Financial Services Authority

The FSA's risk-assessment framework

August 2006

Contents

1 Introduction

1.1 The Financial Services Authority (FSA) is a risk-based regulator and ARROW is the framework we use to make risk-based regulation operational. ARROW stands for the Advanced, Risk-Responsive Operating FrameWork and covers all of our risks, firm-specific, thematic and internal. As such, the ARROW framework has three main components:

- ARROW Firms: used when assessing risks in individual firms (we sometimes call this 'vertical' supervision);
- ARROW Themes: used when assessing cross-cutting risks, i.e. those involving several firms or relating to the market as a whole (we sometimes call this 'horizontal' work); and
- Internal Risk Management: used when assessing the operational risks that might impact the FSA.

What is covered in this paper?

1.2 This paper explains some important changes we have made to ARROW as part of our continuing programme of making the FSA easier to do business with. It sets out what firms can expect of our risk assessment process and how that differs for firms with and without a Relationship Manager. We also explain how we plan to work with you and how we will measure progress against relative service standards. Specifically:

- in Chapter 2 we outline the ARROW framework and explain how we assess risks and relate these to our statutory objectives;
- in Chapter 3 we explain how we apply the ARROW risk model to our supervisory activities, including ARROW Light risk assessments for smaller firms; and
- in Chapter 4 we explain what ARROW means for your firm; this includes an explanation of the risk assessment process and how we communicate the results of our work to your firm.

Please note that this paper does not cover self-assessment. Proposals will be set out in a separate document, at a later date.

Because this report gives updated information about our risk assessment process, it is not subject to formal consultation. However, in combination with the Relationship Management charter, our updated processes include mechanisms which allow firms to provide feedback to us on our supervisory approach. We therefore encourage feedback on the contents of this paper and are always happy to receive any comments on ARROW II more generally.

Who should read this paper?

1.3 We expect that members of firms' senior management (including Board members) will be most interested in this paper as they will be closely involved in our risk-assessment work. This is because of the emphasis we place on senior management to set up and manage effective internal controls, so that your firm's business complies with regulatory requirements.

It will also be of interest to other individuals in firms who are involved in the risk assessment process (e.g. heads of finance, risk, compliance and internal audit functions).

If you are a non-executive director, you may wish to know that we are preparing a briefing specifically aimed at you which will be available on our website in October.

ARROW Firms applies to all authorised firms, recognised bodies, including recognised exchanges and clearing houses, and the Society of Lloyd's. For management of small firms, see the small firms' box on the following page as this refers you to areas in the document which are of specific relevance.

Why is our risk-assessment process important to your firm?

1.4 The risk assessment process is important for your firm and its management because:

- our judgement of the risk that your firm poses to our statutory objectives will determine the overall intensity of our regulatory approach;
- actions within the Risk Mitigation Programme (RMP) will be directly driven by the risk assessment;
- we place a high degree of reliance on senior management responsibility, so we look to management to address the issues we identify during the process; and
- the risk assessment will be the key for many firms in deciding the amount of regulatory capital we will require you to hold.

You can find further details of some of the topics covered in this report on our website at www.fsa.gov.uk, including information on our Relationship Management charter, ARROW service standards and how we apply ARROW to small firm supervision.

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Note for small firms

Para 4.5 – refers to our differentiated approach under ARROW II, as applied to small firms.

Para 4.59 – refers to thematic work and how this applies to small firms.

2 Overview of the ARROW framework

History

2.1 In January 2000, we set out our proposed approach to regulation in 'A new Regulator for the New Millennium'. This explained the framework we intended to put in place to enable us to deliver our statutory objectives. We then issued further reports in December 2000, February 2002 and October 2002 describing the progress we had made.

2.2 As well as these reports, in February 2003 we published a paper called 'The Firm Risk Assessment Framework', which released our internal guidance and set out what firms needed to know about our risk assessment work. This paper replaces the February 2003 paper.

2.3 ARROW has been a hugely successful initiative for us. Within the FSA it has established a common risk language and played a significant part in effecting a successful merger of our predecessor regulators. For firms, it has embodied our principles-based approach, delivering a lighter regulatory touch for those firms that pose less risk to our statutory objectives. For our firms, it has been one of our principal methods of delivering regulation in an efficient and economic way.

2.4 Any risk management approach cannot stand still and in 2003 we began a review of ARROW. This review identified a number of areas for potential improvement, reflecting not only firms' and our own experience of its use, but also our increased ambition to embed our risk-based approach in everything we do. On the back of this review, the ARROW Project was set up in 2004 to establish the detailed causes of the issues identified and to design and implement solutions.

2.5 Over the last two years, we have completely overhauled all of our risk management processes under the name 'ARROW II'. Our aims have been to achieve:

- **Better communication with firms concerning our assessment of them:** we have made several changes to the process to help improve our communication with firms. In particular, we have extensively revised the ARROW risk assessment letters we send to firms to provide more focus on the main issues and what we expect firms to do about them. Firms now receive a draft copy of the ARROW letter and accompanying Risk Mitigation Programme (RMP) to allow factual inaccuracies to be corrected and to reduce surprises in the final letter we send to the firm's Board.

- **Greater efficiency and effectiveness on our management of risk, and sharing and making better use of the knowledge we have:** we make more and better use of thematic work when identifying and assessing cross-cutting risks (i.e. those involving a number of firms or relating to the market as a whole). This means our supervisors now make better use of sector intelligence and analysis work, so we are better informed of emerging risks and other trends in the industry. This makes it easier for our supervisors to choose the most appropriate process (firm or thematic) when dealing with the various issues and risks we face.

- **Greater proportionality and consistency in response to risks, applying our resources where they will make the most difference:** ARROW has always delivered a lower intensity of supervision for firms that pose a lower risk to the FSA. But, ARROW II allows for greater differentiation in the supervisory process. We vary our standard ARROW approach for lower risk firms.

- **Improved skills and supervisory knowledge of our staff:** building on our current training and development programme for regulatory staff, we are providing all our firm supervisors with a bespoke, five-day training programme on ARROW II. We have already trained over 500 of our front-line staff on the practical implementation of risk-based regulation – as this training is a key part of our Regulatory Curriculum. The Regulatory Curriculum itself operates like a syllabus for a professional qualification. In addition, we have written extensive guidance on the ARROW II approach and the detailed processes through which it operates, from our underlying philosophy to the operation of the new ARROW risk model.

- **A major overhaul to our risk model, allowing better comparison of risks in different areas so we can more reliably devote our resources to the areas of greatest risk:** we have more closely aligned the firm, thematic and internal processes within ARROW II, so they now use the same classification of risk and the same concepts of impact and probability. The same kind of information on each risk is now scored in the same way, allowing supervisors more accurately to reflect their views of risk.

- **ARROW II will also fully integrate our firm capital assessments – including Pillar2 of the Capital Requirements Directive (CRD) and Individual Capital Adequacy Standards (ICAS) for insurance companies.** However, this will not be in place before 2007 when the CRD is implemented. In the meantime, we will be piloting the combined approach during 2006. From 2007, where possible, we will synchronise the timing of the capital and risk assessment. Where this cannot be done, the integrated approach will take full account of the need to avoid duplication of effort.

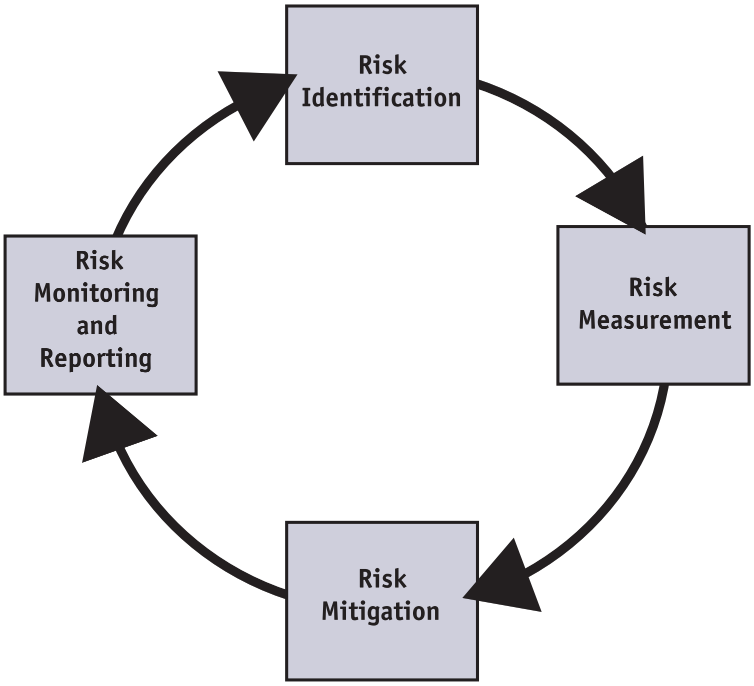
How risk-based regulation works in practice

2.6 ARROW provides the link between our statutory objectives and our regulatory activities, and is designed to:

- identify the main risks to our objectives as they arise;

- measure the importance of those risks;
- mitigate those risks where their size justifies this; and
- monitor and report on progress of our risk management.

Figure 1



2.7 Given the many possible events that could have a negative effect on the financial markets and our limited resources, our risk-based approach is based on a clear statement of the realistic aims and limits of regulation. In other words, we accept that we can never entirely eliminate risks to the statutory objectives we have been set by Parliament – our 'non-zero failure' approach. And although the idea that regulation should seek to eliminate all failures may look superficially appealing, in practice this would impose prohibitive costs on the industry and consumers. Consumers benefit from healthy, competitive markets, where different firms try to meet their needs, and this is recognised in the Financial Services and Markets Act 2000 (FSMA).[1]

2.8 We have, therefore, made a conscious decision to be a risk-based regulator. We regularly review the amount of risk we are prepared to accept and focus our resources on the risks that matter most. By doing so, we believe we can make the greatest overall difference in the UK financial services market, without stifling competitiveness. And from the point of view of those we regulate, our interventions in the marketplace can be justified in terms of the level of risk to our statutory objectives and consequent harm that would otherwise be present.

1 Reasonable Expectations: Regulation in a non-zero failure world (September 2003).

2.9 Within the ARROW framework, we use two basic approaches to manage risks arising from sources external to the FSA: ARROW Firms and ARROW Themes. The ARROW Firms approach involves assessing and dealing with risks as they apply to an individual firm or group of connected firms. By contrast, under the ARROW Themes approach, we consider specific issues as they affect a number of firms, an entire sector, or the market as a whole. We choose one or the other of these approaches (or a mixture of the two) to deal with risks in the most efficient and effective way.

What do we mean by risks?

2.10 Our objectives are clearly set out in FSMA. So, for us to consider something as a risk, it must have the potential to cause harm to one or more of our statutory objectives.

2.11 Within ARROW, we consider seven generic ways in which risks in firms and markets may affect our objectives, and hence why we care about them. These 'Risks to Objectives' (RTOs) are listed in Annex 3. Whenever we are proposing that action be taken against a particular issue, (either within an individual firm or as a theme), we must be clear that it relates to one or more of the RTOs.

2.12 Identifying risks to our statutory objectives involves drawing on a wide range of sources, including intelligence gathering while supervising firms, the regulatory returns firms provide us, contacting consumers directly and monitoring markets and the economy. We use this information to assess the level of risk posed to our statutory objectives and to decide on what approach is needed (if any) to mitigate the risk.

A more principles-based approach

2.13 Although we have made many changes to our processes in arriving at ARROW II, we have not changed our fundamental approach to the task of supervision. Our aim is to encourage and foster good business practice throughout the financial services sector, recognising that firms' duties to their owners and their customers are often consistent with their regulatory obligations.

2.14 We believe in providing firms with the flexibility to decide for themselves what business processes and controls they should operate, whilst continuing to meet our regulatory requirements.

2.15 We are seeking, through ARROW II, to provide greater clarity about the outcomes that really matter to us and, as a consequence, we hope to engender a shared appreciation of the regulatory outcomes we are seeking to achieve. For example, ARROW II explicitly captures our assessment of how a firm is applying the principles of treating its customers fairly.

2.16 Treating Customers Fairly (TCF) is rooted in our statutory objectives and strategic aims. And is embedded in the sixth of our eleven principles, namely that "A firm must pay due regard to the interests of its customers and treat them fairly". Relying on a high-level principle means that TCF can be applied in a more flexible way to reflect business size and purpose. We recognise that there is no standard way for TCF to be applied as no two firms are the same.

2.17 Although our TCF work initially focused on larger firms, we have been looking increasingly at what TCF means for small to medium sized firms. We realise that small firms have differing requirements and have tailored specific information on our website to make it more relevant to individual business needs. If you are a small firm, you can access this information using the following link http://www.fsa.gov.uk/pages/Doing/small_firms/general/tcf/index.shtml

2.18 TCF has a central role in our supervision strategy for smaller firms, and we will continue to ensure that TCF remains at the very top of our agenda by carrying out thematic work to help us understand smaller firms' progress in this area.

2.19 The focus of a more principles-based approach, therefore, is not on the means, but the end. By taking a more overtly risk-based approach to our assessment of whether firms are operating in line with these principles we can create incentives for firms to do the right thing in return for less supervisory intervention.

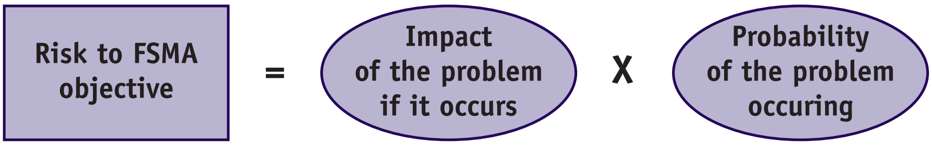
2.20 We have gone much further to make ARROW a lot more transparent. This document is part of that transparency. Under ARROW II, firms will receive more detail than ever before on our assessment of them. We have also outlined what we think firms need to do to prepare, so they have a successful ARROW visit. We believe that a successful visit is an important part of our overall relationshp management proposition to firms.

