



› **JFSC Risk Overview:
Our approach to
risk-based supervision**

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› An Overview of our approach to risk-based supervision



At the Jersey Financial Services Commission (JFSC) we have chosen to enhance our risk-based approach to supervising firms.

This enhanced approach will result in us allocating our supervisory resources towards areas or firms identified as being of higher risk, picking important problems and hopefully fixing them.

We do not seek to eliminate risk completely, but to make the best use of our limited resources to proactively reduce the risks posed to an acceptable level.

We also take an explicitly non-zero failure approach to regulation, meaning that we do not seek to prevent every harm from occurring, choosing instead to allow greater flexibility for firms to operate freely, and in the best economic interests of Jersey as long as risks remain within tolerable levels. In the course of letting firms operate freely, risks will crystallise that fall both within and outside our tolerance and we will respond accordingly.

The success of this risk-based approach will depend on our ability to understand what risks exist in the financial sector and how best they can be addressed.

Our new Supervisory Risk Unit has been working with colleagues across the JFSC to build this approach to risk.



› Risks to what?



The first step has been to identify the risks that exist in the financial services sector.

In order to identify those risks, we must first answer the question 'risks to what?' In the context of the work of the JFSC, the answer is the risks to the Guiding Principles set out in the Financial Services Commission (Jersey) Law 1998, being:

- › Reducing risk to the public of financial loss due to dishonesty, incompetence, malpractice or the financial soundness of financial service providers
- › Protecting and enhancing the reputation and integrity of Jersey in commercial and financial matters
- › Safeguarding the best economic interests of Jersey
- › Countering financial crime both in Jersey and elsewhere

Any risks we identify in the financial services sector, or in the way the JFSC carries out its business, must be something that has the potential to impact on those Guiding Principles.

This document sets out those risks in the sector that we have identified, and how we will assess them.



› Why publish the Overview?



Identifying risks in the financial services sector is not an academic exercise.

The risks we identify will be embedded at the heart of our risk-based methodology for supervision, and all our activities and reporting will be aligned to those risks.

It is also important to our engagement with Industry.

The Overview will provide a common language for our dialogue with firms on risk, and ensure a consistent and transparent view of the risks that both we at the JFSC and in the Industry have to manage, and how we will assess them.

We also want to give those we regulate the opportunity to contribute to our approach to risk, and the publication of the Overview and our survey of industry views on risk is intended to do this.



› Structure of the Overview



We recognise that the problems the JFSC will need to fix and the problems firms in the sector will face are a result of sometimes complex interactions of external or environmental influences, causal factors and the resulting impacts.

The Overview is designed to reflect this by structuring our view of the risks in the sector to mirror, even if simplistically, that real world picture.

We have decided to limit the Overview to risks within regulated firms, excluding the broader environmental factors such as the macroeconomic picture, geopolitical issues and the changing patterns of consumer behaviour that drive risks more at the sector level.

The financial services sector is changing constantly and changes tend to be specific to a particular time and set of circumstances.

With this in mind, we need to constantly review the wider environment to identify changes that could affect the sector. Changes that are significant will be monitored and escalated where necessary.

Rather than placing these environmental factors into our Overview, we will consider them separately.

The Overview sets out a simplified view of risks as ‘inherent’, ‘causal’ or ‘effect’ risks that might be found in supervised firms, each having different characteristics, and potentially a different regulatory focus on the part of the JFSC.

Once a risk is added to the Overview, we will start to capture relevant information to better understand and consider it as we set our priorities for regulatory activity.

We will be consulting on our approach to gathering regulatory data separately.

The Overview structures the risks around two or three levels of description depending on the risk type:

Level 1 – Very high level groupings (e.g. financial crime)

Level 2 – More detailed description of a key risk group within a Level 1 risk group (e.g. terrorist financing within the Financial Crime Level 1 group)

Level 3 – Most detailed description of an individual risk (e.g. risk that a supervised entity participates in terrorist financing, or risk that a supervised entity facilitates terrorist financing)



› Inherent risks

These are risks caused by the strategy, business model and structure of a supervised firm, and are an inherent factor in the overall level of risk a firm may pose.

Although a range of firms may be of a broadly similar type, and might pose a similar level of risk, some will have a conservative strategy and represent lower risk than others which have a more innovative or risky strategy and which would be assessed as a higher risk.

These risks are not usually associated with a regulatory breach as they are a result of legitimate choices around structure, strategy and business model.

