

Financial Supervision Commission

Supervisory Approach

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Financial Supervision Commission Barrantee Oaseirys

SUPERVISORY APPROACH – 2011 EDITION

INTRODUCTION

The Supervisory Approach sets out the Financial Supervision 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 the Commission's supervisory work. 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 July 2009 and the revisions incorporated in this latest edition reflect developments in working methods. 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:

- Further development of the tools available to the Commission in response to supervisory experience in the past two years;
- Increased emphasis upon preventative work; and
- Use of themed questionnaires.

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OPERATING ENVIRONMENT

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

Legislative changes

The last review took place shortly after the implementation of the Financial Services Act 2008 and the Collective Investment Schemes Act 2008. The legislative platform has been in place since August 2008 and the Financial Services Rule Book has been in place since January 2009.

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.

Increased emphasis on the prevention of breaches

The Commission has increased its provision of guidance and compliance support material such as checklists. It aims to help licenceholders (and particularly smaller licenceholders) in a cost effective way to increase their compliance with the rules.

Prevention of breaches is desirable in principle – especially if a breach could be to the detriment of a customer or other third party. Furthermore, prevention is often more cost-effective than remedial action after the event.

The measures involved in breach prevention typically include:

- Identifying rules which are commonly breached or which licenceholders seem to have difficulty in applying;
- Considering possible causes by speaking to licenceholders and looking at examples;
- Developing responses; for example clarifying the wording of the rule, providing guidance about the application of the rule in particular circumstances, or supplying a direct aid to compliance such as a checklist or pro-forma;
- Monitoring results where these can be readily quantified. For example the error rate amongst a sample of licenceholders who submitted a checklist with their annual compliance return was half that of similar licenceholders who did not submit the checklist. Feedback from users indicated that the checklist helped them to prevent omissions and errors.

In addition to the guidance directly aimed at breach prevention, the Commission has published other compliance support material including:

- Updated corporate governance guidance for banks;
- Advertising guidance for banks;
- New corporate governance advice for non-banks;
- Guidance on expected practice for trust service providers;
- Guidance on the materiality of rule breaches under rule 8.14 and on the measures we would expect licenceholders to take when they identify a breach;
- Lists of questions which we frequently ask when we receive a notification of an event such as a merger or takeover. (“FAQ” documents in reverse).

The Commission has increased the range of compliance resources on its website and encourages licenceholders to make use of this material.

Economic situation

The increased risk from imported financial instability has been a major challenge since 2007. 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. There is also a localised 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.

Supervisory teams prioritise their visits to target the key risk areas which are relevant to each Class of regulated activity.

Standards of anti-money laundering compliance and Customer Due Diligence on the Island have been shown to be generally satisfactory. AML compliance remains a statutory requirement which will be applied rigorously.

Aspects of the prevention of financial crime, such as the prevention of identity theft, are being addressed.

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 an effective regulatory regime. The Island was visited by an IMF team in the autumn of 2008. The Commission is addressing the report’s recommendations in a constructive manner.

The Commission will continue to monitor the development of international standards and, following consultation with the industry, will implement them in a form appropriate to local conditions.

Resources

The Commission, like any other organisation, needs to make the best use of its resources and staffing. The Commission has applied the Lean project methodology to aspects of its work and will continually seek gains in efficiency.

The Commission is also seeking to use technology to assist licenceholders to submit information to the Commission.

