

Financial Supervision Commission

Supervisory Approach

July 2009



Financial Supervision Commission Barrantee Oaseirys

SUPERVISORY APPROACH – 2009 EDITION

INTRODUCTION

The Supervisory Approach sets out the Commission's approach to the supervision of the parts of the financial services industry that it regulates.

The Approach is a high-level document and is not an exhaustive list of the requirements for each area of business. The Approach is mainly a working document for Commission staff, but is published to help licenceholders and their customers to have a broad understanding of what the Commission does. It does not set out to duplicate the Commission's Rule Book, nor is it binding upon the Commission or its licenceholders.

The previous edition of the document was published in January 2007 and the revisions incorporated in this 2009 edition arise principally from legislative and economic changes since that date. The updated approach is still based on impact and risk assessment of licenceholders and the use of a supervisory toolkit including visits and desk-based supervision.

The key changes in this review are:

- Responses to legislative changes;
- Responses to risks posed by the economic situation;
- Adopting a more flexible and varied use of the tools available to the Commission in response to supervisory experience in the past two years.

Any queries relating to this document should be addressed to the Supervision Division, at the address below.

Senior Manager, Risk and Compliance
Supervision Division
Isle of Man Financial Supervision Commission
PO Box 58
Finch Hill House
Bucks Road
Douglas
IM99 1DT

Tel: +44 (0)1624 689300

Email: fsc@gov.im

OPERATING ENVIRONMENT

This section covers key changes in the environment in which the Commission operates.

Legislative changes

The Financial Services Act 2008 and the Collective Investment Schemes Act 2008 have both been brought into effect. The two new Acts have replaced the legislative platform which previously underpinned regulation by the Commission. A new Financial Services Act Rule Book has been issued under the Financial Services Act, providing a consistent basis for the supervision of licenceholders, eliminating minor inconsistencies between different types of licence.

The Financial Services Act 2008 (in section 2(2) of the Act) sets out three regulatory objectives for the Commission:

- a) securing an appropriate degree of protection for the customers of persons carrying on a regulated activity;
- b) the reduction of financial crime; and
- c) supporting the Island's economy and its development as an international financial centre.

Whilst the Commission had previously adopted similar goals; the statutory remit gives its work a solid foundation. In particular the Financial Services Act introduced a regulatory objective for the reduction of financial crime.

Economic situation

The increased risk from imported financial instability has been one of the major challenges of the period from 2007 to 2009. The banking crisis of 2007-2008 led to a widespread international recession in 2009. The extent of the impact of the recession upon the local financial services industry cannot readily be forecast, but the industry is unlikely to be immune.

Whilst no regulator can aim for a zero failure regime, events since 2007 have highlighted the potential vulnerability of Isle of Man licenceholders to events elsewhere. However, there is also a generalised risk, as a result of the adverse economic climate.

Regulatory experience

The Supervisory Approach reflects the experience of the Supervision Division and other regulators over the period.

Standards of anti-money laundering compliance and Customer Due Diligence on the Island have been shown to be generally satisfactory. The most recently licensed sector of the industry (corporate services and trust services) has now received two full rounds of visits since the licensing of the industry began in 2001, whilst other sectors have received AML visits since the 1990's.

AML compliance remains a statutory requirement which will be applied rigorously.

Other aspects of the prevention of financial crime, such as the prevention of identity theft, will be addressed. Breaches of data security in other jurisdictions have illustrated the need for high standards in the Island.

International context

The Commission will continue to meet its objective of supporting the Island's economy and its development as an international financial centre by maintaining a regulatory regime which distances the Island from the less reputable jurisdictions. The Island was visited by an IMF team in the autumn of 2008. At the time of writing the IMF report has not yet been published. The Commission will approach the report's recommendations in a constructive manner, as it did with the report from the previous IMF visit in 2003.

Resources

The Commission, like any other organisation, needs to make the best use of its resources and staffing. If resources are limited by budgetary constraints it is more important than ever to make the most effective use of staff time.

