2.71 and 2.77 to 2.82)

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20. The changes suggested above in respect of the statutory roles of the Commissioner and other members of the Commission will improve corporate governance. The Commission has already appointed an Audit Committee and deals appropriately with any potential conflict of interest. We consider that it would be helpful if the FSC were to review the Combined Code on Corporate Governance issued in the UK in July 2003 and consider which recommendations to adopt. Its conclusions could be published in the Annual Report. (Paragraphs 2.73, 2.74 and 2.85 to 2.86)
21. The FSC has developed an analysis of risks and a programme of action to mitigate them. This in turn creates annual objectives for the FSC and cascades down to staff. This is a good system that works at a strategic and tactical level and, in the latter context, results in an action list with a timetable and monitoring system. The risk assessment is monitored by the Audit Committee. This provides assurance to the members of the Commission that the risk-assessment process is being appropriately managed. (Paragraphs 2.72 and 2.84)
22. The FSC is small and communication is effective within it. The use of IT to hold information about institutions and developments in the UK and elsewhere, and to circulate information and policy papers within the FSC, is particularly impressive. We consider, however, that there is a need for more formal arrangements to ensure full dissemination of information about developing policy and practice and to ensure that the FSC operates in a consistent manner. Such arrangements might include peer reviews of specific licensing, supervision and enforcement decisions. The Commissioner's Committee of senior staff (heads of Banking,³ Investment Services, Insurance and Fiduciary Services), whose remit has recently been extended, could be used to discuss all aspects of the FSC's policy and operation and to drive forward its agenda. We note that the FSC has adopted an internal audit process, now certified as meeting the standards of the International Standards Organisation (ISO) in respect of quality management but continue to believe that the processes we suggest above would be of assistance to the FSC. (Paragraphs, 2.75, 2.76, and 2.87 to 2.89)
23. We are aware that the FSC has expanded its staff complement from 16 in March 2004 to 18 in October 2004. However, we consider that the FSC will need significant further staff resources, including additions in most areas of the FSC – to cope with increasing demands from policy developments, from the new programme of on-site visits in insurance and investment services, from the increasing number of EU Directives and UK initiatives in the pipeline, and to implement other recommendations of this report. (Paragraph 2.83)
24. We recommend that:
- a. the FSC seeks additional staff to support policy development so as to ensure that policy proposals are properly researched and their consequences fully identified (other staffing recommendations are included below) (*High*);

³ The Head of Banking Supervision has also been appointed Chief Operating Officer.

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- b. the Commission reviews the Combined Code on Corporate Governance and determines how it should respond to the Code provisions, reporting the result in the Annual Report (*Low*);
 - c. the Commissioner keeps under review the operation of the Commissioner's Committee, ensuring that it becomes an effective vehicle whereby the senior staff of the FSC discuss all aspects of the FSC's policy and operation and drive forward its agenda (*Medium*);
 - d. the FSC puts in place a programme of peer review of regulatory actions (including visits), at any rate on a sample basis, to ensure consistency (*Medium*).
- (Paragraph 2.90)

Consultation with Practitioners and Consumers

25. The FSC has a good reputation with the financial services industry for being accessible and for consulting them. It is to be commended for this. It is difficult to consult consumers when many are offshore. The FSC has produced a useful investor education booklet and there is scope for more initiatives of this kind – including using the FSC's helpful website. (Paragraphs 2.91 to 2.99)
26. We recommend that the Commission proposes that a statutory duty to consult the financial services industry be included within the FSCO (*Low*). (Paragraph 2.100)

Complaints Handling

27. The FSC handles complaints against regulated firms assiduously and investigates them to determine if there are any regulatory breaches. However, it is not in a position to make any award in favour of a customer even if it considered that the customer had been unfairly treated. This is the case regardless of whether or not there is any regulatory breach. Other jurisdictions have dealt with this difficulty by creating an Ombudsman with such powers and we note with approval that plans for an Ombudsman in Gibraltar are in place. (Paragraphs 2.101 to 2.109)
28. We recommend that the Commission continues to support the establishment of an Ombudsman for dealing with complaints against financial services businesses (*Low*). (Paragraph 2.110)

Internal Operation of the FSC

29. Internal processes by which the FSC handles human resources, IT and general business planning are generally effective for the small size of the organisation. The IT systems are particularly impressive. There is little formal career planning and the FSC is vulnerable to the departure (or indeed prolonged absence) of key individuals. However, this is inevitable given the size of the FSC. In practice, the FSC achieves an impressive staff retention rate and has put basic contingency arrangements in place for the loss of key staff. It has also demonstrated its commitment to the training of its staff and supports their professional development. There is no legal adviser but external legal advice is sought as

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necessary and we regard this as appropriate. We also support the appointment of a Chief Operating Officer (COO) but consider that there will be a need for a member of staff to deal with human resources, business planning and to assist with the budgetary cycle. (Paragraphs 2.111, 2.113 to 2.118, 2.120 to 2.128 and 2.138 to 2.139)

