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FINANCIAL SECTOR ASSESSMENT PROGRAM UPDATE

ISLE OF MAN

DETAILED ASSESSMENT OF COMPLIANCE WITH THE BASEL CORE PRINCIPLES

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GLOSSARY

AML/CFT	Anti-money Laundering/ Countering the Financing of Terrorism
BCP	Basel Core Principles for Effective Banking Supervision
Code	Banking (General Practice) Regulatory Code 2005
CP	Core Principle
FCU	Financial Crime Unit
FSA	Financial Services Act
FSC	Financial Supervision Commission
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
IOM	Isle of Man
IT	Information Technology
LECB	Large Exposures Capital Base
MOU	Memorandum of Understanding
RAR	Risk Asset Ratio
Rule Book	Financial Services Rule Book 2008

I. SUMMARY, KEY FINDINGS, AND RECOMMENDATIONS

A. Introduction

1. **This assessment of the implementation the Basel Core Principles for Effective Banking Supervision (BCPs) was undertaken as part of an IMF FSAP Update for the Isle of Man (IOM) in 2008, and in particular was prepared during an IMF mission that visited the IOM during September 2008.** This assessment follows up on an earlier BCP assessment performed in the context of the 2002–2003 IMF Offshore Financial Center assessment of the IOM. The assessors were Peter Kruschel (BaFin) and Ronald MacDonald (banking supervision expert).

B. Information and Methodology Used for Assessment

2. **The assessment of compliance with the BCPs was made on the basis of a study of the legal and regulatory framework and detailed discussions with relevant authorities and stakeholders.** Discussions were held with government representatives, the Board and staff of the Financial Supervision Commission (FSC), the Bankers Association, senior management of banks (both IOM-incorporated and branches of overseas banks), and auditing firms.

3. **The assessment team enjoyed very good cooperation from the IOM authorities.** This included the comprehensive provision of all the documentation requested and extensive supplementary information and explanations delivered orally during meetings with members of the FSC’s Supervision Division. The FSC also made available to the assessors its self-assessment of compliance with the BCPs. The team would like to express its appreciation to the FSC and the representatives of banks and other institutions for their cooperation with the mission.

This assessment was conducted in accordance with the Basel Committee’s revised Core Principles Methodology (October 2006) and involved a qualitative assessment of compliance with each Core Principle (CP). An assessment of compliance with the BCPs is not, and is not intended to be, an exact science. Banking systems differ from one country to the next, as to their domestic circumstances. Furthermore, banking activities are rapidly changing around the world, and theories, policies, and practices of supervision are evolving swiftly. Nevertheless, it is internationally acknowledged that the Core Principles are seen as minimum standards.

C. Institutional and Macroeconomic Setting and Market Structure—Overview

4. **The IOM is a self-governing Crown dependency.** However, it is in a monetary and customs union with the United Kingdom. During the past two decades, the government’s economic policy has been aimed at raising living standards through the development of a stable diversified economy. Key elements of this strategy have been sound public finances (budget deficits are legally prohibited), creation of a stable and favorable tax environment (“tax neutral” in the government’s terms), and the maintenance of the IOM’s reputation as a

safe and reliable jurisdiction for locating business. This last element has been particularly important for the development of banking and other financial activities.

5. **The FSC is the sole supervisory authority for banks operating in the IOM.** It operates within a supportive legal framework and is empowered, subject to approval by parliament (Tynwald), to issue legally binding regulations for banks' operations. The banking law was recently revised. Consequently, the legal basis for banking regulation is now located in the Financial Services Act 2008, which consolidates the provisions of the earlier Banking Act 1998 (now repealed) with those of other acts covering the regulation of all other types of financial institution (except insurance and pensions funds). In general, the FSA 2008 made few substantive changes to the FSC's legal powers, which it has used effectively to issue comprehensive and effective bank regulations. These were contained in the Banking (General Practice) Regulatory Code 2005 (the Code) at the time of the assessment. However, at the beginning of 2009, they will be replaced by new requirements contained in the Financial Services Rule Book 2008 (the Rule Book), which the FSC has already issued under the FSA 2008.¹ At the time of the assessment, the FSC was revising its guidance for banks to take account of the revised provisions in the Rule Book.

6. **Since the previous BCPs assessment (2002), macroeconomic developments have been generally favorable for the development of the banking system.** The Manx economy has performed impressively. Annual GDP growth has averaged over 8 percent over the last 10 years. Unemployment is negligible. Inflation has been moderate. The government is required to budget for a surplus, which has allowed it to build up reserves.² Average residential house prices rose fairly steadily at about 8 percent per year during 2003–2007.

7. **Banking continues to be the largest component of the financial sector, generating almost one-fifth of the IOM's GDP.** With the exception of two Manx banks, all local banks are branches and subsidiaries of parent banks from EU countries (mainly the United Kingdom and Ireland) and some other countries.³ The FSC follows a policy whereby it licenses only subsidiaries or branches of banks based in what it considers to be well-regulated financial centers.

8. **Banks' business models are diverse.** One major component is the collection of retail deposits from overseas (for example, from U.K. nationals working in third countries, and from non-EU nationals resident in the United Kingdom but not domiciled there), or from institutions such as trust services providers which place clients' funds with banks in the IOM. The important deposit-collecting function of Manx banks is reflected in their relatively

¹ The entire Rule Book came into force on August 1, 2008 for new licenses granted after that date. For existing license-holders, the entire Rule Book is not applicable until January 1, 2009 apart from the anti-money laundering part, which came into force on August 1, 2008 for all license-holders.

² The government has an AAA rating.

³ Most major British banks and building societies have operations on the IOM.

simple balance sheet structure, with intra-group claims accounting for over 70 percent of their customer deposits. Besides placements with parents, and limited lending to the local economy, there is some lending to entities incorporated on the IOM with business elsewhere, and residential mortgages in the United Kingdom. Banks do not operate trading books and in almost all cases liquidity is managed by parent banks.

9. **Bank profitability and capital levels are both high.** Since 2003, banks' annual return on equity has been consistently above 15 percent. During the same period, total assets more than doubled from GBP 33.5 billion to GBP 68.1 billion. During 2007, return on total assets was 0.67 percent and return on equity 16.1 percent. Net interest income accounted for 75 percent of banks' total income. The average risk weighted capital adequacy ratio at end-2007 was 16.1 percent.

10. **The recent global financial markets turmoil has had a significant impact on the Manx financial system.** At the time of the assessment, the impact was still small. However, since then a number of U.K. banks with operations on the IOM have undergone various forms of intervention, and the local subsidiary of a non-EU bank has had its license suspended and possibly will be wound up. The full implications of these events will take time to be determined.

D. Preconditions for Effective Banking Supervision

11. **The IOM has its own legal system separate from the United Kingdom, with laws being made by Tynwald (parliament).** In practice, legislation in the commercial and financial fields is very similar to that of the United Kingdom. The legal system, which is based on common law, is highly developed and well-regarded, notably in regard to expertise on financial sector matters. When necessary, the courts generally follow decisions of courts in similar jurisdictions in the major British Commonwealth countries. A full range of high-quality legal, accounting, and other business services are available on the IOM. The payment system is integrated into that of the United Kingdom.

12. **The IOM is not a member state of the European Union (EU) or the wider European Economic Area.** Consequently, the IOM has not been obliged to implement European directives on the regulation of financial services. Instead, it has voluntarily followed a policy of adopting wider international standards such as those of the Basel Committee on Banking Supervision. In practice, there is considerable overlap with EU standards, for example in areas such as banks' capital adequacy requirements.

13. **The IOM has a deposit protection scheme, which was amended shortly after the time of the assessment.** Currently, the scheme provides compensation for depositors in the event of a bank becoming insolvent. The coverage extends to the sterling and foreign currency deposits of both resident and non-resident depositors, with a maximum compensation of 100 percent of deposits up to GBP 50,000 per individual depositor and GBP 20,000 for corporate and other depositors. Several classes of deposits are specifically excluded from protection, notably inter-bank deposits and those of the failed bank's

shareholders and directors. Compensation payments by the scheme are funded by compulsory levies on banks that are members of the scheme with a maximum amount payable in any one year. The scheme may also borrow temporarily. The scheme was activated following the closure of BCCI in 1991, and payouts may be needed in the context of the current global financial turmoil. There is no lender-of-last-resort facility.

E. Main Findings

14. **The IOM has maintained and improved on the generally very high standard of compliance with the Basel Core Principles, which was noted in the previous assessment.** The FSC is commended for its proactive stance in establishing and enforcing high standards for banking supervision, which have contributed very substantially to the maintenance of the IOM's good reputation as an international banking center.

15. **A significant change since the previous assessment concerns the enhanced operational autonomy of the FSC.** Although there is no tradition in the IOM—and indeed no evidence—of any political or governmental interference in the performance of supervision ever having occurred, the Banking Act 1998 allowed the Treasury to issue directions to the FSC regarding its handling of individual supervision cases. This has now been replaced with a much more narrower mandate for the Treasury to specify broad policies and strategies for the FSC, leaving day-to-day operations and case-specific issues to the FSC. The Treasury still has the legal power under FSA 2008 “by order [to] specify policies and strategies” to the FSC after consultation. This arrangement may be viewed as a means to maintain some democratic control over the direction of financial sector policy generally.

16. **Other elements supporting the FSC's autonomy have been broadly enhanced.** New qualification for Board members (e.g., that they not be members of Tynwald or civil servants) have been introduced, but Tynwald retains a right to remove by resolution Commission members for any reason and without having to make its reasons public (although this would be very difficult in practice given the IOM's political arrangements). Public accountability requirements for the FSC have also been improved, and the FSC uses a variety of vehicles to explain its actions and policies. However, Tynwald's approval is still required for new (or amended) regulations made by the FSC.

17. **The FSC remains closely integrated in the government's financial arrangements.** The FSC's expenditure forms part of the government's budget and requires the FSC to obtain approval for any increase in staff or other expenditure. Although the FSC's annual need to request for sufficient resources for banking supervision does not appear to have impeded its operational efficiency in practice, it would be preferable if the FSC had greater financial autonomy. At a minimum, the FSC should have the flexibility to respond to unexpected pressures. It was also noted that the FSC's information systems continue to be part of the government system.

18. **The FSC's present staff levels for banking supervision, although relatively small, appear to be broadly adequate.** The supervisory staff are highly trained and respected for their professionalism by commercial bank management and accounting firms.

19. **The FSC has substantially strengthened its supervisory techniques, and conducts supervision in the IOM in an efficient and cost-effective way.** Its approach is risk-based, and incorporates both desk-based work and on-site visits. A risk profile is assessed for every bank, together with an impact rating based on the bank's size. These factors are then combined to determine the amount of resources the FSC should apply to its supervision of any one bank. In addition to routine "business meetings" with banks, the FSC uses its risk assessments to prioritize other on-site work. These take the form of "focus visits" in which the FSC examines specific areas (for example, internal controls) of a bank's risk profile. In addition, the FSA conducts also programs of visits across all banks to assess particular risks (themes) and banks' ability to mitigate these risks.

20. **The FSC has continued to incorporate best international practices into the supervisory function.** Since the previous assessment, it has made very substantial progress with Basel II, cooperating closely with the supervisory authorities in Guernsey and Jersey in developing common approaches of implementation. Basel II has now been adopted by all banks, save one which has been allowed to postpone until January 2009.

