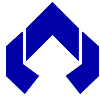

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Guideline

Subject: **Standards of Sound Business and Financial Practices -- Securities Portfolio Management**

No: **F-5** **Date:** **February 1998**

A. PURPOSE

This guideline sets out the minimum policies and procedures that each company needs to have in place and apply, and the minimum criteria it should use, to prudently manage its securities portfolio and exposure to position risk.

Regulatory changes governing the business activities of companies, pressure for increased profitability, innovations in securities instruments and a vastly more complex investment environment have resulted in a re-evaluation of the role of the securities portfolio management function. This includes the availability and use of derivative financial instruments to facilitate portfolio restructuring and hedging objectives, approaches to securities portfolio management strategy, securities analysis and performance measurement. Consequently, the securities portfolios of many companies now constitute a more significant medium for the matching of participating policies, as aids to the matching of very long non-participating policies and for the investment of surplus funds.

Securities portfolio management must be conducted in the context of several considerations, such as the nature of a company's liabilities, its participating policyholders' reasonable dividend expectations, its ability to absorb potential losses and the overall strategic business objectives of the company. Caution must be used in the construction of a portfolio consisting of equities and high yield/low investment-grade debt, taking due account of the risks inherent in a high risk/high return strategy, the time-scale appropriate to such a strategy, and the need for capital to support it. Further, although this guideline focuses on a company's responsibility for managing its securities portfolio and exposure to position risk, it is not meant to imply that the securities portfolio can be managed in isolation from other asset/liability management considerations, or from other risks inherent in a securities portfolio, such as interest rate risk and foreign exchange risk.

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B. DEFINITIONS

For the purposes of this guideline, securities include debt and equity instruments (excluding securities loans, loan substitute securities and strategic investments in subsidiaries) held by a company, both on- and off-balance sheet. Although the underlying transactions of securities loans and loan substitute securities are evidenced by securities, the ultimate risks of such transactions fundamentally involve credit risk. As such, management of these transactions is more appropriately addressed within the credit risk management function of companies.

Position risk is the exposure of a company to the effect of price changes on the market value of those elements of the company's portfolio of securities, both on- and off-balance sheet, which are not already cash flow matched against specific liabilities. Price changes may occur because of a number of factors, such as those solely related to specific securities within a portfolio (e.g., a change in the credit status of an issuer of a security) or those unrelated to any specific attribute of an individual security (e.g., investor preferences/demand, political and economic developments, and broad market price movements). The effect of the price change is a function of the size of the securities position, and the degree of price movement between the purchase date and the date of subsequent re-evaluation or sale, as the case may be.

C. SECURITIES PORTFOLIO MANAGEMENT PROGRAM

Managing the securities portfolio is a fundamental component in the safe and sound management of a company. Sound securities portfolio management involves prudently managing the risk/reward relationship and controlling securities portfolio risks across a variety of dimensions, such as quality, portfolio concentration/diversification, maturity, volatility, marketability, type of security and the need to maintain adequate liquidity.

Although the particulars of securities portfolio management will differ among companies depending upon the nature and complexity of their securities activities, a comprehensive securities portfolio management program requires:

- establishing and implementing sound and prudent policies to effectively manage the securities portfolio, securities activities and position risk;
- developing and implementing effective securities portfolio management processes governing securities investment decision-making and authority; and
- developing and implementing comprehensive procedures to effectively monitor and control the nature, characteristics, and quality of the securities portfolio and the extent of position risk assumed.

Securities Portfolio Management Policies

The foundation of an effective securities portfolio management program is the development and implementation of clearly defined policies, formally established in writing, that set out the securities portfolio management objectives of the company and the parameters under which securities activities are to be undertaken and controlled.

Each company needs to establish explicit and prudent securities portfolio management objectives governing:

- the extent to which the company is willing to assume position risk;
- general areas of securities activities in which the company is prepared to engage or is restricted from engaging, including the company's policy with respect to acquiring securities of related parties;
- minimum quality and rate of return expectations for the securities portfolio;
- the selection of securities dealers and other counterparties with whom the company is authorized to deal or is restricted from dealing with; and
- securities portfolio concentration and exposure limits.