30. Staff sign confidentiality declarations and we support the decision of the Commissioner to extend the use of a gifts and hospitality log and the requirement to sign declarations of interest to all staff. (Paragraphs 2.119 and 2.137)
31. We consider that informal arrangements are often effective but we support the development of the risk-assessment analysis into a full business planning process. We consider that this should encompass individual objectives, staff appraisal and pay, training needs and the IT forward plan. (Paragraphs 2.112 and 2.129 to 2.136)
32. We recommend that:
 - a. the FSC continues to develop its risk-assessment analysis into a formal business planning process (*Medium*);
 - b. the FSC also continues to develop its staff appraisal system as planned so that it is integrated into the business planning system and forms the basis for a training needs analysis as well as pay reviews (*Medium*);
 - c. the IT Committee produces a forward plan aligned with the priorities set in the business plan (*Medium*);
 - d. these processes be brought together in an annual budgeting and planning cycle so as to enable the FSC to set and hold to priorities and have a defensible system for setting its own fees and budget (*High*);
 - e. the FSC considers the need for a dedicated staff member dealing with human resources, business planning and budgeting, as the FSC grows (*Low*).(Paragraph 2.140)

Conclusions Common to Different Business Areas (Chapter Three of the Report)

The FSC's regulatory approach

33. The Commission is to be commended for introducing objectives for the FSC and principles for good regulation. These are based on those in place for the FSA in the UK. We note that the Commission is seeking amendments to existing legislation so that the objectives become statutory and we support this. We consider that it would be helpful if the FSC were also to introduce principles for business (again following the FSA model) with the status of regulations or rules, breaches of which would be the basis for enforcement action. We support the extension to all financial services sectors of the new risk-based approach to supervision and we believe that high level summary results of the FSC's risk assessments need to be published to help financial services businesses understand and deal with the risks they face. (Paragraphs 3.2 to 3.16)

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34. We recommend that:

- a. the Commission continues to seek amendments to the FSCO whereby the objectives already adopted would be incorporated into the FSCO (*Medium*);
- b. the FSC continues to roll out the new risk-based approach across all sectors and to make the visits and assessments necessary to ensure successful use of the model (*Medium*);
- c. the FSC considers the publication of high level summary results (once a useful aggregate number of assessments have been completed) describing the overall level of risk within the Gibraltar financial system and the common risks and weaknesses the FSC is finding, to help supervised institutions proactively deal with them (*Low*);
- d. the Commission adopts principles for business along the lines of those adopted by the FSA and proposes that they be given the status of regulations or rules, a breach of which would be a basis for regulatory sanction (*Medium*).

(Paragraph 3.17)

The supervisory tools available to the FSC

35. The FSC has a good range of supervisory tools which it uses effectively. It has proper authorisation and monitoring powers and an enforcement capability. The FSC insists on changes to owners and controllers of regulated businesses being notified to it and the Commissioner has a right to object on grounds of fitness and propriety. We understand that the FSC is preparing a consultation paper on the introduction of an 'approved persons' regime, which would give it the right to insist on pre-approval of key individuals (with a wider range of key individuals than is currently covered by the existing arrangements in Gibraltar). We support the implementation of a regime comparable to that in the UK, which includes appropriate compliance and audit staff in regulated businesses. We further consider that the FSC should reinforce its general statements about the responsibilities of senior managers by following the FSA arrangements which place specific responsibilities on senior managers for apportioning responsibilities and ensuring adequate systems and controls. In addition, we consider that the range of supervisory tools should be expanded to include, for all sectors, the ability to appoint a 'skilled person' to produce a report at the expense of the regulated firm where such powers do not already exist (Paragraphs 3.18 to 3.19, 3.23 to 3.24 and 3.31 to 3.35)

36. There is no rule-making power available to the FSC at present. The Governor and Government have regulation-making powers for banking, insurance and investment services, while Administrative Notices are issued by the Commissioner to implement Directives in the case of banking and investment services. The FSC and the financial services industry both consider that Administrative Notices are treated as if they were binding on the industry and they can be relied upon by the Courts in litigation. Moreover, the FSC has not become

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aware of any entity that has refused to implement them. Nevertheless, the status of the Administrative Notices is not the same as the regulations issued by the Government and the Governor. It is not satisfactory that the ability to make regulations is inconsistent between different sectors. It is a requirement of international standards⁴ that the regulator should have a rule-making power. The UK FSA has this power. Such powers are necessary to allow the regulator to keep pace with developments in financial markets (while regulations issued by governments can and have been delayed by other priorities). We consider that the Commission should have the power to make rules that are binding on the financial services industry, in that regulatory (although not criminal) sanctions could flow from a breach of such rules. (Paragraphs 3.20 to 3.21 and 3.26 to 3.29)

37. The Commissioner should also adopt the practice of generally making public any waivers of regulatory requirements to which he agrees, whether for individual businesses or groups of businesses, in all sectors where this power exists and the requirement to make them public does not. This would increase transparency. (Paragraph 3.22 and 3.30)
38. We recommend that:
- a. the Commission proposes that it be given the power to make rules that are binding on the financial services industry in that a breach of the rules would be grounds for regulatory sanctions if the FSC judged it appropriate to apply them in the circumstances (*High*);
 - b. where the Commissioner makes waivers from regulatory requirements, he generally makes them public (in all sectors where this power exists and where the requirement to make them public does not) (*Low*);
 - c. the Commission proposes that it be given the power to require any regulated financial business to appoint a skilled person to prepare a report (where this power does not already exist) (*Medium*);
 - d. the FSC continues to develop and then implements its proposals to insist on pre-notification of the appointment of key people in financial services businesses and requires that no appointment be made until the FSC gives consent (*Medium*);
 - e. the Commissioner expands the requirement for notification and approval of key persons to those conducting compliance and audit functions (*Medium*);
 - f. the Commission seeks the necessary changes to regulations to impose a regulatory requirement on senior managers of regulated financial services businesses that they should appoint someone with the duty to apportion responsibilities and to ensure that systems and controls are adequate (*Medium*).
- (Paragraph 3.36)

