



Isle of Man Financial Supervision Commission

Supervisory Approach

January 2007

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I. Introduction

This document sets out a revised high level supervisory approach for the areas of banking, investment business, collective investment schemes, corporate service providers (“CSP”) and trust service providers (“TSP”).

The Commission continues to adopt a risk based approach to supervision, with regulatory effort focused on areas of higher risk. All licenceholders are assessed against the Commission’s core supervisory objectives. These are:-

- Maintain confidence in the Isle of Man as a financial centre;
- Secure the appropriate degree of protection for consumers; and,
- Reduce the scope for financial crime.

Areas that pose a risk to the Commission’s core objectives of supervision in licenceholders are as follows:-

Risk to Objectives	Description
Financial Failure	The risk to market confidence and consumer protection objectives arising out of insolvency or illiquidity of a licenceholder. For high impact licenceholders (<i>see section 2.2</i>), this may 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.
Misconduct/ Mismanagement and inappropriate conduct of business practices	The risk to consumer protection and market confidence objectives arising out of mis-selling or mis-handling of regulated products by licenceholders, or inappropriate behaviour by licenceholders or mismanagement of their operations.
Fraud or dishonesty	The risk to the financial crime and market confidence objectives arising out of the incidence of fraud or dishonesty either within licenceholders, or by external parties defrauding licenceholders.
Money Laundering	The risk to the financial crime and market confidence objectives of money laundering conducted by licenceholders.

When assessing a licenceholder, the Commission identifies areas which pose a risk to the Commission’s core supervisory objectives. Any actions proposed to address issues arising in the course of the assessment must be related to one or more of the supervisory objectives.

2. Risk Assessments

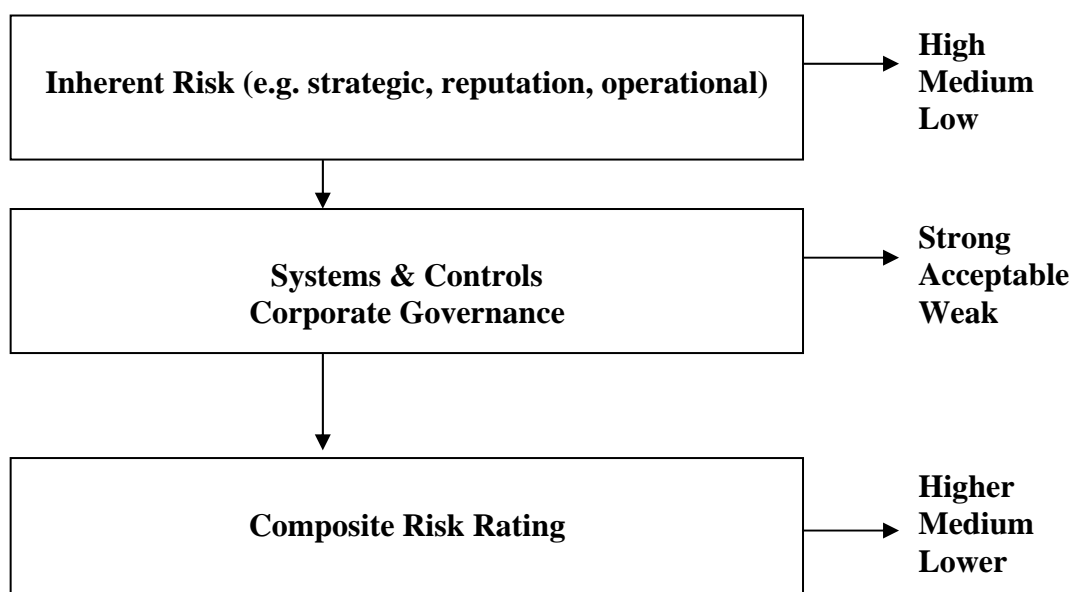
The supervisory approach for an individual licenceholder is driven by a combination of the risk profile and impact rating and is proportionate to the size and complexity of the operation. In particular, the risk profile and the impact rating drive the type of on-site visits carried out by the Commission, the areas to be examined and the frequency of on-site visits

2.1 Risk Profile

Licenceholders are risk assessed on an on-going basis.

The following steps are followed to arrive at the risk profile or the likelihood of a particular event occurring which would pose a risk to the Commission's core supervisory objectives:-

- 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 strong, acceptable or weak. Further detail on "control" risks is in *Appendix 2*.
- Agree 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, per the diagram below, 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		
		STRONG	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 will explain to and discuss with a licenceholder how it determines its risk profile.

2.2 Impact Rating

The impact rating referred to in Section 3.1.1 reflects the fact that an issue arising in certain organisations (e.g. because of their size) may have a greater impact on the Commission's core supervisory objectives. The criteria for each rating, high, medium or low, are defined in Appendix 3.

Where a licenceholder is part of a group, the impact rating is in relation to the overall group. Please see Section 4 for further detail on group supervision.