3 The ARROW Risk Model

Fundamentals

3.1 We consider risk to be the combination of impact (the potential harm that could be caused) and probability (the likelihood of the particular event occurring).

Figure 2



3.2 In the FSA context, we combine these impact and probability factors to give us a measure of the overall risk posed to our statutory objectives. We then use this measure to prioritise risks and make decisions on what, if anything, our regulatory response should be. We also use it to set our strategic aims and outcomes and to allocate resources based on our regulatory priorities.

3.3 Scoring within the ARROW framework is on a simple four-point scale: impact and probability (and risk – the combination of the two) are each rated as either:

- low;
- medium low;
- medium high; or
- high.

3.4 We calculate the impact and probability associated with the firm as a whole (or group of firms – see 3.10), as well as assessing the risk associated with issues relating to the firm or theme. Our rating will determine our overall approach and the intensity of our response.

3.5 An 'issue' is a particular event or set of circumstances that presents risks to our statutory objectives and where the overall level of risk is considered sufficient to warrant action.

Impact

Impact for individual issues

3.6 For each issue (whether related to an individual firm or thematic), we take into account not only quantitative information about the scope and severity of the potential problem (e.g. the number of consumers affected, or the monetary amounts involved) but also qualitative factors (e.g. the vulnerability of the consumers and the nature of the harm they are likely to suffer).

Impact for the firm as a whole

3.7 In assessing the whole firm, impact is designed to capture the size or 'regulatory footprint' of the firm and the potential harm it could do to our statutory objectives. We initially calculate it using numerical data, taken from the firm's regulatory returns.[2]

3.8 Some examples of the types of data used to calculate impact for firms in different sectors are given in Annex 2.

3.9 Our impact measures are, at best, proxy measures. Supervisory overrides can and do, therefore, take place where we do not consider the numerical measure is a fair reflection of the firm's impact.

Aggregating impact in groups

3.10 Where we carry out a group assessment we calculate the impact as the sum of the impact scores for the constituent firms that make up the group.

Probability

3.11 When considering the probability of harm to our objectives, we first consider the gross risks inherent in a particular product, line of business, sector or firm, before assessing the adequacy of the controls needed to reduce that risk.

3.12 Under the ARROW Firms approach, we refer to the gross risk as business risk. So, in our firm supervisory activities we assess the level of business risk in a firm before separately assessing the quality of the controls the firm has in place to deal with those risks. We call this the level of control risk, with high control risk equating to poor controls.

3.13 In the ARROW Firms risk model, we classify probability under ten high-level 'risk groups'. These 'risk groups' are further divided into 'risk elements'. These cover both business and control risks. The current set of risk groups and elements is set out in Annex 1.

3.14 When rating probability for each risk group, we take account of the risk elements within it, but also take an overall view of the firm, weighing both positive and negative aspects and the importance of each risk element to the firm.

2 Our approach to calculating impact in firms will continue to evolve as new regulatory returns come on-line as part of our wider Integrated Regulatory Returns project.

Probability for individual issues

3.15 This is a simple rating of the likelihood of the events described by the issue occurring.

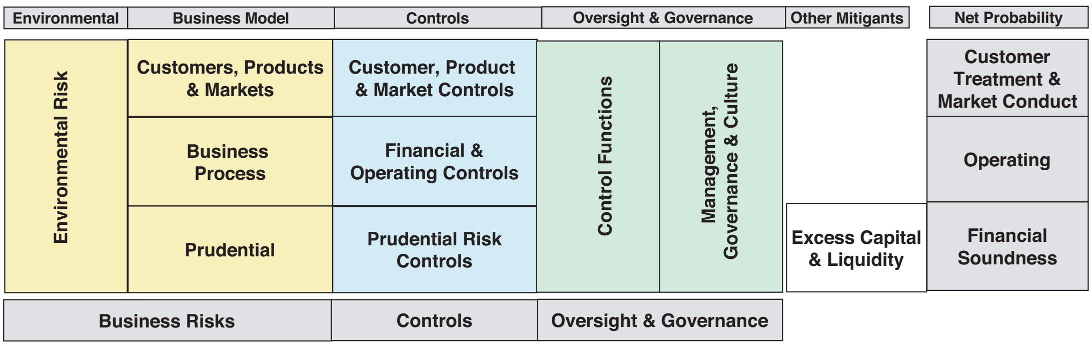
3.16 We will classify issues according to the underlying risk elements and consequently with each risk group. Where an issue is part of an ARROW Firms risk assessment, the probability rating for the issue will help to determine our overall rating of the firm. So, for example, we might classify an issue relating to the quality of a building society's loan underwriting system as follows:

Risk Group	Risk Element
Prudential business risks	Credit risk
Prudential risk controls	Credit risk controls
Control functions	Enterprise-wide risk management

Probability for the firm as a whole

3.17 When we assess probability at the level of the firm as a whole, we consider separately each of the ten risk groups, but take into account any of the issues we have found during the course of our risk assessment. The ARROW risk model provides an overview of how inherent business risks, front-line controls and governance arrangements interact within a firm or group, leading to an overall assessment of net risk. This model of risk is shown in the matrix below:

Figure 3



Assessment-level probability

3.18 The ARROW risk model has both horizontal and vertical dimensions. Horizontally, risks are separated into three basic categories, represented by the three rows in the above matrix:

- risks associated with the firm's direct interactions with retail customers and market counterparties – this may be broadly characterised as the firm's 'front office';
- risks associated with the firm's internal processes; and
- prudential risks, relating to the financial soundness of the firm.

3.19 Each of the ten risk groups (represented by the coloured blocks in the diagram above) may affect one or more of the three rows. There are three risk groups that affect all the rows: Environmental Risk, Control Functions and Management Governance and Culture. As a consequence, strengths or weaknesses in these risk groups will affect all three rows. The remaining seven groups feature in one row only.

Vertically, the risk groups fall into four categories:

- Business Risks – defining the inherent or gross risks within the firm;
- Controls – the primary risk controls of the firm, which *should* directly reduce the inherent business risk of the firm;
- Oversight and Governance – defining the secondary and pervasive controls in the firm; and
- Other Mitigants – the amount of excess capital and liquidity that can be used to absorb prudential risks.

3.20 These vertical categories are the driving factors that determine the nature of the relationship the firm will have with us. In general, our approach is not to take action or seek to mitigate issues with high levels of business risk if the controls are sufficient to manage those risks. If the controls are assessed as high, then we will require mitigating action. If the oversight and governance of the firm is assessed as low risk, the mitigating action will largely fall on the firm to undertake. If the oversight and governance is assessed as high risk, then the actions will typically be conducted by us or third parties such as skilled persons.

Risk Groups

3.21 On the far left side of the matrix is the Environmental Risk group – business risks which originate outside the firm. This risk group spans all three rows, as the level of environmental risk is considered to have a general aggravating or improving effect on the overall risk profile.

3.22 The second column in the matrix contains the three types of intrinsic business risk – those which the firm itself elects to bear when choosing its business model.

3.23 The next column in the grid describes the specific controls which the firm has in place to mitigate each of the three types of risk described above. So, there is a direct matching of these control risk groups to the three intrinsic business risk groups.

3.24 The next two columns in the model represent the high-level controls the firm has in place – specifically its oversight and governance arrangements. These cover the firm's control functions (internal audit, compliance and risk management), its senior management, corporate governance arrangements and overall culture. These high-level controls are general mitigants to all risks within the firm, and so the ARROW risk model includes them in the aggregation of all three rows in the matrix. These two risk groups are the most important controls within the ARROW framework, and the ones that are core to all firm risk assessments.

3.25 Lastly, the model includes an assessment of the level of capital/liquidity that the firm has. The existence of excess capital/liquidity (over the minimums established within the relevant regulatory framework for the firm in question) mitigates prudential risks. Note that it provides no mitigation of customer treatment/market conduct risks, nor of the risks associated with the firm's business processes. Therefore, the model excludes the capital/liquidity risk group from the aggregation of risk in the top two rows.

3.26 The box 'excess capital and liquidity' reflects the extent to which capital and liquidity is available to mitigate other risks. By definition, if the firm has a capital deficiency, it is not meeting Threshold Conditions and generally that will mean a high probability that it will pose a risk to our statutory objectives. A deficiency in liquidity, particularly when combined with a shortfall in capital, would aggravate the risk to financial soundness. If the firm is maintaining capital at the minimum level, there is a significant probability that it will incur a deficiency at some point during the regulatory period. Consequently, there is a significant probability that the firm may fail to meet Threshold Conditions and a medium high to high probability that it will pose a risk to our statutory objectives. Consequently, risk to financial soundness would be aggravated, although not as much as in the case of a capital or liquidity deficiency. If the firm has excess capital and liquidity it has a margin available to mitigate other risks. Depending on the degree of excess, the rating for 'excess capital and liquidity' would be 'medium low' or 'low'. If the rating is 'low', then this would lower the overall risk to financial soundness. If the rating is 'medium low' this would have a neutral effect on the risk to financial soundness.

3.27 As mentioned above, each risk group is broken down into more discrete risk elements. These elements are not a checklist against which your firm is assessed. They simply give supervisors more information on the areas that they should consider when assessing the business and control risks within your firm.

Aggregation of risk group ratings

3.28 Probability is aggregated in the above matrix in both the vertical and horizontal dimensions:

- across each of the three rows, to produce a net risk after the application of controls and other mitigants to the inherent business risks, this produces scores on:
  - how firms treat their customers and/or conduct themselves in markets;
  - operating risks;
  - financial soundness; and
- down each of three widely-drawn columns, to produce average scores for business risks, direct controls, and oversight and governance.

3.29 Across the three rows in the probability matrix, scores are aggregated in a 'multiplicative' way. That is to say, a score above the neutral level of medium low (high or medium high) will act to increase the net risk; equally, low scores will reduce the net risk. One effect of this is that the net risk score for a particular row may actually be higher than any of the individual risk group scores in that row (e.g. if all scores in a row were medium high, the net risk for the row would be high). Conversely, the model is calibrated so a firm with a high level of business risk could still produce a low level of overall risk to the FSA, if the controls were good enough.

3.30 By contrast, the aggregation of scores down the three wide columns in the grid is an averaging process – so the resulting total score for each column will be somewhere between the individual risk group scores in that column.

Determining scores at the risk group level

Risk elements and 'suggested' risk group scores

3.31 The assessment for a risk group is determined by a combination of one or more of four sources (in hierarchical order):

- directly as a top-down assessment of the risk group;
- as a product of scores of risk elements within the risk group;
- as a product of the scores of issues assigned to risk elements; or
- from the sector risk profile for firms of a particular type.

3.32 In the case of group assessments, the risk group score will be a product of:

- scores suggested by any group-level issues and risk element scoring included at the group level; or
- scores against the same risk group in each of the Material Business Units (MBUs) which form part of the group (these are weighted by the relative impact score of the MBU – so an MBU which accounts for more of the group's total impact will make more contribution to the overall suggested score for each risk group).

Adjustments made to the model to reflect FSA's risk appetite

3.33 We have constructed the ARROW II risk model to be very flexible. The model contains parameters that can be set by our senior management to reflect their risk appetite. The main parameters that can be set are:

- **Impact Thresholds –** the point at which the impact of a firm, issue or theme is categorised as low, medium low, medium high or high impact.
- **Sector Weightings –** the model can be set up to emphasise or de-emphasise the risk from certain sectors.

- **Aggregation –** how aggressive the model is when aggregating scores across rows or down columns. A more aggressive model will typically yield a greater dispersal of scores.
- **Risk Group Weightings –** the model can be set up to emphasise or de-emphasise risk groups within the model. A risk group with a high weight would therefore be more influential on the aggregated scores than a risk group with a lower weight.
- **Core Areas –** certain parts of the risk model are mandatory in the risk assessment. These are set centrally and can be changed.

3.34 We intend to undertake an annual exercise to reset the model and its parameters, but will be prepared to make adjustments in between these periods on an exceptional basis. The parameters would be set for future assessments and would not mean that existing assessments would need to be re-scored.

3.35 We will publish the model so firms can make their own risk assessment based on our approach. This is covered in Appendix 3. Publication would also include the parameters.

4 How we use ARROW to assess the risk in firms

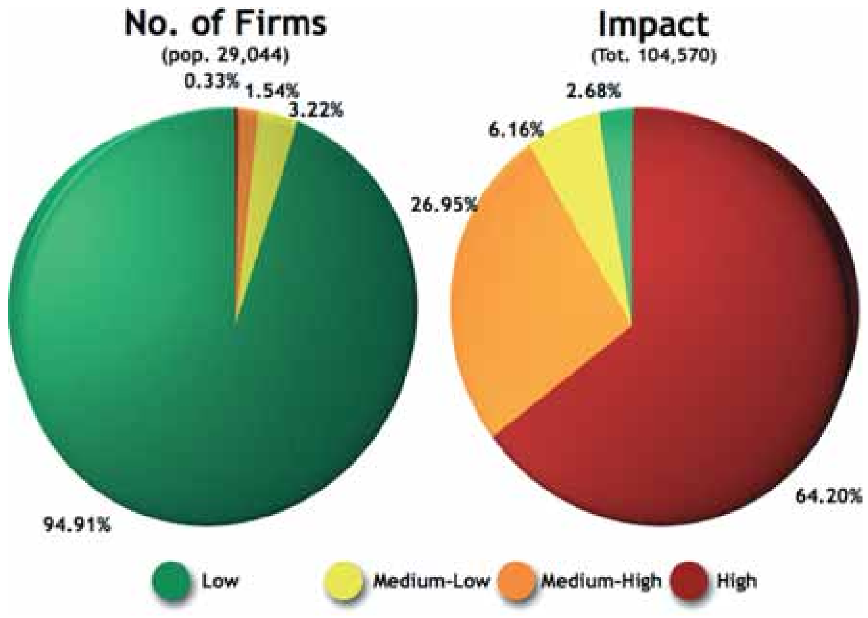
Our approach to supervision

4.1 Our approach to supervision is first determined by the impact the firm has on our statutory objectives. For those firms we assess as low impact we rarely carry out firm-specific risk assessment work, placing reliance on thematic assessment and remote monitoring of the information submitted by the firm.