SUMMARY OF KEY RISKS

Table I sets out key risks to the Commission’s achievement of its regulatory objectives. Some of the responses available to the Commission and includes comments on how a recession can aggravate these risks:

Table I: Principal Risks to regulatory objectives and regulatory tools

Risk to Objectives	Description	Examples of regulatory tools for the mitigation of risk
Financial Failure	<p>The risk to consumer protection and market confidence objectives arising out of insolvency or illiquidity of a licenceholder. For high impact licenceholders, this could also include financial losses that, while short of causing failure, can still adversely affect market confidence because of the scale of these licenceholders in relation to the market.</p> <p><i>Recessions make financial failure more likely.</i></p>	<p>Financial resources rules. Review of financial returns. Monitoring of large exposures, related party lending and upstream lending. Audit. Exchange of information with home regulators. Action for breach*</p>
Misconduct mis-management and inappropriate conduct of business practices	<p>The risk to consumer protection arising from the mis-selling or mis-handling of regulated products by licenceholders; or inappropriate behaviour by licenceholders or mismanagement of their operations.</p> <p><i>Economic effects of a recession result in a decline in real returns from traditional savings and investment products and increase the attractiveness of products which offer higher returns. These can pose an increased risk to capital which might not be fully disclosed or might be poorly understood by the consumer.</i></p>	<p>Conduct of business rules. Vetting of key persons and financial advisers Placing restrictions on business by way/ conditions on licence eg limited transactions Visits. Complaints. Whistle blowing Action for breach*</p>
Fraud or dishonesty	<p>The risk to the financial crime and market confidence objectives arising out of external parties defrauding licenceholders or their customers, or the incidence of fraud or dishonesty within licenceholders.</p> <p><i>Existing frauds tend to come to light during recessions. Instances of crimes of dishonesty tend to rise.</i></p>	<p>Vetting of key persons and financial advisers. Recruitment controls. Risk Management and Internal Control rules. Action for breach*</p>
Money Laundering and CFT	<p>The risk to the financial crime and market confidence objectives of money laundering or terrorist financing conducted through the facilities of licenceholders.</p> <p><i>Understaffed or financially stressed licenceholders find it more difficult to spot problem applicants or to turn away borderline applicants.</i></p>	<p>AML Code. Visits Action for breach*</p>

* “Action for breach” includes a range of remedial measures, including directions, suspension or revocation of licences, appointment of a manager, warning notices and “not fit and proper” findings and disqualification of a company officer.

RISK AND IMPACT ASSESSMENT OF LICENCEHOLDERS

The Commission prioritises its workload by conducting a process of risk and impact assessment of licenceholders. The supervisory approach for a licenceholder is based on a combination of:

- The impact rating;
- The risk rating; and
- Identifying relevant actions for the Commission and licenceholder to take.

In general terms, the risk profile and the impact rating drive the type of on-site visits carried out by the Commission, the areas to be examined and the frequency of on-site visits. However, the actual frequency and type of visits will depend not only upon the overall rating, but also on the nature of the risks identified. Some risks may lead to a specific area being examined in a “focus” visit. Other risks are not amenable to resolution through a visit at all; in these cases an alternative form of intervention may be more appropriate.

Impact Rating

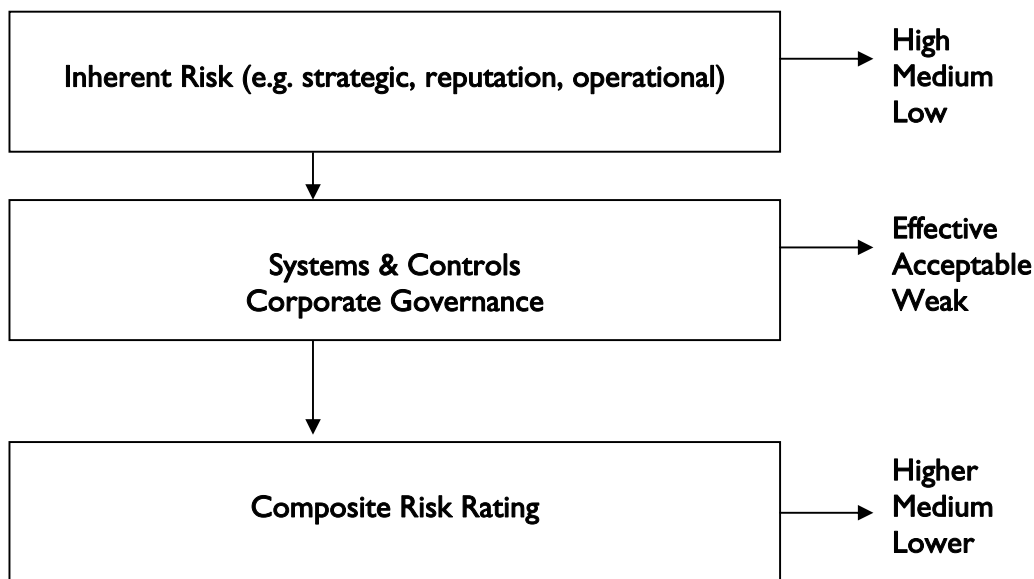
The impact rating reflects the fact that certain licenceholders (for example large organisations and deposit takers) would have a greater impact on the Commission’s consumer protection objectives if they failed.