Securities portfolio management objectives reflect a company's risk philosophy, codify investment criteria, establish the foundation for the development of securities portfolio management strategies, and provide the basis for monitoring portfolio characteristics and measuring portfolio performance. Securities portfolio objectives provide overall parameters governing securities investment decisions by describing the broad purpose and goals of securities investments. Securities portfolio objectives assist in ensuring that securities investments are sound and prudent, and that the securities portfolio risk is acceptable given the expected return.

i) Securities Portfolio Management Philosophy

The securities portfolio management philosophy is a statement about the willingness of a company to engage in securities portfolio investment activities and to assume position risk. The securities portfolio management philosophy will vary with the nature and complexity of a company's business activities, liquidity management needs, the extent of other risks assumed and its ability to absorb potential losses.

ii) General Areas of Securities Activities

A statement of the general areas of securities activities in which a company is prepared to engage usually specifies types of securities, issuers, industry or geographic sectors on which a company may focus its securities investment activities, or may establish constraints on an company's securities investment activities. This statement should include the company's policy with respect to acquiring securities from, and of, related parties, and in situations of potential conflict of interest.

To assist in ensuring that specific securities are within permitted areas of securities activities, and meet the company's securities portfolio management objectives, a company should consider maintaining a list of securities, categories, or issuers that the company is authorized, or alternatively not permitted, to engage in (or with).

iii) Securities Portfolio Quality and Return Objectives

Objectives governing the quality of securities that may be held in a securities portfolio are usually stated in terms of minimum acceptable credit or investment rating for securities investments or issuers of securities (such as those established in-house or by independent rating agencies for securities), or an approved list of securities or issuers of securities. Objectives respecting the acceptable return for a portfolio of securities are usually stated in terms of return on investment and should consider the company's cost of funds and effective after-tax return on investment.

Individual security/issuer selection should be made taking into consideration the overall quality and return objectives established for the portfolio. In this context, although there may be certain securities or issuers that do not by themselves meet the portfolio risk/return criteria, they may still yield an appropriate overall return when combined with other securities or investments in like issuers.

iv) Selection of Securities Dealers and Other Counterparties

It is important that companies have sufficient confidence in the ability of the securities dealers and other counterparties with whom they are dealing to fulfil their commitments. Moreover, some companies may rely on the expertise and advice of a securities dealer for recommendations about proposed securities alternatives and portfolio strategies and for the timing and pricing of securities transactions. In this context, except in situations in which a company settles securities transactions with counterparties on a value for value basis, each company needs to:

- establish in writing sound and prudent selection and retention criteria for securities dealers and other counterparties;

- maintain a list of securities dealers and other counterparties with whom they are authorized to conduct business; and

- actively monitor exposure to securities dealers and other counterparties.

v) Securities Portfolio Concentration Limits

Clearly defined and documented securities portfolio concentration limits ensure that the nature and level of a company's exposure in the form of either securities or credit positions is appropriately diversified and does not exceed sound and prudent limits.

Securities portfolio concentration occurs when a company's securities portfolio contains an excessive level of exposure to:

- one type or class of security; or

- single and groups of associated issuers of securities.

Excessive concentration is contrary to the sound investment principle of adequate diversification and renders a company vulnerable to adverse price changes in the area where exposures are concentrated. Determining whether or not an undue concentration risk exists is a matter of judgement. As with other aspects of financial management, a trade-off exists between risk and return. Although the avoidance of concentrated security positions or the hedging of such exposures may mitigate position risk, such a securities portfolio management policy may not be desirable for other sound business reasons. Accordingly, the objective of securities portfolio management need not necessarily be the complete elimination of exposure to changes in market prices of securities. Rather, it should be to manage the securities portfolio's risk and return and the impact of price changes within self imposed limits after careful consideration of a range of possible market price environments.

Securities portfolio diversification policies must establish sound and prudent aggregate and individual exposure limits for each type or class of security, and for single issuers and groups of associated issuers in which the company is permitted to invest. Usually, limits by class of security include limits for how much of the portfolio should be made up of specific types of securities such as equities and the portfolio concentration by geographic and industrial sector. Such limits need to be established in the context of the company's aggregate exposure to a single issuer or a group of associated issuers in terms of both securities and credit exposures. The management of such aggregate exposures is usually done at a level senior to securities traders and lending personnel so as to ensure that appropriate "firewalls" are maintained between the securities portfolio and credit risk management areas of the company.