4.2 For those firms that are designated as other than low impact, we conduct regular assessments of risks within the firm. The period between those assessments is known as the 'regulatory period'. This may vary in length from one year to four years, depending on the risk profile of the firm and the length of time for which we believe our ARROW risk assessment will remain valid. We may also elect to conduct an interim 'stocktake' to update the firm on our views of its risks as well as its progress in complying with its RMP.

FSA's current portfolio of firms (as at August 2006)

Figure 4



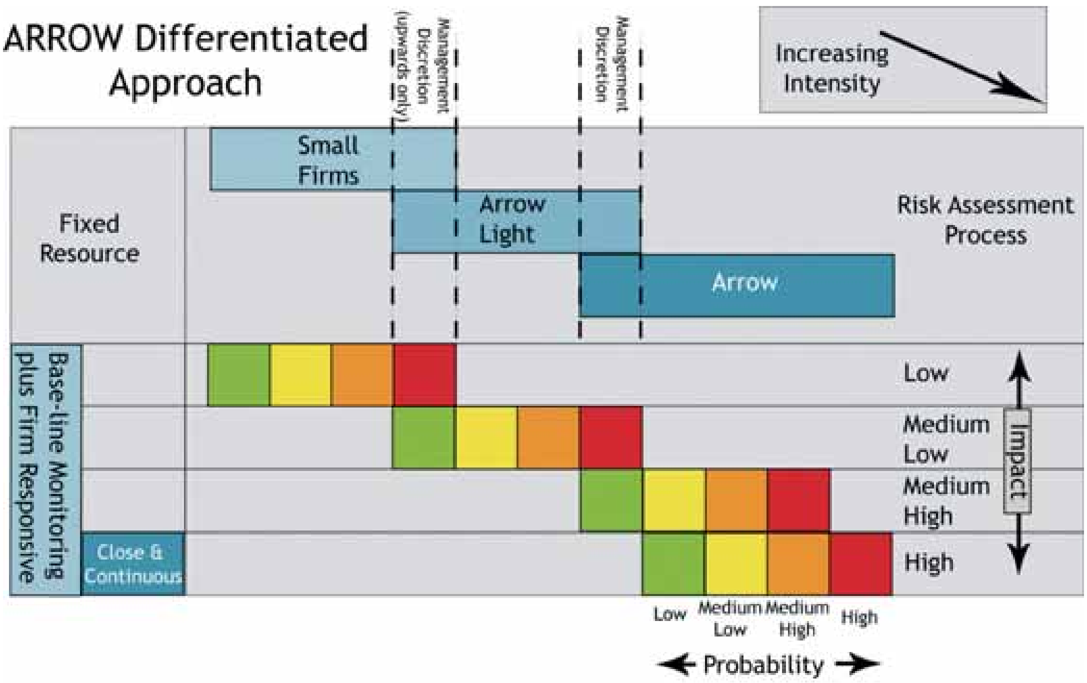
4.3 The chart on the left shows that we assess the overwhelming majority of firms as low impact, so they are subject to the Small Firms model (see page 19). However, the chart on the right shows that these small firms, in total, represent only a very small proportion of the total impact of all the firms we regulate. In contrast, those firms that are high impact account for only 0.33% of the number of the firms we have, but are nearly two-thirds of FSA's total impact.

Risk assessment phases

4.4 Once during every regulatory period we will perform a firm risk assessment. This risk assessment will have planning, discovery, evaluation and communication phase. During the rest of the regulatory period (until we conduct the next re-assessment), the firm is subject to ongoing monitoring. The results of the risk assessment itself may also lead to further actions during the rest of the regulatory period directed towards specific issues. These actions are known as a Risk Mitigation Programme (RMP). We carry out any such work in what we call the follow-up phase. Refer to 4.50 for further details.

4.5 These phases are differentiated by both impact and probability. Depending on the ratings of impact and probability, the overall supervisory approach will be as set out below:

Figure 5



The three approaches are:

- **Full ARROW –** a full risk assessment of probability (all business risks and control risks) within the firm. The supervisory team has discretion to investigate any areas and issues during the assessment, to the extent they see fit. This is subject to challenge for proportionality by those validating the risk assessment internally. All risk group scores in the risk assessment will be communicated to the firm in the ARROW letter (see Appendix 1).

- **ARROW Light –** a reduced-scope risk assessment (matching the relatively low level of resources available), covering certain core areas and sectorally-important issues only, unless other clearly identified significant risks need attention.

- **The Small Firms model –** we call low impact firms 'small firms': such firms do not have a specific relationship manager attached to them at the FSA. Instead, they are dealt with through our Firm Contact Centre. We do not conduct regular firm-specific assessments. Instead, they are subject to thematic reviews and to specific risk mitigation work triggered by remote monitoring of returns from firms and of information from other sources such as the Financial Ombudsman Scheme.

You should note that firms which are classified as high impact are also subject to close and continuous supervision, see 4.57.

Core areas of assessment

4.6 There are certain core areas which must be explicitly assessed in all Full ARROW and ARROW Light assessments. The purpose of the core areas is to ensure that consistent minimum areas of assessment are always assessed and our supervisors' views of these areas are recorded.

4.7 The core areas are those risk groups or risk elements which are assessed for all firms for which we carry out a risk assessment. Following the risk assessment the supervisor should have a definitive view of the level of risk posed to our statutory objectives and the quality of the associated controls in each of these core areas. As set out in 3.33, the core areas are subject to change, but currently they are:

For all firms

- management, governance and culture (control risk group);
- control functions (control risk group); and
- capital and liquidity (control risk group).

For firms with significant retail business

- Customers, products (and markets) (business risk; risk group).

For firms with significant wholesale business

- Customers, products (and markets) (business risk; risk group).

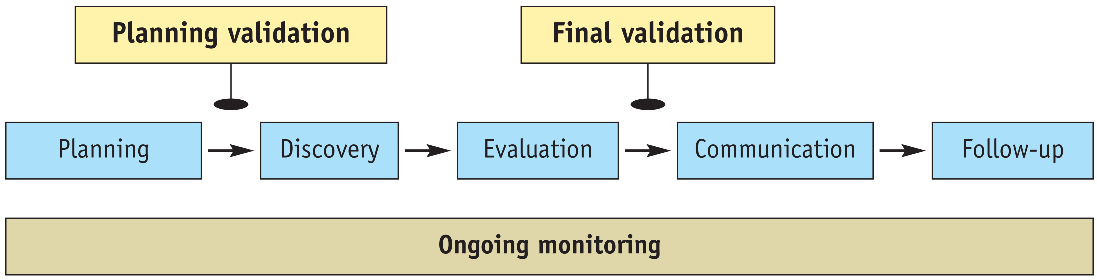
For firms with permission to hold or control client money

- Client money (control risk element within the financial and operating controls group).

The ARROW Firms supervisory process

4.8 The Full ARROW and the ARROW Light processes involve a series of structured stages that are designed to ensure we gather the information we need to form a view of the risks and controls within the firm in question. They also focus the supervisor's attention on the risks that matter most and then help them devise an RMP to address these risks. The stages of the process are shown in the figure below.

Figure 6



4.9 The process is subject to validation by senior and independent FSA staff who provide challenge at certain stages of the process and when the final letters and RMPs are produced. There are two points at which validation occurs.

4.10 For higher impact firms, the validation process consists of a formal review by a committee, which might be chaired by the relevant FSA director, or at least a head of department. For lower impact firms, the validation work may be overseen by a committee, but will at least be reviewed by a manager who does not have day-to-day responsibility for the firm. This review:

- provides a challenge mechanism to the supervisory team on the risk issues for the particular firm;
- helps us make sector comparisons of risk;
- checks that the RMP is proportionate, including the use of our resources and a firm's significant external spend; and
- provides overall quality and consistency control.

Planning – preliminary assessment and scoping activities

4.11 The planning stage of the assessment is designed to give us an initial estimate of the level of risk, and allow us to decide what further information (and hence discovery work) is required.

4.12 The first step in planning an ARROW Firms risk assessment is to identify which firms will be assessed and how. This includes decisions on assessment structure.

4.13 In ARROW we assign the individual legal entities (firms) we regulate to ARROW Firms risk assessments for which we calculate the impact and probability scores, described in Chapter 3.

4.14 Where we regulate a group of related entities, we may wish to perform our risk assessment of them as a group, rather than separately assessing the individual firms. So, we may attach more than one firm to a single risk assessment. We may also decide that, in the case of large groups, we need to break the assessment down – that division will usually correspond to a split by (groups of) legal entities but might not do so in cases where that is not the most efficient way of assessing risks to our objectives (e.g. in cases of matrix management).

4.15 Where we regulate a group of related firms, there are essentially three options for structuring our assessment of them. These are:

- separate risk assessments for each firm;
- a single risk assessment covering all firms in the group; and
- multiple, linked risk assessments – one for each Material Business Unit (MBU) – plus a consolidated Group Summary Assessment (GSA).

Supervisors use a degree of flexibility when structuring assessments (particularly with complex groups). However, in general, the approaches are as follows:

Separate risk assessments

4.16 Under this approach, each firm will receive its own separate risk assessment. The impact score for each assessment will simply relate to the size of the firm concerned, and the probability rating for the assessments will relate entirely to the activities of the single firms attached to them.

Single group risk assessments

4.17 In this case, all firms in the group are combined under a single risk assessment. The impact score for the group will be the sum of all the impact scores for the firms in the group, and the probability rating for the assessment should relate to an aggregate of the businesses of all of the individual firms (in theory a weighted average).

Multiple, linked risk assessments (MBU/GSA structure)

4.18 Under this approach, the group is broken down into a number of ARROW risk assessments, but not necessarily along the lines of the legal entities within the group. Instead, the group is typically split along business and management lines (MBUs). Each of these MBUs receives its own risk assessment. In addition, a Group Summary Assessment (GSA) is created, which is a consolidated assessment of the entire group (including the businesses in all of the MBUs).

4.19 In choosing the scope of each MBU, the aim is to ensure that each risk assessment represents a coherent, meaningful portion of the business. So, each MBU would normally cover an area of the group's business which is:

- a discrete business line, for example operations in one or more particular sub-sectors of the financial services industry; and/or
- managed as a discrete unit by the group itself.

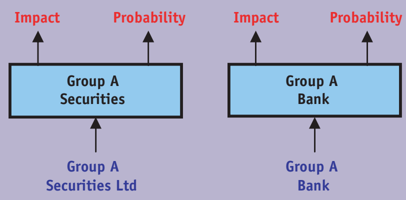
Example 1

Group A is based overseas. It has two UK operations: a subsidiary which conducts securities business and a branch of its home country bank. The two are managed separately, and are not consolidated for accounting purposes in the UK. So, we decide to assess the two as separate entities.

Ratings:

ARROW risk assessments:

Firms:



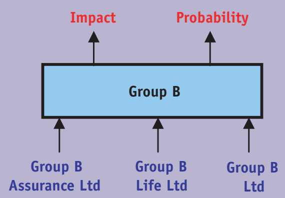
Example 2

Group B operates entirely in the UK. It contains three firms: Group B Assurance Ltd (a general insurer), Group B Life Ltd (a life insurer) and Group B Ltd (the parent company, which includes some banking and investment activities). The general and life insurance businesses are run
as separate units, although they are both subject to oversight from Group B Ltd's senior management. In total, the three *firms* have an *impact* rating of *medium high*. We decide to make a single *risk assessment* of the group.

Ratings:

ARROW risk assessments:

Firms:



Example 3

Group C is a major international banking group based in the UK.
The parent company is Group C plc, which directly undertakes some retail banking and investment banking activities. There are many subsidiary companies, including Group C Bank Ltd, Group C Asset Management Ltd and Group C Insurance Ltd. The group is organised into retail banking, investment banking, asset management and insurance divisions. The group is rated as *high impact*. We decide to use a *GSA/MBU* structure for the *risk assessment*.

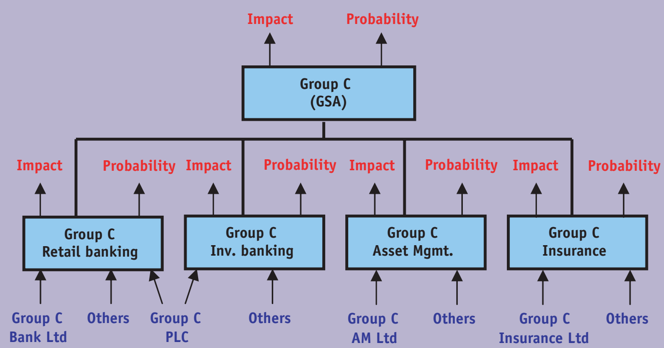
Ratings:

ARROW risk assessments:

Ratings:

ARROW risk assessments:

Firms:



Territorial Scope

4.20 We also consider questions of jurisdiction and territorial scope at this stage. These jurisdictional issues arise from the nature of our objectives, the international nature of some firms and the effect of EU directives and their influence on how we apply the framework.

