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**TO** : i. **Cyprus Investment Firms**  
ii. **UCITS Management Companies**  
iii. **Administrative Services Providers**  
iv. **Regulated Markets**

**FROM** : **The Cyprus Securities and Exchange Commission**

**DATE** : **02 September 2014**

**CIRCULAR No.** : **CI144-2014-27**

**FILE No.** : **EK.02.03.001, EK.01.03.004**

**SUBJECT** : **Development of a Risk Based Supervision Framework- A brief description**

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As previously communicated, with circular CI144-2014-05, the Cyprus Securities and Exchange Commission ('the Commission' or 'CySEC') has proceeded with the design and development of a Risk Based Supervision Framework ('RBS-F'), as part of its effort to increase efficiency and effectiveness in supervising the Regulated Entities, thus ensuring their healthy operation. Such framework will enable the Commission to determine its supervisory approach, by evaluating and accounting for the risks faced by each Regulated Entity.

The purpose of this circular is to provide a brief description of the framework and how this will amend CySEC's current approach of supervision.

## **1. What is RBS-F and CySEC's Attitude to Risk**

Effective risk management requires a framework that helps to facilitate and support all formal risk-management activities. It is a process, which reflects and takes into consideration the activities and issues occurred in the past or present, but also take into consideration potential and plausible future events. In order to be an effective risk-based regulator, CySEC has implemented a structured approach to assess risk.

The Risk Based Supervision Framework ('RBS-F'), is designed to ensure that risks are managed at a relevant level. This involves ensuring appropriate review, challenge and oversight of the risks bared by the Regulated Entities.

A methodology was established which will allow CySEC to identify those Regulated Entities which warrant more intensive supervision. It is acceptable that risk cannot be entirely eliminated, while some of the risks accepted or that are not eliminated, may lead to failures.

The aim is that more focus is given to those entities which are of greatest importance, in terms of the impact their possible failure will have and those which are considered to have the greatest risks. Consequently, CySEC's judgement of the risk that each Regulated Entity poses to its statutory objectives, will determine the overall intensity of the regulatory approach to be followed.

## 2. The Advantages of RBS-F

Significant benefits exist, which make the implementation of the RBS-F important to both the entities regulated by the Commission and the Commission itself.

The RBS-F is aiming to assist with:

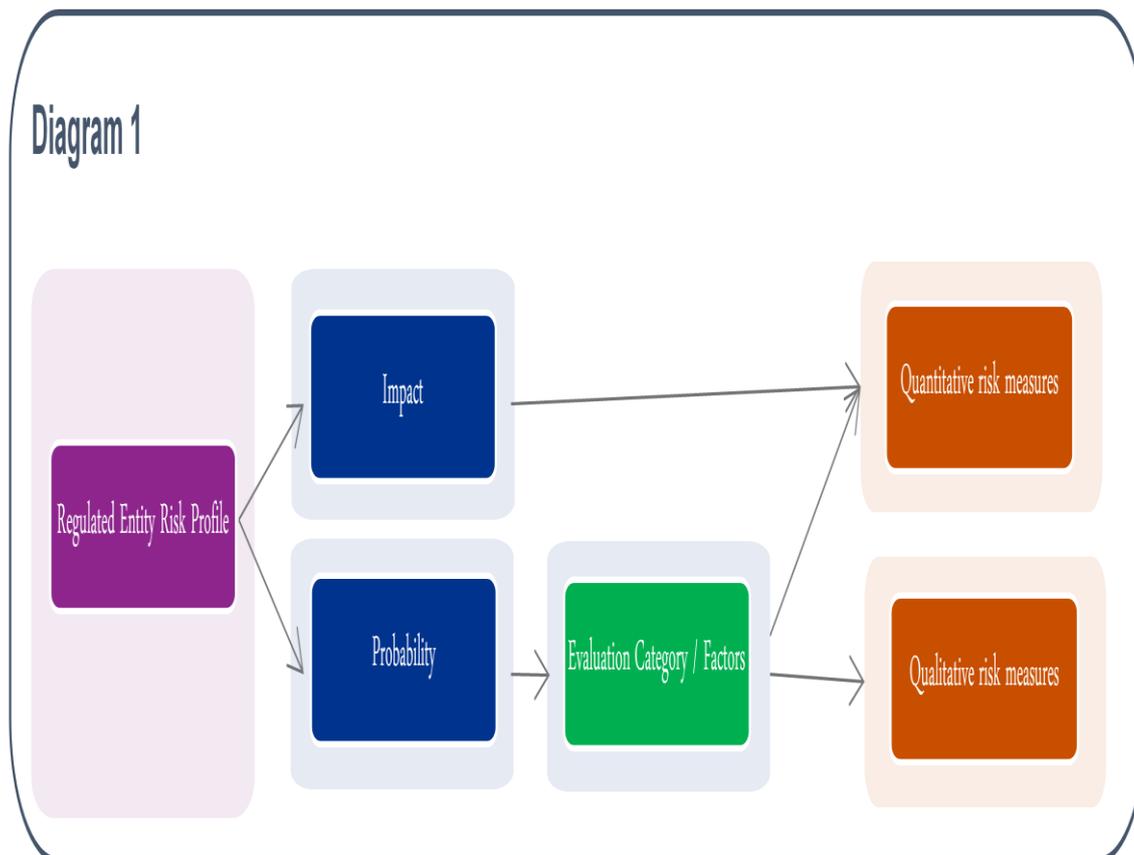
- (a) Making better risk-based judgments.
- (b) Taking prompt and consistent regulatory action where necessary.
- (c) Prioritising regulatory activities.
- (d) Strengthening the ability to take effective regulatory action.
- (e) Improving oversight and reporting on high risk regulated firms.
- (f) Allocating resources in a more efficient manner and where these are mostly required.
- (g) Adopting a consistent way of risk assessment across all Regulated Entities.
- (h) Operating a framework which is in line with those used by other significant regulators, both within the European Union and other countries.
- (i) Achieving better understanding of the Regulated Entities' operations and key risk.
- (j) Providing clarity of the risks posed by each Regulated Entity.
- (k) Encouraging the frequent, open communication between the Regulated Entities and the Supervisor.