3. Supervisory Tools

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

3.1 On-site Supervision

3.1.1 Frequency and nature of on-site meetings/visits

On-site supervision takes the form of a business meeting or a compliance visit. Compliance visits may be a review of the entire business or may focus on a certain area, depending on the circumstances of individual licenceholders as assessed via the composite risk rating for inherent risks (*see section 2.1*).

The frequency of meetings and visits depends on the combination of the composite risk rating and the impact rating of the licenceholder. The following table outlines the *typical* frequency (business meetings and compliance visits may be combined) although the Commission may arrange an ad hoc visit outside the typical frequencies, where necessary.

IMPACT	COMPOSITE RISK RATING		
	HIGHER	MEDIUM	LOWER
HIGH	Business meeting every year; Compliance visit every year.	Business meeting every year; Compliance visit every two years.	Business meeting every year; Compliance visit every three years.
MEDIUM	Business meeting every year; Compliance visit every year.	Business meeting every year; Compliance visit every two years.	Business meeting every two years; Compliance visit every three years.
LOW	Compliance visit every year.	Compliance visit every two years.	Compliance visit every three years.

3.1.2 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

Compliance visits may take the form of full supervisory visits, focus visits (which may be on a themed basis) or on-site risk assessments. The visit process consists of pre visit work, on-site work and post visit work. Prior to commencing on-site work, the

Commission will define the scope of the visit to the licenceholder and may request information to be provided in advance.

As part of the post visit work, a visit report will be produced which outlines the areas covered and any actions required of the licenceholder. The objective is as follows:-

- to re-confirm to the licenceholder the scope of the visit;
- to ensure that actions/recommendations are documented;
- to ensure that the responsibility for the action/recommendation is clearly stated;
- to ensure that timescales are clearly stated (for follow-up action); and
- to document recommendations from a best practice/regulatory point of view if appropriate.

All reports are provided to the licenceholder in draft form before a final version is agreed.

There may be occasions where a letter confirming any actions is judged more appropriate than a full report. This could be due both to the limited nature of the activity reviewed and/or the absence of material actions arising out of the visit.

3.2 Off-site Supervision

This may include some or all of the following:-

- Desk based reviews and analysis of information;
- Requests for information;
- Themed questionnaires;
- Meetings with management / compliance;
- Letters to management;
- Review of prudential returns;
- Review of external and internal audit reports;
- Review of specific reports required from licenceholders;
- Setting licence conditions and/or directions; and
- Report/review carried out by an “expert” third party.

4. Groups

Each licenceholder is individually risk assessed in relation to each regulated activity it carries out. For example, a group may have a number of different licenceholders which carry on banking, funds, investment, CSP and TSP activities. Each licenceholder will be risk assessed for the specific activity it conducts. It may also be the case that one licenceholder carries on a number of different regulated activities such as both banking and CSP business. This entity would also have distinct risk assessments for each activity, unless one is incidental to another.

In addition to the individual assessments, a group risk assessment is carried out, depending on the level of integration within the particular group.

Licenceholders are assigned a relationship manager for each area of regulated business conducted. In addition, where licenceholders are part of a group carrying on a number of activities, a group co-ordinator is assigned. Where there is a bank in the group, the banking relationship manager will normally take on this role. In addition to the individual risk assessments, the group co-ordinator will review all risk assessments for the group and, together with the other relationship managers, produce the group risk assessment referred to above, identifying any common areas of weakness which may then be addressed on a group basis.

Where a licenceholder is part of a group, impact is assessed on a group basis. Where a licenceholder is not part of a group, impact is assessed on a standalone basis.

Where a group is composed of very distinct standalone entities, the group approach may not be appropriate.

5. Other Regulators

5.1 General

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

5.2 Commission as Host Regulator

Where the home/lead regulator is in a different jurisdiction, the Commission will contact the 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 for a particular portfolio of licenceholders.

5.3 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.

5.4 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 that is not regulated by the Commission, but is 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 core objectives of supervision.

Any queries relating to the information contained in this paper should be addressed in the first instance to the Head of Supervision, at the address below. Alternatively a relationship manager within Supervision may be contacted.

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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.

Summary definitions of each risk group

	Risk Group	Risk Elements
1)	Strategic/Business Risk	Quality & suitability of strategy
		Industry, economic and legislative changes
		Type of customer
		Type of products
		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,
- CSP or TSP with companies/trusts under administration of 700 or more; and/or,
- Joint CSP/TSP licenceholder with companies/trusts under administration of 1400 or more; 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,
- CSP or TSP with companies/trusts under administration of more than 250 but less than 700; and/or,
- Joint CSP/TSP licenceholder with companies/trusts under administration of more than 500 but less than 1400.

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
- CSP or TSP with companies/trusts under administration of up to 250; and/or,
- Joint CSP/TSP licenceholder with companies/trusts under administration of up to 500.