Level 1	Level 2
Inherent Risk Factors	Inherent risks posed by a supervised entity's business model or strategy
	Inherent risks posed by a supervised entity's structure that might limit the JFSC's ability to regulate the supervised entity or the supervised entity's ability to adequately oversee its own structure



› Causal risks



These are risks that relate to the operation of financial services firms, and arise from a firm's people, policies, processes and systems. These risks represent a state of being within the firm and, although they can be a regulatory breach, are not always associated with any harm that can impact on the JFSC's Guiding Principles.

For example, a firm can exist in a state of financial distress for some time, without any direct harm to its customers, and can eventually trade its way out of difficulty.

These causal risks can, however, give rise to impact risks which do cause direct harm.

If a firm is unable to trade out of financial distress, there are a number of impacts that could arise. Consumers may lose money, there may be a knock-on effect on creditors of the firm and staff could be made redundant. All of those effects could impact on the Guiding Principles, especially if the firm is large, and important in the context of Jersey's economy and health of the financial services sector.

Proactive supervision of firms in respect of these causal risks can have a preventative effect, with causal risks being mitigated by the JFSC and the firms themselves, preventing harms from arising at all.

Governance, Risk & Compliance	Risk that a supervised entity's corporate governance is ineffective or inadequate
	Risk that a Principal or Key Person of a supervised entity is not 'fit and proper'
	Risk that a supervised entity's culture is inappropriate
	Risk that a supervised entity's arrangements for the training and development of employees are ineffective or inadequate
	Risk that a supervised entity's arrangements for recruitment of suitable employees are ineffective or inadequate
	Risk that a supervised entity's compliance function is ineffective or inadequate
	Risk that a supervised entity's risk management arrangements are ineffective or inadequate
	Risk that a supervised entity's assurance functions, internal or external, are ineffective or inadequate
Financial Soundness	Risk that a supervised entity is in financial distress
	Risk that a supervised entity's financial group support is insufficient
	Risk that a supervised entity could be adversely affected by its own financial group
	Risk that a supervised entity has insufficient capital
	Risk that a supervised entity has inadequate PII cover
	Risk that a supervised entity has insufficient liquidity
	Risk that a supervised entity's home regulator is ineffective
Financial Crime	Risk that a supervised entity's AML/CFT governance is ineffective or inadequate
	Risk that a supervised entity's AML/CFT monitoring is ineffective or inadequate
	Risk that a supervised entity's CDD measures are ineffective or inadequate
	Risk that a supervised entity's suspicious activity reporting is ineffective or inadequate
	Risk that a supervised entity's sanctions measures are ineffective or inadequate
	Risk that a supervised entity's measures for the prevention of market abuse are ineffective or inadequate
Conduct	Risk that a supervised entity lacks sufficient understanding of its customers
	Risk that a supervised entity's business arrangements are not transparent
	Risk that a supervised entity's complaint handling processes are ineffective or inadequate
	Risk that a supervised entity's information security controls are ineffective or inadequate
	Risk that a supervised entity's customer asset controls are ineffective or inadequate
	Risk that a supervised entity's record keeping controls are ineffective or inadequate



› Impact risks



These are risks that have a direct and negative impact, causing harm. They are a result of an individual or set of action(s) or omission(s) on the part of a firm, and will always impact on the Guiding Principles.

These risks will almost always be associated with a regulatory breach.

For example, a firm loses or inadvertently discloses customer data, which could cause financial loss or reputational damage to the customer and the firm, and also damage the reputation of Jersey.

These risks will always be associated with one or more causal risks. Customer data is only usually lost if the firm has inadequate information security controls, poorly trained staff or ineffective risk management and assurance arrangements.

The JFSC will not be able to prevent all risks from occurring, and its focus in respect of these risks when they occur will be prevention of repetition, recovery and action in respect of any regulatory breach.