Ratings of high, medium or low, are applied, in accordance with the table at Appendix 3. Where a licenceholder is part of a group, an impact rating is calculated in relation to the group as a whole. It can be seen from Appendix 3 that applying an impact rating is a reasonably simple and mechanical process.

Risk Assessment

Licenceholders are risk assessed on an on-going basis. The following steps are followed:

- Assess the licenceholder in relation to its inherent risks i.e. those to which the licenceholder is subject due to the nature of its business. These may vary depending on the type of licenceholder and type of business conducted. Ratings are high, medium or low. Further detail on inherent risks is in *Appendix 1*.
- Assess the corporate governance framework and systems and controls the licenceholder has implemented to help mitigate its risks. Ratings are effective, acceptable or weak. Further detail on “control” risks is in *Appendix 2*.
- Set a composite rating of higher, medium or lower, balancing the level of inherent risk against the adequacy of the corporate governance framework and systems and controls, for each inherent risk.



The composite risk rating is assessed for each inherent risk and allows a targeted approach to the supervisory effort, focusing on areas of higher risk, when following the Commission’s broad approach to on and off-site supervision (*as shown in section 3*). The composite risk profile is arrived at via the following matrix:

		RISK MANAGEMENT SYSTEMS, ENVIRONMENT AND CORPORATE GOVERNANCE		
		EFFECTIVE	ACCEPTABLE	WEAK
INHERENT RISK	HIGH	Medium composite risk	Higher composite risk	Higher composite risk
	MEDIUM	Medium composite risk	Medium composite risk	Higher composite risk
	LOW	Lower composite risk	Lower composite risk	Medium composite risk

The Commission discusses specific aspects of the risk profile with a licenceholder. In particular it draws attention to any areas in which the Commission perceives that the licenceholder:

- Has not identified and addressed the inherent risk of an activity; or
- Has not put in place sufficiently robust corporate governance, compliance or risk management arrangements.

Typically these would be evidenced by findings from visit reports or issues raised at business meetings and would give rise to an action plan.

SUPERVISORY TOOLS

The Commission performs both on-site and desk-based supervision, the results of which feed into the on-going risk assessment of the licenceholder.

While the two aspects of supervision are described separately below, in practice the two are inter-related. Deficiencies found during visits may lead to new advice or rules. Breaches or complaints may lead to compliance checks in visits, and to visits being brought forward.

On-site supervision

On-site supervision takes the form of a business meeting or a compliance visit. A compliance visit may be a general review of the business (a “supervisory visit”) or may concentrate on a certain aspect or a limited number of areas of the business (a “focus” visit). The focus may be selected in response to a perceived risk specific to the licenceholder, an outstanding action point from a previous visit; or a perceived risk across all or part of the industry. The Commission may combine a business meeting and a compliance visit in the same visit cycle.

The previous edition of the Supervisory Approach emphasised visits as the principal regulatory measure to establish any problems with levels of compliance and to assist in their resolution. Visits will remain the principal form of monitoring. However, some of the factors which raise a licenceholder’s perceived risk to the Commission’s regulatory objectives (for example financial resources issues) are not necessarily amenable to monitoring and resolution through visits. The Commission will use alternative measures which relate more directly to the matters which have given rise to the risk rating.

In general the frequency of meetings and visits relates to a combination of the impact rating and the composite risk rating of the licenceholder. The following table outlines the typical frequency of visits. However, as noted in the previous paragraph, some risk factors are not amenable to monitoring and resolution through visits and are addressed through measures, which relate more directly to the perceived risk. In addition, the Commission may arrange an ad hoc visit outside the typical frequencies, where necessary.

On occasions the Commission will undertake “themed” visits, or some other form of information gathering, across a sample of groups and licenceholders in order to get a representative sample of information on how the industry addresses a particular issue. It is the Commission’s practice to provide feedback to the industry from such themed visits and exercises.