Securities concentrations by single or associated issuers need to be reviewed regularly to ensure that prior considerations have not changed to an extent that warrant reclassification.

Securities portfolio concentration limits are usually defined either in absolute dollar or volume terms or in terms of a company's capital or assets.

Securities Portfolio Management Process

To develop and maintain a sound securities portfolio, each company must have:

- an effective formal evaluation process that provides for an objective analysis and assessment of securities investment proposals; and
- clearly defined, prudent and appropriate levels of delegation of securities transaction approval authority, formally established in writing.

i) Securities Analysis and Assessment

Prudence suggests that securities investment decisions be made only after careful examination and consideration of several areas including:

- the company's securities portfolio management policies, and other corporate objectives and policies, such as the nature of the company's liabilities and the need to maintain adequate liquidity;
- potential risks and returns related to a particular security in the overall context of the company's securities portfolio management policies, the composition of the securities portfolio and the reasonable expectation of a fair return or appreciation given the nature of the security, and the risk of loss or impairment;
- current and projected regulatory and economic/financial environment under which securities transactions are made; and
- investment alternatives.

ii) Securities Transaction Approval Authorities

Clearly defined and appropriate levels of securities transaction authority help ensure that a company's securities activities are appropriately undertaken and that securities positions do not exceed the limits established under its securities portfolio management policies.

Approval limits may relate to type of security, size, maturity, or other criteria, such as the retention or delegation of voting rights acquired through securities. Authorities may be absolute, incremental or a combination thereof, and may also be individual, pooled, or shared within a committee.

The delegation of authority needs to be clearly documented, and should include:

- the absolute and/or incremental securities transaction approval authority being delegated;
- the units, individuals, positions or committees to whom securities transaction authority is being delegated;
- the ability of recipients to further delegate approval authority; and
- the restrictions, if any, placed on the use of delegated authority.

The degree of delegation of securities transaction authority will depend on a number of variables including:

- the company's securities portfolio management objectives and overall risk philosophy;
- the quality of the securities portfolio;
- the ability of the company to absorb losses;
- the size and types of securities and the complexity of risks being assessed; and
- the experience and ability of the individuals responsible for carrying out the securities portfolio management activities.

Securities Portfolio Management Monitoring Procedures

Each company needs to develop and implement effective and comprehensive procedures, accounting policies and information systems to monitor and manage the characteristics and quality of its securities portfolio. These procedures should be appropriate to the size and complexity of the company's securities activities and need to include:

- systems to measure and monitor securities positions;
- controls governing the management of the securities portfolio; and
- independent audits.

i) Securities Portfolio Monitoring

Managing securities activities requires a clear understanding of the nature and characteristics of the securities portfolio and securities positions. To make these determinations, each company needs to ensure that:

- effective information systems are developed and used to appropriately record, and regularly monitor and evaluate the securities portfolio;
- effective and appropriate quality and performance criteria are developed and implemented, and that the portfolio is regularly assessed against these criteria; and
- appropriate and conservative accounting policies and procedures are developed, documented and implemented for:
    - properly classifying and carrying securities on the books of account of the company; and
    - recognizing income related to such securities.

Regular evaluations of the securities portfolio should be carried out so as to provide an effective means of ensuring that portfolio performance and quality are meeting the company's securities portfolio management policies and objectives, and that the portfolio is not unduly concentrated by type of security, and by single and associated groups of issuers.

ii) Securities Portfolio Management Controls

Sound securities portfolio management dictates that effective procedures be established and followed relative to the execution of securities transactions decisions and the management/ custody of securities. Effective procedures and controls ensure that securities activities are in compliance with the company's securities portfolio management policies and provide safeguards to protect a company from potential losses by ensuring that unauthorized exposure does not occur from improper or uncontrolled securities activities.