21. **The FSC has adequate powers to ensure compliance with its regulations and other orders, and it uses these powers when the occasion demands.** A broad and flexible range of sanctions are available. The FSC now the power to petition the court for the appointment of a person to manage a bank's business.

22. **The major risk factors facing the IOM, which have been given prominence by the global financial crisis, relate to large exposures towards parent banks.** Close relationships with parent banks are risk-mitigants in normal times, but operate as powerful risk transmittal mechanisms when the parents come under severe stress. These exposures to related parties generally dominate local banks' balance sheets, which gives rise to major solvency and liquidity risks. The authorities recognize these concerns and the threats which they represent to overall financial stability. The FSC is commended for its proactive approach in addressing these concerns. Nonetheless, the importance of these risks require that the authorities prioritize the further development of relevant regulations and supervisory practice.

23. **Principle-by-principle compliance with the BCP is summarized in Table 1 below.**

Table 1. Summary of Compliance with the Basel Core Principles

Core Principle	Grading	Comments
1. Objectives, independence, powers, transparency, and cooperation	C	The FSC has wide powers and autonomy.
1.1 Responsibilities and objectives	C	Objectives are clearly stated.
1.2 Independence, accountability and transparency	LC	Operational independence has been enhanced, and in practice the independence is not under threat. However, members of the FSC can still be removed by resolution of Tynwald for any reason, and Tynwald can reject regulations made by the FSC. The FSC is effectively accountable to government and the public.
1.3 Legal framework	C	The legal framework is comprehensive and kept up-to-date.
1.4 Legal powers	C	A full range of enforcement powers and sanctions are available. Fines are currently used only for infringement of administrative requirements.
1.5 Legal protection	C	Legal protection of supervisors is provided.
1.6 Cooperation	C	Means are available and used for domestic and international cooperation.
2. Permissible activities	LC	Permissible activities are well defined. The term "bank" should be protected explicitly .
3. Licensing criteria	C	The licensing criteria are full satisfactory.
4. Transfer of significant ownership	C	Recent legislation has introduced a definition of significant ownership and an explicit requirements for FSC approval of major transfers of ownership.
5. Major acquisitions	LC	Recent legislation has introduced an explicit requirements for FSC approval of major acquisitions. Given the structure of the banking sector and in particular the absence of complex groups headquartered on the island, major acquisitions have not yet been an issue. However, there are as yet no established criteria for assessing proposals for major acquisitions.
6. Capital adequacy	C	Capital adequacy requirements are fully adequate. Basel II has been introduced.
7. Risk management process	C	The FSC regulates and effectively supervises risk management processes.
8. Credit risk	C	The FSC regulates and effectively supervises credit risk.
9. Problem assets, provisions, and reserves	C	Banks are required to recognize problem assets and make provisions in a timely fashion.
10. Large exposure limits	LC	Exposures to related parent banks are

		generally not limited.
11. Exposure to related parties	LC	Exposures to related parent banks are generally not limited, yet they constitute the main vulnerability for the system.
12. Country and transfer risks	C	Country and transfer risks, while limited for most banks, is adequately regulated and supervised.
13. Market risks	C	Market risk, while limited for most banks, is adequately regulated and supervised.
14. Liquidity risk	LC	Local banks' liquidity management capacity is limited given the typical business model. Consideration should be given to requiring them to hold a stock of highly liquid assets in the form of marketable assets or short-term balances with non-group banks.
15. Operational risk	C	Operational risk is addressed. The FSC should strengthen its guidance on operational risk relating to legal risk.
16. Interest rate risk in the banking book	C	Interest rate risk is adequately regulated and supervised.
17. Internal control and audit	C	Banks are required to have effective internal controls and audit.
18. Abuse of financial services	C	Extensive provisions, supported by supervision, are in place to deter and prevent the abuse of financial services.
19. Supervisory approach	C	Cross-bank comparisons and system-wide stability analyses should be developed, for example, through more regular stress testing, evaluation of systemic developments, and review of the distribution of financial soundness indicators.
20. Supervisory techniques	C	The FSC makes use of a array of supervisory techniques, including sophisticated off- and on-site supervision.
21. Supervisory reporting	C	Supervisory reporting is fully satisfactory. It is important to ensure that strict control continue to be maintained to prevent unauthorized access to confidential data.
22. Accounting and disclosure	C	Banks maintain a high level of accounting and disclosure.
23. Corrective and remedial powers of supervisors	C	The authorities enjoy a full range of corrective and remedial powers, which they have exercised when the occasion has demanded.
24. Consolidated supervision	LC	Although not currently of great materiality for the IOM, the FSC should establish an adequate supervisory regime for consolidated supervision.
25. Home-host relationships	C	The FSC actively pursues constructive

		cooperative relationships with home supervisors.
Aggregate: Compliant (C) – 24, Largely compliant (LC) – 7, Materially noncompliant (MNC) – 0, Noncompliant (NC) – 0, Not applicable (N/A) – 0		

F. Recommended Action Plan and Authorities' Response to the Assessment

Recommended action plan

Table 2. Recommended Action Plan to Improve Compliance with the Basel Core Principles⁴

CP1(2)	Remove Tynwald's legal powers to remove members of the FSC by resolution and to veto proposed FSC regulations.
CP1(4)	Consideration should be given to more use of fines other than for infringement of purely administrative requirements.
CP2	Make explicit that only licensed deposit takers can use the term "bank" and derivatives thereof in relevant names.
CP5	Develop criteria for assessing major acquisitions by locally incorporated banks.
CP10	Decide on a regular basis whether or not an exemption for large exposures should be renewed.
CP11	Regularly monitor the status and financial condition of parent companies of local subsidiaries, and review whether exemptions of group-related exposures from the concentration risk requirements should be renewed.
CP14	Consider requiring banks to hold a stock of highly liquid assets in the form of marketable assets or short-term balances with non-group banks. Keep liquidity guidance under review in light of evolving international standards in this area.
CP15	Strengthen guidance on operational risk relating to legal risk.
CP19	Develop cross-bank comparisons and system-wide stability analyses, and publish more analysis.
CP24	Establish a formal supervisory regime for consolidated supervision.

Authorities' response to the assessment

Core Principle	Recommended Action	Authorities' response
CP1(2)	Remove Tynwald's legal powers to remove members of the FSC by resolution and to veto proposed FSC regulations.	The Commission will ask Treasury to take forward amending legislation to address these recommendations.
CP1(4)	Consideration should be given to more use of fines other than for infringement of purely administrative requirements.	Consideration will be given to adopting this recommendation in an update to the Rulebook which is planned for 2009. Civil Penalties for submission of late returns was introduced as a first stage of a Civil Penalties regime.
CP2	Make explicit that only licensed deposit takers can use the term "bank" and derivatives thereof in relevant names.	The Commission will ask Treasury to take forward amending legislation to address this recommendation.
CP5	Develop criteria for assessing major acquisitions by locally incorporated banks.	The Commission can demonstrate the criteria that was used in assessing a major acquisition by a

⁴ Note that several recommendations are included under CPs that are assessed as fully compliant.

		locally incorporated bank. This will be reviewed and formally adopted as the criteria to be used in the future during 2009 / early 2010.
CP10	Decide on a regular basis whether or not an exemption for large exposures should be renewed.	This will be done annually.
CP11	Regularly monitor the status and financial condition of parent companies of local subsidiaries, and review whether exemptions of group-related exposures from the concentration risk requirements should be renewed.	This is already being done but more formalised procedures will be adopted.
CP14	Consider requiring banks to hold a stock of highly liquid assets in the form of marketable assets or short-term balances with non-group banks. Keep liquidity guidance under review in light of evolving international standards in this area.	This has already been discussed during 2008 and these discussions will continue in 2009. This has been implemented.
CP15	Strengthen guidance on operational risk relating to legal risk.	This will be done during 2009.
CP19	Develop cross-bank comparisons and system-wide stability analyses, and publish more analysis.	This will be done either during 2009 or early 2010.
CP24	Establish a formal supervisory regime for consolidated supervision.	This will be done during 2009 / early 2010

II. DETAILED ASSESSMENT

24. **The methodology makes a distinction between “essential” and “additional” criteria.** However, in accordance with the usual standards applied in the case of assessments which are conducted as part of an FSAP, this assessment takes into account the essential criteria only in determining the level of compliance.

25. The methodology provides that supervision of an individual principle is considered **compliant** when all essential criteria are generally met without any significant deficiencies. A principle is considered **largely compliant** when only minor shortcomings are observed, which do not raise any concerns about the authority’s ability and intent to achieve full compliance with the principle within a prescribed period of time. A principle is considered **materially non-compliant** whenever, despite progress, the shortcomings are sufficient to raise doubts about the authority’s ability to achieve compliance. A principle is considered **non-compliant** when no substantive progress toward compliance has been achieved. A principle is considered **not applicable** whenever, in the view of the assessors, the principle does not apply given the structural, legal, and institutional features of a country.

Table 3. Detailed Assessment of Compliance with the Basel Core Principles

Principle 1.	Objectives, autonomy, powers, and resources. An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance, and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Principle 1(1).	Responsibilities and objectives. An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.
Description	<p>The Financial Supervision Commission (the FSC) was established in 1983 as a statutory body. The commission's functions are described in the FSA, which came into force on August 1, 2008. The FSA provides for the regulation and supervision of persons undertaking regulated activities (i.e., deposit-taking, investment business, services to collective investment schemes, fiduciary services, money transmission services) in or from the IOM, the maintenance and development of the regulatory regime for regulated activities, the oversight of directors and persons responsible for the management, administration or affairs of commercial entities, as well as the operation of the Companies Registry.</p> <p>The FSC's responsibilities do not extend to the insurance and pensions industries, which are supervised by the Insurance and Pensions Authority.</p> <p>The FSC's regulatory objectives are securing an appropriate degree of protection for the customers of persons carrying on a regulated activity, the reduction of financial crime and supporting the IOM's economy and its development as an international financial centre.</p> <p>The work of the commission is overseen by seven commissioners appointed by the treasury, subject to the approval of Tynwald. The chief executive is a commissioner.</p> <p>The legislation defines the responsibilities and objectives of the FSC. It provides a framework of prudential standards that banks must meet.</p> <p>Banking laws and regulations have been updated recently and remain effective and relevant to changing industry and regulatory practices.</p> <p>Laws are in place for the (single) banking authority, and its responsibilities and objectives are clearly defined and publicly disclosed.</p> <p>The laws and supporting regulations in the IOM provide a framework of prudential standards that banks must meet. Banking laws and regulations are updated as necessary to ensure that they remain effective and relevant to changing industry and regulatory practices.</p>
Assessment	Compliant
Comments	
Principle 1(2).	Independence, accountability, and transparency. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources,