⁴ See for example, the Core Principles for Effective Supervision issued by the Basel Committee for Banking Supervision in September 1997.

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The sanctions available to the FSC

39. The enforcement department focuses on fitness and properness checks, requests for assistance from foreign regulators and policing the perimeter (looking for unauthorised business) which it does on a proactive basis. This is to be commended. Enforcement, in the sense of action taken in response to breaches of regulations, is carried out by the sector regulators. We note that the Commissioner is able to revoke authorisations, impose conditions on authorisation, apply to the court for injunctions and impose Directions on businesses (although the powers vary slightly between sectors). (Paragraphs 3.37 to 3.39)
40. We note that the Commission has already sought the power to make a public statement of censure and that it has obtained the Government's agreement that it should be able to petition the court to wind up a company in the public interest. We support this. We also consider that the Commission should be able to impose fines and that the power of Direction should be consistent between sectors. (Paragraphs 3.40 to 3.43)
41. We recommend that the Commission proposes changes to legislation (or, where appropriate, continues to propose legislation) that would have the result that:
- a. the Commission has the power to make public statements of censure and that it should be able to impose fines (*High*);
 - b. the power to issue a Direction in different Ordinances is consolidated into a general power to issue a Direction to take or refrain from taking any action and that a breach of a Direction should be a criminal offence (*Low*);
 - c. the Commission has the power to petition the court to wind up a company in the public interest where it does not already have this power (*Medium*).
- (Paragraph 3.44)

Domestic and international co-operation

42. The FSC makes a determined attempt to co-operate with other regulators and this is successful. It provides assistance, information and other support. Other regulators appreciate this. The FSC needs to review the legislative provisions regarding international co-operation, taking account of the implications of the judgement in the recent case involving international co-operation that went to judicial review and international developments since the current provisions were drafted in 1989. We support the efforts of the FSC, and the Governments of Gibraltar and the UK to explain to all EU Member States that the FSC is willing and able to provide assistance to any regulator quickly. (Paragraphs 3.45 to 3.70)
43. We recommend that:
- a. the FSC reviews its approach to providing assistance to overseas authorities in the light of the outcome of the judicial review, including the *obiter dicta*, as well as developments in UK practice and the provisions of EU Directives in relation to data protection and the protection of the

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confidentiality of regulatory information, so as to ensure that the FSC can continue to provide good assistance to foreign regulators as it has in the past (*High*);

- b. the Commission seeks changes in the FSCO as necessary to implement the outcome of the review recommended above (*High*);
- c. the FSC takes every opportunity to explain to EU regulators that Gibraltar is fully capable of responding quickly to requests for assistance (*Medium*).

(Paragraph 3.71)

Measures to Counter Money Laundering and Financial Crime (Chapter Four of the Report)

- 44. Gibraltar followed the UK in implementation of the First EU Money Laundering Directive in 1995 and was consequently ahead of many other European countries and other offshore centres in implementing comprehensive all-crimes anti-money laundering (AML) requirements for financial institutions. The FSC Guidance Notes for the financial sector were based on those in force in the UK in 1995. They introduced customer identification procedures and other AML systems and controls applicable to all financial institutions but which, in line with the requirements of the First Directive and international standards at the time, focussed on the risks to banks in particular. (Paragraphs 4.1 to 4.10)
- 45. The provisions of the Second EU Directive have also been brought into effect through the implementation of the Criminal Justice (Amendment) Ordinance 2004 (CJAO), which extends the scope of the businesses that are subject to enhanced due diligence and other AML requirements. As a result of Gibraltar's decision to regulate professional trustees and company management, enforcement of these requirements in Gibraltar now exceeds that in the UK, even taking account of the different risks posed by the business. (Paragraphs 4.11 to 4.28)
- 46. The Guidance Notes have been substantially updated since they were first introduced. For example, changes, primarily to cover developments in customer due diligence, the extension of the scope of the AML regime to all financial sector activities and measures to counter the financing of terrorism (CFT) were included in the version of the Guidance Notes published in the autumn of 2004. Nevertheless, a significant review of legislation and Guidance Notes is now required. This is necessary to reflect the increased understanding of the vulnerabilities of different sectors to money laundering; to deal more comprehensively with the extension of the Guidance Notes to the professional trusteeship and company management sector; to reflect the increase in understanding since 1995 of the risks of money laundering in different sectors; and to reflect the fact that the process of updating Guidance Notes, first drafted a decade ago, has run its course and it is time to begin with a clean sheet. A similar review is currently being undertaken within the UK Crown Dependencies. It would be prudent if the FSC were to wait for the first consultation draft issued by the Crown Dependencies before finalising its own review and embarking on its own consultation process. (Paragraphs 4.70 to 4.76)