Although the controls over securities activities will vary among companies depending upon the nature and extent of their activities, the key elements of any securities portfolio management control program are well-defined guidelines governing:

- organizational controls to ensure that there exists a clear and effective segregation of duties between those persons who:

  - authorize, initiate or supervise securities activities; and

  - are responsible for operational functions such as the physical custody of securities, or arranging prompt and accurate settlement of securities transactions, or account for securities activities;

- procedural controls to ensure that:

  - securities are properly recorded and accounted for by the company;

  - securities transactions are settled in a timely and accurate manner;

  - securities are appropriately safeguarded (including, where the member uses the services of third-party depositories for securities, procedures to ensure that such depositories have established appropriate procedures to obtain and maintain possession or control of securities purchased on behalf of the company); and

  - unauthorized securities activity is promptly identified and reported to management; and

- controls to ensure that securities activities are monitored frequently against the company's securities portfolio management policies and risk limits, and excesses reported.

Moreover, each company needs to ensure that employees conducting securities trading activities on behalf of the company do so within a written code of conduct or guideline governing securities dealing. Such a guideline or code of conduct should provide guidance respecting confidentiality, trading with related parties and transactions in which potential conflicts of interest exist. These should include trading with affiliated entities, personal trading and investment activities of securities portfolio management personnel, including trading on insider information and taking personal gain from one's position, and trading relationships with securities dealers with whom the company deals. Each company should ensure that these guidelines are periodically reviewed with all securities portfolio management personnel.

The use of hedging techniques is one means of managing and controlling securities portfolio exposures. In this regard, many different financial instruments can be used for hedging purposes; the more commonly used, however, are derivative financial instruments. Examples include futures contracts, options and market price indices.

Generally, few companies will need to use the full range of hedging techniques or instruments. Each company should consider which techniques or instruments are appropriate for the nature and extent of its securities activities, the skills and experience of management, and the capacity of reporting and control systems.

Financial instruments used for hedging may not be distinguishable in form from instruments that may be used to take risk positions. Before using hedging products, companies must ensure that they understand the hedging technique and that they are satisfied that the instrument meets their specific hedging needs in a cost-effective manner.

Further, the effectiveness of hedging activities should be assessed not only on the basis of the technical attributes of individual transactions, but also in the context of the overall risk exposure of the company resulting from a potential change in asset/liability mix and other risk exposures such as credit, interest rate and foreign exchange risk.

In this context, hedging activities need to take place within the framework of a clear hedging strategy, the implications of which are well understood by the company under varying market scenarios. In particular, the objectives and limitations of using hedging products should be uniformly understood, so as to ensure that hedging strategies result in an effective hedge of an exposure rather than the unintentional assumption of additional or alternate forms of risk.

Companies that make use of derivatives either as limited or as active end-users must have the appropriate policies and procedures in place as well as the capability to implement them.

The process of risk management for derivatives activities should be integrated into the company's overall risk management system to the fullest extent possible, using a conceptual framework common to the company's other activities.

Companies should base their derivatives policies and procedures on two guidelines issued by the OSFI, and any subsequent amendments to those guidelines (i.e., the Derivatives Best Practices Guideline and the Guideline on Derivatives Disclosure).

iii) Internal Audits

Internal audits are a key element in managing and controlling a company's securities activities. They provide an objective assessment of the securities portfolios' existence, the integrity of the securities portfolio management process, and they promote the detection of problems relating thereto. Each company should use them to ensure compliance with, and the integrity of, the securities portfolio management policies and procedures. Internal audits should, over a reasonable period of time, test the company's securities portfolio management activities in order to:

- ensure that securities activities are in compliance with the company's securities portfolio management policies and procedures, and with the laws and regulations to which these activities are subject;
- ensure that securities transactions are duly authorized and accurately and completely recorded on the books of the company;

- ensure that recorded securities exist and are conservatively valued on the books of the company;

- confirm that securities held by depositories to the order of the company conform with the records of the company;

- ensure that management has established suitably designed controls over securities positions and that such controls operate effectively; and

- ensure the adequacy and accuracy of management information reports regarding the company's securities portfolio management activities.

Assessments of the securities portfolio management activities should be presented to the company's board of directors on a timely basis for review.

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