	and be accountable for the discharge of its duties.
Description	<p>The FSC consists of not less than seven qualified persons appointed by the treasury, subject to the approval of Tynwald.</p> <p>According to Schedule 1, section 1 (2) of the FSA the treasury shall appoint one commissioner to be chairperson and another to be deputy chairperson of the commission.</p> <p>A person who is a member of Tynwald, a civil servant or an employee of a department or statutory board cannot be a member of the commission, with the exception of the Chief Executive Officer of the commission.</p> <p>A commissioner shall go out of office, on the expiration of five years after his appointment. He can also be removed, if he ceases to be a qualified person. A commissioner may be removed from office by resolution of Tynwald (Schedule 1, section 1 (4)).</p> <p>The treasury may by order specify policies and strategies for the FSC after consulting the FSC and the banks affected. In practice, this has resulted in an effective public consultation process between the private sector, regulatory authorities, and government with the aim of ensuring that relevant stakeholders are fully on board with any regulatory changes prior to their implementation.</p> <p>The modalities of cooperation between the FSC and the treasury are further set out in a Memorandum of Understanding (MOU) between the two bodies. This MOU includes arrangements to ensure that the FSC is accountable to treasury for its actions; clarifies the circumstances in which sensitive information may flow between the FSC and the treasury; states that the FSC is represented by the treasury in Tynwald; and confirms that the treasury sets the legal framework within which regulation is carried out, including the core corporate governance structure of the FSC, as well as the “Overriding Regulatory Strategy.”</p> <p>The MOU also states that the FSC operates independently from government and that the treasury does not interfere on bank-specific issues, but the treasury is to set the “Overall Regulatory Strategy.” The MOU lays out the regular meetings that are to be held between the treasury and the FSC and all regulatory proposals by the FSC must be approved by Tynwald.</p> <p>The FSC’s income and expenditure is part of the general revenue account of the IOM government. Accordingly, any income is part of government finances and is not retained by the FSC. During 2007–08 the FSC levied fees amounting to GBP 12.6 million, while its expenditure amounted to GBP 3.9 million leaving a surplus of GBP 8.7 million for government. The greater part of income came from the FSC’s activity as the Companies Registry (GBP 10.9 million), while income from banking license fees totaled GBP 0.7 million. The FSC is currently working on a revised scale of license fees made necessary by the new definition of “regulated activities” introduced by the FSA.</p> <p>The FSC has to operate within a headcount restriction set down centrally within government and its entire expenses are met out of the government budget. Each year the FSC identifies its expenditure needs for the following year and agrees its budget with treasury. The treasury then includes the FSC budget in the overall government budget which goes to the Council of Ministers for approval. If additional costs were to be incurred during the course of the budget year, the FSC would have to apply to the treasury for a supplementary budget. However, this need has never arisen.</p> <p>The FSC’s payments and receipts are handled by the government. Also, the FSC’s revenue</p>

	<p>and expenditure is audited annually by the government’s external auditors, and is subject to review by the government’s internal audit department.</p> <p>The FSC disposes of a budget that provides it with staff in sufficient numbers and with skills commensurate with the size and complexity of the institutions supervised.</p> <p>The FSC has a learning and development strategy which records its commitment to the learning and development of all employees. All employees are expected to take ownership of their own learning and development with support of their superiors. The learning and development strategy sets out a benchmark of 10 days per annum being set aside for each member of staff.</p> <p>The supervisory authority and its staff have credibility based on their professionalism and integrity.</p>
Assessment	Largely Compliant
Comments	<p>Positive is to remark that the chairman is no longer a political person and that the treasury as well as other governmental authorities shall not give orders to the FSC regarding specific supervisory cases. However, the treasury can “by order specify policies and strategies” to the FSC after consultation, and sets the “Overall Regulatory Strategy.” Thus, in principle, the objectives of financial sector policy is set by the democratically-elected Tynwald via government, while the FSC has operational independence and, in particular, independence in dealing with specific cases. Nonetheless, the boundaries of “policies and strategies” as opposed to specific measures are not explicitly defined in legislation.</p> <p>The commissioners can still be removed by Tynwald. The reasons for doing this are not specified in the act, and Tynwald is not formally required to publish an explanation should the case arise (although the debates in Tynwald are made public).</p> <p>The FSC is empowered to issue secondary legislation, but Tynwald can reject it.</p> <p>The FSC is still funded by the budget and staffing levels are controlled by the treasury.</p>
Principle 1(3).	Legal framework. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision.
Description	<p>The FSA gives the FSC the power to grant and refuse, as well as to revoke licenses. The FSC may impose on a license certain conditions. The FSA empowers the FSC to set prudential rules concerning regulated activities, the conduct of business, service and products, relationships with customers, corporate governance and risk management. Those rules can be rejected by Tynwald (see CP 1(2)).</p> <p>The law or regulations empower the supervisor to obtain information from the banks and banking groups in the form and frequency it deems necessary.</p> <p>Guidance notes issued by the FSC give guidance to banks about how it will operate in particular circumstances. As a rule, extensive consultation is held with the industry in formulating policy guidance and best practice.</p> <p>The FSC has a comprehensive system for assessing applications for banking licenses. The FSC has recently reviewed its licensing policy for companies holding or seeking a financial services license. According to the FSA there are seven classes of license for various “regulated activities,” including those of deposit taker, financial and investment advisor,</p>

	discretionary portfolio manager, custodian, and stockbroker (see CP3).
Assessment	Compliant
Comments	
Principle 1(4).	Legal powers. A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.
Description	<p>The FSA gives the FSC a range of powers. Apart from its responsibility for the licensing procedure, it can take different measures including warnings, conditions and directions.</p> <p>If a person is in contravention of a condition and/or a direction, the FSC may undertake such action for a breach as is appropriate. The FSC uses these instruments in practice on a regular basis.</p> <p>The FSC may also require a bank to pay a penalty in respect of a contravention, if the FSC is satisfied that the bank has contravened an administrative requirement, such as on the timely submission of statistical returns; regulations could be amended to allow fines to be imposed for other contraventions of the FSA. If a license-holder is in contravention of the Rule Book the FSC may undertake action for a breach.</p> <p>The FSC may apply to the high court for the appointment by the court of a person as a manager to manage the affairs of persons in so far as those affairs relate to the carrying on of a regulated activity.</p> <p>The FSC has also the power to require a bank person to provide it with a report by an accountant or other person with relevant professional skill on any matter relating to the affairs of the bank.</p> <p>All these powers enable the FSC to address compliance with laws and the safety and soundness of the banks under its supervision. The law and regulations permit the FSC to apply qualitative judgment in safeguarding the safety and soundness of the banks within its jurisdiction.</p> <p>The law or regulations empower the supervisor to obtain information from the banks and banking groups in the form and frequency it deems necessary.</p>
Assessment	Compliant
Comments	Consideration should be given to more use of fines other than for infringement of purely administrative requirements.
Principle 1(5).	Legal protection. A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.
Description	<p>According to Section 33 of the FSA, the FSC's employees are not liable in damages for any act or matter unless the act or matter is shown to have been in bad faith.</p> <p>In addition, the FSC's officers are protected by the Statutory Boards Act 1987. According to paragraph 11, Schedule 2 of this act, an officer of the board shall not be personally liable in respect of any act done by him in the performance of his functions if he acted reasonably and in the honest belief that his duty required or empowered him to do it. Where an action has been brought against an officer in respect of an act done by him in the performance of his functions, the board may also indemnify him against the whole of any damages which he may</p>

	have been ordered to pay or may have incurred.
Assessment	Compliant
Comments	
Principle 1(6).	Cooperation. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Description	<p>Schedule 5 of the FSA regulates the disclosure of information. Accordingly, any person appointed or authorized to exercise any powers under the act is subject to the restrictions. Several authorities are excluded from the restrictions.</p> <p>The FSC is not permitted to disclose any information relating to the affairs of a customer unless the customer consents. The FSC may consent to the disclosure of information, if it is satisfied that the disclosure is appropriate having regard to its functions and regulatory objectives, the confidential nature of the information and the purpose for which it is required.</p> <p>Any person who contravenes the duty of restriction on disclosure of information is guilty of an offense.</p> <p>When releasing information to a foreign supervisor, the FSC specifies that the information must remain confidential to the receiving agency and must not be disclosed to any third party without the prior written consent of the FSC.</p> <p>The FSC is able to deny any demand (other than a court order or mandate from a legislative body) for confidential information in its possession.</p> <p>Because the FSC's information technology (IT) infrastructure is integrated within that of the IOM government, there is a risk that confidential information supplied by banks and their customers (and the FSC's own internal documents) may be accessed from time to time by unauthorized persons. Moreover, access to the data is not routinely recorded. It is therefore questionable whether there is adequate protection for confidential information.</p>
Assessment	Compliant
Comments	
Principle 2.	Permissible activities. The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word "bank" in names should be controlled as far as possible.
Description	<p>Deposit taking is defined as a financial services activity in Section 3 of the FSA. The FSA also defines other activities as financial services activities: investment business, any service to a collective investment scheme, corporate services, trust services, any service or activity involving money transmission. In addition, any other financial service or financial activity of a specified kind may be defined as financial services activity by order.</p> <p>The permissible activities of institutions that are licensed and subject to supervision as banks are not defined.</p> <p>The FSC publishes and keeps a list of licensed banks including foreign banks operating within its jurisdiction.</p> <p>The term "bank" is not defined in any laws or secondary regulations. Some protection of the</p>

	<p>term “bank” can be derived from the Registration of Business Names Act (primary legislation). According to this, the FSC may refuse the registration of a name that in its opinion is undesirable or misleading. The Practice Note on Registration and Continuance of Business Names issued by the FSC makes clear that this power extends to the inclusion of the word “bank” in a name. Furthermore, Art. 36 of the FSA makes it a offense to make false or misleading statements for the purpose of inducing another to make a deposit or entering into an investment agreement; this provision could presumably be used to prevent the mis-use of the term “bank” and derivations thereof.</p>
Assessment	Largely compliant
Comments	<p>To be strictly compliant with the essential criteria, use of the term “bank” should be expressly limited to licensed and supervised entities, and banking activities should be defined clearly in legislation or regulation. The protection of the term “bank” is a matter of consumer protection (for other purposes, current financial legislation is appropriately framed in terms of deposit takers). Use of any terms which indicate—or may be reasonably understood to indicate—that a person is a “bank” or “banker” or is “carrying on a banking business” should be restricted to appropriately licensed entities, unless expressly authorized by the FSC. It may be sufficient to set out in regulation that only licensed deposit takers may use the term “bank” and derivations in a name connected to financial services.</p>
Principle 3.	<p>Licensing criteria. The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.</p>
Description	<p>The basic licensing criteria are set out in Section 6 of the FSA. According to this, a license will not be issued unless the FSC is satisfied that the applicant is a fit and proper person to carry on the regulated activity and provide the services described in that application, any controller or director of the applicant is a fit and proper person to act as such, such other persons as appear to the FSC to be key persons are fit and proper persons and the applicant is managed and controlled in the IOM.</p> <p>In assessing whether an applicant is a fit and proper person, the FSC will examine the integrity, competence, financial standing, structure and organization of the applicant, the integrity, competence and financial standing of any controller or director of the applicant as well as of key persons in relation to the applicant and the description of the business the applicant proposes.</p> <p>A license may be issued in respect of one or more regulated activities and where a license is issued in respect of more than one regulated activity, different conditions may be imposed in respect of different regulated activities. The commission may make a license subject to conditions.</p> <p>The decision on whether or not to grant a license is made by the FSC Board. If an applicant is aggrieved by the decision of the FSC not to issue a license or to attach conditions to a license, it may seek a review by the Council of Ministers’ Review Committee.</p> <p>The FSC has issued a general licensing policy. According to this any office in the IOM that represents an off-island deposit taking business is required to hold a license.</p>