4.21 We therefore consider the effect on firms of risks arising from overseas operations and we will have a wider remit where we have responsibilities defined by EU directives (for example, as a consolidated supervisor or as the home state regulator responsible for prudential matters). In these cases, we will work with overseas regulators where we are able. When we do work with overseas regulators in carrying out our responsibilities, we differentiate between them based on our assessment of their effectiveness. We assess overseas regulators on a variety of criteria, including adherence to generally accepted international regulatory standards (such as the Basel Core Principles) and accounting standards.

4.22 For a firm with overseas operations this means that, other things being equal, we will carry out more work, or seek to ring-fence the UK operations of overseas firms, where the overseas regulator is judged to be less effective.

Jurisdictional examples

1. A European bank operates through a branch in the UK and has business units engaged in retail brokerage and wholesale equities. We do not have responsibility for prudential oversight of this firm, since under the EU Banking Consolidation Directive the bank can branch into other EU countries with prudential responsibility residing with the home state regulator. However, we do have responsibility for liquidity for the branch (unless superseded by a global liquidity agreement), conduct of business in relation to regulated products sold to UK consumers, market abuse in the UK, financial promotion and money laundering conducted through the UK branch. In addition, since this firm is a significant player in the UK equities market, we will want to assure ourselves that the home state regulator's prudential supervision adequately addresses the risks to our market confidence objective that may arise from financial failure of the firm, even though we do not have direct responsibility for prudential risks.

2. A bank domiciled in a non-EEA country operates through a branch in the UK. Here, our prudential responsibility technically applies to the whole bank as it is the legal entity that is authorised. As such, in assessing the whole bank we will rely on the home country regulator, with considerable reliance (so less work for us) on strong regulators and proportionately less reliance (so more work for us) on less effective regulators.

Preliminary probability assessment

4.23 The next stage in our planning is to determine the preliminary probability scores. This will be based on our existing knowledge of your firm and the sector it operates in, including any specific issues and risks of which we are aware.

Information requests

4.24 At the planning stage of the assessment process, we will often write to firms, requesting specific information that we need to complete our planning work. Typical information we request might include:

- current business plans / strategy documents;
- group structure and organisation charts;
- financial statements;
- Board and other committee papers and minutes;
- risk management information; and
- compliance and internal audit plans and reports.

However, the nature of the information requested will vary, depending on the circumstances of your firm and the information we already hold.

Notification of the assessment

4.25 We will write to you at the early stages of planning our ARROW risk assessment to inform you of the assessment, and of the dates of any proposed on-site visit to your firm. This notification may include a request for information as described above.

Planning validation

4.26 Planning validation takes place after the discovery plan has been produced and before the risk assessment visit to the firm begins. The aim of planning validation is to ensure that the structure of the risk assessment and the scope of the discovery plan are appropriate before starting the visit. Following planning validation, we may ask you to provide additional information ahead of our visits.

What can I do to prepare for an ARROW risk assessment?

You can get an indication of what is likely to come up in the assessment from our pre-visit information request. Taking time to prepare this information will help ease the assessment. Simple things, such as ensuring you explain your firms’ abbreviations, can help understanding and save time in the long run.

You may find it useful at this stage to think about the types of areas we will be focusing on during our work, and consider how your business measures up in these areas. Take a look at our Financial Risk Outlook and Business Plan[3] – they will indicate the key areas that we are focusing on. In the same vein, make sure you keep up-to-speed with what the FSA Sector Leaders are saying as sector priorities also feed supervisory priorities, and recent 'Dear CEO Letters' and similar publications on our website.

At this stage, also remember to keep in touch with your relationship manager (if you have one) – relationship management is a two-way street, and an ARROW visit without surprises for the relationship manager is more likely to be a good visit for the firm. Be prepared to discuss the information request with us. It may be that you feel that some other documents might be more suitable for the FSA than the ones we requested. Normally we would not expect you to create documents especially for the visit; let us know if this is likely and is unduly burdensome.

Brief those who are likely to be interviewed. If they have a clear understanding of our aims and objectives this will help keep the interview focused. For those who have no previous experience of an ARROW assessment it may be useful to hold mock interviews.

Discovery – on-site visit to the firm

4.27 Following our planning activities, we will usually conduct an on-site visit to your firm, to fill gaps in our knowledge and investigate any specific areas that may present risks to our objectives.

4.28 Your firm's usual supervisory contacts (relationship managers) will normally carry out the risk assessment visit. The team may be supplemented with specialists where particular skills are needed – for example, our Risk Review Department specialists.

4.29 On occasions the risk assessment team may also include staff from other areas of the FSA. They may be there to carry out quality assurance work on the assessment process or they may be there for their own learning and development purposes. We will explain the team and their roles to you before the visit.

4.30 We make risk assessment visits to identify where your firm's business, or control structure, is likely to give rise to material risks to our statutory objectives. So, we may not make risk assessment visits when we feel we already have enough information to complete the risk assessment.

4.31 On-site risk assessment visits can involve any of the following:

- filling gaps in the information we already hold, including regular submissions sent to us (e.g. returns, complaints data), previous risk assessments, reviews of specific areas (e.g. by our Risk Review Department) and other information supplied by your firm;
- following up issues that have been identified from previous work or information; and

3 The Financial Risk Outlook and Business Plan are published annually and can be viewed on the FSA website.

- undertaking some limited review work to verify our views about certain aspects of your firm's control structure.

4.32 These visits involve interviews of key individuals in your firm – this will include non-executive directors. The number of individuals we would expect to see, and the time required overall for the on-site visits, will vary depending on the size and scope of your firm and the issues we have identified in our preliminary work. However, examples of the individuals that we may want to interview (who are likely to include approved persons for the key controlled functions, but are not limited to these) are set out in Appendix 4. This recognises that in some firms a single individual may perform more than one of the functions described. And these are the key risk groups that may be covered in interviews with these individuals – these are illustrative only.

What should I do during the visit?

It helps to save time if you agree with us before the visit whether there will be note takers in meetings. Be prepared to accept that for some meetings we may not feel a note taker is appropriate. Or we may feel a note taker from a certain area is inappropriate for that meeting (e.g. it would not be appropriate, for example, to discuss with the CEO his or her view of the Head of Compliance with a member of Compliance in the room).

Many firms have benefited from having an internal debrief meeting at the end of the day with their own staff who have been interviewed on what issues have come up during the interviews.

It would help us if you provided somewhere for us to work and carry out these interviews, but again don't be surprised if we ask to hold some meetings in interviewees' offices.

Encourage those who are being interviewed to bring key documents with them. Key documents would be management information, strategic documents and organisation charts. They should have detail to hand, but be ready to present the high-level information first. Remember that we assess risk in terms of business and control risk, and framing issues in this context can help get your points across clearly and concisely.

Evaluation – finalising and recording the assessment

4.33 After we finish our discovery work, including any on-site visits, we will complete our assessment of probability (against the structural model outlined in 3.18), and begin to develop an RMP for your firm. RMPs are programmes of actions designed to achieve certain regulatory outcomes. This means that we select a range of regulatory tools to achieve the outcome we want in relation to the issues we have identified during the risk assessment.

4.34 The RMP is driven from the risk assessment of your firm and is designed to address issues we have identified in a proportionate way. The type of regulatory tool we select depends on the severity and nature of the risk and the outcome we are seeking. In many cases, these tools will involve your firm taking action to achieve a particular outcome rather than us taking action. This is consistent with our approach to senior management responsibility.

4.35 We bear in mind the Principles of Good Regulation as we develop the RMP, and, in particular ensuring the most efficient and economic use of resources. This means we consider the overall costs of the programme as well as the most efficient tools to address specific issues. We ensure that the overall resources applied to an RMP are considered by the validation panels in the course of the challenge they provide.

4.36 We aim to ensure that the overall intensity of the RMP is proportionate to the risk that your firm poses both in terms of its impact and probability. It is also the case that the greater the reliance we can place on your firm's own functions, such as internal audit or risk management, the less the additional burden we place on your firm in terms of our visits, use of skilled persons and overall intensity of the RMP.

4.37 We will also set the regulatory period at this stage. This is the period between formal risk assessments and also the period for which the risk mitigation programme lasts. Remember that the period will vary depending on the risk profile of your firm.

Preliminary feedback – 'close-out meetings'

4.38 The purpose of preliminary feedback is for us to share significant findings from the risk assessment with your firm, before we formalise the RMP. It will usually be given when we complete the on-site risk assessment work. However, it may take place at a later time, particularly if we need time to arrive at our conclusions about the significant findings. For larger, complex groups we may hold more than one feedback meeting with different MBUs.

4.39 It is important to note that the preliminary feedback meeting provides an opportunity for your firm to correct any errors of fact, rather than negotiate the interpretation we may draw from these facts. Following the preliminary feedback meeting we may also seek to check certain key facts that are the basis for issues in the RMP that we develop.

Final Validation

4.40 When we have completed the risk assessment process and developed a RMP, we carry out an internal validation before we send you the results.

Communicating the results of the assessment to your firm

4.41 Following the internal validation, we send the results of our assessment to your firm in a letter. This sets out our view of the risks your firm poses and is accompanied by the RMP that sets out the issues we have identified and the actions to be taken by your firm (and us) to address these issues.

4.42 The ARROW letter forms part of our internal validation process. In response to feedback from firms and industry bodies, we have made significant changes to the format and style of the ARROW letters. We now send the letter to firms in draft form (for comment on factual accuracy) before we send the final letter to the firm's Board.

Within the letter itself

4.43 The communication is in two parts.

- A letter setting out:
  - key findings from our work;
  - our view of the main risks and controls within your firm – this provides the context for the firm specific issues we have identified;
- a high-level description of the risk assessment process;
- a summary of our rating of your firm against our risk model;
  - key issues and points of the RMP; and
  - the length of the regulatory period.
- An RMP setting out:
  - the issues identified by us and the authorised firms to which they relate;
  - the intended outcome we seek for each issue;
  - the action to be taken to achieve the intended outcome, specifying whether the action is to be taken by us or your firm; and
  - the timetable for the action.

4.44 The letter to your firm will be addressed to the Board of directors, or equivalent body. This is done to emphasise the importance we place on senior management's responsibility for setting up and operating effective internal controls and running your firm's business in compliance with regulatory requirements. In line with this approach, our preference is for a bias in RMPs for action to be taken by your firm rather than us to achieve specific intended outcomes and management being responsible for ensuring that the action is taken. In addition, a copy of the letter will be sent to the individual, or individuals, within your firm who are the primary point of contact with us.

4.45 Additionally, if your firm is a branch or subsidiary of an overseas-based organisation we will send the risk assessment letter and RMP as follows:

- if your firm is an inward passported entity from an EEA country, we will send the risk assessment letter to the UK General Manager, or equivalent, with a copy for the attention of the individual in your firm's head office responsible for the UK branch;
- if your firm is a branch of an overseas entity from a non-EEA country, we will send the letter for the attention of the individual in the head office responsible for the UK branch with a copy to the UK General Manager, or equivalent; and
- if your firm is a branch or subsidiary, we will send a copy of the letter to the home country or consolidated supervisor.

4.46 We will ask your firm to respond formally to the letter confirming you will follow the RMP. The letter is confidential to your firm, but we do ask you to copy it to your professional advisers, such as auditors and actuaries.

4.47 If your firm disagrees with the findings of the risk assessment including concerns over factual inaccuracies, or the proposed actions in the RMP that remain unresolved following discussions at the feedback meeting, you should formally raise these with your supervisor. He or she will consider the areas of disagreement and respond to your firm. If your firm feels that the supervisor is not being responsive to reasonable points, you should, in the first instance, contact the supervisor's manager or head of department.

4.48 If your firm declines to carry out the actions in the RMP, we will consider the use of other regulatory tools. For example, in the case of authorised firms, we may require a skilled person report under section 166 or a formal request for information under section 165 of FSMA. If we believe the issue is still not addressed, we will consider whether your firm has breached any rule, principle or Threshold Condition (recognition requirement in the case of recognised bodies) and consider whether other formal action should be taken, such as, in the case of authorised firms, enforcement action. We would make the decision to take formal action using our usual decision-making processes which have in-built appeal mechanisms up to, and including, the Financial Services and Markets Tribunal.

What should I do at this stage?

The ARROW letter forms part of the FSA's internal validation process. Following final validation, you will be sent a draft ARROW letter and RMP to check for factual inaccuracies.

When you receive the draft ARROW letter, make sure you understand the issues raised in it (prioritisation and desired outcome etc, should be clearly stated). Also, make sure you understand the overall rating of your firm (impact, business risks and controls). If things are not clear, then ask your Relationship Manager (if you have one) for clarification.

Each issue within the RMP will be explained in terms of the risk it poses, the outcome we would like to achieve, the tool we would like to use and the timetable for completion. If you feel you can deliver the desired outcome in a different way (i.e. in a more efficient, economic or effective one) then please let us know.

You have two weeks to respond to the draft ARROW letter. You should already have discussed the issues identified during the close-out meeting, and this should help to avoid debates around supervisory judgements at this stage. If you respond with valid comments on matters of factual accuracy, these will be considered and amendments made as appropriate.

Once all changes have been agreed (or if no response is received from the firm within the agreed time period of sending the draft ARROW letter), we will send the final letter and RMP to your Board of directors.

4.49 We feel it is in the interests of both regulator and regulated firm that the ARROW risk assessment is as appropriate to the firm's risk profile as possible. Although it may be too much to hope that it is an experience that will always be enthusiastically welcomed, we hope the changes we are making will foster more understanding and cooperation. This will lead to a more efficient and effective process and help make us easier to do business with.