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47. The amended Guidance Notes take account of the Financial Action Task Force (FATF)⁵ revised 40 recommendations on measures to combat money laundering and counter the financing of terrorism, the Basel Committee papers (“Customer Due Diligence” and “Guide to Account Opening Practices”) and the changes introduced by the UK Proceeds of Crime Act 2002, adapted to meet Gibraltar’s circumstances. The latest amendments to the Guidance Notes, where they include amendments to the earlier text, now have a clear distinction between those provisions which are advisory and those the FSC regards as mandatory, where the language is less permissive in tone. We commend the FSC’s decision to extend the new approach throughout the text. (Paragraphs 4.37 to 4.45 and 4.77 to 4.79)
48. We consider that the FSC needs to be more closely factored in to consultation by HM Treasury, the Home Office and the FSA, as appropriate, on AML/CFT measures so as to enable the FSC to match UK standards. The FSC should also give more consideration to the implications for its own supervisory practices of any departure from the UK approach. (Paragraphs 4.65 to 4.69)
49. The new FSC AML regime now provides specific guidance on recognising and combating terrorist financing. The FSC needs to deal with the specific risks faced by Gibraltar businesses with particular emphasis on the non-bank financial sector and the special vulnerabilities of controlled activities (professional trusteeship and company management) which, in our view, creates the greatest risk of money laundering. (Paragraphs 4.29 to 4.36)
50. The FSC has imposed a review of the identification evidence held on all existing customers by Gibraltar financial institutions. This requirement goes beyond the position in the UK. The FSC is to be particularly commended for this. However, we consider that it should also position the financial services industry to follow the UK in other areas. In particular, the forthcoming Third Directive will include the introduction of an objective test⁶ for reporting suspicions of money laundering. The FSC should give particular consideration to the impact that this provision has on the ‘know your customer’ (KYC) obligations placed on financial institution and the need to monitor accounts in line with the requirements already in place within the UK. (Paragraphs 4.15, 4.83 and 4.93)
51. Monitoring of AML/CFT procedures in financial institutions has hitherto been limited primarily to the banking sector, initially through examinations by ‘reporting accountants’, and to the professional trusteeship and company management sector. More recently and (the FSC inform us) in future, the monitoring of systems and controls within all licence-holders will be carried out by the FSC’s own staff as part of the risk-based supervision programme extending to all sectors and this is to be commended. The FSC have not found it necessary to impose any formal sanctions on any regulated business for non-compliance with

⁵ The FATF is an inter-governmental body which sets standards, and develops and promotes policies to combat money laundering and terrorist financing. It currently has 33 members.

⁶ The ‘objective test’ is the requirement that a suspicion should be reported if there were reasonable grounds to suspect money laundering even if subjective knowledge or suspicion did not exist.

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their requirements. There should be themed reviews in each of the non-bank sectors to establish the degree of AML/CFT compliance. The FSC should require that an annual report be provided to management by Money Laundering Reporting Officers (MLROs) in all but the smallest financial services businesses. The review team's recommendations that there should be an ability to place specific responsibilities on senior managers, that the FSC should have a rule-making power and that there should be an enhanced range of sanctions available to the FSC, would be particularly useful in the AML/CFT context. (Paragraphs 4.46, 4.86 to 4.92)

52. As in all jurisdictions, the FSC has focussed primarily on money laundering and more recently the countering of terrorist financing. However, it has not yet taken action to implement its new objective of assisting in the fight against other financial crime – beyond giving general assistance for international regulators and the guidance given to consumers on avoiding financial scams. The FSC needs to consider providing additional guidance to financial services business on measures to prevent and detect fraudulent activity. (Paragraphs 4.63 and 4.84)
53. It is likely that FSC staff will need specially tailored AML/CFT training designed to be appropriate for the particular risks that arise within Gibraltar's financial services sector with specific attention being paid to controlled activities and encompassing the objectives and focus of the new international standards. We recommend that the FSC also encourages the development of training aids for financial services businesses that are tailored to Gibraltar's business activities, again with specific attention being paid to controlled activities. The FSC should also require key personnel in financial services businesses to be subject to competence testing on anti-money laundering requirements. (Paragraphs 4.47 to 4.49 and 4.80 to 4.82)
54. Taking a risk-based approach, particular attention needs to be paid to the area of professional trusteeship and company management as a matter of priority. The recent amendment to the Criminal Justice Order (CJO) to bring this sector within the scope of the AML/CFT legislation will permit the FSC to enhance its defences in this area. By encompassing this sector within regulation, the FSC will continue to exceed UK standards. Nevertheless, the fight against money laundering and terrorist financing is rapidly evolving and measures must continue to be taken to ensure that the AML/CFT defences match UK standards, meet international requirements and are tailored to Gibraltar's specific risks and vulnerabilities, for example by including sector-specific analyses of risks and vulnerabilities and the measures that should be taken to address them. We conclude that, although the FSC has been assiduous in addressing money laundering concerns and was in the vanguard of action to introduce an effective regime, there is still action to be taken if it is to follow recent UK developments and establish and implement standards that fully match legislation and practice in the UK. The necessary actions are set out in the recommendations below. (Paragraph 4.94)