	<p>The FSC expects banks to start their business within 6 months of the date of the issue of the license.</p> <p>The paid-up share capital of a license-holder must not be less than GBP3,500,000 or its equivalent in another currency.</p> <p>The licensing authority has the power to reject an application if the criteria are not fulfilled or if the information provided is inadequate.</p>
Assessment	Compliant
Comments	
Principle 4.	Transfer of significant ownership. The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.
Description	<p>Section 10 of the Financial Services Act 2008 refers to “Controllers” and Section 48 defines a Controller. In effect, a controller is someone who alone, or with an associate, is entitled to exercise or control the exercise of 15 percent or more of the voting power at any general meeting of the licence-holder or of another body corporate of which it is a subsidiary.</p> <p>According to section 7.4 “Changes in ownership” of the Rulebook:</p> <p>(1) A licenceholder must notify the Commission of —</p> <ul style="list-style-type: none"> (a) any transfer of 5% or more of its voting shares; or (b) any other transfer of its voting shares which has a material effect on the immediate or ultimate control of the licenceholder. <p>(2) A notification under paragraph (1) must be made —</p> <ul style="list-style-type: none"> (a) where the shares are quoted on a recognised stock exchange, within 5 business days after the licenceholder becomes aware of the transfer; (b) in all other cases, 20 business days before the transfer is registered. <p>(3) A licenceholder must notify the Commission of —</p> <ul style="list-style-type: none"> (a) any change in the ownership structure between it and its ultimate parent company; or (b) any material change in its ultimate ownership. <p>(4) A notification under paragraph (3) must be made —</p> <ul style="list-style-type: none"> (a) if practicable, not less than 20 business days before the change takes place; or (b) otherwise, as soon as practicable. <p>Rule 7.5 “Acquisitions etc. of business” of the Rulebook applies, <i>inter alia</i>, to the following transactions:</p> <ul style="list-style-type: none"> • a merger of the licenceholder’s business with another; • a takeover or acquisition by the licenceholder of another business; • a purchase by the licenceholder of the assets or liabilities of another business; and • the acquisition of a controlling interest, or any change in an existing controlling interest, in the licenceholder’s business. <p>According to 7.5, a licenceholder must not enter into a transaction to which this rule applies without the consent of the FSC.</p>

	<p>A licenceholder must notify the FSC of any transaction to which this rule applies, if practicable, not less than 20 business days before the transaction takes place; or, as soon as practicable.</p> <p>Previously there was a regulation on the transfer of shares in the Banking Guidance Note (BGN 1.2) to the Banking Regulatory Code 2005. According to Section 14 of this note, banks had to give the FSC at least 21 business days prior notification of any change in ownership structure between it and its ultimate parent company. This included any intermediate layers between the bank and its ultimate parent company. Changes in the capital structure had also to be notified at least 21 business days in advance.</p> <p>A bank whose shares are quoted on a recognized Stock Exchange, has to inform the FSC within five days of the discovery of any transfer of 5 percent or more of its voting shares or any lesser transfer which has a material effect on its immediate or ultimate beneficial control.</p> <p>In assessing new owners, the FSC assesses that they are “fit and proper” according to the same criteria as are applied during licensing. If it is not satisfied on this point it has a wide range of possible measure (e.g., revoking the license) which it can employ to block unsuitable transfers.</p> <p>The accuracy of the FSC’s information on significant shareholders in banks is checked to the annual financial statements of license-holders and their parents. The FSC does not receive a periodic return on shareholders. Under new legislation, an ownership schedule has to be submitted annually.</p>
Assessment	Compliant
Comments	
Principle 5.	Major acquisitions. The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.
Description	<p>The Rulebook contains Rule 7.5 “Acquisitions etc. of business.” The rule applies to the following transactions:</p> <ul style="list-style-type: none"> • a merger of the licenceholder’s business with another; • a takeover or acquisition by the licenceholder of another business; • a purchase by the licenceholder of the assets or liabilities of another business; and • the acquisition of a controlling interest, or any change in an existing controlling interest, in the licenceholder’s business. <p>According to 7.5, a licenceholder must not enter into a transaction to which this rule applies without the consent of the FSC.</p> <p>A licenceholder must notify the FSC of any transaction to which this rule applies, if practicable, not less than 20 business days before the transaction takes place; or, as soon as practicable.</p> <p>The Rulebook also contains the following:</p> <p>Rule 7.7 - Acquisition of shares of company</p>

	<ol style="list-style-type: none"> 1. A licenceholder must notify the Commission before subscribing for or acquiring, or entering into a contract to subscribe for or acquire, 10% or more of the issued share capital of a company. 2. Paragraph (1) does not apply to a subscription for shares, undertaken in the course of regulated activities falling within Class 4 or Class 5, by a licenceholder licensed to carry on those activities or an officer or employee of such a licenceholder. 3. A notification under paragraph (1) must be given — <ol style="list-style-type: none"> a. if practicable, not less than 20 business days before the event; or b. otherwise, as soon as practicable. c. <p>Rule 7.8 - Subsidiaries etc. Guidance Note A licenceholder incorporated in the Island must not, without the consent of the Commission, acquire or establish a trading subsidiary, branch or representative office in the Island or elsewhere.</p> <p>Previously there was a regulation on the acquisition and sale by banks in the Banking Guidance Note (BGN 1.2) to the Banking Regulatory Code 2005. According to this, prior notification of at least two months was required where practical in respect of proposals to establish or to acquire any subsidiaries or branches. At least 21 business days' notice was to be provided in respect of proposals to establish representative offices in other jurisdictions. A notification period of two months was also applicable, where practical, when banks intend to acquire a nonbanking company.</p>
Assessment	Largely Compliant
Comments	The FSC must be notified of major acquisitions and has relevant powers to review such transactions. However, the regulations are new and the FSC has not yet developed explicit criteria for evaluating whether or not a major acquisition might expose the relevant bank to undue risks or hinder effective supervision.
Principle 6.	Capital adequacy. Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.
Description	<p>For some years, the FSC has required all banks to maintain a minimum risk asset ratio (RAR) calculated in accordance with the Basel Committee's recommendations.</p> <p>The FSC has responded pro-actively to Basel II, explaining to banks during 2006–07 that they would be expected to adopt Basel II and co-operating closely with the supervisors in Guernsey and Jersey to develop approaches to Basel II requirements which are appropriate for banks in the IOM (and the other Crown dependencies). Implementation of Basel II by IOM banks is now well advanced. During discussion with the banks in late 2007 the FSC ascertained that most banks would be able to adopt Basel II from January 2008 and to submit revised reports from end-March 2008 onwards. In practice, Basel II has now been adopted by all banks save one which has been allowed to postpone until January 2009.</p> <p>For <i>credit risk</i> under Pillar I, the FSC has adopted the Standardized Approach as the norm for all banks although the Simplified Standard Approach is also allowed if warranted by a bank's risk profile. For <i>operational risk</i>, the Basic Indicator Approach is the minimum requirement while the Standardized Approach is acceptable for a bank that can demonstrate adequate segregation and reporting of income streams and appropriate oversight. With regard to <i>market</i></p>

risk, the FSC does not consider that locally incorporated banks have trading books in equities or interest-bearing instruments and does not therefore apply any capital charge for this risk. However, under the heading of market risk it does apply capital charges for foreign exchange (FX) and commodities price risk. It also applies a capital charge for *settlement risk*.

For Pillar II, the FSC has required every bank to produce a documented Internal Capital Adequacy Assessment Process (ICAAP) which relates its capital needs to its risks. The FSC reviews the adequacy of each ICAAP and, if necessary, meets with the bank to discuss changes. After the FSC is satisfied that the bank has performed a proper internal assessment of its capital policy, it will set the bank's capital charge required under Pillar II (see below). So far the FSC has received five ICAAPs for review. The aim is to have approved all banks' ICAAPs before end-year.

The FSC considers that the Pillar III disclosure requirements are not applicable to the majority of locally incorporated banks since these are subsidiaries of overseas banks, and does not intend to set additional general disclosure requirements for them. In adopting this approach, the FSC has recognized that such disclosures will be made at the level of overseas parent banks.

In adopting Basel II, the FSC has not had to significantly amend its definition of capital, which continues to comply closely with the international recommendations. However, as part of the adoption process, the FSC has lowered the minimum legally required RAR from 10 to 8 percent. This change reflects a recognition that many locally incorporated banks are part of banking groups based in countries where the 8 percent minimum is applied on both a solo and consolidated basis.

At the same time, the FSC is continuing its existing practice of setting a separate RAR for each individual bank (which it does by exercising its legal power to issue directions to banks). Each bank's required ratio is determined on the basis of the FSC's assessment of the quality of the bank's own ICAAP, the risks inherent in its business (such as credit concentration risk, interest rate risk in the banking book, and strategic risk) or those arising from the wider group to which it belongs.

Individual RARs are in accordance with the following guideline:

Overall Risk Profile	Required RAR (percent)
Lower	8–10
Medium	11–14
Higher	> 14

However, notwithstanding the reduction of the legal minimum RAR to 8 percent, the FSC is not setting any new RARs below 10 percent until it has completed its review of all banks' ICAAPs.

Once the review process is completed, monitoring of overall capital adequacy will be based on the requirement that a bank's eligible capital should not be less than:

- 8 percent of its risk-weighted assets (in accordance with the statutory requirement and Pillar I); plus
- the amount of capital required in accordance with the Pillar II capital assessment, this being an amount equal to the RAR *minus* 8 percent of risk-weighted assets.

	<p>Surplus capital beyond these requirements is also reported and monitored.</p> <p>In addition to the RAR, the FSC sets a non-statutory “trigger ratio” for each bank which is at least one percent higher than the RAR. The purpose of the trigger ratio is to provide early warning of capital deterioration and some margin of safety for observance of the RAR. Accordingly, a bank must notify the FSC whenever its capital adequacy ratio falls below the trigger level and advise the remedial action it proposes to take. The FSC then assesses the cause of the weakening and, if necessary, requires the bank to take appropriate action.</p> <p>Since 2005, all banks have been legally required to have an absolute minimum share capital of GBP 3.5 million or its equivalent in another currency.</p>
Assessment	Compliant
Comments	The FSC can be commended on its detailed adoption of international standards for capital adequacy. The new legislative framework, which will enter fully into force in January 2009 is comprehensive in nature and provides the FSC with scope to respond speedily to any future developments in international standards . The adoption of Basel II is progressing well and should be substantially completed by end-2008.
Principle 7.	Risk management process. Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including board and senior management oversight) to identify, evaluate, monitor, and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.
Description	<p>Sections 42 and 87 of the code require banks to have a comprehensive and appropriate risk management policy, and processes to identify, measure, monitor and control all material risks of an operational nature. The policy is to be reviewed annually. The policy is to cover delegation, separation of functions that involve committing the bank, paying away funds, and accounting for its assets and liabilities; reconciliations; safeguarding of assets; and independent internal or external audit and compliance functions to test adherence to controls and applicable laws and regulations. These requirements will be replaced on January 1, 2009 when the similar, but more detailed requirements, of the Rule Book issued under the FSA 2008 come into force.</p> <p>To assist banks in meeting these legal obligations the FSC has issued detailed guidance for banks’ boards of directors and senior management in its Guidance Note on Corporate Governance in Banking Institutions.</p> <p>In brief, the FSC expects the Board of Directors to “<i>oversee</i>” risk management in their bank which it interprets as meaning that the board must :</p> <ul style="list-style-type: none"> • understand the significant risks to which the bank is exposed; • establish appropriate and prudent risk management policies for those risks; • establish appropriate risk management and compliance procedures for dealing with regulatory matters and timely reporting to the regulator; • review those policies at least once a year to ensure that they remain appropriate and prudent; and • obtain, on a regular basis, reasonable assurance that the bank has an ongoing, appropriate and effective risk management and control process and that its risk management policies for significant risks are being adhered to.

