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AUTORITÉ DES MARCHÉS FINANCIERS

INTEGRATED RISK MANAGEMENT GUIDELINE

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Preamble

The Autorité des marchés financiers (the "AMF") establishes guidelines setting out its expectations with respect to financial institutions' legal requirement to follow sound and prudent management practices. These guidelines therefore cover the interpretation, execution and application of this requirement.

The AMF favours a principles-based approach rather than a specific rules-based approach. As such, the guidelines provide financial institutions with the necessary latitude to determine the requisite strategies, policies and procedures for implementation of such management principles and to apply sound practices based on the nature, size and complexity of their activities. In this regard, the guidelines illustrate how to comply with the stated principles.

AMF Note

The AMF considers governance, integrated risk management and compliance (GRC) as the foundation stones for sound and prudent management of financial institutions and, consequently, as the basis for the prudential framework provided by the AMF.

This guideline is part of this approach and sets out the AMF's expectations regarding sound and prudent integrated risk management.

Scope

This *Integrated Risk Management Guideline* is intended for insurers of persons (life and health), damage insurers, portfolio management companies controlled by an insurer, mutual insurance associations, financial services cooperatives as well as trust and savings companies, which are governed by the following Acts:

- *An Act respecting insurance*, CQLR, c. A-32;
- *Act respecting financial services cooperatives,* CQLR, c. 67.3;
- *An Act respecting trust companies and savings companies,* CQLR, c. S-29.01.

Lastly, this guideline applies to financial institutions operating independently as well as to financial institutions operating as members of a financial group.[1] As regards financial services cooperatives and mutual insurance associations that are members of a federation, the standards or policies adopted by the federation should be consistent with—and even converge on—the principles of sound and prudent management as detailed in this guideline.

The generic terms “financial institution” and “institution” refer to all financial entities covered by the scope of this guideline.

[1] For purposes of this guideline, “financial group” refers to any group of legal persons composed of a parent company (financial institution or holding company) and legal persons affiliated therewith.

Coming into effect and updating

This *Integrated Risk Management Guideline* has been in effect since April 1, 2009.

With respect to the legal requirement of institutions to follow sound and prudent management practices, the AMF expects each institution to have developed strategies, policies and procedures based on its nature, size, complexity and risk profile and to have been applying them since April 1, 2011.

Given its importance for financial institutions, this *Integrated Risk Management Guideline* has been updated to reflect the evolution of principles of sound and prudent management emanating from international bodies in keeping with the integrated management of risks and to complement the *Capital Management Guideline*.

This revised version will come into effect on April 1, 2015. As stated in the original version, the developments in integrated risk management and the AMF's observations in the course of its supervision of financial institutions may lead to further updates of this guideline.

Introduction

Risks and their management are intrinsic to all financial institutions. However, lack of or inadequate management of such risks can result in serious consequences and adversely affect the operation and solvency of financial institutions.

The core principles and guidance published by the Basel Committee on Banking Supervision[2] and the International Association of Insurance Supervisors[3]clearly explain the need for financial institutions to manage their risks in a sound manner. These international bodies also emphasize the governance component that must underlie such a framework and stress that financial institutions must have complete, formal and integrated risk management strategies, policies and procedures that enable them to identify, assess, quantify, control, mitigate and monitor risk. Moreover, regulators are encouraged to provide financial institutions with the framework to do so.

The AMF adheres to the principles and guidance published by international bodies that foster sound and prudent management practices. Pursuant to the authority conferred upon it under various sector-based statutes,[4] the AMF is issuing this guideline expressly to inform financial institutions of its expectations regarding integrated risk management.

One of the objectives of the guideline is the implementation of an integrated risk management framework within each financial institution. The guideline favours the adoption by each financial institution of a comprehensive and co-ordinated approach to integrated risk management that takes into account their interrelations and interdependencies.

2 Bank for International Settlements, Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision,* September 2012.

Bank for International Settlements, Basel Committee on Banking Supervision, Joint Forum, *Principles for the Supervision of Financial Conglomerates*, September 2012.