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55. We recommend that:

- a. the FSC asks the Home Office, as the sponsoring department for criminal justice legislation, and HM Treasury, as the sponsoring department for the Money Laundering Regulations, to factor the FSC into advance consultation on all AML/CFT and financial crime legislation and regulations, so that it can determine the appropriate supervisory response; that the FSC asks the FSA to factor the FSC into consultation on amendments to the Money Laundering Sourcebook and other issues relating to the prevention of financial crime; and that the FSC advises the Government of Gibraltar to make a similar request to the UK Government on its own behalf (*High*);
- b. the FSC gives more consideration to analysing the effects of legislation that is implementing EU Directives and to the consequences for its supervisory practices of any departure from the UK approach (*Medium*);
- c. the FSC rewrites the Guidance Notes to take account of the increased understanding of the risks of money laundering since the Notes were first drafted and to overcome the difficulties that arise when a document of this kind is subject to repeated amendment and that it waits for the publication of the first consultation paper by one of the Crown Dependencies before doing so (*Medium*);
- d. in its Guidance Notes, the FSC discusses the specific risks and vulnerabilities to the products and services offered by the Gibraltar financial services industry – especially the professional trusteeship and company management sector - and shows how the measures in the Guidance Notes are intended to address them (*High*);
- e. the FSC formally supports the need for awareness raising and training materials that address the specific financial products and services that are delivered in Gibraltar, with particular reference to the professional trusteeship and company management sector (*High*);
- f. the FSC requires that key personnel in financial services businesses, especially the MLROs, are subject to competence testing on AML/CFT defences (*Medium*);
- g. in addition to the existing training given to its staff, the FSC provides all regulatory staff with tailored ongoing AML/CFT awareness raising and training covering the specific vulnerabilities of the products and services provided by Gibraltar's financial sector businesses (*High*);
- h. as part of the recommended redraft, the FSC ensures that the Guidance Notes maintain the clear distinction now achieved between the permissive language appropriate for guidance and the more direct language appropriate for what are, in the FSC's view, mandatory provisions (*Medium*);
- i. the FSC requires in the Guidance Notes that senior management should receive an annual report from the MLRO with an exemption for the smallest institutions (*Low*);

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- j. the FSC commences a series of themed reviews, either by its own staff or by skilled persons in sectors other than banking, to assess the awareness of AML/CFT requirements and the training and competence provisions in financial services businesses (*Medium*);
- k. the FSC amends the Guidance Notes to position the financial services industry for the adoption of the objective test for reporting suspicions and the consequent changes to KYC and account monitoring procedures, in line with the situation that already exists in the UK and in anticipation of the change that will be required under the Third Directive (*Medium*);
- l. the FSC discusses, with the law enforcement agencies and the financial services industry, the particular vulnerabilities of Gibraltar's financial institutions to financial crime and develops guidance and awareness training to address those risks and the more general risks of financial fraud (*High*).

(Paragraph 4.95)

Banking (Chapter Five of the Report)

- 56. Gibraltar banks are, mostly, subsidiaries or branches of UK and European Economic Area (EEA) banks. Local business is largely confined to three banks. Many banks service expatriate customers in southern Spain and Portugal. This business largely consists of asset management and lending on property. Much of the investment selection and execution is conducted by others in the banking group often outside Gibraltar, with more general advisory activity done in Gibraltar. The remainder of the banking business is offshore banking for non-resident trusts and companies. This business is mainly introduced by local law and accountancy firms and is in competition with other offshore centres. (Paragraphs 5.1 to 5.6)
- 57. Most banking risks faced by Gibraltar banks are lower than the equivalent in the UK, largely because of the relatively simple nature of the business and the fact that Gibraltar banks are part of larger banking groups with resources to support the Gibraltar operations. However, Gibraltar faces the risk of migration of that offshore business which has little connection with Gibraltar. Gibraltar's small size also means that it may be more vulnerable to one-off exogenous shocks, such as a change in EU tax arrangements. (Paragraphs 5.14 to 5.16)
- 58. The FSC approach is effective. It has kept out weak banks and focussed on banks of high reputation and strong parents. The FSC's approach has been based on the former Bank of England approach, using desk-based supervision augmented by reports from reporting accountants. Since the last review in 1998, it has introduced a supervisory risk-assessment model broadly based on the Bank of England 'RATE' approach, which identified risks in each institution and devised an appropriate supervisory response – essentially a combination of desk-based monitoring, on-site visits, and selective use of reporting accountants. It is now moving to a new risk-based approach, again broadly following the 'ARROW' model in the UK, although, unlike the UK, no bank will be regarded as too small to warrant a visit. The model has been amended to reflect the nature and risks in

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the Gibraltar financial system and, like the UK's ARROW process, can be applied to any type of financial business. (Paragraphs 5.7 to 5.13)