	<p>The FSC expects senior management to be <i>more closely engaged in risk management than the board</i>. In particular, the board has to take responsibility for developing and ensuring that the bank has an ongoing, appropriate and effective risk management process. Particular responsibilities include:</p> <ul style="list-style-type: none"> • identifying the risks to which the bank is or will be exposed, whether on- or off-balance sheet and whether directly or through one or more of its subsidiaries, in conducting its current and planned operations, and measuring those risks on an aggregate basis; • measuring, on an aggregate basis, the different types of risk to which the bank is or will be exposed in relation to a single counterparty or issuer and groups of associated counterparties or issuers; • assessing the significance of particular risks; • developing appropriate and prudent risk management policies, including policies on aggregate exposure limits; • submitting to the Board of Directors, for its consideration and approval, policies for managing significant risks; • reviewing the bank’s risk management policies at least once a year to ensure that they remain appropriate and prudent; • managing the risks to which the bank is exposed in accordance with its risk management policies; • establishing appropriate and effective procedures and controls for managing the risks to which the bank is exposed, monitoring adherence to those procedures and controls, and reviewing them on a regular basis to ensure that they remain appropriate and effective; • providing the board with timely, relevant, accurate and complete reports on the management of significant risks and on the procedures and controls for managing those risks; and • providing the board with timely, relevant, accurate and complete reports that will enable it to assess whether the bank has an ongoing, appropriate and effective risk management process. <p>In practice, major banks are not required to establish comprehensive stand-alone risk management systems, but can draw on those of their parents and be integrated operationally with them.</p> <p>The FSC follows a high level, risk-based approach to supervision. In brief, all banks are assessed against the degree of risk they present to the achievement of the FSC’s statutory objectives. The process begins with an assessment of the risks inherent in the nature of a bank’s business. This is followed by an assessment of the extent to which the bank’s corporate governance framework and systems and controls mitigate its inherent risks. These two assessments are then combined (using a matrix) to produce a composite rating or risk profile (higher, medium or lower).</p> <p>In order to employ its resources efficiently, the FSC also determines an impact rating for every bank. This reflects the reality that weaknesses (discovered during risk rating) present a larger threat to achievement of the FSC’s objectives if they occur in larger rather than smaller groups/firms. Impact ratings are combined with risk ratings to produce a second matrix, which determines the frequency with which individual banks receive visits from the FSC. For example, a high impact bank with a higher risk rating has a “business meeting” plus a compliance visit from the FSC at least once every year.</p> <p>In addition, the FSC carries out visits in which it examines in detail how all banks are managing particular types of risk such as credit risk, with reference to banks’ observance of</p>
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	the FSC’s published guidance on the particular risk. These are described further under CPs 8,9,13,14, and 16 below.
Assessment	Compliant
Comments	
Principle 8.	Credit risk. Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor, and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.
Description	<p>The regulatory requirements for credit risk are currently contained in Section 32 of the code (from 2009 in Part 8 of the Rule Book).</p> <p>These require banks to have a credit risk policy which is appropriate to the nature and scale of their business. The policy has to include limits on different types of lending (including geographical, economic and individual sectors), connected and related party lending, sanctioning limits and authorization procedures, permissible forms of collateral, monitoring and control procedures, arrears, and provisioning procedures. Banks are also required to have adequate systems for monitoring compliance with their credit risk policy and ensuring that it is adhered to.</p> <p>The policy has to be reviewed annually and approved by the Board of Directors. The board must provide the FSC with a copy of its policy within 21 business days of the board’s approval of the policy; and must inform the FSC of significant amendment(s) to that policy, within 21 business days of the board’s approval of the changes. In addition, the board must confirm to the FSC, within four months of each year-end, that at the last full board meeting the directors confirmed that the policy was up to date and appropriate.</p> <p>The FSC has also issued detailed guidance on credit risk management in two guidance notes: Credit Risk, Arrears & Provisions (March 2006) and Guidance on Corporate Governance for Banking Institutions, Section 3.2.3 (December 2006).</p> <p>With regard to avoiding conflicts of interest the current code makes no requirement. However, The FSC’s guidance makes clear that banks should have controls in place to ensure that business with persons connected to the bank is concluded at “arm’s length” basis.</p> <p>During 2005–06, the FSC carried a program of visits to banks focused on credit risk. The program was comprehensively scoped to cover:</p> <ul style="list-style-type: none"> • banks’ credit policies; • preparation and acceptance of new lending propositions; • sanctioning processes; • authorities and limits; • the adequacy and monitoring of arrangements, including security; • monitoring, reporting and review of existing facilities; • exceptions reporting; and • arrears, bad debts and provisioning. <p>In addition to reviewing adherence to the FSC’s guidance, the supervisor obtained a lot of information about good practices in some banks which it could usefully use in assessing other</p>

	banks.
Assessment	Compliant
Comments	The FSC's approach to on-site visits has considerably strengthened supervision of credit risk.
Principle 9.	Problem assets, provisions, and reserves. Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.
Description	<p>The code (from 2009 the Rule Book) requires each bank to have a policy on arrears and provisioning for bad and doubtful debts which is appropriate to the nature and scale of its business. The Board of Directors has to review the policy annually and confirm to the FSC that it is up to date and appropriate. Banks must also have an adequate level of provisions for specific bad and doubtful debts and submit quarterly reports to the FSC.</p> <p>The FSC provides more detailed guidance on meeting these requirements in its guidance note Credit Risk, Arrears & Provisions Management (March 2006):</p> <ul style="list-style-type: none"> • Banks' policies on arrears have to contain a clear definition of a nonperforming exposure. At a minimum, all loans that are 90 days in arrears should be placed in this category. However, the policy should document those circumstances where a more conservative approach would be prudent. • Policies must outline the procedures that are to be followed in respect of accounts where interest payments are in arrears; where security has deteriorated in value; or where the borrower is otherwise in breach of his contractual obligations. There must be clear procedures to follow should any of these events occur. • Policies should prescribe how both general and specific provisions are to be calculated; and by whom and when they should be reviewed. • Policies should detail who has the authority to make or release provisions and the procedures to be followed. <p>The on-site visit program described under CP7 included review of banks' provisioning.</p>
Assessment	Compliant
Comments	Considerably strengthened since the previous assessment.
Principle 10.	Large exposure limits. Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.
Description	<p>The FSC has imposed limits on <i>locally incorporated</i> banks' large exposures to a single counterparty or group of connected counterparties. The detailed requirements are currently contained in the code and will be replicated from 2009 onwards by the requirements in the Rule Book.</p> <p>The code defines "an exposure" to mean a claim on an individual counterparty or group of closely related counterparties, and "large exposure" to mean any exposure which is 10 percent or more of a bank's Large Exposures Capital Base ("LECB"). The LECB is the amount of the bank's regulatory capital according to its most recent audited financial statements and agreed with the FSC. The Rule Book expands its basic definition of an exposure with detailed information which makes clear that exposures are to include all types of claim and transaction, including off-balance sheet items. Further information is provided in the FSC's</p>

	<p>Banking Guidance Note on Large Exposures (April 2007).</p> <p>Certain exposures are exempt from the regulatory limits and reporting requirements which apply to large exposures. Exempt exposures comprise:</p> <ul style="list-style-type: none"> • exposures of one year or less to Zone A banks (excluding multilateral development banks) not related to the bank provided the relevant placing is not subject to any form of charge and is part of the bank's normal treasury operations; • exposures to or guaranteed by central governments and central banks from Zone A countries; • exposures to Zone B central governments denominated in local currency and funded by liabilities in the same currency; • exposures secured either by cash (including certificates of deposit issued by the lending bank) held by the lender; • exposures to other group companies that are credit institutions in Zone A countries; and • exposures with parental guarantees. <p>A bank must notify the FSC before it incurs any exempt exposure except those in category (1). Exposures under exemption (5) are the most important for banks operating on the IOM.</p> <p>The regulatory limits for large exposures (except exempt exposures) provide that a bank:</p> <ul style="list-style-type: none"> • may not incur a large exposure which exceeds 25 percent of its LECB; • must notify the FSC if the total of its large exposures is about to exceed 300 percent of its LECB; • must limit the total of its large exposures to 800 percent of its LECB; and • must notify the FSC if it breaches the 25, 300, or 800 percent limits or its LECB falls below its agreed level. <p>The FSC also requires to have a large exposure policy which is appropriate to the nature and scale of its business, and has to be observed in practice. The policy has to be reviewed and approved by the Board of Directors. The policy has to include exposure limits for customers, counterparties, countries, and economic sectors, sanctioning limits and authorization procedures, permissible forms of collateral, procedures where exposures are to a guarantor, monitoring and control procedures and regulatory reporting policy.</p> <p>The procedures and systems for reviewing, monitoring, and controlling exposures should include the composition and terms of reference of the main credit committee, delegated authority, and the nature and frequency of the bank's review and monitoring procedures, including exception reports. Procedures must also detail how the bank monitors its large exposures relative to the LECB and ensure that limits are not exceeded.</p> <p>A bank must implement the necessary control systems to enable it to monitor exposures on a daily basis and ensure adherence to its policy on large exposures. It also has to report its large exposures quarterly to the FSC.</p> <p>The FSC does not apply any limits to the large exposures of <i>IOM branches of overseas banks</i>. However, the Regulatory Code requires these banks to have (and comply with) documented controls and procedures which are in accordance with its head office. They must also report the 10 largest bank exposures and the ten largest nonbank exposures that relate to their operations in or from the IOM.</p>
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	<p>The FSC obtains some limited information on the breakdown of banks' lending to nonbanks: between sovereign, PSEs, corporate borrowers, retail and residential mortgages.</p> <p>The credit risk program of on-site visits during 2005–06 (see CP8 above) addressed concentration risk and found generally low levels of nonbank credit concentration.</p>
Assessment	Largely Compliant
Comments	<p>There are effective and enforced limits on large exposures to counterparties other than parent banks. However, exception (5) on exposures to other group companies that are credit institutions in Zone A countries implies that there are no general prudential limits on exposures to parent institutions. These exposures constitute the dominant vulnerability of the IOM financial system (see also comments on Principles 11 and 14).</p> <p>Although there is an ongoing discussion—for example, within the EU on how to regulate large exposures and, closely connected with this, exposures to related parties—many countries chose to set more prudent rules than this jurisdiction. It could well be seen as an evolving international standard to require that the supervisor has to decide on a regular basis whether or not an exemption for large exposures granted should be renewed. Hence, the FSC should decide on a regular basis whether or not an exemption for large exposures should be renewed.</p>
Principle 11.	Exposures to related parties. In order to prevent abuses arising from exposures (both on balance sheet and off balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.
Description	<p>There is no definition of “related parties” in the FSA, the current code or the new Rule Book. However, the FSC provides a comprehensive definition in Section 4.5 of its Banking Guidance Note on Large Exposures (see CP 10 above). This definition includes group undertakings, associated companies, directors, controllers, shareholders, and non-group companies with which these individuals are associated. It also includes any such companies to which the bank has lent on preferential terms.</p> <p>There is no specific statutory or regulatory limit on banks' exposures to related parties (although the large exposure limits continue to apply) irrespective of whether they are extended at arm's length or on preferential terms. However, such exposures which exceed 25 percent of LECB are subject to the prohibition on non-exempt large exposures (see CP 10). In addition, the Rule Book requires that banks' credit policies must contain provisions in respect of connected and related party lending, while the FSC's Guidance Notes explain: (a) that banks should have particular procedures for sanctioning such exposures; and (b) that they are justified only when there is a clear commercial advantage for the lending bank and when they are negotiated and agreed on an arm's length basis.</p> <p>The FSC's approach to supervising related exposures consists of: (a) reviewing banks' own policies and procedures for related exposures and, if necessary, insisting that these are prudent and appropriate for the individual bank; and (b) monitoring the outstanding related exposures reported in the quarterly returns. The FSC has powers to limit an individual bank's related party exposures by imposing license conditions or issuing directions to an individual bank. It may also impose mitigating measures such as requiring specified related exposures to be deducted from regulatory capital or given an additional 50 percent risk weighting.</p>