Follow-up work – carrying out the Risk Mitigation Programme

4.50 In the period after we send the ARROW letter and RMP to your firm, the actions set out in the RMP should be undertaken by those responsible for them. If the action has been completed and the intended outcome achieved, we can close the issue. If the action has not been carried out or the action has not resulted in the intended outcome, or a reduction in the level of risk to enable us to close the issue, we may consider setting a new action. We will either communicate this in a new RMP or if, for example, there is only one or two issues, we may communicate the action, intended outcome and timescales in a separate letter to your firm.

4.51 Reviews can also take place when the risk assessment needs to be updated as a result of specific events affecting your firm. These could include:

- changes in the external environment that materially affect your firm;
- proposed or actual changes to your firm's business activities, strategy, infrastructure or management; and
- the successful achievement of intended outcomes in the RMP which, other things being equal, should lead to an improvement in the risk profile.

4.52 In addition, there may be cases where we need to review the effectiveness of regulatory tools in dealing with specific issues, for example where a tool has not delivered the outcome sought. In these cases, and where specific events adversely affect your firm, the review may lead to changes to the risk assessment and RMP, which are then notified to your firm.

4.53 There may also be cases where identified risks escalate to the point where we need to consider using other remedial tools, such as enforcement action in the case of authorised firms. This could happen where there is a potential breach of the Threshold Conditions, rules or other relevant legislation.

4.54 During the regulatory period we will monitor the RMP and follow up the actions within it to ensure that these, and the intended outcomes, are achieved within the timeframe set.

What should you do at this stage?

You should set up a process to monitor progress against the RMP and allocate responsibilities for the actions.

If the RMP is materially slipping, you should let us know.

Ongoing monitoring and response to changes in risk

4.55 The regulatory period (the time between sending the draft ARROW letter and RMP to the firm, and sending the next draft ARROW letter and RMP on re-assessment) will have been set as part of the last full risk assessment. We will have stated this in the ARROW letter we sent to you.

4.56 During this period, we conduct specific activities designed to identify emerging risks and changes to those we have already identified. These activities include:

- **Baseline monitoring –** this is undertaken for all firms. It involves us analysing a firm's financial and other returns, checking compliance with notification requirements and regulatory transactions, such as processing waivers and variations of permission applications. Breaches and other indicators of risk may be followed up by the supervisory team, where one exists. For small (low impact) firms, a case team will perform any follow-up work needed. These firms do not generally have a dedicated relationship manager.

- **Close and continuous –** for high-impact firms only, we apply a closer monitoring regime. We still apply baseline monitoring activities to them; however, in addition, we have a planned schedule of contacts with the firm throughout the regulatory period. These allow the supervisory team to meet the firm's senior management and control functions regularly.

Close and continuous monitoring

4.57 The reason we do close and continuous work is threefold:

- to ensure that we identify emerging risks promptly. In the largest firms, the harm done by (i.e. impact of) an issue crystallising will be too great if we fail to identify and mitigate it promptly;

- to ensure that our assessment of the degree of relevance we can place on senior management and the control functions remains valid through the regulatory period. In the largest firms, we generally place significant reliance on the firm itself to manage the risks (and tell us of new and increased risks). So, we need to be confident that the high-level controls perform adequately between periodic ARROW risk assessments. Our meetings with senior management and the control functions help us to keep our assessments up-to-date; and

- since the largest entities we regulate can be complex, and their operations can change rapidly through takeovers, mergers etc, it is important that we are aware of developments during the regulatory period. Otherwise, the time and effort needed to get reacquainted with the firm's operations in preparation for the next periodic ARROW risk assessment would be excessive.

What should I do at this stage?

At all times, we expect your firm to keep us informed of significant events that may affect our risk assessment (Principle 11). In fact, in our risk assessment we will take into account the attitude and performance of your firm towards keeping us informed of events in advance, wherever possible. These events are set out in SUP 15 of the Handbook but, as examples, they may include the following:

- your firm becoming aware that an employee has committed a fraud against one of its customers;
- any significant failure in your firm's systems or controls;
- your firm starting to provide a new type of product or service; and
- significant breach of a rule.

These events may lead us to update our risk assessment. We may also update our risk assessment as a result of other factors, such as changes to the environment within which your firm operates or the results of thematic work we carry out across a number of firms. In these cases, we will discuss with you changes to our risk assessment before sending you a letter explaining any material changes to your RMP.

Involvement in thematic work

4.58 During the regulatory period, your firm may be subject to thematic work that we undertake on specific issues. Where we undertake such work we will endeavour to coordinate this with your firm-specific work that is set out in the RMP.

4.59 For small firms which have no dedicated relationship manager, almost all our on-site supervisory activity is carried out on a thematic basis. Thematic regulation also plays an important role in the supervision of larger firms. This may range from a limited piece of work looking at a small peer group of firms potentially facing similar issues through to much larger exercises covering relevant firms right across the retail and wholesale markets.

4.60 Thematic work looks at a particular issue or set of issues across a sample of firms. It helps us identify the scale and nature of risks which emerge from intelligence and surveillance, putting us in a position to take a risk-based and proportionate view as to whether, and if so to what extent, regulatory intervention is appropriate.

4.61 The decision to select a firm takes into account a number of factors, including how many – and what type of – firms are active in the market or sector that we are interested in.

4.62 It is often desirable to find a sample of firms which is representative of the different sizes or structures in the relevant market. This may include some firms which we think are likely to set the highest standards in terms of systems and controls and practices so that we and others can learn from observed good practice. Because a firm has been selected does not imply that we have already decided that there is a problem in that firm. However, if a supervisor has concerns about a firm's controls in a particular area, including the firm may be one way of testing whether such concerns are justified.

Communicating the results of major thematic work

4.63 In the light of feedback from trade bodies and others, we have made some changes to the process for communicating the outcomes of major pieces of thematic work.

4.64 Briefing trade and consumer bodies about the major pieces of thematic work planned every six months will provide an opportunity to learn about our overall agenda. We will also make this material available on our website. We will also contact smaller trade associations who might have an interest in one particular review as part of our small firms' communications strategy.

4.65 Before each piece of major thematic work begins, we will generally inform the major trade associations of the scope, purpose and timing. We may not always do this if mystery shopping is involved, particularly if it is to be undertaken in relatively concentrated sections of the market.

4.66 We will publish information on our website on how we run thematic visits to help firms know what to expect at different stages in the process. In particular we would like firms to be aware of the following:

4.67 Thematic work is carried out to assist us in performing our regulatory functions: it is not 'optional'. Although the primary purpose is often to assess current industry practice, this does not preclude the possibility of further investigation as a result of work carried out at an individual firm. Such investigation may be undertaken by Enforcement and may or may not lead to disciplinary action.

4.68 Following a visit, a firm will normally receive feedback on our findings. Often that will be via a close-out meeting which will give initial feedback on what we have found and any immediate areas of concern which might merit urgent remedial action. We will reserve the right – even if the firm carries out remedial action as a result of this feedback - to decide at a later stage that what we have discovered is so serious that it justifies referral to Enforcement for investigation. At the close-out stage we will not normally be in a position to give the firm any indication of where it stands compared to its peers. In most cases, feedback would not be in writing at this stage. That will happen later.

4.69 As well as writing to the trade bodies, we will write to firms that were included in the sample of visits, explaining our conclusions, handling plans and, if appropriate, anything concerning their individual positioning in relation to others. This is to help firms understand the positioning of the work prior to publication and is not intended to invite comments. If we have decided to refer firms to Enforcement for investigation we will inform them by this stage.

Letter template (Full ARROW)

Direct line:

Local fax:

Email:

[*DATE*]

Board of Directors

Our Ref:

[*FIRM/GROUP NAME*]

[*FIRM/GROUP ADDRESS*]

For the attention of [*NORMALLY NAME OF CEO*]

Dear Sirs

RISK ASSESSMENT – [*ASSESSMENT NAME*]

As you are aware, we conducted our risk assessment of [*ASSESSMENT NAME*] during [*DATE*]. In this letter we summarise our findings and advise you of the actions we expect you to take.

We assessed your firm by applying our risk assessment framework – ARROW– [*which also includes our pillar 2 Supervisory Review and Assessment Process (SREP)/Individual Capital Adequacy Standards (ICAS) methodology*]. For an explanation of ARROW [*and the giving of Individual Capital Guidance (ICG)/ICAS*] please see Appendix 1. Appendix 2 sets out the scope of the risk assessment, and the resulting impact and probability scores [*and the areas where we have taken a different view to your Internal Capital Adequacy Assessment Process (ICAAP) in giving ICG*]. We also attach the risk mitigation programme as Appendix 3.

Overall assessment

[ ]

Key issues

These are the key issues that arose from our risk assessment. We have set them out according to our view of the risk they pose, with the most significant risk first.

[ ]

Risk mitigation programme

The risk mitigation programme, which sets out what steps you need to take, is subject to review if there is any significant change or potential change to [*ASSESSMENT NAME'S*] business or control structure, or the nature of the issues identified. In line with your general obligations under the FSA Handbook, you should notify us of any such changes.

Further assessment

Firm specific work

[ ]

Cross-firm work

[ ]

Close and continuous work

[ ]

Individual Capital Guidance

We have reviewed the level of capital you should hold as part of this assessment. We have concluded that [*an additional amount of capital would be appropriate for your firm/the ICG can remain unchanged.*] The individual capital guidance for your firm is to hold:

- [*capital resources*] in excess of [150% of your pillar 1 requirement/£100m].

The full details of the ICG [*and those areas where we have taken a different view on the risks in your ICAAP*] are contained within Appendix 2. [*Certain of these areas are linked to specific actions set out in the risk mitigation plan in Appendix 3. We would expect that once these actions are completed we would be able to revise our ICG accordingly.*]

Individual guidance on liquidity

We have also reviewed the level of liquidity you should have as part of this assessment. Based on our review the individual liquidity guidance for your firm is:

[ ]

Individual Capital Adequacy Standards

[ ]

Period to the next risk assessment

On the basis of our current assessment we plan to carry out and communicate the next full risk assessment in [*X*] months [*although we will review your ICAAP within the next year*]. It is important to note that we may undertake further work at any time, or expect [*ASSESSMENT NAME*] to undertake additional work if, for example, additional risks are identified or crystallise. In such cases, we will communicate any significant changes to our risk assessment of [*ASSESSMENT NAME*] to you as they arise.

Confidentiality and response to this letter

This letter has been prepared for regulatory purposes only and its contents should be treated as confidential. You should copy this letter to your auditors but please discuss with us if you intend to disclose it to any other third party. This is because its contents could be misunderstood or misinterpreted if disclosed in another context. We will send a copy of this letter to [*NAME OF OVERSEAS REGULATOR and BOARD OF THE PARENT UNDERTAKING*].

Please confirm to me by [*DATE*] that the Board of [*ASSESSMENT NAME*] has considered this letter and has agreed to implement the sections of the risk mitigation programme in Appendix 3 which require action by you.

Yours faithfully

Appendix 1 (to Full ARROW letter)

ARROW risk assessment methodology

The FSA's risk assessment process – ARROW – is a high-level review aimed at assessing the significance of a particular risk posing a threat to our statutory objectives. It is not an examination or audit, and may not identify all of the risks associated with current and proposed activities. The ultimate responsibility for identifying and assessing risks remains with the Board of Directors.

Our four statutory objectives were established by the Financial Services and Markets Act 2000:

- **'Market Confidence'** – Maintain confidence in the UK financial system;
- **'Public Awareness'** – Promote public understanding of the financial system;
- **'Consumer Protection'** – Secure the appropriate degree of protection for consumers; and
- 'Reduction of Financial Crime' - Reduce the scope for financial crime.

The ARROW framework is at the core of our risk-based approach to regulation. Using the ARROW process, we consider the particular risk your firm might pose by assessing:

- the **impact** on our statutory objectives if the particular risk actually materialised; and
- the **probability** that the particular risk will materialise.

Individual Capital Guidance

The FSA's SREP is not an examination or audit and may not identify all of the risks associated with your current and proposed activities; but is designed to enable us to supervise firms appropriately and provide ICG.

ICG reflects the minimum amount of and quality of capital that we consider is needed for your firm and group to meet GENPRU 1.2.26R (adequate financial resources). The ICG takes into account the nature and the inherent risks of the business, and is underpinned by your own assessment of the capital you require (your ICAAP); but the giving of ICG is also one of the tools at the FSA's disposal to address specific concerns arising out of our risk assessment where we believe that there is the potential for an issue to have a material financial impact.

The FSA's issuance of the ICG should not be seen as an alternative to the responsibility of a firm's management to monitor and assess the level of capital appropriate to its needs.

You can rely on the comments we have made in this letter when you are dealing with the FSA. In making these comments we have relied on you giving us complete and accurate information, and have taken into account the environment in which your organisation operates. Please be alert to any changes, including to our rules that might affect your position. Our views cannot affect the rights of third parties such as those of your clients.

Individual Capital Adequacy Standards (ICAS)

Our approach to ICAS is set out in PS 04/16-Integrated Prudential sourcebook for insurers. Under the ICAS framework, a firm is required to make an individual assessment of its capital needs. In addition, we will give most firms individual capital guidance (ICG) reflecting our own view of what an adequate level of capital is for their particular business. ICG is set taking into consideration capital consistent with a 99.5% confidence level over a one-year period or, if appropriate to the firm's business, a lower confidence level over a longer period. We consider that, as the ICG gives our view of what an adequate level of capital is for a particular firm, it represents a regulatory intervention point.

Appendix 2 (to Full ARROW letter)

Scope of assessment

The scope of the risk assessment includes:

FSA Firm Ref No	Firm Name
<Centred>	<Left aligned>

Overall assessment

The information below shows our assessment of the risks posed by [*ASSESSMENT NAME*] to our statutory objectives.