59. There are some differences in supervisory practices as compared with the UK. There is a closer relationship between the FSC and Gibraltar business, which is largely a function of size. The FSC relies on the home state consolidated supervisor to deal with corporate governance issues. The FSC, on the other hand, goes beyond the FSA where it is a host supervisor in monitoring strategy and controls within a branch. It also exceeds the practice in the UK by continuing to publish a list of representative offices. There are minor differences in the approach to monitoring liquidity risk. (Paragraph 5.38)
60. Most of these differences are justified by Gibraltar's small and relatively simple banking market and its position as a host rather than home supervisor, the higher reputational risk in Gibraltar and the closer supervision made possible by Gibraltar's small and compact market. (Paragraphs 5.39 to 5.40)
61. In future, the FSC will have to cope with Basel II. Some of the Gibraltar banks will be part of groups that will move towards the more advanced methods of assessing capital and the FSC will have to keep abreast of this. This, and the move to replace part of the previous reporting accountants' work with on-site visits by the FSC staff, will create a need for more resources. In addition, the current banking supervision staff (the Head of Banking Supervision and the Regulatory Officer) are being called upon to carry out additional work outside the scope of banking supervision which may also result in more resources being needed for this area. (Paragraph 5.48)
62. EU legislation is normally implemented using Administrative Notices and Gibraltar follows the EU capital requirements. In practice, Gibraltar usually adopts the UK approach wholesale. A number of Directives have been implemented late in the past but the new tracking system is improving. (Paragraphs 5.41 to 5.45)
63. Only the recommendation regarding the creation of a Banking Ombudsman remains outstanding from the 1997 and 1998 reviews (where action is in hand but is not a matter for the FSC). Where we suggest further action, this is included in the list of recommendations below. We make these suggestions having concluded that, on balance, the FSC's supervision for banking establishes standards which match those required by legislation and supervisory practice in the UK. (Paragraphs 5.46 5.54)
64. Our main recommendations in respect of banking, in addition to those relevant to all sectors, are that:
 - a. the FSC seeks resources sufficient to be able to absorb the impact of the greater reliance on staff for inspections, as opposed to the use of reporting accountants, as well as dealing with impending developments such as the implementation of Basel II and taking account of the additional duties placed on banking supervisory staff (*Medium*);

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- b. the FSC continues to mount communications initiatives with the banks and the financial sector more generally to increase understanding of the risk-assessment methodology, taking the steps set out in paragraph 5.49 (*Low*);
- c. the FSC provides more information on its opinion of the risk posed by an institution in the risk-assessment letter sent to banks and gives all items in the action plan a specific deadline (*Low*);
- d. the FSC makes greater use of the tools already available to it as described in its risk-assessment framework and in paragraph 5.50 (*Low*);
- e. the FSC draws up guidance setting out its expectations in respect of corporate governance in subsidiaries of banks and includes an assessment of compliance with this in its routine inspections and in its risk assessment (*Low*);
- f. the FSC reviews its approach to liquidity and considers the issues set out in paragraph 5.52 (*Low*);
- g. the FSC maintains its efforts to encourage the legislative changes necessary to implement the remaining recommendations from earlier reviews that are described in paragraph 5.54 (*Low*);
- h. the FSC continues its programme of meeting home state supervisors where the need arises (*Medium*);
- i. the FSC monitors the regulation of mortgages in the UK and, in the second half of 2005, considers the need for recommending similar regulation in Gibraltar (*Medium*).

(Paragraph 5.57)

Investment Services (Chapter Six of the Report)

65. Most investment services are provided in Gibraltar by banks. The non-bank sector consists of some investment dealers, investment managers, insurance intermediaries, passported firms and some small collective investment schemes. The business includes the provision of services to the expatriate community in southern Spain and Portugal, to the local Gibraltar community and to institutional investors located elsewhere. (Paragraphs 6.1 to 6.4)
66. The risks posed by the Gibraltar business are that investors may suffer as a result of unfair or incompetent treatment by the service providers. There is also a substantial reputational risk that could arise in the event of a major failure. (Paragraphs 6.9 to 6.13)
67. There are two separate pieces of legislation covering the Investment Services Directive (ISD) and non-ISD firms respectively. There would be advantage in consolidation at a suitable time. (Paragraph 6.18)
68. Within the FSC, regulation of investment services conducted by banks is separated from the regulation of non-bank investment services. Previously, the approach was to classify each non-bank firm as high, medium or low risk – but this had little practical impact on the number of visits, since on-site visits were not

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routine. This began to change in 2003 with the adoption of a desk-based assessment of the business and control risks of each firm. A further change in December 2003 resulted in the adoption by the investment services regulator of the FSC-wide risk model. This determines the risk mitigation approach for each firm, including the frequency of on-site visits. This proactive development is commended, although at the time of the visit by the review team, on-site visits had only recently started, having been postponed by other events. While there were some staff increases in 2003, it may be necessary to increase staff resources further than was envisaged in the plans discussed with the review team by the FSC in order to make this development work effectively. (Paragraphs 6.5 to 6.8 and 6.74)