Assessment	Largely compliant
Comments	<p>While the Basel Committee’s criteria for assessing the supervision of related exposures do not require limits for related exposures to be in place, most countries consider them essential. Most home country supervisors apply a regime of strict limits but recognize that in some circumstances uniform limits can impede group operations unnecessarily. They are therefore prepared to grant concessions from these limits, but only on a tightly controlled case by case basis.</p> <p>The general absence of any limit for IOM banks is therefore somewhat unusual. It appears to have been motivated by a wish not to impede the operation of overseas parent banks. However, the very large contraction of liquidity which has occurred in major financial centers during the past 15 months, as a result of extensive re-appraisal of risk, is now causing the FSC to reassess its traditional approach. In addition to consulting individual banks and intensifying liaison with home country supervisors, the FSC has recently begun to consider whether there is a need to introduce some regulatory limit on exposures to related banks. The FSC will need to regularly monitor the status and financial condition of parent companies of local subsidiaries, and review whether exemptions of group-related exposures from the concentration risk requirements should be renewed. The FSC can be commended for its proactive approach to this problem.</p> <p>The impact of market pressures has also called into question the quality of the liquidity which group exposures represent for local banks. This is discussed in relation to liquidity management under CP14 below.</p>
Principle 12.	Country and transfer risks. Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.
Description	<p>The code (from 2009 the Rule Book) requires banks within their overall credit policy to have limits on their lending to “geographical” sectors, together with established procedures for monitoring and controlling such exposures, and establishing any required provisions.</p> <p>Compliance with these requirements is included in the off-site review of credit policies. In addition, during on-site visits, FSC supervisors may review the internal reporting of this risk and adherence to limits.</p> <p>When individual banks have exposure to parent banks located in countries where the FSC considers that there is material country risk, it places limits on their exposure to their parent. The power to impose limits is exercised from time to time.</p> <p>The FSC does not prescribe provisioning levels or percentage guidelines for country risk. However, each bank has to consider the need for provisions against this risk and, should this be required, has to satisfy its external auditor that their level is sufficient. Failure to make sufficient provisions would be likely to result in the auditor giving a qualified opinion on the bank’s financial statements.</p> <p>Many banks employ a large proportion of their funds in the country of their parent bank, principally the United Kingdom, the other Crown dependencies, and Ireland. All Crown dependencies share the United Kingdom’s currency, while the United Kingdom and Ireland are both EU members. In these circumstances, the transfer risk to such assets is close to nonexistent. Country risk in banks’ lending elsewhere is also insignificant.</p>

Assessment	Compliant
Comments	
Principle 13.	Market risk. Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor, and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.
Description	<p>Banks in the IOM do not incur significant market risk in their operations. Banks do not trade in marketable securities or derivatives to any material extent and are not exposed to price risk. For this reason, no regulatory requirements or guidance have been issued for managing this risk.</p> <p>Some trading in FX takes place although it mainly consists of covering customer transactions. Most banks back their FX exposure into their parent bank's treasury which manages FX risk on a group basis.</p> <p>The code (from 2009 the Rule Book) requires every bank to have a prudent FX risk management policy which is appropriate to the nature and scale of its business and which includes specific limits. The policy and any significant amendments have to be shared with the FSC. The Board of Directors must review and approve the policy annually (or more frequently) and confirm annually to the FSC that the policy is up to date and appropriate. banks must also have appropriate systems and procedures for measuring and monitoring FX risk on a frequent and timely basis; ensuring these are adhered to in practice; and reporting its FX positions to the FSC.</p> <p>The FSC's Guidance Note on Foreign Exchange Risk Management (March 2006) provides clear and comprehensive guidance to banks on the nature of FX risk and the issues to be addressed in developing acceptable policies and procedures. In practice, these policies are frequently prepared by parent banks. The guidance explains that while the FSC does not impose specific limits for FX exposure, banks should not assume risk that, in the event of a 10 percent adverse movement in exchange rates would cause a loss equivalent to 10 percent of a bank's LECB. Banks are expected to carry out periodic (minimum six monthly) stress testing to assess the potential cost of a shock 20 percent movement in exchange rates as appropriate to their business.</p> <p>The FSC does not impose any capital charges for market risks (securities, FX, or commodities risk) in the trading book in accordance with the Basel Accord*. However, the FSC does have a capital charge for market risks in the banking book. Banks' net open FX positions are weighted at 100 percent and included in total risk-weighted assets. The FSC's quarterly reporting forms for capital adequacy already provide for banks to be able to report all forms of market risks in accordance with the Basel Accord.</p> <p>* The accord is directed at the supervision of internationally active banks only. It requires these banks to make capital charges against the market risks in their trading book and the totality of their FX and commodity price risks. The FSC does not consider that any banks in the IOM have trading books.</p>
Assessment	Compliant
Comments	
Principle 14.	Liquidity risk. Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to

	<p>identify, measure, monitor and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.</p>
Description	<p>The activities of banks in the IOM vary widely. While relatively few banks take funds in the wholesale market, many banking groups use their IOM offices primarily to collect deposits which they employ elsewhere in their operations. As a consequence, many groups include such funding from their IOM offices in their central management of liquidity on a global basis. In these cases local banks have little or no scope to manage their liquidity independently, and would be completely dependent on their group treasury if they were to incur unexpected liquidity pressures in their own IOM operations. Banks do not engage in significant foreign currency liquidity transformation.</p> <p>Against this background the FSC recognizes that it is not feasible to lay down detailed supervisory rules for liquidity that would be appropriate for every bank. Nevertheless, the FSC requires all banks to have a prudent liquidity policy, and appropriate systems in place to measure and monitor liquidity, and to ensure that the policy is adhered to. The FSC recognizes that systems and controls for liquidity risk will vary with the scale, nature, and complexity of a bank's activities. The policy must, however, ensure compliance with any short-term liquidity limits set by the FSC under the code (from 2009 the Rule Book).</p> <p>In the case of <i>banks incorporated in the IOM</i> the FSC expects the liquidity policy to be drawn up by senior management and approved by the Board of Directors. Inter alia, it should reflect :</p> <ul style="list-style-type: none"> • the nature of the bank's business and the types of asset it is funding; • the funding strategy (wholesale versus retail); • the stability of the customer base; • relationships with other group entities in respect of funding and liquidity risk management, including the degree of independence of the bank in managing its liquidity and its internal limits for intra-group exposures; • reporting of liquidity within the bank and to the group or parent banks; • monitoring and reporting mismatch limits to the FSC; • procedures for reporting any breaches of the limits to the FSC; and • classes of marketable assets that may be held for liquidity purposes. <p>To monitor banks' liquidity the FSC concentrates on the mismatches between maturing short-term assets and liabilities, and has made clear that in certain cases it requires individual banks to observe positive cumulative mismatch limits in the sight to eight days time band and a maximum negative mismatch of minus 5 percent (defined as a percentage of total deposits) in the sight to one-month time band. Banks report their maturity breakdown of their assets and liabilities quarterly.</p> <p>If necessary, the FSC may require a bank to hold a specified amount of marketable assets. The FSC is also alert to the danger that balances held with overseas parents, although legally repayable on demand, may not in practice be readily repayable. If these balances represent long-term funding of capital nature, the FSC deducts them from capital. In four cases the FSC is requiring banks to hold liquid balances with non-group banks equivalent to 10 and 5 percent respectively of their deposits. (A number of other Isle of Man-incorporated banks voluntarily have a significant percentage of their total assets outside of their respective groups as part of their business models.)</p> <p><i>Banks which are branches of overseas banks</i> are also required to have a liquidity policy</p>

	<p>which is acceptable to the FSC. In these cases the FSC is willing to approve a liquidity management policy which has been drawn up by the head office of the bank provided senior management understand the liquidity and funding needs of the bank, it has been reviewed by local senior management and provides and prudent liquidity procedures for the IOM branch.</p> <p>The FSC does not impose mismatch limits on branches. However, it expects them to monitor their liquidity by means of maturity mismatch calculations in the same way as locally incorporated banks and to have reliable systems that can produce accurate liquidity reports promptly.</p> <p><i>All banks</i> report their liquidity quarterly on Form SR-3A.</p> <p>The FSC requires all banks to have contingency plans for dealing with unexpected liquidity shortages either within its liquidity policy or separately and has provided guidance on the key elements of these plans, including relevant warning signals and regular stress testing, channels of communication with parent banks and the FSC and possible short-term steps to increase funding.</p>
Assessment	Largely compliant
Comments	<p>Because of the nature of banking operations on the IOM, many banks do not have their own capacity to manage liquidity on a day-to-day basis. This is one of the major risks facing the system.</p> <p>The FSC is concerned about the current liquidity pressures in international markets and their potential spill-over effects on subsidiary banks in the IOM. Cooperation with home country supervisors has been increased recently and possible measures to reinforce liquidity were under active consideration at the time of the assessment, including a requirement to hold a stock of highly liquid assets in the form of marketable assets or short-term balances with non-group banks.</p> <p>Taking into account recent turbulence and the evolving international standards in this area, the FSC should also review its liquidity regulations and guidance with a view of taking into account the new paper on liquidity management and supervision published in September 2008 by the Basel Committee on Banking Supervision.</p>
Principle 15.	<p>Operational risk. Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor, and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.</p>
Description	<p>The code (from 2009 the Rule Book) requires each bank to include in its risk management policy the processes it employs in order to identify, measure, monitor and control all material risks of an operational nature. The FSC places responsibility for developing and implementing these processes on senior management. However, they must also be reviewed annually and approved by the Board of Directors.</p> <p>The Guidance Note on Corporate Governance advises bank that controls/processes for managing operational risk are required in a large number of fields. Some of these are also applicable to other areas of risk management (e.g., AML procedures). In summary, those which relate more closely to the Basel Committee's definition of operational risk include:</p> <ul style="list-style-type: none"> • human resources; • documenting significant processes, policies and controls;

