

Discussion document: the 2009 review of the Commission's Supervisory Approach

March 2009



Financial Supervision Commission Բարանտե Ծասիրյս

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Introduction

The past 18 months have been a period of turmoil in financial markets worldwide. The market instability and failures of major international banks have led to scrutiny of regulatory structures and of regulatory approaches.

Like other jurisdictions, the Isle of Man will need to address these issues and the Commission will contribute to that debate. In the meantime, the Commission is conducting its own review of its Supervisory Approach. The Supervisory Approach sets out the Commission's approach to the supervision of the parts of the financial services industry that it regulates. The last edition of the document was published in January 2007.

The Commission's General Licensing Policy provides a framework for standard-setting. The Supervisory Approach builds on the General Licensing Policy, and is primarily concerned with identifying risks and rule breaches, and putting in place a framework for mitigation of risks where possible and remediation of breaches. Both documents are relevant to Authorisations in assessing applications and to Supervision in working with licenceholders.

The potential revisions that are under consideration for 2009 arise principally from legislative and economic changes since 2007, in particular, the changes in the economic situation over the past year.

The Supervisory Approach is not an order or regulation to which Section 44 of the Financial Services Act 2008 applies and the Commission is not under a statutory obligation to consult. However, the implementation of the Supervisory Approach affects licenceholders. The Commission has therefore decided to publish this discussion document, with an opportunity to comment.

If you have comments or questions, then please address them to the address below. It would help us if you could comment by Tuesday 14 April 2009.

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Factors that will influence the development of the Supervisory Approach

Legislative changes

1. 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.
2. The Financial Services Act 2008 gives the Commission three statutory objectives (in section 2(2) of the Act):
 - (2) The regulatory objectives are —
 - (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 has previously adopted similar goals; the statutory remit gives its work a solid foundation, particularly the introduction of a statutory objective for the reduction of financial crime.

Economic situation

3. The run on Northern Rock in September 2007 was the first run on a British bank in more than a century. The Island was not directly affected by the events at Northern Rock. However, acquisitions and state intervention to protect depositors, provide liquidity support and capital became almost commonplace during 2008. Most directly affecting the Island, Kaupthing Singer & Friedlander was placed into administration in the UK, which led to the closure of its sister bank Kaupthing Singer & Friedlander (Isle of Man) Limited.
4. Whilst no regulator can aim for a zero failure regime, the events of 2007-2008 highlighted the potential vulnerability of Isle of Man licenceholders to events elsewhere. To date this has occurred in a licenceholder-specific and acute form, as a result of issues arising across the group. The parents of several of the Island's banks have been wholly or partly nationalised during the past year. Many of these are institutions that previously had a high credit rating and would have been regarded as "blue chip". In none of these cases have the difficulties of the banks been directly attributable to their operations in the Island.
5. There is also a generalised and chronic risk, as a result of the adverse economic climate. The increased risk from imported financial instability has

been one of the major challenges of 2008 and this trend is expected to continue in 2009.

6. Most of the economies of North America and Europe are either in recession or forecast to slip into recession in the near future. The extent of the impact of such a recession upon the local financial services industry cannot readily be forecast, but the industry is unlikely to be immune from conditions prevailing elsewhere and job losses have been announced by some firms in early 2009.
7. In a difficult economic climate, financial failure becomes more likely and enhanced scrutiny of business plans and financial returns is necessary, particularly for high impact groups and licenceholders. For international groups, cooperation with the regulators of the parent organisations is essential. The Commission will continue to work with the home regulators of the Island's banks and to monitor economic news from the home jurisdictions.
8. The effective segregation of client monies and client assets is always important for investment businesses, (including custodians) and fiduciaries. These arrangements are already examined in visits. However, in view of the increase in counterparty risk, scrutiny of will be increased and the Commission is considering a themed review, using desk-based work supported by on-site inspections. The Commission will also enquire into operational risk management policies in respect of the legal security of licenceholders' agreements with market counterparties.
9. Recent events have raised customers' awareness of the possibility of problems arising and the Commission will enhance its provision of information for consumers.
10. Table I (overleaf) sets out the principal risks to the Commission's objectives and the regulatory tools that can address these risks. The comments under each heading (in bold italics) illustrate how recession can increase these risks.