69. EU Directives have been implemented. Delays may have occurred in the past but the new tracking system should improve matters. New Directives, implementing the EU Financial Services Action Plan, will require considerable discussion to determine the right approach for Gibraltar and this will absorb policy-making resources. (Paragraphs 6.52 to 6.66)
70. Gibraltar has put in place an investor compensation scheme with limits that are in line with the requirements of the EU Directive but less generous than the UK Financial Services Compensation Scheme (FSCS). This means that Gibraltar is not matching UK standards in this respect. The FSC argues that the matching requirement does not apply to investor compensation, because investor compensation is not encompassed within the term ‘supervision’ in Section 8(2) of the FSCO. However, the danger is that UK or UK expatriate customers (who are likely to be assured, by their intermediary, that Gibraltar regulation matches UK standards) are unlikely to interpret that assurance as excluding what, to them, is one of the most visible elements of regulatory protection – namely the level of investor compensation. One way of dealing with this problem is for Gibraltar firms to ‘top up’ into the UK FSCS when selling to UK customers (should they be permitted to do this). So long as the level of compensation remains below that of the UK, clear and prominent disclosure of the more limited compensation arrangements is essential. (Paragraphs 6.48 and 6.76 to 6.77)
71. The FSC has been given guidance in the past on measures designed to close any gaps between Gibraltar and UK practice in investment services. The 1997 review under Section 12A of the FSCO made some recommendations at a high level of generality. A Guidance Note issued by HM Treasury in 1999 provided further detail on measures to be taken (including measures that concerned matters outside the terms of this review). In respect of the guidance on investment services, there has been progress on a number of items, including formal standards of fitness and propriety, implementation of EU legislation then required (although more Directives have become due since 1999), more proactive monitoring of regulated businesses and the introduction of quarterly returns. Authorisation procedures have been enhanced. However, at the time of the review, there was no requirement for a ‘key features’ document; and capital requirements for non-ISD firms still needed to be clarified and formalised. Moreover, a number of important matters discussed in the 1999 Guidance Note were included in draft regulations that had yet to be implemented at the time of the review. Some further progress would be

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made in following the guidance if those draft proposals submitted by the FSC to the Government were implemented. (Paragraphs 6.42 to 6.47 and 6.67 to 6.70)

72. Our conclusion is that, at present, the FSC's supervisory activities in respect of investment services establish and implement standards that substantially match legislation and practice in the UK but do not fully do so. We consider, however, that this could be rectified readily by the adoption of the recommendations of this report. The recommendations, in addition to those relevant to all sectors, are that:
- a. the FSC seeks additional resources to ensure that it is able to implement its risk-assessment programme and to implement the recommendations of this report (*Medium*);
 - b. the Commission proposes the consolidation of FSO 89 and FSO 98 at the time of the implementation of the Markets in Financial Instruments Directive (MiFID) (*Low*);
 - c. the capital adequacy requirements of non-ISD firms be clarified and formalised (*Low*);
 - d. the FSC seeks to ensure that newsletters and circulars implementing a range of conduct of business and other requirements are consolidated into revised Conduct of Business Regulations (we understand that draft Conduct of Business Regulations have been prepared for consideration by the Government of Gibraltar) (*Medium*);
 - e. the FSC implements its proposal to introduce a modified key features regime (providing that such documents prepared for other markets would be acceptable within Gibraltar) (*Medium*);
 - f. the Commission considers, and advises the Government of Gibraltar to invite HM Treasury to consider, an arrangement whereby investment services in Gibraltar would 'top up' the provisions of the Gibraltar investor compensation scheme to the levels of the UK scheme when selling to UK residents (*High*);
 - g. the FSC takes action to remove the other differences in the Gibraltar and UK regulatory arrangements that are listed specifically in paragraphs 6.45 to 6.47 (and where appropriate measures are currently planned, such as in the proposed draft regulations, the FSC attaches appropriate priority to the fulfilment of those plans) (*High*);
 - h. the FSC seeks to ensure that requirements are introduced to provide that any projections of the performance of packaged products comply with specified requirements (*Medium*);
 - i. the FSC reviews, as part of its implementation of the Market Abuse Directive, the measures introduced in the UK in 2001 (*High*);
 - j. as part of the implementation of the Market Abuse Directive, the Commission advises the Government of Gibraltar to review the extent of the FSC's responsibilities for insider dealing investigations (*Low*);

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- k. the FSC discusses with the Government of Gibraltar the implementation of the draft Financial Services (Miscellaneous Provisions) Ordinance 2004, thereby providing for the recognition of foreign exchanges (*Low*);
- l. the FSC considers introducing a formal training requirement on the lines of that suggested in paragraph 6.80 (*Medium*).

(Paragraph 6.82)

Insurance (Chapter Seven of the Report)