	<ul style="list-style-type: none"> • valuation methods and accounting principles; • accurate and complete record-keeping; • IT development and maintenance; and • business continuity plans, including backup. <p>The guidance makes no mention of legal risk.. However, ICAAP the guidance document “The Supervisory Review and Evaluation Process and ICAAP” issued by the FSC in July 2007 does include legal risk when referring to operational risk. In assessing a bank’s treatment of and capitalization against legal and other operational risks, the FSC will drawing on the Basel Committee document, “Sound Practices for the Management and Supervision of Operational Risk” (February 2003).</p> <p>The code obliges banks to notify the FSC before they outsource (delegate) any material management or business function irrespective of whether this is done to a company inside or outside the same group. Outsourcing must be evidenced by a written agreement which clearly sets out the responsibilities and duties of each of the parties. The outsourcing bank must retain ultimate responsibility for all functions delegated and, in the event of a breakdown, be able to carry out or reassume the outsourced activity. The FSC must also be able to have access to any records of outsourced activities.</p> <p>During the licensing process, banks must provide the FSC with full details of its business resumption/contingency plan and once licensed must maintain these arrangements and test them at appropriate intervals. The Board of Directors must also provide confirmation annually that they remain up to date and appropriate. In the event of any serious or prolonged breakdown in their systems, banks must notify the FSC and communicate any contingency arrangements that have been activated.</p> <p>The FSC’s approach to supervising banks’ management of operational risk consists of: (a) reviewing banks’ policies and procedures off-site and, if necessary, insisting that these are prudent and appropriate for the individual bank; and (b) reviewing adherence to these policies during on-site visits.</p> <p>Since March 2008 banks have been reporting quantitative estimates of operational risk as part of the implementation of Basel II (see CP6 above).</p>
Assessment	Compliant
Comments	Given the possible significance of legal risk for some banks, the FSC may wish to elaborate its guidance in this area of operational risk beyond the brief references in the ICAAP document.
Principle 16.	Interest rate risk in the banking book. Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor, and control interest rate risk in the banking book, including a well defined strategy that has been approved by the board and implemented by senior management; these should be appropriate to the size and complexity of such risk..
Description	<p>The code (from 2009 the Rule Book) requires every bank to have a prudent interest rate risk management policy appropriate to the nature and scale of its business which includes specific limits. The Board of Directors is required to understand the policy, to review and approve the policy at least annually, and to confirm to the FSC that the policy is up to date and appropriate. Banks must also have appropriate systems and procedures for measuring and monitoring interest rate risk.</p> <p>The FSC has issued a guidance note on this risk—Interest Rate Risk Management</p>

	<p>(March 2006)—in which it states that each individual bank is required: (a) to have a prudent interest rate risk policy; (b) to have appropriate systems for measuring and monitoring the risk; and (c) to ensure its policy is adhered to. The board must approve the written policy and any changes to it. In addition banks are expected to carry out periodic (minimum six monthly) stress tests to estimate the loss they would incur following an interest rate shift of either 300 or 500 basis points.</p> <p>The FSC recognizes that IOM banks use various different methods for measuring interest rate risk. In most cases, these have been developed by parent banks or head offices overseas and are used primarily to measure total interest rate risk across a group or large international bank. The FSC does not object to banks using these internally. For its own monitoring purposes, however, it requires <i>banks incorporated in the IOM</i> to report their interest rate risk quarterly using a standard residual maturity band approach.</p> <p>Until 2008, the FSC required the total amount of banks’ potential losses from interest rate movements to be included with their risk-weighted assets for RAR purposes. As part of the implementation of Basel II, the FSC now considers that it should determine any capital charge for interest rate risk under Pillar II.</p> <p>Branches of overseas banks are subject to the same requirements as locally incorporated banks. However, the FSC does not require them to submit interest rate risk reports.</p>
Assessment	Compliant
Comments	
Principle 17.	<p>Internal control and audit. Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank’s assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.</p>
Description	<p>As mentioned under CP7 above, Sections 42 and 87 of the code require banks to have a comprehensive and appropriate risk management policy, and processes to identify, measure, monitor, and control all material risks arising in their operations. The more detailed requirements for banks in respect of their internal controls, and the methods employed by the FSC to determine their fitness for purpose, are also described there.</p> <p>Drawing on the statutory framework, the FSC has explained very clearly to banks the particular responsibilities of the Board of Directors and senior management with respect to corporate governance, including effective control over all elements of their business. These are set out in its note “Guidance on Corporate Governance for banking institutions.” The FSC has power to require changes in the composition of the Board of Directors.</p> <p>Banks are required to have an adequate internal audit function. The board must also have an audit committee (unless the board itself decides to act as such). The FSC assesses the adequacy of internal audit during focus visits (described in paragraphs 17 and 27, CP7 and CP above).</p> <p>Banks must have compliance officers who are responsible for ensuring adherence to banking and AML regulations respectively.</p>

Assessment	Compliant
Comments	
Principle 18.	Abuse of financial services. Supervisors must be satisfied that banks have adequate policies and processes in place, including strict “know-your-customer” rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.
Description	<p>The Department of Home Affairs is responsible for AML/CFT legislation and the operations of the IOM’s Financial Crime Unit (the “FCU”) and Financial Intelligence Unit. In practice, the development of new legislation and regulations is coordinated across all relevant governmental departments and regulatory authorities including the FSC. During 2007–2008 the FSC participated in the drafting of the Criminal Justice (Money Laundering) Code 2007 (the “AML Code”).</p> <p>Under the FSA 2008 the FSC’s regulatory objectives include combating financial crime. In the Rule Book issued by under the act the FSC has made detailed AML/CFT regulations (Part 9), which apply to banks (and other persons licensed under the Act). Part 9 came into effect on August 1, 2008. In addition, Section 43 of the FSA 2008 empowers the FSC to take action against a bank which is in contravention of the AML Code; in such cases, however, the FSC has no power to impose financial penalties or obtain an injunction.</p> <p>The AML Code sets out the requirements for banks with regard to customer due diligence, including identifying an applicant for business and verifying their identity using reliable, independent source documents, data or information identifying the beneficial owner, obtaining information on the purpose and intended nature of the business relationship and conducting ongoing due diligence. The AML Code also details when this should be conducted and the penalties for noncompliance. Requirements are set out in relation to the formation of new business relationships as well as existing business relationships, one-off transactions and introduced business relationships. The AML Code further imposes requirements for screening of staff, staff training and record keeping. Money Laundering Reporting Officer requirements including requirements to maintain registers of AML/CFT suspicions and enquiries from law enforcement and requirements to have procedures in place for internal recognition and reporting of suspicious transactions and reporting to the FCU are also contained within the AML Code.</p> <p>Part 9 of the Rule Book imposes additional AML/CFT obligations on banks. Banks have to adopt a risk-based approach. In particular, it requires banks to conduct a risk assessment of their business, including both new and existing customers. Banks have to conduct customer due diligence (“CDD”) procedures in accordance with the risk assessment, and enhanced CDD is required when the assessment has identified higher risks. The Rule Book obliges banks to verify the identity of beneficial owners, beneficiaries and underlying principals, including legal person or a legal arrangement. It also prohibits the maintenance of anonymous accounts. The Rule Book brings in requirements with respect to source of funds, politically exposed persons, correspondent banking services, foreign branches and subsidiaries, non-face-to-face relationships and technological developments, and ongoing monitoring of relationships.</p> <p>The FSC has also produced a handbook to guide banks in complying with the Rule Book and the AML Code. This handbook provides guidance on adopting a risk based approach to AML/CFT measures and the factors that banks should consider. All risk assessments conducted by banks have to be recorded and documented, and integrated into banks’ policies, procedures and controls in respect of AML/CFT.</p>

	<p>The FSC supervises banks' AML/CFT policies and procedures through a combination of off-site reviews and on-site visits. During the last three years, the FSC has conducted numerous on-site visits to banks specifically to test their KYC procedures and their compliance with the anti-money laundering regulations.</p> <p>The FSC has power to report suspicious transactions to the FCU, to cooperate with overseas supervisors and to share information with them where this is required for supervisory purposes.</p>
Assessment	Compliant
Comments	An assessment of compliance with the FATF 40+ 9 Recommendations was conducted in parallel with this BCPs assessment.
Principle 19.	Supervisory approach. An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.
Description	<p>Off-site supervision is focused on the submission by the banks of detailed quarterly Banking returns. These are checked for compliance with the prudential supervisory requirements (see CP20 for a more detailed description of the off-site supervision process).</p> <p>The FSC has policies and processes in place to develop and maintain a thorough understanding of the risk profile of individual banks and banking groups. It confirms banks' compliance with prudential regulations and other legal requirements.</p> <p>The supervisor requires banks to notify it of any substantive changes in their activities, structure and overall condition, or as soon as they become aware of any material adverse developments, including breach of legal or prudential requirements.</p> <p>The FSC also monitors and assesses trends, developments, and risks for the banking system as a whole.</p>
Assessment	Compliant
Comments	The authorities should pursue the initiative to develop cross-bank comparisons and system-wide stability analyses, for example, through more regular stress testing, evaluation of systemic developments, and review of the distribution of financial soundness indicators. It would be useful to publish more of this analysis.
Principle 20.	Supervisory techniques. An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.
Description	<p>The FSC is empowered to conduct inspections of banks (Schedule 2 of the FSA). It may also take possession of all books, accounts, and documents of the banks. The powers of the FSC contained in this section do not limit the scope of the inspection. In addition, the FSC may appoint external officers to conduct such an inspection.</p> <p>The FSA (Section 23) permits the FSC to appoint "Reporting Accountants" to report on any aspect of a bank's business. In practice this happens very rarely.</p> <p>In practice, the FSC's staff conduct on-site visits, which take usually between one and three days, rather than inspections. The supervision division annual plan is set up for a period of three years and confirmed by the FSC Board. Those institutions regarded as "higher risk and</p>

	<p>high impact” are visited at least once a year. In addition, the FSC conducts on-site visits regarding special subject areas.</p> <p>Banks are also required to have an annual audit by external auditors and there are obligations on such auditors to report to the FSC if they become aware of facts, during the course of their audits, that they believe to be of material significance in relation to the FSC’s functions under the Banking Code.</p> <p>The external auditor is also required to submit a letter to the FSC confirming that to the best of his knowledge and belief, the banking institution has complied with certain requirements laid down in the code.</p> <p>According to the former legislation, the auditors were obliged to provide an opinion relating to the existence and application of a sound process of control. The accounting profession felt itself unable to comply with this standard. However, this regulation has now been cancelled.</p> <p>Auditors are also required to verify the consistency of a bank’s supervisory returns with the underlying accounting records at least once per year and provide an opinion as to the accuracy of the information reported.</p> <p>The FSC may also request a bank to provide it with any information that it may reasonably require for the performance of its functions.</p>
Assessment	Compliant
Comments	The FSC relies to a limited degree on the auditors’ statements. However, the FSC has no process for monitoring the quality of the work performed by external auditors.
Principle 21.	Supervisory reporting. Supervisors must have a means of collecting, reviewing, and analyzing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.
Description	<p>Sections 20 and 74 of the code require banks to submit a quarterly banking return in a form prescribed by the FSC. Where a bank’s year-end does not fall on a calendar quarter, it is required to provide a further return taking into account the period to the financial year-end.</p> <p>The Banking returns (for incorporated banks) consist of nine distinct sections: (1) Assets, Liabilities, and Off-Balance Sheet Items; (2) Credit Risk; (3) Operational Risk; (4) Capital, Current Period’s Profit and Loss, Provisions and Nonperforming Assets; (5) Large Exposures; (6) Memorandum Items; (7) Liquidity Risk; (8) Interest Rate Risk; and (9) Market Risk and Settlement Risk. For branches only sections (1) (4) (5) (6) and (7) apply. The information provided is mainly prudential but also partially statistical. The banking returns have to be submitted to the FSC not later than 21 business days after the quarter end date. From 2009, the final date for providing the banking returns will be one month after the end of a quarter. The two “four-eyes” are responsible but an “authorized” person (who is usually one of the “four-eyes”) is authorized to send in the banking return electronically.</p> <p>Section 2 of Schedule of the FSA empowers the FSC to seek on an ad hoc basis any information it may require.</p> <p>The reporting process is monitored to ensure returns are being received on a timely basis, and to highlight anomalies and concerns in the information provided that may have implications for the effective management and operation of the bank. Where issues warrant further</p>