SUMMARY OF KEY RISKS

Table 1 sets out key risks to the Commission’s achievement of its regulatory objectives and ways in which the Commission addresses these risks:

Table 1: Principal Risks to regulatory objectives and regulatory tools

| Risk to Objectives | Description | Examples of regulatory tools for the mitigation of risk |
|---|---|--|
| Financial Failure of licenceholder | <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>Whilst the Commission’s powers relate only to its licenceholders, at a time of financial uncertainty, regulators need to consider financial risks arising from parent entities and from the sovereign risk of home jurisdictions.</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 financial products by licenceholders; or inappropriate behaviour by licenceholders or mismanagement of their operations.</p> | <p>Conduct of business rules. Vetting of key persons and financial advisers. Placing restrictions on business by way of conditions on a licence. Visits. Complaints. Whistle blowing. Action for breach.* Consumer awareness publications - website</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>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>AML Code. Visits. Action for breach.*</p> |

* “Action for breach” includes a range of remedial measures, including directions, suspension or revocation of a licence, appointment of a manager, warning notices and “not fit and proper” findings. The Commission may also apply to the Court for the 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 visit. Other risks are not amenable to resolution through a visit at all; in these cases another form of intervention may be more appropriate.

For Supervisory Approach purposes the term “group” is used more broadly than in company law or other documents produced by the Commission. For example it may be applied where one licenceholder manages another.

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.

Risk Assessment

Licenceholders are risk assessed on an ongoing basis, using the following steps:

- 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. 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. Further detail on “control” risks is in *Appendix 2*.
- Set a composite rating of higher, medium or lower, taking into account both the inherent risk and the corporate governance 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

In planning its supervision of groups or licenceholders, the Commission takes into account factors related to the impact, structure and perceived risk of the group or licenceholder.

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.

Desk-based Supervision

Desk-based supervision activities include monitoring (cyclical and ad-hoc) and intervention. Every licenceholder provides an Annual Compliance Return and related material such as audited accounts. Many also provide prudential returns on a quarterly basis. These returns are analysed and the information is used by the Commission to update its records and its risk assessment of the licenceholder and of any group to which the licenceholder belongs.

The Commission structures its supervisory teams so that each licenceholder has a relationship manager who is responsible for regular dialogue with the licenceholder.

Risk assessments are updated to reflect new information as it becomes available.

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 (e.g. 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 (e.g. late fund accounts, qualifications on fund accounts, fund suspensions)
- Review of specified risk policies (banks)
- The supervisory review and evaluation of a bank's internal capital assessment
- Identification of Rule Book issues
- Meetings with auditors

Intervention

- Addressing rule breaches and complaints
- Requiring a licenceholder to address a risk factor
- Applying licence conditions
- Levying civil penalties
- Issuing directions
- Appointing a manager
- Suspension or revocation of a licence
- Assessment of fit and proper status of controllers, directors, resident officers and other key persons – section 10 or the use of a section 11 warning notice
- Refer breaches of anti money laundering legislation to the Attorney General

Appendix 4 illustrates further some of the forms of intervention that may be open to the Commission.

On-site supervision

Business Meetings

A business meeting is a “top-down” review of the business, attended by representatives of its local senior management and Commission staff.

A business meeting is held annually with each high impact group or licenceholder.

Business meetings are held with medium impact groups or licenceholders either on an annual or biennial cycle (if the entity is medium impact and has been assessed as higher risk, a business meeting is held every year).

Groups are covered by a single business meeting, providing that the group’s activities are sufficiently integrated for this to be effective. Where there is little integration between entities within a group, we normally hold a separate meeting with each entity.

Supervisory visits

A supervisory visit is a “bottom-up” review of a group or licenceholder’s activities, involving examination of procedures and sampling of files.

Supervisory visits are held at frequencies of between one and three years, depending upon

- the impact of the licenceholder,
- whether there are remedial actions arising from previous visits and
- the extent of other contact between Supervision and the licenceholder.

Supervisory visits may be “full” supervisory visits, covering a full spectrum of activities, or “smart” supervisory visits, which address a selection of activities that the Commission regards as a priority. The visits may be preceded by a questionnaire.

Within groups, the licenceholders in the group will be visited at frequencies which vary according to their respective impact and risk. The frequency of visits may also be adjusted to take account of the perceived strength of internal controls within the group.