The table overleaf sets out in summary form how the Commission’s visit planning (and other risk mitigation work) reflects both the impact and risk assessment of a licenceholder or group:

IMPACT	COMPOSITE RISK RATING		
	HIGHER	MEDIUM	LOWER
HIGH	Business meeting every year; Compliance visit every year or other risk mitigation programme in place but with a maximum visit cycle of two years.	Business meeting every year; Compliance visit every two years or other risk mitigation programme in place but with a maximum visit cycle of three years	Business meeting every year; Compliance visit every three years.
MEDIUM	Business meeting every year; Compliance visit every year or other risk mitigation programme in place but with a maximum visit cycle of three years.	Business meeting every two years Compliance visit every two years or other risk mitigation programme in place but with a maximum visit cycle of three years.	Business meeting every two years; Compliance visit every three years.
LOW	Compliance visit every year or other risk mitigation programme in place but with a maximum visit cycle of three years	Compliance visit every two years or other risk mitigation programme in place but with a maximum visit cycle of three years.	Compliance visit every three years.

Events during 2008 demonstrated the amount of damage that could arise from a lower probability risk crystallising in a high impact licenceholder. Furthermore an assessment of impact is more objective and likely to be more reliable than that of perceived risk. The Commission is increasing its focus on high impact licenceholders.

There is a minor exception to the table above in respect of those individuals who work as non-executive directors or joint trustees. Because of the limited nature of their permitted activities, and because statutory records in respect of the companies and trusts will be kept elsewhere, these licenceholders are monitored in terms of their fitness and propriety only, taking into account their qualifications and continuing professional development, knowledge and relevant experience.

The Commission visits more flexibly where a licenceholder has already demonstrated generally satisfactory compliance (for example during two or more supervisory visits). Here, the emphasis may switch to focus visits

The number of visits conducted is included in the narrative of the Commission's Annual Report.

Outputs from on-site meetings and visits

Business Meetings

A letter is sent to the licenceholder, advising of any actions agreed in the course of the meeting.

Compliance Visits

Prior to commencing on-site work, the Commission informs the licenceholder of the intended scope of the visit and may request information to be provided in advance of the visit.

After the visit a report is produced, which itemises any remedial actions required and timescales for completion. A report may include non-mandatory “best practice” recommendations. The report is provided to the licenceholder in draft form before a final version is issued. Visit reports are written on an exception-reporting basis. A letter may be issued instead of a full report due to the limited nature of the activity reviewed or the absence of material actions arising out of the visit.

The Financial Services Rule Book 2008 emphasises the responsibility of a licenceholder's Board for the identification and management of risks. Visits will respond to this by placing greater emphasis on checking the effectiveness of the controls put in place by management and on focus visits that address a particular regulatory theme.

Desk-based Supervision

Desk-based supervision activities include monitoring (cyclical and ad-hoc) and intervention. Examples are set out below:

Monitoring

- Examination of prudential returns and statistical information
- Examination of external and internal audit reports
- Desk based reviews and analysis of information (eg breaches, errors, complaints)
- Review of performance against business plans
- Requests for information
- Themed questionnaires
- Meetings with management or compliance
- Letters to management
- Liaison with home regulators
- Exception reporting (eg late fund accounts, qualifications on fund accounts, fund suspensions)

Intervention

- Addressing rule breaches and complaints
- Applying licence conditions
- Issuing directions
- Appointing a manager
- Suspension or revocation of a licence
- Assessment of fit and proper status – section 10 or the use of a section 11 warning notice
- Refer breaches of anti money laundering legislation to the Attorney General

THE MANAGEMENT OF LICENCEHOLDER RELATIONSHIPS

Team structure

Three teams within the Supervision Division are directly responsible for licenceholder relationships. The teams are sector-based, dealing with:

- Deposit takers;
- Investment businesses and providers of services to collective investment schemes;
- Corporate services, trust services and money transmission services.

A licenceholder is assigned a relationship manager for each area of regulated business conducted.

Each licenceholder is risk assessed for the specific activity it conducts.

Where a licenceholder is part of a group, one of the relationship managers will act as a group coordinator. The group coordinator reviews the risk assessments for entities within a group and, together with the other relationship managers, produces a group risk assessment, identifying any common areas of weakness which may then be addressed on a group basis. Impact is also assessed on a group basis. Exceptionally, where a group is composed of very distinct entities (as in different divisions of a large international group), the licenceholders may be regarded on a stand-alone basis.