Change from last assessment

[ ]

Impact assessment

Impact	[*RATING*]

Impact is designed to capture the size of the firm or group, the potential harm it could do to our statutory objectives. It is measured for each firm attached to the risk assessment based on quantitative information supplied by your firm as part of its regulatory reporting which varies depending on the sector in which the firm operates. Impact scores for each firm are combined to produce a total impact score for the risk assessment.

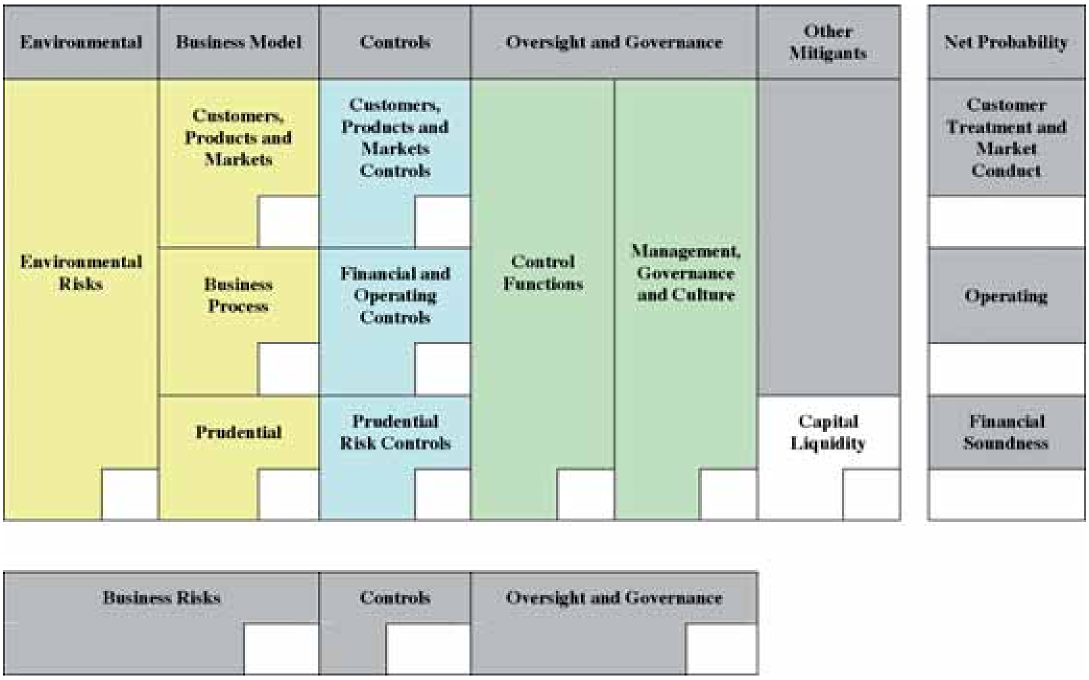
Probability assessment

The probability scores reflect our assessment of the likelihood that [ASSESSMENT NAME] will pose risks to our statutory objectives. The rating of probability associated with a risk assessment uses a model based on three overall ratings:

- business risk – the risks inherent in the firm's business model and the environment in which it operates;
- controls – the controls the firm has in place to mitigate the business risk;
- oversight and governance – the high-level controls and arrangements the firm has in place to oversee the effectiveness of its business and to mitigate its risks.

The ten risk groups model the way the various business risks and control risks interact in the context of a firm. The probability scores recorded for these ten risk groups are aggregated in the matrix below in two dimensions:

- across each of the three rows, to produce a net risk after the application of controls and other mitigants to the inherent business risks; and
- down each of the three columns, to produce average scores for business risk, direct controls, and oversight and governance.



Please note that a highly-scored business risk will not automatically lead to a material risk to our statutory objectives. We assess the associated control risks and oversight and governance to establish whether there is a material net risk. If controls and oversight and governance are also highly scored, this may result in an issue in the risk mitigation plan with associated mitigating action.

Individual Capital Guidance

The individual capital guidance for your firm is to hold:

- total capital resources of at least [*150%*] of the capital resources requirement; and
- [*general capital resources of at least [90%] of the capital resources requirement plus £100m]*]

The individual capital guidance for your UK consolidation group is to hold:

- total capital resources of at least [*150%*] of the consolidated capital resources requirement, and
- [*general capital resources of at least [90%] of the consolidated capital resources requirement plus* [*£100m*]].

[*The guidance to hold an extra amount of [£100m] (i.e. extra above [90%] of the capital resources requirement) has been based on our review of the stress test you have undertaken in accordance with BIPRU 4.3.34G [as modified by your IRB waiver] and our view of the firm's likely financial position and management actions you would take in the event of an economic downturn. If you consider the circumstances and economic environment changes in the period before we next review your ICAAP assessment then we would be prepared to consider revising our ICG based on appropriate evidence.*

However, we would not normally expect to take a view on the broad economic environment in which you operate and your current position in the cycle more frequently than annually, unless exceptional circumstances have occurred.]

We would expect you to inform us as soon as your capital falls, or is expected to fall, below the level set by the ICG with the reasons why and your proposed response.

Adjustments to the ICAAP in arriving at ICG

In forming our view of the appropriate ICG and individual guidance on liquidity to give, we have taken into account your ICAAP; and set out below those matters where we have formed a different view, along with our reasons.

Letter template (for ARROW Light)

Direct line:

Local fax:

Email:

[*DATE*]

Board of Directors

Our Ref:

[*FIRM/GROUP NAME*]

[*FIRM/GROUP ADDRESS*]

For the attention of [*NORMALLY NAME OF CEO*]

Dear Sirs

RISK ASSESSMENT – [*ASSESSMENT NAME*]

As you are aware, we conducted our risk assessment of [*ASSESSMENT NAME*] during [*DATE*]. In this letter we summarise our findings and advise you of the actions we expect you to take.

We assessed your firm by applying our risk assessment framework – ARROW– [*which also includes our pillar 2 Supervisory Review and Assessment Process (SREP)/Individual Capital Adequacy Standards (ICAS) methodology*]. For an explanation of ARROW [*and the giving of Individual Capital Guidance (ICG)/ICAS*] please see Appendix 1. Appendix 2 sets out the scope of the risk assessment, and the resulting impact and probability scores [*and the areas where we have taken a different view to your Internal Capital Adequacy Assessment Process (ICAAP) in giving ICG*]. We also attach the risk mitigation programme as Appendix 3.

Overall assessment

[ ]

Key issues

These are the key issues that arose from our risk assessment. We have set them out according to our view of the risk they pose, with the most significant risk first.

[ ]

Risk mitigation programme

The risk mitigation programme, which sets out what steps you need to take, is subject to review if there is any significant change or potential change to [*ASSESSMENT NAME'S*] business or control structure, or the nature of the issues identified. In line with your general obligations under the FSA Handbook, you should notify us of any such changes.

Further assessment

Firm specific work

[ ]

Cross-firm work

[ ]

Close and continuous work

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We have reviewed the level of capital you should hold as part of this assessment. We have concluded that [an additional amount of capital would be appropriate for your firm/the ICG can remain unchanged.] The individual capital guidance for your firm is to hold:

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[ ]

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Please confirm to me by [*DATE*] that the Board of [*ASSESSMENT NAME*] has considered this letter and has agreed to implement the sections of the risk mitigation programme in Appendix 3 which require action by you.

Yours faithfully

Appendix 1 (to ARROW Light letter)

ARROW risk assessment methodology

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Our approach to ICAS is set out in PS 04/16-Integrated Prudential sourcebook for insurers. Under the ICAS framework, a firm is required to make an individual assessment of its capital needs (ICA). In addition, we will give most firms individual capital guidance reflecting our own view of what an adequate level of capital is for their particular business. ICG is set taking into consideration capital consistent with a 99.5% confidence level over a one-year period or, if appropriate to the firm's business, a lower confidence level over a longer period. We consider that, as the ICG gives our view of what an adequate level of capital is for a particular firm, it represents a regulatory intervention point.

Appendix 2 (to ARROW Light letter)

Scope of assessment

The scope of the risk assessment includes:

FSA Firm Ref No	Firm Name

Overall assessment

The information below shows our assessment of the risks posed by [*ASSESSMENT NAME*] to our statutory objectives.

Change from last assessment

[ ]

Impact assessment

Impact	[*RATING*]

Impact is designed to capture the size of the firm or group, the potential harm it could do to our statutory objectives. It is measured for each firm attached to the risk assessment based on quantitative information supplied by your firm as part of its regulatory reporting which varies depending on the sector in which the firm operates. Impact scores for each firm are combined to produce a total impact score for the risk assessment.

Probability assessment

The probability scores reflect our assessment of the likelihood that [*ASSESSMENT NAME*] will pose risks to our statutory objectives. The rating of probability associated with a risk assessment uses a model based on three overall ratings:

- business risk – the risks inherent in the firm's business model and the environment in which it operates;
- controls – the controls the firm has in place to mitigate the business risk;
- oversight and governance – the high-level controls and arrangements the firm has in place to oversee the effectiveness of its business and to mitigate its risks.

In arriving at our ratings of each of the above areas we considered a number of underlying areas of risk.

The rating for business risk is a result of consideration of the following risk groups:

- Environmental risks;
- Customers, Products & Markets;
- Business process; and

- Prudential.

The rating for controls is a result of consideration of the following risk groups:

- Customers, Products & Markets controls;
- Financial & Operating Controls; and
- Prudential Risk Controls.

The rating for oversight and governance is a result of consideration of the following risk groups:

- Control Functions; and
- Management, Governance and Culture.

The overall ratings for [ASSESSMENT NAME] are:

Business Risks	Controls	Oversight and Governance

Please note that a highly-scored business risk will not automatically lead to a material risk to our statutory objectives. We assess the associated control risks and oversight and governance to establish whether there is a material net risk. If controls and oversight and governance are also highly scored, this may result in an issue in the risk mitigation plan with associated mitigating action.

Individual Capital Guidance

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The individual capital guidance for your UK consolidation group is to hold:

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- [*general capital resources of at least [90%] of the consolidated capital resources requirement plus [£100m*].

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We would expect you to inform us as soon as your capital falls, or is expected to fall, below the level set by the ICG with the reasons why and your proposed response.

Adjustments to the ICAAP in arriving at ICG

In forming our view of the appropriate ICG and individual guidance on liquidity to give, we have taken into account your ICAAP; and set out below those matters where we have formed a different view, along with our reasons.

Example of a risk mitigation programme (RMP)

Nature of issue	Firms to which issues relate	Intended outcome	Action	Action by
The firm's expertise in e-commerce is limited. As a result the rollout of a website could led to a heightened risk of cyber crime affecting the firm or its customers if robust IT security is not incorporated.	ABC XYZ Ltd	IT security measures in place that protect the firm and its customers from the risk of fraud.	FSA to visit website project management to gain a greater understanding of the IT security controls for the website, how these have and will be tested and what external advice has been sought.	29/08/06
The MLRO has stated that insufficient Know Your Customer (KYC) information is obtained on new clients. This leaves the firm potentially vulnerable to money laundering.	ABC XYZ Ltd	Sufficient KYC information is obtained on all clients (new and existing) to mitigate the risk of money laundering being conducted through the firm.	Firm to review its account opening procedures and address any deficiencies.	14/10/06
Firm does not have adequate monitoring of sales force training and in addition under-resourcing of the compliance function has led to inadequate compliance monitoring of sales practices. As a result, the firm is not able to ascertain which of its customer base is suitable to be sold the more complex investment products it is developing.	ABC XYZ Ltd	The sales force sells complex products only to suitable customers and there is a compliance function that is staffed, and has policies and procedures that suit the business of the firm.	Firm to review its monitoring of sales force training and address any issues identified. FSA to require a Skilled Person report under Section 166 of FSMA to review the policies, procedures and effectiveness of the compliance function. Firm to address any issues identified.	23/02/07
Firm does not have a risk-based internal audit function leading to several higher risk functions not being reviewed in a timely manner.	ABC XYZ Ltd	There is an internal audit function in place that is able to provide assurance to the Board and senior management on the key risks faced by the firm.	Firm to draw up and implement a risk-based audit methodology using external expertise as appropriate. FSA specialist team visit to gauge effectiveness of revised methodology.	05/10/07
There is no systematic framework within the firm for the identification, monitoring or management of operational risk.	ABC XYZ Ltd	The Board/senior management is aware of the key operational risks faced by the firm at all times and ensures controls are in place to mitigate them.	Firm to introduce a process to ensure operational risks are identified, monitored and controlled.	12/12/07

Appendix 3

Ideas on further disclosure of information

As part of our drive to improve the communication of our risk assessment work with firms, the main document contains the changes we have made in relation to the specific risk assessments affecting firms and our thematic work (see Chapter 4).

In this appendix, we set out some of our early ideas for further disclosure of our process and of aggregated information in relation to peer groups and sectors.

Process

Further information on the ARROW process will be made available on the FSA's website in due course. This will include additional information on the ARROW Firms risk model, so that firms will be able to use the model for their own risk assessment, should they wish to do so. There will also be a need to keep stakeholders informed of changes to the position as set out in the main document, for example, if we decide to change the core areas of the assessment (see 3.33 and Annex 1).

Aggregated information

It is our intention to include peer-group information where possible to firms as part of the feedback when they will receive from our risk assessment (see 4.41). Of course, one of the paramount considerations in such disclosure is that the components of the aggregation should not be discernible in order to maintain confidentiality. We will consider making some form of aggregated data more widely available – for example, through publication on the FSA website. This may take the form of an aggregated risk profile or it may be a commentary on our findings from the risk assessment work we have carried out.