	Level 1	Level 2	Level 3	
Conduct of Business		Risk that customers of a supervised entity are defrauded	Risk that a supervised entity is deliberately structured to defraud its customers Risk that an employee of a supervised entity defrauds its customers	
		Risk that a supervised entity provides products or services that are reputationally damaging	Risk that aggressive tax avoidance products or services are provided by a supervised entity Risk that a supervised entity is engaged in predatory business practices Risk that customers of a supervised entity are engaged in activities that are reputationally damaging	
		Risk that a supervised entity suffers a material disruption to its services	Risk that customers of a supervised entity suffer loss or other detriment due to an inability to transact Risk that a third party causes a material disruption to the services of a supervised entity	
		Risk that a supervised entity loses control of confidential information	Risk that customer data held by a supervised entity is stolen by an employee or other third party Risk that a supervised entity loses or inadvertently discloses customer data	
		Risk that customers of a supervised entity suffer detriment due to malpractice	Risk that a supervised entity mismanages conflicts of interest Risk that a supervised entity is engaged in deliberate or negligent mis-selling Risk that a supervised entity is engaged in providing misleading information to customers Risk that a supervised entity is engaged in over-charging	
		Risk that customers of a supervised entity suffer detriment due to incompetence	Risk that a supervised entity fails to follow its agreed terms of business Risk that a supervised entity provides poor levels of service to its customers	
	Financial Soundness		Risk of financial failure of a supervised entity	Risk of a failure of a supervised entity resulting in customer losses Risk of a failure of a supervised entity without resulting in customer losses
		Financial Crime	Terrorist financing	Risk that a supervised entity participates in terrorist financing Risk that a supervised entity facilitates terrorist financing
	Breaching sanctions		Risk that a supervised entity participates in the breaching of sanctions Risk that a supervised entity facilitates the breaching of sanctions	
	Money laundering		Risk that a supervised entity participates in money laundering Risk that a supervised entity facilitates money laundering	
Market abuse	Risk that a supervised entity participates in market abuse Risk that a supervised entity facilitates market abuse			



› How will the JFSC assess these risks?



A risk is assessed by the combination of impact (the potential harm that could be caused) and probability (the likelihood of a particular risk occurring).

In our risk-based approach, impact and probability are combined to give a measure of the overall risk posed to the Guiding Principles. This assessment is then compared to our appetite for risk and used to prioritise and select the appropriate response.

Risks are typically considered at an individual, entity and thematic level. In some cases, risks may already have occurred, meaning that we actually assess and respond to the consequences rather than the potential harm posed by a risk.

A key advantage to taking a risk-based approach is that it enables us to become much more proactive, identifying and tackling risks before they occur, rather than acting retrospectively once harm has arisen.

Consistent assessment by the JFSC, across the broad spectrum of risks that we monitor, is essential to ensure that action is targeted proportionately at controlling the risks that we will not tolerate.

Assessment takes into account both risks that have occurred and those that could potentially occur.



› Firms and individuals



Risk assessment will be used to inform decisions about individuals, for example their entry into the sector or their nomination as key role holders, and in response to conduct issues. This has not changed significantly under the enhanced approach.

The biggest change is in the assessment of risk at the level of regulated firms.

Our Supervisory teams were previously organised around individual licence types which meant that firms holding multiple licences were supervised by multiple teams. We wanted to simplify and improve our interaction with firms.

In order to achieve this, we have re-organised ourselves into four new Supervisory Units, based broadly around the business models of the firms that we supervise. All supervised firms have now been contacted and advised how these changes will affect them.

Firms will be assessed under this approach using the calculation: Risk = Impact (footprint x severity) x Probability, where:

- › The regulatory footprint is a reflection of a firm's potential to impact upon the Guiding Principles. The footprint score represents the likely worst case scenario event happening in a firm
- › The severity of the impact of a particular risk is a percentage score reflecting how serious each risk is compared to the other risks in the Overview
- › The probability of a particular risk arising in a firm is assessed after a consideration of the controls it has in place to manage those risks.



› Footprint



A firm's footprint takes into account attributes such as the amount of assets under management, number and nature of its clients, number of employees and the type of work undertaken. These attributes have been identified as being relevant to the firm's potential to impact on the Guiding Principles, and will be combined to provide an overall view of the impact a firm could have if a worst case scenario event happened in a firm. These attributes will be scored and weighted to produce scores on a scale of 1-100; the higher the score, the more impactful the firm.

In the risk model, this worst case scenario view will be moderated by the severity score allocated to each individual risk being assessed, as it is very rare for any risk when it happens to result in a worst case scenario failure of the firm in question. As well as contributing to the assessment of risks in a firm, this assessment of footprint will also determine the broad approach to supervision that a firm is subject to:

› **Enhanced supervision** – large footprint firms that have the individual capacity to significantly impact on the Guiding Principles will be subject to enhanced supervision. What this means in practice is that we will seek to maintain a close awareness of the firm's risk profile through a combination of regular update meetings, periodic reporting, engagement with key assurance providers (such as internal and external audit) and on-site examinations

› **Proactive supervision** – medium footprint firms with the individual capacity to materially impact our objectives will be subject to proactive supervision. We will maintain an ongoing awareness of the firm's risk profile through a combination of update meetings, periodic reporting and on-site examinations

› **Reactive supervision** – small footprint firms that do not have the individual capacity to materially impact our objectives will be subject to reactive supervision. Our engagement with these firms will be primarily through outreach initiatives and thematic examinations.