For Supervisory Approach purposes the term “group” is used more widely than in company law or other documents produced by the Commission. In addition to companies in common ownership, group supervision can also apply to two companies in different ownership where licenceholder A manages and administers licenceholder B. This is because any deficiency in the systems of the manager A is likely to be mirrored in the managed entity B.

Staff development

In regulating each of its licenceholders, Supervision addresses a range of factors such as financial resources, corporate governance, AML/CFT (anti money laundering and countering the financing of terrorism), handling of client money and conduct of business. Whilst financial resources has always been the top priority for the supervision of deposit takers, the supervision of other licenceholders tends to give a high priority to AML/CFT, handling of client money and conduct of business (which is where the immediate risk for customers tends to arise). Adverse financial conditions may lead to a greater need to scrutinise and respond to financial resources issues amongst non-deposit taking licenceholders, possibly with implications for the Division’s resource needs. IT knowledge may need to be increased in response to the regulatory objective for the reduction of financial crime - an area in which data security risks are particularly prominent.

The Commission has powers to authorise external persons to exercise its powers of inspection and investigation under the Financial Services Act and will continue to make use of these powers where appropriate.

WORKING WITH OTHER REGULATORS

The Commission liaises with regulators both on and off Island as appropriate. This may involve requesting information from other regulators, providing information to other regulators using the statutory gateways, meeting to discuss common licenceholder issues or conducting joint visits.

It is usual for regulators of international groups, particularly banks, to work on a “home” and “host” basis. The “Home” regulator is normally the regulator in the country where the parent company, for consolidated supervision purposes, is incorporated and headquartered and is usually also the “lead” regulator, responsible for taking an overview of the group’s position. The “host” regulators are the regulators in other countries where the group has operations.

Commission as Host Regulator

Where the home/lead regulator is in a different jurisdiction the Commission will contact that regulator on an annual basis seeking confirmation that there are no outstanding regulatory issues. The Commission will also send copies of any visit reports to the home/lead regulator. Where necessary, the Commission will meet with the home/lead regulator for a specific licenceholder issue, or to obtain an update on developments.

On occasions, because of the group structure and/or the flow of business between group companies, there will be a need for the Commission as host regulator to liaise with other host regulators, possibly in conjunction with the home regulator.

Commission as Home/Lead Regulator

Where a licenceholder has regulated branches or subsidiaries in another jurisdiction the Commission will be the home and, in some cases, the lead regulator. In these cases the Commission may be responsible for consolidated supervision of the licenceholder. The Commission will contact the host regulator(s) on an annual basis seeking confirmation that there are no outstanding regulatory issues, and will meet with the host regulator(s) when necessary.

Relationship with Insurance & Pensions Authority (“IPA”)

The Commission meets quarterly with the IPA to discuss areas of common interest. The Commission also invites the IPA to participate in any relevant meetings or visits for licenceholders that are also regulated by the IPA. For groups where there is an entity regulated by the Commission and also an entity regulated by the IPA, the Commission will liaise with the IPA as appropriate to discuss any issues within that entity that may impact on the Commission’s regulatory objectives. Where either the Commission or the IPA is the home or lead regulator, the two regulators will communicate on the basis described above.

Appendix I – Inherent Risks

Inherent risks are categorised into “risk groups” and within each group there are a number of “risk elements” which are considered when carrying out the risk assessment. Inherent risks are defined below:-

Strategic/Business Risk

This is the risk of current and prospective impacts on earnings, capital, reputation or standing arising from poor business decisions, improper implementation of decisions or lack of response to industry, economic or technological changes. This risk is a function of the compatibility of a licenceholder’s strategic goals, the business strategy developed to achieve these goals, the resources deployed to meet these goals and the quality of implementation.

Operational Risk

This is the risk of direct or indirect loss resulting from inadequate or failed internal processes, staff and systems or from external events. This includes legal risk which is the risk arising from the potential that unenforceable contracts, non-compliance with regulation and laws (new or existing), lawsuits or adverse judgements may disrupt or otherwise negatively affect the operations or financial condition of a licenceholder.

Reputation Risk

This is the potential that negative publicity regarding a licenceholder’s business practices, whether true or not, will cause a decline in the customer base or lead to costly litigation or revenue reductions. Market rumours or public perceptions are significant factors in determining the level of risk in this category.

