SECURITIES AND EXCHANGE COMMISSION

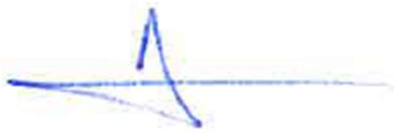
Protecting Investors in the Capital Markets

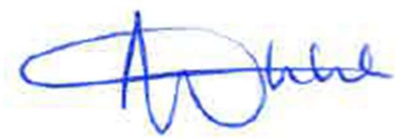
RISK BASED SUPERVISION POLICY

Approved 14th June 2021

APPROVAL OF THE SEC RISK BASED SUPERVISION POLICY

This policy document was approved by the Board of the Securities and Exchange Commission on the 14th day of June 2021 in Lusaka and signed on its behalf by:

) CHAIRPERSON

) COMMISSIONER

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1. Introduction

1.1 The Securities and Exchange Commission

1.1.1 The Securities and Exchange Commission ("the Commission" or "the SEC") is the regulator of the Capital Markets in Zambia. It was established through Cap 354 of the Laws of Zambia and its existence was continued through the Securities Act no. 41 of 2016 ("the Act").

1.1.2 The Commission's mandate as prescribed in Section 9 of the Act is to create and promote conditions in the capital markets aimed at ensuring the orderly growth, integrity and development of the capital markets. Central to the SEC's mandate are the objectives of:

(a) protecting investors.;
(b) ensuring that markets are fair, efficient and transparent; and
(c) reducing systemic risk[1].

The SEC's mandate is aligned to the International Organisation for Securities Commissions ("IOSCO") Objectives and Principles for Securities Regulation ("the Principles").[2] IOSCO has noted that in order to effectively apply the Principles, "an increasing number of (its) members are now moving away from a rigid rules-based system of regulation to a system that is more reliant on the supervisor's discretion and professional judgment through adoption of a risk-based supervisory structure."[3]

1.1.3 Upon consideration of the benefits and outcomes that are anticipated to be achieved through the application of risk based supervision in the Zambian capital markets and the legal basis provided by section 9 of the Act, the SEC resolved to adopt risk based supervision.

1.2 SEC Risk Based Supervision Policy

1.2.1 This document sets out the Commission's Risk Based Supervision (RBS) Policy ("SEC RBS Policy") for the supervision of Capital Market Operators (CMOs) operating in Zambia. This policy document is supported by the Commission's Risk Based Supervision Framework ("RBS Framework") and other operational manuals developed by the Commission.

1.3 Scope of the SEC RBS Policy

The SEC RBS Policy applies to all CMOs in Zambia including but not limited to licensees, issuers of securities that are registered with the Commission, authorised Collective Investment Schemes, Custodians, Trustees and Self-Regulatory Organisations. The RBS Policy also applies to foreign capital markets operators and participants operating in the Zambian capital markets.

1.4 Importance of RBS Policy to stakeholders

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1 *See the Objectives and Principles of Securities Regulation of the International Organisaton of Securities Commission ("IOSCO"), May 2017*

2 The SEC is a member of IOSCO, the recognised standard setter for securities and capotal markets regulation

3 Guidelines to Emerging Market Regulators Regarding Requirements for Minimum Entry and Continuous Risk-Based Supervision of Market Intermediaries http://www.iosco.org/library/pubdocs/pdf/IOSCOPD314.pdf

It is critical for stakeholders, principally the boards and senior management of CMOs, to fully appreciate the RBS Policy, owing to the Commission's expectation of their role in mitigating risk in the business operations of their respective CMOs. Amongst other benefits, the RBS Policy provides a basis for improved and better communication between the CMO and the SEC focusing on the key risk areas.

2. Commission's approach to Risk Based Supervision

The following is the SEC's general approach to supervision:

2.1 Principles-Based Supervision: The Commission's supervisory approach is principles-based, emphasizing the use and application of sound predictive judgment in identifying and assessing risks faced by the CMO, assessing the adequacy of the CMOs' risk management processes and determining the appropriate supervisory response/ intervention.

2.2 Supervisory Intensity and Intervention: The intensity of supervision will depend on the nature, size, complexity and risk profile of a CMO, and the potential consequences to the system of the CMO's failure. It is expected that CMOs posing greater risks to investors and the public interest would require a greater supervisory intensity.

2.3 Board and Senior Management Accountability: A CMO's Board of Directors and Senior Management are responsible for the strategic management and direction of the CMO and are ultimately accountable for ensuring that the CMO and its employees perform their duties and obligations in a manner that complements the SEC's supervisory mandate.