73. The insurance market in Gibraltar is small but growing. The most significant area, and the fastest growing, is personal lines business, mainly motor, covering risks outside Gibraltar. One third of the licensees are captive insurers. The small size of the market means that supervisors are much closer to the industry than in the UK. Moreover, the use of insurance managers by many Gibraltar businesses means that the applicant has an adviser familiar with the local regulations and supervisory approach, as well as being knowledgeable about the industry. This has an advantage in improving understanding but also carries the risk (realised in a few cases) of adding to delays in communications. The FSC must guard against the potential dangers that can arise from this close relationship. (Paragraphs 7.1 to 7.6)
74. The main risks are to the policyholder and to Gibraltar's reputation. UK policyholders of Gibraltar companies insuring risks into the UK are covered by the FSCS in the UK, so that UK policyholders have the same protection as policyholders of UK firms. No such scheme or protection applies to Gibraltar policyholders. Gibraltar insurers are aware that business could migrate from Gibraltar very easily in the event of damage to its reputation caused by a well publicised failure. (Paragraphs 7.18 to 7.25)
75. The insurance regulatory system is based on that operated in the UK by the Department of Trade and Industry (DTI) and HM Treasury prior to the implementation of the FSMA, updated as necessary to implement subsequent EU Directives. At the time of the last review in 1997, regulation was judged to match that in the UK. However, while the FSC's supervisory practice has developed positively since then, the UK has also moved on very significantly as a result of the FSMA and reforms introduced under it, and will move on further in the future. Gibraltar has not fully adopted all the changes introduced in the UK. (Paragraphs 7.7 to 7.10)
76. The Gibraltar approach to authorisation is to focus on the viability of the business, as demonstrated by the firms' business plans, on the fitness and propriety of the owners and controllers and on the adequacy of the capital to support the business which is proposed to be written. Ongoing supervision is based on ensuring, through scrutiny of annual (and for newly authorised companies, quarterly) returns, that a required margin of assets over liabilities meets pre-set minima and is calculated in accordance with the regulations. Assets must also be managed prudently. In addition, particular attention is given to monitoring firms' progress against their business plans and budgets which, in the case of newly authorised

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companies, must be submitted to the FSC and approved by it prior to the commencement of each financial year. (Paragraphs 7.32 to 7.39 and 7.43 to 7.46)

77. The solvency requirements placed on Gibraltar companies are in excess of the EU minima – as is the case in the UK. However, at least at the stage of authorisation, there is clear evidence that Gibraltar companies are allowed to start up with less capital than the FSA would accept as adequate in the UK. The FSC sets what it regards as adequate capital requirements on the basis that the amount of business to be written is strictly limited, there is closer supervision and capital can be built up in later years. (Paragraphs 7.40 to 7.41)
78. The FSC is moving towards the adoption of a risk-based model (using that developed for all financial services businesses) and to regular on-site visits. (Paragraphs 7.47 to 7.48)
79. Recent and forthcoming changes in the UK include:
- a. a new risk-based capital adequacy regime;
 - b. new reporting requirements;
 - c. new arrangements to eliminate potential conflicts in life business.
- (Paragraph 7.58)
80. The result is that Gibraltar is not now matching UK practice in respect of capital requirements at the time of authorisation and the matters described in paragraphs 33 to 38, and this divergence will have widened following the introduction of the FSA's risk-based capital regime at the end of 2004. The action necessary to remedy this situation is likely to require significant resources. (Paragraphs 7.64 to 7.65)
81. All the relevant EU Directives have been implemented, albeit frequently after some delay. As new EU legislation is enacted, such as the proposed new Solvency 2 Directive, timely and effective implementation will be necessary to maintain Gibraltar's standing. The FSC should ensure that it is in a position to provide effective advice to the Governments of Gibraltar and of the UK to assist in achieving this. This is likely to consume considerable resources. (Paragraphs 7.67 to 7.70)
82. The recommendations of the previous review have largely been implemented. Where recommendations have not been implemented, the team agrees with the FSC's approach. (Paragraph 7.71)
83. Our conclusion is that the FSC's supervisory activities in respect of insurance establish and implement standards that substantially match legislation and practice in the UK but do not fully do so. We consider, however, that this could be rectified readily by the adoption of the recommendations of this report, which, in addition to those common to all sectors, are that:
- a. the FSC seeks to add sufficiently to its staff complement to enable it to undertake the new risk-based methodology it has already put in place,

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together with more systematic on-site visits; to assess the changes being introduced in the UK in respect of insurance supervision; and to implement changes recommended in this report as well as those it judges necessary to continue to match changing UK standards (*Medium*);

- b. the FSC seeks further explanation from the FSA on how, under the interim prudential sourcebook regime, it determined what were acceptable levels of solvency, both for companies seeking authorisation and those already established, and how this was affected by assessment of the relevant risk factors (*High*);
- c. in the light of discussions with the FSA, the FSC considers whether to revise the solvency requirements which it currently expects of companies seeking authorisation and which it expects of established companies (*High*);
- d. the FSC puts in hand work, and seeks assistance from the FSA, to assess the new risk-based capital regime which the FSA has just introduced in the UK, discussed in paragraph 7.58, and to consider what changes might appropriately be introduced in Gibraltar (this might include inviting Gibraltar companies to undertake an individual capital requirement assessment, on a trial basis, so that the industry and the FSC have a clear understanding of the issues and implications of the proposed new approach) (*High*);
- e. the FSC considers shortening the period allowed for the submission of regulatory returns, taking a strict line with those who seek extensions of the deadline and an even stricter line with those who submit returns late without permission (*Low*);
- f. the FSC considers ensuring that the valuation of liabilities in life company regulatory returns are subject to audit (*Low*);
- g. the FSC, when assessing applications for authorisation, keeps under review its recently revised procedures, so as to ensure that it gives close attention to the source of funds to be used and that formal requirements as to the declaration to be made by applicants and the evidence to be provided are always implemented (*Low*).

(Paragraphs 7.78 to 7.79)