## 3. Overview of the RBS-F

A risk assessment will be performed for all entities at least on an annual basis, the results of which will be used to define each entity's monitoring program for the regulatory period.

CySEC will assess risk for each Regulated Entity based on the *impact* (i.e. the potential harm that could be caused) and *probability* of failure (i.e. how likely the event is to occur).

Each of these (i.e. the impact and probability) will be assessed based on a set of predefined risk measures and / or evaluation categories / factors - **Diagram 1**.



**Impact** is designed to capture the size of a Regulated Entity and the potential harm that it could do to CySEC's responsibilities and reputation. The impact is calculated using numerical data about the entity, from information to be taken from the entity's regulatory returns.

**Probability** will be assessed based on the *evaluation categories* applicable to the Regulated Entity. The *evaluation categories* are distinguished in four (4) main *categories*:

- (a) *Anti Money Laundering*: Aim is to ensure that Regulated Entities minimise the possibility that they may be used for financial crime.
- (b) *Prudential*: Aim is to assess the safety and soundness of the Regulated Entities and reduce the threat entities pose to the stability of the financial system in providing critical financial services.
- (c) *Conduct*: Aim is to ensure that clients get a fair treatment and ensure that markets are resilient and fair.
- (d) *Governance*: Aim is to assess whether processes and decisions that seek to define actions, grant power and verify performance of the entity are adequate.

Different evaluation categories / factors will be assessed with a set of predefined *risk measures*.

Risk measures can be both quantitative and qualitative:

- (a) *Quantitative assessment* will be performed for all entities and will reflect the entity's inherent probability (i.e. in combination with impact will indicate each entity's inherent risk).

Inherent probability will be assessed based on a set of (mostly) numerical data, which will be provided by the Regulated Entities upon CySEC's request, and will indicate each Regulated Entity's size and key characteristics of its business activities.

- (b) *Qualitative assessment* evaluates each entity's procedures, systems and controls implemented. The areas of qualitative assessments will be driven from the results of the quantitative assessment, or other external factors identified during the regulatory period.

CySEC, based on the results of the qualitative assessments, will identify any actions that need to be taken from the Regulated Entities, and will monitor these accordingly.

The probability calculated from the *quantitative* and the *qualitative assessment* will result to an entity's overall probability (i.e. net probability).

The graph in **Appendix A** indicates the core areas of the risk assessment: the main evaluation categories and the factors which fall under each category. To be noted that depending on the type of entity and the risk profile of each entity identified during the quantitative risk assessment, evaluation categories, evaluation factors and risk measures may differ.

#### **4. RBS-F Stances and Approach to Supervision**

The risk assessment will be performed for all entities at least on an **annual basis** (i.e. the **regulatory period**) and depending on the results, the intensity of supervision will be defined.

CySEC will score each entity in four (4) risk categories: **low (L)**, **medium-low (ML)**, **medium-high (MH)**, **high (H)**. This is measured based on similar scores allocated to impact and probability.

All entities will be subject to the basic monitoring procedures which involve the analysing of their regulatory returns submitted to CySEC. An illustration (not a definite one) of the way CySEC will supervise Regulated Entities is shown below.

		Probability Rating			
		Low	Medium Low	Medium High	High
Impact Rating	High				
	Medium High				
	Medium Low				
	Low				

<b>H</b>	Relationship managed	Establishment of a supervisory programme, that is designed to enable each of the Probability Ratings to be assessed through regular meetings, targeted reviews and tailored remediation plans
<b>MH</b>	Remediation from thematic reviews	Entities will be prioritised for thematic reviews to where inherent probability scores show they are relevant. Where thematic reviews show that probability of failure is higher, then closer supervision may be required until remediation is completed
<b>ML</b>	Thematic reviews	Subject to desk-top data analysis and potential selection for thematic reviews
<b>L</b>	De minimis	Limited interaction beyond administrative supervisory processes/ supervision through reporting / regulatory returns

Concluding we note that CySEC is currently working towards preparing a more detailed documentation with respect to the approach to be followed. This will be shared with Regulated Entities in due time.

Should you have any queries on the RBS-F, please do not hesitate to contact: Mrs. Marinella Georghiadou (Officer, Supervision Department), or send an email to the address [supervision@cysec.gov.cy](mailto:supervision@cysec.gov.cy).

Yours sincerely,

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Chairman, Cyprus Securities and Exchange Commission

APPENDIX A OF CIRCULAR CI144-2014-27

Core Areas of the Risk Assessment