2.4 Risk of failure of a CMO: Operational and/or financial failure of CMOs is anticipated to happen from time to time. The SEC will endeavour to ensure that CMOs regularly demonstrate resilience and have in place or formulate recovery plans as needed. In addition, where CMOs fail or face the prospect of failure, the SEC will work with other relevant authorities to implement appropriate resolution plans.

2.5 Groupwide supervision: The Commission supervises CMOs that fall within conglomerate or group structures. In supervising such CMOs, the Commission uses information available from other regulators as appropriate.

2.6 Cross sectoral considerations: For CMOs whose activities spill over into areas regulated by other financial sector regulators such as Bank of Zambia, Pensions and Insurance Authority, the Commission takes into account the potential impact of the non-capital markets activity on the CMO.

2.7 Reliance on External Auditors and other experts: The Commission may rely on and use the work of CMOs' external auditors and experts in specialist areas such as Information technology, property valuation, fraud and forensics etc. to undertake its supervisory activities.

3. Key principles:

In applying RBS, the Commission is guided by three core principles:

- **Principle 1: Use of judgement:** The Commission's supervisory activities are based on judgements reached by Commission staff to assess the inherent risks that CMOs face, the risks that CMOs pose to Commission's objectives and the adequacy of the CMO's resources to manage the risks identified and the determination of supervisory responses.

- **Principle 2: Focus on key risks:** The risk assessment the Commission performs in its supervisory work is focused on identifying key risks posed by a CMO to the SEC's supervisory objectives. The emphasis on key risks ensures that the Commission allocates resources efficiently to areas with the highest risk. Other risks will be tracked through various monitoring mechanisms.
- **Principle 3: Forward-looking, early intervention:** Risk assessment is forward-looking and dynamic. This view facilitates the early identification of issues or problems, and timely intervention where corrective actions need to be taken, so that there is a greater likelihood of the satisfactory resolution of issues.[4]

SEC RBS governing principles

4. Primary risk assessment concepts

3.1 The SEC RBS methodology

3.1.1 The Commission will apply the following RBS methodology and primary risk assessment concepts.

1) **Significant activities:** Using Knowledge of Business ("KoB") to identify the CMO's significant activities.
2) **Inherent Risks:** Identification and assessment of Inherent Risks, emphasis on key Inherent Risks
3) **Quality of Risk Management ("QRMs"):** identification and assessment of QRM functions, which are Operational Management, Risk Management, Compliance, Internal Audit, Senior Management and the Board of Directors in the CMO.
4) **Net Risk:** Assessment of the residue inherent risk in the significant activity after considering the impact of QRMs.
5) **Overall Net Risk:** Assessment of the potential adverse impact that significant activities collectively could have on the CMOs ability to ensure protection of investors.
6) **Institutional Level Support:** an assessment of the CMO's financial resources (Earnings, Capital & Liquidity) available to enable it to manage Net risk.
7) **Composite Risk Rating:** the risk taking into account the adequacy of the CMO's financial resources to manage its overall net risk.
8) **Intervention Rating:** to determine the supervisory intervention.

3.2 Inherent Risk

Inherent risk is the probability of material loss to investors due to exposure to, and uncertainty arising from, current and potential future events arising from the undesirable market conduct practices of a CMO or its representatives/agents. The Commission uses the following categories to assess inherent risk:

[4] This principle also enables the Commission to apply the IOSCO Principle 7 which requires regulators to have or contribute to a process to review the perimeter of regulation.

1) **Conduct risk:** risk that the conduct of the CMO and/ or its employees will result in poor outcomes for investors and/or other stakeholders.
2) **Credit risk:** risk arising from a counterparty's potential inability or unwillingness to fully meet its on and/or off-balance sheet contractual obligations.
3) **Market risk:** arises from potential changes in market rates, prices or liquidity in various markets e.g interest rates, foreign exchange, equities, commodities.
4) **Operational risk:** arises from potential problems due to inadequate or failed internal processes, people and systems, or from external events.
5) **Legal and Regulatory risk:** arises from a CMO's potential non-conformance with laws & regulations and contractual obligations entered into in the normal course of its business operations.
6) **Strategic risk:** arises from a CMO's potential inability to implement its strategies, make decisions or adapt to changes in its business environment.
7) **Money Laundering/ Terrorist Funding Risk (ML/TF Risk):** ML/ FT Risk is the risk that the CMO's activities result in its being used as a conduit to conduct money laundering activities and financing of terrorism.