Themed visits

The Commission undertakes “themed” visits, in order to conduct an in-depth examination of a subject across a segment of the industry. Themed visits are designed to address a particular aspect of a licenceholder’s business which is critical to the delivery of customer services or the financial stability of the licenceholder. We provide feedback to the industry from such themed visits and exercises.

Themed questionnaires

The Commission will sometimes issue themed questionnaires, each of which will address a single topic that is not considered to be conducive to a supervisory or themed visit.

Themed questionnaires are intended to encourage and support self-assessment within licenceholders and the sharing of good practice across the industry.

For any questionnaire, the Commission produces a briefing paper and publishes the questionnaire to encourage self-assessment by all licenceholders. The Commission requests a sample of licenceholders to complete the questionnaire, analyses the replies and publishes a summary of the outcome.

A questionnaire will normally be despatched on a sample basis. The sample might be a representative cross-section of licenceholders, or might be targeted – for example it might be a sample of licenceholders of a particular size or some or all of the licenceholders that conduct a particular regulated activity. It would be rare for a licenceholder to receive more than one or two questionnaires in a year.

The number of visits conducted is reported in 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.

Visits

Prior to commencing on-site work, the Commission informs the licenceholder of the intended scope of the visit and requests information to be provided in advance of the visit and advises of information to be made available at the start 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/guidance” 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. Exceptions are colour-coded:

- red for aggravated rule breaches
- amber for other rule breaches and
- blue for best practice points.

High priority action points are labelled as such.

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

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 (banks) and payment service providers (including e-money and money transmission services);
- Investment businesses and providers of services to collective investment schemes;
- Corporate services and trust services.

Each licenceholder is assigned a relationship manager. Exceptionally, a licenceholder with two main business activities may have two relationship managers.

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, identifies 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.

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

The Commission has powers to authorise external persons to exercise its powers of inspection and investigation under the Financial Services Act.

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 1 – 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 contractual problems, 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 illustrates 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 (e.g. 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.

Appendix 4 – Examples of the escalation of regulatory issues

This table illustrates methods by which Supervision staff address an issue and if appropriate, escalate the action. Escalation addresses the licenceholder directly and might also address the fitness and propriety of its management through warning notices and/or prohibition under the Financial Services Act. The following list is illustrative only and is not exhaustive.

| Event | Typical regulatory steps | Why might fitness and propriety be at issue? |
|--|---|--|
| Visit finds breaches (of Rules / AML Code / Company law) or operational deficiencies | Issue visit report with remedial steps If serious AML breaches – refer to Enforcement | Competence of directors / key persons in the event of serious or widespread breaches |
| Follow-up visit finds failure to carry out remedial action from previous visit | Issue visit report with remedial steps Issue directions – to remedy breaches and perhaps prohibiting new business Suspend licence Ultimately revocation of licence If serious AML breaches – refer to Enforcement | Competence of directors / key persons Integrity of directors / key persons (if inaccurate assurances that the work had been done) |
| Individual unresolved rule breach | Breach letters Initial civil penalty where applicable Increased civil penalty Meeting with Head of Supervision to explain reasons | Competence, integrity or solvency of directors / key persons (depending upon the cause of the breach) |
| Frequent rule breaches (or other problems such as operational failures) | Breach letters Civil penalties Directions Suspend licence Ultimately revocation of licence | Competence of directors / key persons |
| Frequent and uncorrected breaches (or other problems such as operational failures) | Breach letters Civil penalties Directions Suspend licence Ultimately revocation of licence | Competence (possibly integrity) of directors / key persons |
| Serious misconduct by the principal of a small business (for example identified in a visit, or from a whistleblower) | Directions Appointment of a manager Suspend licence Ultimately revocation of licence | Integrity of directors / key persons |
| Failure to meet financial resources requirements | Breach letters Directions Suspend licence Ultimately revocation of licence | Competence of directors and/or solvency of the controllers (depending upon the cause of the breach) |