Typical individuals interviewed and risk groups discussed in risk assessment visits

Position	Environmental Risks	Customers, Products & Markets	Customers, Products & Markets Controls	Business Processes	Financial & Operating Controls	Prudential Risks	Prudential Risk Controls	Control Functions	Management, Governance & Culture	Excess Capital & Liquidity
	ARROW Risk Group									
Chairman	✓							✓	✓	
Chief Executive	✓							✓	✓	✓
Chairman of Audit Committee					✓			✓	✓	
Non-Executive Director									✓	
Chief Financial Officer				✓	✓	✓	✓			✓
Head of Risk Management		✓	✓			✓	✓	✓		
Head of Business Unit	✓	✓	✓	✓	✓	✓	✓		✓	
Chief Investment Officer	✓					✓	✓			
Head of Internal Audit			✓		✓		✓	✓		
Chief Actuary						✓	✓			✓
Head of Compliance		✓	✓	✓	✓	✓	✓	✓	✓	
Head of Operations				✓	✓					
Head of IT				✓	✓					
Head of HR			✓	✓	✓					
Head of Sales & Marketing		✓	✓							
Head of Regulation (Recognised Body)			✓	✓	✓	✓	✓	✓	✓	✓

Risk groups and risk elements

Business Risk Elements

	Risk Groups		Risk Elements
1	Environmental Risks	1	Economic Environment
		2	Legislative/Political Environment
		3	Competitive Environment
		4	Capital Market Efficiency
2	*Customers, Products & Markets*	*5*	*Institutional Client/Counterparty Characteristics*
		6	*Retail Customer Characteristics*
		7	*Institutional Product/Market Characteristics*
		8	*Retail Product Characteristics*
		9	*Distribution Channels*
		10	*Conflicts of Interest*
3	Business Process Risks	11	Litigation/Legal Risk
		12	People Risk
		13	IT Systems
		14	Other Business Process Risks
		15	Structure & Ownership
4	Prudential Risks	16	Credit Risk
		17	Market Risk
		18	Operational Risk
		19	Liquidity Risk
		20	Insurance Underwriting Risk
		21	Element 2 Risks
		22	Element 3 Risks
		23	Element 4 Risks

Italics = core area

Control risk elements

	Risk Groups		Risk Elements
5	Customers, Products & Markets Controls	21	Accepting Customers
		22	Sales Process & Product Development
		23	Post Sale Handling of Customers/Counterparties
		24	Market Conduct Controls
		25	Membership Arrangements for RIEs
		26	Conflict of Interest Management
6	Financial and Operating Controls	27	Clearing and Settlement Arrangements
		28	Financial Controls
		29	IT Security and Controls
		30	Policies, Procedures and Controls
		31	Human Resources Controls
		32	*Security of Client Assets or Client Money*
		33	Business Continuity Planning
7	Prudential Risk Controls	34	Credit Risk Controls
		35	Market Risk Controls
		36	Operational Risk Controls
		37	Liquidity Risk Controls
		38	Insurance Risk Controls
		39	Element 2 Controls
		40	Element 3 Controls
		41	Element 4 Controls
8	*Control Functions*	*42*	*Compliance*
		43	*Internal Audit*
		44	*Enterprise-wide Risk Management*
9	*Management, Governance and Culture*	*45*	*Culture & Management*
		46	*Corporate Governance*
		47	*Relationship with Regulators*
		48	*Strategic Planning*
		49	*Relationship with Rest of Group*
10	*Capital & Liquidity*	*50*	*Adequacy of Capital*
		51	*Adequacy of Liquidity*
		52	*Adequacy of PII*

Italics = Core area

Current impact metrics

ARROW II currently uses the same base data that was utilised in ARROW I to calculate impact scores for individual firms. The type of data used is driven by the activities that the firm undertakes. A specific denominator is applied to the raw data to arrive at a basic impact score.

Examples of the data used and denominators applied for various types of firms are given in the table below:

Firm Activity	Base metric(s)
Banks and building societies	Total assets or liabilities £90,000,000 Sector-weighted deposits £32,500,000
Credit unions	Number of members 5,000
Life assurers	Total assets or liabilities £180,000,000
Friendly societies	Total assets or liabilities £180,000,000 Number of members 10,000
General insurers	Gross premium income £10,000,000
Advising, arranging and dealing as agent (equities and derivatives)	Total assets or liabilities £180,000,000 Daily trade volume 125 trades Daily trade value £75,000,000
Advising, arranging and dealing as agent (pensions and other products)	Annual turnover £1,250,000
Investment management firms (holding client money)	Funds under management £400,000,000

Note that, for some types of firms, more than one base metric may be considered in arriving at the basic impact score for the firm.

The basic impact scores calculated as described above are then subject to a weighting multiplier, which depends on the industry sub-sector to which the firm belongs. This produces a final impact score for the firm in question.

This final impact score is then translated into an impact category: high, medium-high, medium-low or low. The boundaries between each category are set in terms of the numerical impact scores.

Both the values of the sub-sector multipliers and the impact category boundaries are set by FSA senior management from time to time, to ensure that the risk model continues to reflect their current priorities and risk appetite. (This regular calibration process is described in 3.33 above, "Adjustments made to the model to reflect FSA's risk appetite".)

The current boundaries between the impact categories are as follows:

Impact category	**Impact score** (after sub-sector weighting)
Low	<5
Medium-low	≥5 <20
Medium-high	≥20 <300
High	≥300

Risks to FSMA Objectives (RTOs)

Risk to Objectives	Description
Financial Failure (FF)	The risk to the market confidence and consumer protection statutory objectives - arising from the insolvency or illiquidity of a firm. For high-impact firms/groups this may also include financial losses that, while short of causing failure, can still adversely affect market confidence because of the scale of these firms/groups in relation to particular markets.
Misconduct and/or mismanagement (MM)	The risk to the consumer protection and market confidence statutory objectives of mis-selling or mis-handling of regulated products by firms, of inappropriate behaviour by firms in their wholesale market activities, or other mismanagement of their operations.
Consumer understanding (CU)	The risk to the consumer protection and public awareness statutory objectives arising from possible lack of understanding by consumers of regulated products bought from firms.
Market quality (MQ)	The risk to the market confidence and consumer protection statutory objectives arising from possible deterioration in a market's function. This channel will only be relevant to certain authorised firms and recognised bodies that are important in the operation of UK markets.
Fraud or dishonesty (FD)	The risk to the financial crime and market confidence statutory objectives of the incidence of fraud or dishonesty – either within firms, or by external parties defrauding firms.
Market abuse (MA)	The risk to the financial crime, consumer protection and market confidence statutory objectives of market abuse conducted by firms.
Money laundering (ML)	The risk to the financial crime and market confidence statutory objectives of money laundering conducted through firms.

ARROW Service Standards

Our Performance Account provides you with information about the areas of our service that we measure, how we are performing against these measures and our monitoring of customer satisfaction. Our standards apply to a range of our services, including how we deal with telephone enquiries, correspondence and applications.

On 1 April 2006 , we introduced a further three new standards. The first performance figures for these standards will be given in the next update to our Performance Account in October 2006 – as we publish quarterly updates.

The new standards relate to:

- replying to correspondence received from firms; (CM1.1)
- notifying firms of our findings following an "ARROW" discovery visit to a firm; (CM1.2) and
- timely payment of invoices. (CM10.1)

Service Standard [CM1.2]

To provide a draft letter of our findings and recommendations following an "ARROW" discovery visit to a firm.

What does this standard mean?

We aim to provide firms with a draft Risk Mitigation Programme (RMP) letter as soon after the completion of a discovery visit as possible. Once the final close-out meeting has been held, a discovery visit is deemed to be complete and a draft RMP letter can start to be prepared. We will aim to issue this draft within the target timescales set-out below.

Target

The standard is to provide 70% within 10 weeks following a Full ARROW assessment or 6 weeks for an ARROW Light assessment.

Latest Performance

This is a new standard for the FSA and we began measuring it on the 1 April 2006. There is therefore no trend data available for this standard at present.

Glossary of terms

Action(s)
An activity undertaken in relation to an issue, for either assessment or mitigation - or remediation, in the case of crystallised risk. Note that a risk is said to have crystallised when the event it describes has occurred, and the resultant harm has been experienced. The probability of a crystallised risk is therefore 100%. It is impossible to mitigate the crystallised portion of a risk (since it is historical rather than prospective), but the harm experienced may be remediated.

ARROW
ARROW stands for the Advanced, Risk-Responsive, Operating frameWork.
It is the FSA's risk-based approach to regulation.

ARROW letter
The letter that we send to firms following an ARROW risk assessment, setting out the results of the assessment, any issues raised, and the actions which we want to be undertaken as a result.

ARROW Light
A reduced scope ARROW Firms risk assessment applicable to medium low impact firms and lower risk medium high impact firms.

ARROW risk assessment
In general, an assessment of risk under the ARROW risk assessment framework; specifically, this may mean:

- Firms: the assessment of risk associated with a firm/group as a whole.
- Themes: the assessment of risk associated with a particular issue (within the context of a single firm, or horizontally);

ARROW risk model
The conceptual framework, including risk groups, risk elements, the risk measurement scale for articulating, measuring and aggregating risks in firm, sub-sector and thematic assessment.

ARROW small firms approach
The risk-based approach developed specifically for small (i.e. low impact) firms. It makes use of remote monitoring using information collected from various sources including electronically-submitted regulatory returns from many firms, product sales and other data provided by product-providers, output from visits to firms, information received from the FSA Firm and Consumer Contact Centres, the Financial Ombudsman Service and from 'whistleblowers'. Much of this information is analysed electronically. Many of the problems identified are relatively small scale non-compliance issues which are dealt with using standardised processes. Complex cases are assessed more thoroughly so we can identify a proportionate plan of action to deal with them. The small firms approach makes extensive use of thematic work.

ARROW Themes (horizontal)
When an issue or risk pertains to more than one firm, or relates to a whole sector, or the market as a whole, we may choose to describe and manage the issue/risk as a single discrete item (rather than, say, many individual issues in multiple firms). This approach may be termed 'horizontal' or 'thematic' work.

ARROW visit
An on-site visit to a firm, as part of an ARROW risk assessment. This may be part of a vertical assessment by the supervisory team, or horizontal/thematic assessment work.

Baseline monitoring
Routine collection, collation and analysis of specific data from/in relation to firms. This includes firms' regulatory returns.

Business risk
Risks arising from the firm's business decisions and strategy, the environment in which it operates, and its ability to provide suitable products and services to its customers. The first four risk groups in the ARROW framework fall into this category.

Capital Requirements Directive (CRD)
The CRD is a shorthand term we use for the two directives implementing the Basel Accord within the EEA. The CRD revises the existing prudential framework and aims better to match regulatory capital requirements to the risks that firms are exposed to, thus providing incentives for firms to improve their risk management procedures. Implementation of the CRD will directly affect banks and building societies and some investment firms.

Close and continuous
The relationship we have with high impact firms, whereby the supervisory team undertakes ongoing monitoring activities, usually comprising regular meetings with the firm's senior management and control functions.

Close-out meetings (preliminary discussions)
The relationship we have with high impact firms, whereby the supervisory team undertakes ongoing monitoring activities, usually comprising regular meetings with the firm's senior management and control functions.

Communication
Following internal validation, we send the results of our risk assessment to your firm in the form of an ARROW letter. This sets out our view of the risks your firm poses and is accompanied by the Risk Mitigation Programme (RMP) that sets out the issues we have identified and the actions to be taken by your firm and us to address these issues.

Control functions
The high-level, independent functions within an organisation that act to mitigate risk – these include internal audit, compliance and risk management.

Controls
The risk that a firm cannot or will not identify, assess, monitor, manage and respond appropriately to the risks it faces. The latter five risk groups in the ARROW framework fall into this category.

Core area
The risk groups or risk elements that form the minimum areas of assessment for which an explicit view must be recorded for all ARROW firms risk assessments.

Discovery
Work is carried out within the risk assessment process to assess the level of the risk and fill gaps in our information in specific areas. In the ARROW firms risk assessment process, this often involves an on-site visit to the firm.

Discovery plan
A record of the areas the supervisory team has decided to assess during the discovery stage of a risk assessment. The plan is challenged and approved during the planning review (known as planning validation for ARROW firms risk assessments).

Draft ARROW letter
A draft version of the ARROW letter and RMP, approved during final validation for an ARROW firms risk assessment, which is sent to the firm to allow them to check for any factual inaccuracies before the final version is sent.

EEA (European Economic Area)
The area established by the agreement on the European Economic Area signed at Oporto on 2 May 1992 and which consists of the following states:

Austria, Belgium, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Italy, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, the Netherlands, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden and the United Kingdom.

EEA branch
The UK branch (i.e. not a subsidiary) of a firm based in an EEA country.

Enforcement
The Enforcement Division within the FSA investigates when firms breach our rules or provisions of the Financial Services and Markets Act (FSMA) and may seek to take legal action against such firms.

Evaluation and follow-up
The stage in the ARROW firms risk assessment process when the conclusions of discovery are reviewed, recorded and validated. The stage also covers carrying out and reviewing progress against the RMP.

Final validation
The process by which the conclusions and planned communication of a risk assessment is challenged and approved. It is known as the final validation in the ARROW firms risk assessment process.

Financial Services and Markets Act 2000 (FSMA)
The Financial Services and Markets Act 2000 (FSMA) fully came into force in December 2001. It sets out the framework of our regulatory system including FSA's powers and responsibilities.

FSA Handbook
The single Handbook of rules and guidance for all authorised financial firms carrying on business in the UK.