	<p>assessment, queries are sent to banks and followed up. An internal procedures document has been developed to ensure consistency of assessment over regulatory returns.</p> <p>The Guidance for Review of New Banking returns refers to several forms, describes different objects, and indicates the benchmarks and the follow up action if required. Similar indications are included in the Guidance for branches' Returns.</p> <p>An internal database of information has been developed to provide validation checks on specific reporting items. This database is available to the banking team as well as other selected staff.</p> <p>An enhanced Financial Reporting System (FRS) has been developed and allows the bank supervision team to expand their institution specific analysis to allow for more focus to be placed on broader trends and systematic issues. This system is used as a delivery channel.</p> <p>The FSC's IT infrastructure is integrated within that of the IOM government. A concern is therefore to ensure that confidential information supplied by banks and their customers (and the FSC's own internal documents) are not accessed by unauthorized persons. However, data held by the Commission, including that provided by the banks, is "ring-fenced" from possible access by other Government Departments. Security in that area has been substantially enhanced since 2003, and Government has secured accreditation to reinforce this. The relevant Servers are also secured within the already secure environment in which Government's Information Systems Division operates.</p>
Assessment	Compliant
Comments	
Principle 22.	Accounting and disclosure. Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.
Description	<p>The Companies Acts place a legal obligation on a banks' directors to ensure that they keep accounting records in the IOM which are capable of accurately disclosing the financial position of their business at any time. The FSC is concerned that boards should properly discharge this responsibility and as part of its guidance on risk management (see CP7 above) has made clear that boards of directors and senior management must ensure that their banks develop and maintain adequate accounting records.</p> <p><i>Banks incorporated in the IOM</i> are required to draw up annual audited financial statements. These must be prepared in accordance with International Financial Reporting Standards (as promulgated by the International Accounting Standards Board) or United Kingdom Accounting Standards (as promulgated by the Accounting Standards Board) and must include additional detailed disclosures specified by the FSC (relating to the maturity breakdown of assets and liabilities and assets /liabilities vis-à-vis related parties).</p> <p>The FSC has no specific legal power to rescind the appointment of an auditor who did not meet the regulatory requirements. However, should such a need arise, the FSC could achieve this by issuing a direction to the bank to put a motion removing the auditor to a general meeting of its shareholders. Failure to pass such a motion would entitle the FSC, inter alia, to revoke the bank's license.</p> <p>The FSC requires the annual financial statements to be audited by a member of one of the</p>

	<p>professional accountancy bodies in the UK or Ireland. Other regulatory requirements are that the responsible audit partner or audit director must have not less than five years experience in bank auditing and that the auditor carries indemnity insurance, acceptable to the FSC, of at least GBP 20 million. In practice, all banks are audited by “Big Four” accounting firms. Audits are carried out in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board.</p> <p>Bank auditors are appointed by the shareholders and, if they wish to remove the auditor, the bank must give the FSC written notification of the shareholders’ intention together with a copy of any representations which the auditor has made against the proposal. Similarly, if the auditor wishes to resign, the bank has to notify the FSC in advance and provide it with information about the auditor’s reasons for taking this step.</p> <p>The audited accounts must be submitted to the FSC within four months of the end of the accounting period to which they relate and must be accompanied by a copy of the auditor’s management letter or, if the auditor is not issuing a management letter, a copy of the auditor’s letter confirming this fact.</p> <p>Within four months of end-year, banks must make their full annual audited financial statements available for public inspection in the IOM by displaying a notice in all their offices stating that a copy of the latest audited balance sheet of the bank, together with the last auditor’s report (as it appears in the audited financial statements), may be inspected by any person on demand and that copies are available to be taken away. Banks may also make available abridged financial statements provided these contain minimum financial information specified by the FSC.</p> <p>In practice, banks comply punctiliously with all relevant IFRS. Consequently, published financial statements do reflect banks’ true financial position and provide both qualitative and quantitative information on banks’ financial condition and risk management strategies.</p> <p><i>Branches of banks incorporated outside the IOM</i> are required to submit a copy of the audited annual accounts of the bank to which they belong, together with a detailed profit and loss account in respect of the bank’s operations in or from the IOM. These banks must provide the FSC with copies of the audited annual financial statements of their immediate and ultimate parent companies as soon as these are available. They must also make these statements available to the public in the exactly the same manner as IOM incorporated banks (described above).</p> <p>The FSC has recently begun to publish aggregate information about the banking system in its annual report. The 2007–08 report breaks down banks and their countries of origin and provides a consolidated balance sheet of the banking system, a geographic breakdown of sources of deposits and information about current levels of risk asset ratios. In addition, the FSC publishes figures for total deposits at the end of each calendar quarter.</p>
Assessment	Compliant
Comments	
Principle 23.	Corrective and remedial powers of supervisors. Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking license or to recommend its revocation.
Description	The FSC raises supervisory concerns with bank management as soon as these come to light. Typically, these cases emerge during off-site review of banks’ supervisory returns and policy

	<p>documents (less frequently during supervisory visits) and in the first instance the FSC responds by discussing its concerns with the bank. If appropriate, these will be followed up in a letter. In practice, the FSC is able to resolve most concerns in this way. This may reflect the fact that the FSC has considerable legal powers to act against noncompliant banks and banks' realization that any unwillingness to take corrective action voluntarily would lead to the imposition of tougher sanctions.</p> <p>The FSC's powers to compel corrective action was contained in the Banking Act 1998. On August 1, 2008 these were replaced with generally similar powers contained in the FSA 2008. The principal difference is that the FSA confers on the FSC a new power to appoint a "business manager" to a bank.</p> <p>To compel banks to take specific remedial steps, the FSC can issue directions or impose license conditions. In both cases, the FSC has full discretion to decide on the particular measures an individual bank has to take. An essential difference between the two procedures, however, is that conditions are a matter of public record while any directions issued are kept confidential. For this reason, the FSC imposes conditions only in those cases where it considers that the imposition will not undermine public confidence in the bank concerned. The FSC has full discretion to use its powers to enforce compliance with any regulatory requirements, including the minimum capital ratio.</p> <p>Contravention of license conditions or directions is an offence for which civil (monetary) penalties can be imposed. In addition, in cases where any person is contravening or is likely to contravene the provisions of the banking legislation, the banking regulations, license conditions or directions, the FSC can obtain an injunction from the high court to prevent such an occurrence. As further sanctions the FSC has an absolute legal power to suspend or revoke a banking license.</p> <p>In serious cases where resolution is required, the FSC has legal power to petition the high court for the appointment of a receiver who takes control of a bank and can dispose of its property. The legislation specifies several grounds on which the court may appoint such a receiver: because it is in the public interest: to protect depositors' interests; to wind up a bank; or to sell its business in an orderly manner.</p> <p>In addition, the FSA 2008 has empowered the FSC to make an order prescribing circumstances in which it may apply to the High Court for the appointment of a person to manage the business of a bank including the disposal of its property. The FSC has consulted upon the draft order and it is in the process of being made..</p> <p>The FSC has extensive powers to impose sanctions against any director, key person, or controller of a bank whom it decides is no longer fit and proper to continue in their position. In particular, it may issue a direction to such an individual requiring him to leave his position. Failure to comply amounts to a legal contravention by both the individual and the relevant bank for which penalties can be imposed.</p> <p>The FSC has adequate powers, if necessary, to ring fence a bank from the actions of its parent and other related companies.</p> <p>The FSC has legal power to issue public statements in respect of banks' regulatory contraventions. Moreover, it has a legal duty to make a public statement when it issues a direction that an individual is not fit and proper.</p>
Assessment	Compliant

Comments	
Principle 24.	Consolidated supervision. An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.
Description	<p>The FSC is familiar with the structure of banking groups and has an understanding of the activities of all material parts of these groups, domestic and cross-border. It has the power to review the overall activities of banks, both domestic and cross-border. The FSC has the power to supervise the foreign activities of banks incorporated within its jurisdiction. On the accounting side the legislation on consolidation is established.</p> <p>The FSC has not yet established prudential standards on a consolidated basis to cover such areas as capital adequacy, large exposures, exposures to related parties and lending limits. The FSC's licensing policy for banks is to permit only branches or subsidiaries of large banking groups that are subject to effective consolidated supervision in their home jurisdiction.</p> <p>The FSC states in its guideline on banking returns that consolidated returns in relation to banks incorporated in the IOM will normally be required in certain circumstances, such as where the bank has provided substantial finance for subsidiaries companies, where it carries on a significant part of its business through a subsidiary or where a subsidiary is material. The requirements should be discussed and agreed with the FSC in advance.</p>
Assessment	Largely Compliant
Comments	For the time being and in the past, banking subsidiaries and other relevant subsidiaries do not exist or are not significant. Hence, consolidated banking system is not of immediate importance. Nevertheless, the FSC should consider establishing an adequate regulatory and supervisory regime.
Principle 25.	Home-host relationships. Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.
Description	<p>When licensing a foreign subsidiary or branch, the FSC requires prior approval by the home supervisor. Although such a requirement is not stated in law, the FSC would not grant any license without the home supervisor's approval.</p> <p>According to the General Licensing Policy issued by the FSC, it will not grant a license to a branch unless it is satisfied that the regulator of the home country is prepared to exercise consolidated supervision over the IOM banking presence.</p> <p>The FSC cooperates very closely with supervisory authorities of the relevant home countries. The cooperation covers the exchange of information and supervisory reports as well as supervisory visits. Visits by home supervisors to local subsidiaries and branches in the IOM for supervisory purposes are permitted and have taken place. Staff from the FSC usually join such on-site visits.</p> <p>Home country supervisors are advised of regulatory action taken by the FSC in respect of local subsidiaries or branches of foreign banks and copies of reports on on-site visits are sent to the home supervisors. The FSC applies to the home supervisor on a regular basis for</p>

	<p>information on the compliance of the parent bank/head office with the home regulatory requirements. In addition, the FSC asks whether the home supervisor has imposed any special conditions on the relevant bank.</p> <p>As home supervisor, the FSC also regularly provides information to the host supervisor on the issues recommendations, risk assessment, on-site supervision and consolidated supervision. According to 34 of the FSA 2008, the FSC is authorized to enter into mutual assistance agreements with other regulatory authorities in relation to a regulated activity. With several foreign supervisory authorities, the FSC has signed Memoranda of Understanding. These MOUs cover among other matters the cooperation of the relevant authorities, the undertaking of inspection visits, requests for assistance of information and confidentiality. However, such an agreement is not a condition for cooperation.</p> <p>The FSC is not permitted to disclose any information relating to the affairs of a customer otherwise than in accordance with Schedule 5 of the FSA 2008. Paragraph 6 of Schedule 5 forbids the disclosure of such information unless the customer consents, or the FSC is satisfied that disclosure is appropriate having regard to its functions and regulatory objectives, the confidential nature of the information and the purpose for which it is required (see also CP 1(6)).</p> <p>Since almost all the licensed banking entities in the IOM are foreign owned, cooperation with home country supervisory authorities is of essential importance to the FSC.</p> <p>Foreign branches in the IOM are excluded from several supervisory regulations. Among others, they are not subject to solvency supervision, to any large credit regime and to annual external audits (albeit auditors are required to report annually on a set of prudential returns submitted to the commission).</p> <p>Subsidiaries and branches may utilize group functions rather than establish their own internal control and internal audit systems, provided the FSC is satisfied that the parent/head office's systems are adequate to be used by them.</p>
Assessment	Compliant
Comments	