Statement of Guidance

Investment Securities and Derivatives Risk Management for Banks

1. Statement of Objectives

1.1. This guideline sets forth sound risk-management practices that are relevant to most portfolio management endeavours and provides guidance on the management of investments and end-user activities.

2. Introduction

2.1. This policy statement provides guidance to banks on sound practices for managing the risks of investment securities and end-user derivatives activities. This guidance describes the practices that a prudent manager normally would follow and is not intended to be a checklist. Management should establish practices and maintain documentation appropriate to the bank's individual circumstances, consistent with this statement.

3. The Guidance

3.1. Scope

3.1.1 This guidance applies to all securities in *held-to-maturity* and *available-for-sale* accounts, certificates of deposit held for investment purposes, and end-user derivative contracts. It covers all securities used for investment purposes, including money market instruments, fixed-rate and floating-rate notes and bonds, structured notes, mortgage pass-through and other asset-backed securities, and mortgage-derivative products. Similarly, this guidance covers all end-user derivative instruments used for non-trading purposes, such as swaps, futures, and options.

3.1.2 As a matter of sound practice, banks should have programmes to manage the market, credit, liquidity, legal, operational, and other risks of investment securities and end-user derivatives activities (investment activities). While risk-management programs will differ among banks, there are certain elements that are fundamental to all sound risk-management programs. These elements include board and senior management oversight and a comprehensive risk management process that effectively identifies, measures, monitors, and controls risk. This statement describes sound principles and practices for managing and controlling the risks associated with investment activities.

3.2. Board and Senior Management Oversight

3.2.1 The Board of directors and senior management over-sight is an integral part of an effective risk-management program. The board of directors is responsible for approving major policies for conducting investment activities, including the establishment of risk limits. The board should ensure that management has the requisite skills to manage the risks associated with such activities. To properly discharge its oversight responsibilities, the board should periodically review consolidated portfolio activity reports, based on the level of risk and materiality of the portfolio, and require management to demonstrate compliance with approved risk limits.

3.2.2 The Board should have an adequate understanding of investment activities. Boards that do not should obtain professional advice to enhance its understanding of investment-activity oversight, so as to enable it to meet its responsibilities under this statement. Senior management is responsible for the daily management of the bank's investments. Management should establish and enforce policies and procedures for conducting investment activities. Senior management should have an understanding of the nature and level of various risks involved in the institution's investments and how such risks fit within the bank's overall business strategies.

3.2.3 Management should ensure that the risk-management process is commensurate with the size, scope, and complexity of the institution's holdings. Management should also ensure that the responsibilities for managing investment activities are properly segregated to maintain operational integrity. Banks with significant investment activities should ensure that back-office, settlement, and transaction-reconciliation responsibilities are conducted and managed by personnel who are independent of those initiating risk-taking positions.

3.3. Risk-Management Process

3.3.1 An effective risk-management process for investment activities includes (1) policies, procedures, and limits; (2) the identification, measurement, and reporting of risk exposures; and (3) a system of internal controls.

3.3.2 Policies, Procedures, and Limits

a) Banks must adopt prudent investment policies, and procedures approved by the board of directors.

b) The investment policies and procedures must be defined and commensurate with the nature and complexity of their activities, and should include at a minimum:

   I. An appropriate investment management, measurement and monitoring process;
   II. Adequate controls over the investment portfolio; and
   III. Operating limits and other practices that maintain exposures within levels consistent with the banks' internal policies

c) Investment policies, procedures, and limits provide the structure to effectively manage investment activities. Policies should be consistent with the organization's broader business strategies, capital adequacy, technical expertise, and risk tolerance. Policies should identify relevant investment objectives, constraints, and guidelines for the acquisition and ongoing management of securities and derivative instruments.

d) Potential investment objectives include generating earnings; providing liquidity; hedging risk exposures; taking risk positions; modifying and managing risk profiles; managing tax liabilities; and meeting pledging requirements, if applicable.

e) Policies should also identify the risk characteristics of permissible investments and should delineate clear lines of responsibility and authority for investment activities. The bank's management should understand treatment for all securities and derivatives holdings.

f) This treatment should be consistent with the bank's business objectives, generally accepted accounting principles, and regulatory reporting standards.

3.3.3 Risk Identification, Measurement, and Reporting

a) Banks should ensure that they identify and measure the risks associated with individual transactions prior to acquisition and periodically after purchase. This can be done at the institutional, portfolio, or individual-instrument level.

b) Prudent management of investment activities entails examination of the risk profile of a particular investment in light of its impact on the risk profile of the institution. To the extent practicable, banks should measure exposures to each type of risk, and these measurements should be aggregated and integrated with similar exposures arising from other business activities to obtain the institution's overall risk profile.

c) In measuring risks, banks should conduct their own in-house pre-acquisition analyses, or to the extent possible, make use of specific third-party analyses that are independent of the seller or counter party. Irrespective of any responsibility, legal or otherwise, assumed by a dealer, counter party, or financial advisor regarding a transaction, the acquiring institution is ultimately responsible for the appropriate personnel understanding and managing the risks of the transaction.

d) Reports to the board of directors and senior management should summarize the risks related to the bank's investment activities and should address compliance with the investment policy's objectives, constraints, and legal requirements, including any exceptions to established policies, procedures, and limits. Reports to management should generally reflect more detail than reports to the board of the institution.

e) Reporting should be frequent enough to provide timely and adequate information to judge the changing nature of the institution's risk profile and to evaluate compliance with stated policy objectives and constraints.

3.3.4 Internal Controls

a) An institution's internal control structure is critical to the safe and sound functioning of the organization generally and the management of investment activities in particular. A system of internal controls promotes efficient operations; reliable financial and regulatory reporting; and compliance with relevant laws, regulations, and institutional policies. An effective system of internal controls includes enforcing official lines of authority, maintaining appropriate separation of duties, and conducting independent reviews of investment activities.

b) For banks with significant investment activities, internal and external audits are integral to the implementation of a risk-management process to control risks in investment activities. The bank should conduct periodic independent reviews of its risk-management program to ensure its integrity, accuracy, and reasonableness. Items that should be reviewed include but is not limited to:

(i) compliance with and the appropriateness of investment policies, procedures, and limits;

(ii) the appropriateness of the institution's risk-measurement system given the nature, scope, and complexity of its activities; and

(iii) the timeliness, integrity, and usefulness of reports to the board of directors and senior management.

c) The review should note exceptions to policies, procedures, and limits and suggest corrective actions. The findings of such reviews should be reported to the board and corrective actions taken on a timely basis.

d) The accounting systems and procedures used for public and regulatory reporting purposes are critically important to the evaluation of an organization's risk profile and the assessment of its financial condition and capital adequacy.

e) Accordingly, an institution's policies should provide clear guidelines regarding the reporting treatment for all securities and derivatives holdings. This treatment should be consistent with the organization's business objectives, generally accepted accounting principles (GAAP), and regulatory reporting standards.

f) Banks should provide reports to their boards on the market-risk exposures of their investments on a regular basis. To do so, the institution may report the market-risk exposure of the whole institution. Alternatively, reports should contain evaluations that assess trends in aggregate market-risk exposure and the performance of portfolios in terms of established objectives and risk constraints. They also should identify compliance with board-approved limits and identify any exceptions to established standards.

g) Banks should have mechanisms to detect and adequately address exceptions to limits and guidelines. Management reports on market risk should appropriately address potential exposures to yield curve changes and other factors pertinent to the institution's holdings.