› Severity



At present, the risks we have identified are not weighted or prioritised. This means, for example, if the same firm footprint and probability were applied to the risk of loss of confidential information and to the risk of terrorist financing, they would be considered to have the same level of impact on the Guiding Principles. In reality, the risks we have identified are not equally serious.

The new severity component of our approach influences the weight and priority given to specific risks in our assessments because severity scores reflect how serious we believe different risks are in their relative potential to impact on the Guiding Principles.

Each of the impact risks we have identified will have a percentage severity score which will place it relative to, and in context with, other impact risks. So for example, if it is considered that the risk of terrorist financing inherently has more potential to impact on the Guiding Principles than the risk of a conflict of interest, it will be allocated a higher severity score.

We currently do not have consistent quantitative information to inform how severe all risks are in relation to one another. To understand the relative seriousness of risks to the Guiding Principles a wide range of opinions from respondents who are well versed in risk will be sought.

We will be using a survey method called Maximum Difference Scaling that will measure the preference or importance participants give to each of the eleven Level 2 impact risks. The advantage of this technique is that it enables robust scaling to be applied without the need for ranking or rating of each and every risk. This method also establishes the intensity of the difference between risks, which a ranking approach could not.





We have conducted this exercise internally, but we also want to provide those we regulate with the opportunity to contribute their view.

We have therefore sent an email invitation to a range of people across the sector to participate in a survey to help us understand what those in the sector think are the most serious risks we at the JFSC have to manage.

In the survey each respondent will be asked to choose which of a selection of risks they believe is the most severe and which is the least severe in terms of the harm they could cause to the Guiding Principles and reputation of the Island.

This process will be repeated using different risk combinations, a set number of times, for each respondent.

A single respondent's results in isolation have limited value, but by aggregating responses together, a robust view on the severity of the impact risks is formed.

By surveying both internal and external respondents a range of responses will be obtained from people who understand the risks, and the Guiding Principles in different contexts.



Probability



The final aspect of the risk calculation is an assessment of the probability or likelihood of a risk occurring in a firm. The starting point is to look at the 'inherent probability'.

This is an assessment of how likely it is over a 12 month period that there will be a material occurrence of that risk, in an average firm of a particular type, having an average level of risk controls.

This 'inherent probability' can then be amended up or down by a set of supervisor-made judgements about the likelihood of the risk occurring in a specific firm, following an assessment of its business model, structure, culture and controls.

By including an assessment of a firm's controls, credit in the form of a reduction in probability scores can be given to firms with good controls, and Supervisors will be able to highlight improvement areas for firms whose controls are weak.

This amended probability will be the 'net probability' used in the final scoring calculation of risk exposure.



› Thematic risks



We will combine our firm based risk assessments, market intelligence and other information to identify particular themes that cut across a range of firms in the sector, or affect the sector as a whole.

These thematic risks will be addressed using a range of tools from on-site visits to research and issuing guidance.

As an example, there is a solid evidence base to suggest that cyber-security and data loss are issues that cuts across the Industry as a whole, and is of sufficient seriousness to justify the JFSC allocating resources to research it, examine firms on a thematic basis, and subsequently issue guidance for the whole Industry.

In May, we contacted the firms we regulate to advise them of the range of thematic work that we are planning.



› An evolving approach



Our approach to risk has been constructed in order to be very flexible. The firm risk model contains parameters that can be set by senior management to reflect the JFSC's risk appetite and tolerances, as well as accommodate new or emerging risks.

The accuracy of risk assessment within the model is dependent upon the quality and adequacy of available information.

We recognise the time and cost associated with the provision of data to us and therefore will regularly assess the relevance of our information requirements to ensure that we are being proportionate in establishing these, whilst securing sufficient data to inform accurate and timely risk assessment.

Ultimately, information gathered allows us to focus regulatory attention and activities where they are most needed.

As the enhanced approach evolves, we will continually evaluate its effectiveness and how well it is operating in practice to ensure desired outcomes are achieved and to identify potential improvements.

On the basis of our evaluation, we will adapt our regulatory approach, resourcing levels and tolerances to direct regulatory activities appropriately.



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