Full ARROW
An approach to an ARROW firms risk assessment where a full assessment of probability for all the risk groups is carried out, and communicated to the firm. Alternative approaches are ARROW Light and the small firms model.

Gross risk
The inherent risk associated with an event, issue or firm, before taking into account controls or other mitigation.

Group Summary Assessment (GSA)
Where we divide an ARROW risk assessment of a group of firms into Material Business Units, we also create a risk assessment for the group as a whole. This assessment, termed a GSA, contains group-level information (including risk scoring and issues) as well as a consolidated assessment – an aggregation of the group-level scores with those attributed to the MBUs making up the group.

Impact
A measure of the size of a risk – the harm to our objectives that would be caused, were a risk to crystallise.

Individual Capital Adequacy Assessment Process (ICAAP)
A regular risk-based assessment of their capital needs that firms are obliged to carry out. The ICAAP is a requirement that falls on firms and is set out in the Capital Requirements Directive (CRD).

Individual Capital Adequacy Standards (ICAS)
An assessment made by insurance firms of the level of capital and other financial resources which they believe is necessary to meet the risks and uncertainties of their business adequately. The FSA will issue Individual Capital Guidance where we feel a firm's assessment of how much capital it needs is insufficient.

Individual Capital Guidance (ICG)
The FSA Handbook requires a firm at all times to maintain overall financial resources, which are adequate, to ensure that there is no significant risk that its liabilities cannot be met as they fall due. Individual capital guidance (ICG) is the supervisory tool that we use to communicate our view of the capital that a firm needs to hold to meet this requirement.

Individual Capital Ratio (ICR)
The capital requirement for a bank set by the FSA taking account of the nature and inherent risk in the bank's business.

Integrated Regulatory Reporting (IRR)
A cross-FSA project to update new statistical reporting for firms (broken down by firm type and risk category).

Intended outcome
The result the FSA wishes to achieve through an action or actions within the RMP.

Interim review
A review carried out on all ARROW Firms risk assessments at the mid-point of the regulatory period to formally consider whether the planned date for the next re-assessment remains appropriate.

Internal risk
These are risks relating to FSA's own internal processes and systems and are not covered by the ARROW risk assessment framework.

Issue
An issue, either in a firm or thematic assessment, describes a set of events that have the potential to harm our objectives. An issue may be articulated as quite a narrow combination of events, or relatively broadly. As a risk assessment progresses, our understanding of an associated issue and ability to score it both improve.

In a firm risk assessment, issues have the following role:

- Issues suggest assessment work; either at the supervisor's own initiative or from the sector teams.
- Issues inform the risk assessment. A given risk element/group might have a number of associated issues, and the supervisor will look at the scores for these issues as well as the sub-sector analysis in formulating their overall view.
- Issues drive the RMP – actions are associated with issues, i.e. things that we regard as a problem.

Management Information (MI)
Focused information provided to management to assist with decision-making.

Markets
As defined under FSMA.

In the main this is the financial system, which includes financial markets and exchanges (and activities connected with them).

Material Business Unit (MBU)
For large groups of firms, a single ARROW risk assessment may be inappropriate – for example, where the group operates in multiple sectors, or has separately managed business lines. In these cases, a single assessment may result in important details about individual business areas being lost in an amalgamated assessment.

We may therefore decide to split the assessment into a number of smaller assessments, each of a distinct area of the group's business/operations. These are termed "material business units".

See also Group Summary Assessments.

Medium-high (impact or probability)
See risk measurement scale.

Medium-low (impact or probability)
See risk measurement scale.

Net risk
The level of risk left over after the effect of controls in mitigating the gross risk. (Note that we usually measure net risk without taking account of any further mitigating action that we are proposing; so only current controls will be taken into account in determining net risk).

Non-zero failure
The word 'failure' refers to a regulatory failure, such as consumer detriment or a loss of market confidence. By accepting that there will be failures (that is there will be more than zero), the FSA can establish a risk-based approach.

Ongoing monitoring
Ongoing activities undertaken to keep us appraised of the level of risk associated with an issue or firm and to allow us to identify emerging risks.

Examples include baseline monitoring and close-and-continuous work.

Pillar 1
Pillar 1 is one of the three supervisory pillars set out in the New Basel Accord and adopted by the EU in the Capital Requirements Directive (CRD). Pillar 1 sets out the minimum capital requirements firms will be required to meet for credit, market and operational risk.

Pillar 2
Pillar 2 is one of the three supervisory pillars set out in the New Basel Accord and adopted by the EU in the Capital Requirements Directive (CRD). Under Pillar 2, firms and supervisors have to take a view on whether a firm should hold additional capital against risks not covered by Pillar 1 and must take action accordingly.

Pillar 3
Pillar 3 is one of the three supervisory pillars set out in the New Basel Accord and adopted by the EU in the Capital Requirements Directive (CRD). The aim of Pillar 3 is to improve market discipline by requiring firms to publish details of their risks, capital and risk management.

Planning
The stage in the ARROW risk assessment process when the scope and structure of the risk assessment and the discovery plan are produced and reviewed/validated.

Planning validation
The process by which the scope of a risk assessment and discovery plan is challenged and approved. This is known as planning validation in the ARROW Firms risk assessment process.

Principles
As defined in the FSA Handbook these articulate high-level business principles for firms – the fundamental obligations of all firms under our regulatory system.

Principles of Good Regulation (PGR)
In pursuing our functions under the Financial Services and Markets Act (FSMA) we are required to have regard to additional matters that we refer to as principles of good regulation. These are: efficiency and economy; role of management; proportionality; innovation; international character; competition.

Probability
The likelihood of an event, or combination of events happening. This may be related to an issue, risk element, risk group or assessment.

Probability score
A measure of probability on the risk measurement scale.

Re-assessment
The second and subsequent ARROW risk assessment for a firm or issue. Re-assessments generally occur once every regulatory period.

Regulatory period
The period of time between two consecutive ARROW risk assessments.

Regulatory tools/toolkit
The range of diagnostic, preventive, monitoring and remedial methods within the ARROW risk framework. Tools are effectively generic types of actions.

Relationship manager
Staff within the FSA who manage our supervisory relationship directly with an authorised firm. If we judge you to have a low impact on our statutory objectives, we will not provide you with a designated Relationship Manager. We will, however, maintain contact with you through targeted communications including dedicated web pages and local events where you can seek advice and help on regulatory and supervision issues affecting you. And you will, of course, have access to our Contact Centre.

Relationship management charter
As part of our programme to make the FSA easier to do business with, we have set clear, mutual expectations for our firms covering compliance to our Principles and rules, adherence to our service standards and what firms can expect if they have a designated Relationship Manager.

If you are assigned a Relationship Manager, you should expect them to:

- be the focal point for your relationship with us – in addition to direct supervisory issues, the Relationship Manager should be aware of direct contact that you may have with any of our areas, such as Regulatory Transactions and Enforcement;
- carry out an open, two-way dialogue with you;
- know your industry;
- know the regulatory framework related to your activities, including significant rule and policy changes;
- assess the major risks posed by you and communicate this in detail to you; and
- set out and actively monitor an appropriate and proportionate risk mitigation programme for you. Your Relationship Manager will use the processes outlined above to conduct our ARROW risk assessment and risk mitigation programme.

To determine whether we are meeting the criteria above, our senior management will conduct one-to-one meetings each year with a sample of relationship-managed firms. This will give your senior management an opportunity to provide us with in-depth feedback on how we are conducting supervision.

Remediation/remedial action
The rectification of actual harm to our statutory objectives – (crystallised risk) e.g. compensating customers for losses; improving consumer awareness.

Review (validation)
The process by which assessments of risks are challenged and approved by senior/independent FSA staff.

Risk
The expected harm associated with a situation (e.g. an issue or a firm) – the product of impact and probability.

Risk appetite
Risk appetite is the amount of risk that one is prepared to accept, tolerate, or be exposed to at any point in time.

Risk-based approach
The FSA does not set out to eliminate all failures from the financial system; indeed, we would not consider a financial system that had zero-failure to be a desirable public policy outcome. So, it is inevitable that, for example, detriment will occur to consumers of UK financial services; that there will be a certain level of financial crime; and that some of the firms we regulate will suffer financial failure. The FSA therefore has to make conscious choices as to which risk it seeks to mitigate. How it makes those choices, such as the factors it takes into account, is its risk-based approach.

Risk cycle
The continuous, four-stage approach that we use to describe how risks are managed within the ARROW framework.

The four stages are:

- Identification
- Measurement
- Mitigation
- Monitoring and reporting

Risk element
A discrete and separately identifiable source of potential risk to the FSA's objectives which forms part of the probability assessment.

Risk group
A collective term for sets of business risk elements or control risk elements which pose similar risks to the FSA's objectives.

Risk Mitigation Programme (RMP)
A set of intended outcomes and timetabled actions designed to mitigate the risk associated with an assessment or firm risk assessments, and any other follow-up work necessary. For firm risk assessments, the RMP is a document attached to the ARROW letter and the actions may be either for us or for the firm.

Risks to FSMA Objectives (RTOs)
Risks to a FSMA statutory objective (also referred to as a risk to the objectives). RTOs are the generic ways in which a risk/issue may affect one or more of our strategic objectives.

Section 166 (reports)
Section 166 of FSMA gives us the power to require firms to give us reports by skilled persons. The use of skilled persons is a regulatory tool for diagnostic, monitoring, preventative and remedial purposes. It can be used in risk assessment, risk mitigation programmes and when responding to risk escalation or crystallisation.

Sector
A cross-cutting view of each of the major financial services sectors that the FSA regulates. The FSA currently has nine recognised sectors: Accounting and Audit, Asset Management, Banking, Consumer, Capital Markets, Financial Crime, Financial Stability, Insurance and Retail Intermediaries.

Sector teams
Sector teams are aligned to each of the FSA sectors. Their core functions are risk identification and mitigation; representing the FSA on sectoral issues; overviewing the coherence of FSA regulation of the sector; and staff development.

Severity
In the context of scoring thematic issues, the severity score represents the loss experienced per consumer if an issue crystallises.

Skilled Persons
A person appointed to make a report required by Section 166 of FSMA (Reports by Skilled Persons) for provision to the FSA and who must be a person:

(a) nominated or appointed by the FSA; and

(b) appearing to the FSA to have the skills necessary to make a report on the matter concerned.

Small firms
Firms which are rated as low impact.

Statutory Objectives
The FSA's four objectives as set out in the Financial Services and Markets Act (FSMA), describing the FSA's overall purpose consistent with the principles of good regulation.

Sub-sector(s)
A division of the FSA sector structure for the purpose of making sub-sector analyses sufficiently relevant to our population of firms. Refer to the ARROW Reference Manual for the current list of sub-sectors.

Sub-sector analysis
The sub-sector process has two key outputs – sub-sector issues and sub-sector risk profiles. Together these make up the sub-sector analysis.

Sub-sector issue(s)
The key issue(s) that the FSA perceives to be affecting firms in a particular sub-sector at a particular point in time.

Sub-sector risk assessment
The FSA's 'house view' of the issues and probability assessment relating to a notional average firm within a particular sub-sector. The sub-sector risk assessment consists of the sub-sector risk profile and the sub-sector issues and is loaded into IRM as a risk assessment by the sector-analyst.

Sub-sector risk profile
The FSA's 'house view' of the probability score within firms in a particular sub-sector. Scores are given against risk elements (and aggregated to inform risk group scores) and relate to a notional average firm within a particular sub-sector. Sub-sector profiles can be inserted in all firm assessments.

Suggested outcome
Wording for an intended outcome that is suggested to firm supervisors for a sub-sector issue.

Supervision
The FSA's ongoing assessment and mitigation of risks in individual firms (vertical supervision) and the wider financial markets (thematic or horizontal supervision). In relation to firms, compare with authorisation and enforcement.

Target risk
The desired level of net risk that will be achieved in relation to an issue when the intended outcome for a particular action within a RMP has been met.

Thematic work
As well as work in relation to individual financial institutions (or groups), the FSA conduct 'thematic' work to address wider industry issues. In some cases, a narrow group of financial institutions may be targeted, such as institutions in a particular sector. Sometimes the FSA might look at issues covering the market as a whole. This will normally involve some contact with firms - in many cases we will make a short visit (typically a day) to a selection of firms. But, other techniques may be used such as telephone interviews, questionnaires, document reviews and consumer or market research and 'mystery shopping'. We normally communicate the findings of this work to firms through letters, discussion papers or in guidance on the FSA website. In some cases, the findings of thematic work may lead to changes to our Handbook of rules. Whichever tool or combination of tools the FSA chooses, ultimately the aim is to encourage behavioural change within relevant sectors.

Treating Customers Fairly (TCF)
The aim of the FSA's TCF project is to ensure that firms meet the requirements of principle 6 to "pay due regard to the interests of its customers and treat them fairly". The FSA has said that it expects firms and their senior management to consider the implications of TCF for their business and to take steps to tackle any shortfalls which they identify as a result.

Variation of Permission
If any firm authorised by the FSA decides that it wants to carry on a new type of business/regulated activity, extend a business line into a new product or to a new class of people, may need to apply to change ('vary') its permission in order to be authorised to do so.

This can be achieved by completing the 'Variation of Permission' application form. Firms who have been invited to register for Firms Online can submit an online application form. Alternatively, firms can obtain an application form by phoning the Firm Contact Centre on 0845 606 9966 (call rates may vary) and selecting Option 5 when prompted. If any firm wants to have its permission/authorisation cancelled it should complete the Cancellations Form.

Waivers
A direction waiving or modifying a rule given by the FSA under sections 148, 250 or 294 of the Financial Services and Markets Act 2000 or regulation 2 of the OEIC Regulations. We can not waive those rules that implement European Directives.

Job number: 2674

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