Table I: Principal Risks to statutory 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 (see section 2.2), 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/ Mismanagement 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>Recession and low interest rates produce low returns from traditional savings and investment products and increase the attractiveness of products which offer higher returns. These can pose a risk to capital which might not be fully disclosed or might be poorly understood by the consumer.</i></p>	<p>COB rules. 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. Recruitment controls. Risk M'gement 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, "not fit and proper" findings and disqualification of a company officer.

Anti Money Laundering and Financial Crime

11. Standards of basic Anti-Money Laundering / Countering the Financing of Terrorism (“AML/CFT”) compliance and Customer Due Diligence on the Island have been shown to be generally satisfactory. The fiduciary supervision team has now completed two full rounds of visits since the licensing of the corporate services and trust services industry began in 2001, while other licenceholders have been subject to AML checks since the 1990s.
12. AML/CFT compliance is a statutory requirement and will be continue to be applied rigorously. However, where a licenceholder has demonstrated satisfactory compliance during two or more supervisory visits, the law of diminishing returns clearly applies to conducting similar broad-brush visits. The Commission will identify ways of visiting more flexibly where a licenceholder has already established a track record of sound compliance. Here, the emphasis will switch to focus visits which address new developments in the AML/CFT environment and known risk factors such as the handling of Politically Exposed Persons, risks arising from new technology or the effectiveness of specific procedures.
13. Breaches of data security in other jurisdictions have reinforced the need for high standards in the Island. Maintaining data security is an important part of the prevention of identity theft and other types of financial crime. The Commission proposes to work with licenceholders, and if appropriate with other interested agencies, to check standards of data security.

International regulatory context

14. 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.
15. In November 2008 the UK Treasury announced that it had commissioned another report into the financial services regulation of the Crown Dependencies and the Overseas Territories in early 2009. The Commission will address any recommendations arising from this report.

Responding to the challenges

16. The Commission, like any other organisation, needs to make the best use of its resources and staffing.

Visits

17. The existing visit process is rigorous, but it would be desirable to reduce the time involved before a report is finalised. The Commission will review its use of letters and abbreviated forms of report, particularly where the outcome is clear-cut and undisputed. More use will be made of exception reports. Concise and timely reports will increase the emphasis upon remedial measures, where these are needed.

Skill sets

18. In regulating its licenceholders other than deposit takers, Supervision has prioritised AML/CFT and conduct of business issues and has aligned the skills profile of its staff with these priorities. We now envisage greater emphasis on accounting knowledge in response to adverse financial conditions and IT knowledge in response to the statutory objective for the reduction of financial crime - an area in which data security risks are particularly prominent. A similar approach has previously been used to good effect to develop projects to review specific activities in the banking sector (e.g. credit risk in 2005/2006).
19. 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.

Regulatory tools

20. The Financial Services Rule Book 2008 emphasises the responsibility of a licenceholder's Board for the identification and management of risks. The Supervisory Approach will place greater emphasis on checking the effectiveness of the controls put in place by management and on focus visits that address a particular regulatory theme.
21. The new Rule Book places an emphasis on licenceholders having a realistic business plan and applying that plan in practice. Supervision and Authorisations will increase their scrutiny of licenceholders' business plans both at the time of licensing and on an ongoing basis.
22. The Commission has considered the relative weighting of risk and impact in its assessment of licenceholders. 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 will increase its focus on high impact licenceholders.

23. 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 statutory objectives are not amenable to resolution through visits. The revised document will cover the use of alternative measures which relate more directly to the matters which have given rise to the risk rating. It will also consider improvements to the current ratings system.

Financial Supervision Commission
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Questions

If you are considering commenting, you might like to think about these questions:

The discussion document emphasises the risks arising from the adverse economic climate and possible responses, in the form of:

- Risk of external shocks, such as the failure of a parent organisation;
- Risk of financial failure of local businesses;
- Increased likelihood of fraud and other forms of financial crime;
- Risk of increased vulnerability to money laundering;
- Risk of financial loss – to be addressed by increased monitoring of segregation of clients' assets and clients' money.

What are your views on this assessment and on the proposed responses put forward?

The Commission aims to increase the variety of its response to risks by:

Carrying out more focussed examinations of particular risk areas;

- Making more use of methods other than visits as a way of addressing issues with licenceholders;
- Bringing additional skills to bear, either on a project basis or in the longer term.

What are your views on this approach?

The Commission aims to make its reports shorter and finalise them more quickly.

What are your views on this?