Liquidity Risk

This is the risk that a licenceholder may be unable to meet its obligations as they fall due.

Credit Risk

This is the risk that a borrower or counterparty may fail to fulfil an obligation. The assessment of credit risk involves evaluating both the probability of default by the counterparty, obligor or issuer and the exposure or financial impact on the licenceholder in the event of default.

Market Risk

The is the risk to a licenceholder’s financial condition resulting from adverse movements in market rates or prices, including interest rates, foreign exchange rates, equities and other instruments.

Conduct of Business Risk

This is the risk to a licenceholder arising from inappropriate investment advice, failure to observe conduct of business rules relating to dealing, inadequate disclosure and inadequate client agreements and risk warnings. This may lead to a decline in the customer base or costly litigation or revenue reductions.

Security of Clients' Assets Risk

This is the risk arising from a licenceholder failing to appropriately segregate clients' monies and/or assets which are under its control. This could lead to a loss in consumer confidence and thus a loss of business, as well as litigation against the licenceholder.

Financial Soundness

This is a potential consequence of the above risks and arises from a licenceholder experiencing problems with solvency and profitability. It also links the level of support a licenceholder could expect from its parent or group to its level of risk.

The following table includes all inherent risks that may apply to all areas of regulated activity. This table may be tailored depending on the area under review. Not all of the risk groups and risk elements will apply to all licenceholders.

	Risk Group	Risk Elements
1)	Strategic/Business Risk	Quality, suitability and aggressiveness of strategy
		Industry, economic and legislative changes
		Type of customer
		Type and mix of products, exposure to related risk factors
		Markets
		Distribution channels & Sources of business
		Systemic impact
2)	Operational Risk	People
		IT Systems
		Outsourcing/Insourcing
		Changes (eg technology, products, structure)
		Organisation/Structure/Ownership
		Litigation/Legal Risk
		Complaints
		Fraud
3)	Reputation Risk	Market/Public perception
		Historical incidents of negative publicity

		Strategy/Nature of business
		Level of higher risk customers
4)	Liquidity Risk	Liquidity Profile
		Independent Liquidity
		Asset Quality
		Deposit Base profile
		Pricing Strategy
		Contingency Plan
5)	Credit Risk	Concentration
		Large Exposures
		Products
		Markets
		Arrears
6)	Market Risk	Trading Book
		Management of banking book
		Interest rate risk profile (banking book)
		Foreign exchange risk (open positions)
		Securities/Equities volatility
7)	Conduct of Business Risk	Suitability
		Execution of deals
		Conflicts of interest
		Disclosure of information
		Client Agreements
8)	Security (of Client Assets) Risk	Clients' Money/Trust Accounts
		Clients' Investments
9)	Financial Soundness	Capital Adequacy
		Earnings
		Parental/Group support

Appendix 2 – Control Risks

	Risk Group	Risk Elements
1)	Corporate Governance & Management	Organisation & Structure
		Board of Directors
		Board Committees
		Allocation & Definition of management responsibilities
		Management & Staff
2)	Internal Control Functions	Compliance
		Internal Audit
		Risk Management
3)	Systems & Controls	Segregation of Duties
		Clear definition of authorities
		Financial & Regulatory Reporting
		Management Information Systems
		Risk Reporting
		Operational Procedures
		Money Laundering Controls
		IT Security & Controls
		Change Management
		Professional Advisors
		Business Continuity

Appendix 3 – Impact Criteria

High Impact

- Membership of an Isle of Man compensation scheme and/or
- 50 or more staff; and/or,
- Total liabilities (including contingents) of £500 million or more; and/or
- Assets under management and/or administration of £500 million or more; and/or,
- Corporate services or trust services licenceholder with 1400 or more companies and trusts under administration; and/or,
- Impact on the local community.

Medium Impact

- Between 10 and 49 staff; and/or,
- Total liabilities (including contingents) of more than £100 million but less than £500 million; and/or,
- Assets under management and/or administration of more than £100 million but less than £500 million; and/or,
- Provision of corporate services to a company which is Listed or admitted to trading on a stock exchange.
- Corporate services or trust services licenceholder with more than 500 but less than 1,400 companies and trusts under administration.

Low Impact

- Less than 10 staff; and/or,
- Total liabilities (including contingents) of up to £100 million; and/or,
- Assets under management and/or administration of up to £100 million; and/or
- Corporate services or trust services licenceholder with up to 500 companies and trusts under administration.