3.3 Quality of Risk Management

The RBS emphasizes the requirement to assess the effectiveness of the mitigants available to the CMO to address the assessed inherent risks. Under RBS, the Commission assesses the QRMs/ lines of defense as follows:

Name of QRM	Level of defense
Operational management	1st Line of defense
Risk Management	2nd Line of defense
Compliance	
Internal Audit	3rd Line of defense
Senior Management	4th Line of defense
Board of directors	5th Line of defense

3.4 Composite Risk & Intervention Ratings

The Commission applies the following intervention ratings for the level of CRR determined by the supervisors:

Composite Risk Rating	Intervention rating
Low (L)	0 Normal
Moderate (M)	0 Normal
	1 Early warning
Above Average (AA)	1 Early warning
	2 Risk to financial viability or solvency
High (H)	2 Risk to financial viability or solvency
	3 Future financial viability in serious doubt
	4 Non-viable/ Insolvency imminent

3.5 Risk Matrix and Link to Supervisory Actions

A Risk Matrix (refer to example below) is used to record all the assessments described above. The purpose of the Risk Matrix is to facilitate a holistic risk assessment of a CMO. This assessment culminates in a Composite Risk Rating (CRR) for the CMO, which CRR informs the Commission's supervisory response based on the Intervention Rating (as determined using the table in 3.4 above). The CRR is the "final" rating and reflects the assessment of the entity's ability to manage the inherent risks in its significant activities after considering its financial resources (i.e., Earnings, Liquidity and Capital). Accordingly, the assessment includes a review of the quality, quantity, and availability of externally and internally generated capital. The CRR may change if something material occurs in the risks that affects the risk rating. The time frame between the last assessment of a CMO's CRR to the next assessment is generally over a 12-month period, or until there is a material change affecting the CRR. Below is an example of a Risk Matrix.

SIGNIFICANT ACTIVITIES	MATERIALITY	INHERENT RISKS							QUALITY OF RISK MANAGEMENT						NET RISK	DIRECTION OF NET RISK
		Conduct	Credit	Market	Operational	Legal and regulatory	Strategic	Money Laundering/ Terrorist Financing	Operational management	Risk Management	Compliance	Internal Audit	Senior management	Board of Directors		
Activity 1																
Activity 2																
Activity 2																
Overall rating																
Overall Net Risk																

INSTITUTIONAL LEVEL SUPPORT	
Component	Rating
Earnings	
Capital	
Liquidity	

Composite Risk Rating	
Rating	
Direction	
Time frame	

INTERVENTION RATING	

5. The core supervisory process

4.1 Dynamic, iterative and continuous supervisory process

4.1.1 Commission uses a defined process to guide its CMO-specific supervisory work. There are three broad steps: The Commission supervisory process is dynamic, iterative and continuous, as shown below:

4.1.2 Performing supervisory work in this fashion helps keep the Commission's risk assessments current and forward looking, which is vital to its ongoing effectiveness.

4.2 Planning & Risk Profiling:

A supervisory strategy for each CMO is prepared annually. The supervisory strategy identifies the supervisory work necessary to keep the CMO's risk profile current. The intensity of supervisory work depends on the nature, size, complexity and risk profile of the CMO. The Commission's planning also includes a process to compare the work effort across CMOs, e.g., thematic reviews. This is done to ensure that assessments of risk for individual CMOs are subject to a broader standard, and that supervisory resources are allocated effectively to higher-risk CMOs and significant activities.

4.3 Executing supervisory work and updating the risk profile

There is a continuum of supervisory work that ranges from monitoring (CMO-specific and external), to off-site reviews, to on-site reviews, including testing or sampling where necessary. When there are changes in the risk assessment of the CMO, the Commission responds by adjusting work priorities set out in the supervisory strategy and annual plan, as necessary, to ensure that important matters emerging take precedence over items of lesser risk. Such flexibility is vital to the Commission's ability to meet its mandate.

Commission's iterative supervisory process

4.4 Reporting and intervention:

For each CMO, the Commission will designate a staff member as the relationship manager (RM). The RM will be responsible for the supervisory process in 4.2 and 4.3 for the CMOs under his or her responsibility. RM will be the main point of contact for the CMO with respect to all supervisory matters.

Among other communications, the Commission communicates its supervisory assessment and supervisory concerns to CMOs through Supervisory letters. Supervisory Letters are addressed to the CMO's Board of Directors with a copy to the Chief Executive Officer (CEO). The CMO is required to respond to the Commission and address all issues raised within timelines set by the Commission.