3 International Association of Insurance Supervisors, *Insurance Core Principles, Standards, Guidance and Assessment Methodology*, October 2011, *ICP 9* amended October 2012, *ICP 22* amended October 2013.

4 *An Act respecting insurance*, CQLR, c. A-32, ss. 325.0.1 and 325.0.2;

An Act respecting financial services cooperatives, CQLR, c. C-67.3, s. 565;

An Act respecting trust companies and savings companies, CQLR, c. S-29.01, s. 314.1.

1. Integrated risk management

Risks are inherent in the conduct of a financial institution's business and can represent both opportunities and threats. Since undesirable risks cannot be eliminated entirely, they should be managed based on their significance, i.e. the scope and frequency of the effects they are likely to have on a financial institution if they materialize. It is therefore important for an institution to adopt strategies, policies and procedures to be able to manage its risks effectively and efficiently.

Risk management is therefore essential to the conduct of a financial institution's business. It is an ongoing, dynamic and evolving process that should be part of the institution's corporate culture to help it achieve its strategic objectives.

The AMF further believes that financial institutions should gravitate toward integrated risk management rather than take an approach where risks are considered separately. A holistic approach takes into consideration the interrelationship and interdependence between risks, important aspects that can influence how much risk the institution will assume. As a result, financial institutions will need standardized processes and reliable information systems that allow them to identify connections between risks and to obtain complete, clear reports that enable senior management and the board of directors to track the achievement of the institution's strategic objectives.

This approach also makes it possible to better take into account risks that are harder to quantify using traditional methods. Certain operational risks, strategic risk and reputation risk are good examples.

An integrated risk management framework therefore increases the effectiveness with which the cascading effects of risks with multiple consequences are handled. Risks associated with the use of technologies, given their multiple ramifications, are good examples: interrupted operations, loss of data, identity theft, cyberattacks, damage to reputation, lawsuits, etc. With this in mind, strategies, resources, technologies and knowledge must be aligned to manage these risks across the entire financial institution.

As stated above, integrated risk management involves identifying, assessing, quantifying, controlling, mitigating and carefully monitoring the material risks to which a financial institution is exposed. It also allows the institution to identify events likely to affect it beyond the limits of its risk appetite.

2. Risk appetite, tolerance levels and limits

The AMF expects financial institutions to define and maintain a general risk appetite statement containing qualitative and quantitative elements. It also expects institutions to clearly define their tolerances for the most significant risks and embed them in their operations in keeping with their risk management policies and procedures.

Risk appetite refers to a broad notion whereby a financial institution determines the aggregate level of risk it can assume or accept in order to reach its strategic objectives and execute its business plan, all while respecting its obligations to its insureds and depositors and available capital.

Risk appetite is therefore closely tied to the institution's business strategy. A clear definition is essential to sound risk management insofar as it helps define the overall level of risk the institution is prepared to accept and assume in relation to its strategic objectives. It can be broken down as follows:

1. The risk appetite statement should contain qualitative information that make it possible to situate the targeted risks as well as the desired behaviour of the institution based on different scenarios. The statement could also contain quantitative objectives or limits, expressed as a function of revenue, capital or any other metric deemed relevant (for example, based on maximum loss or concentration limits).

2. Risk tolerance levels should specify the level of variation the financial institution deems acceptable for each major risk category in pursuing its objectives.

3. Risk limits aim to define risk appetite and tolerance levels according to specific and tangible granular components (for example, by business segment). The objective is to guide and support the institution's risk takers to ensure their decisions are in line with the institution's strategic objectives.

Defining a risk appetite statement that is understandable, easily communicable and reflects the institution's objectives and profile helps strengthen the institution's risk management culture.

The financial institution's general risk appetite statement should be backed by sufficient documentation justifying the choice of risk tolerance levels and limits. This documentation should make it possible to understand the context that led to this choice and also aim to facilitate and guide the periodic review of risk appetite strategies.

A financial institution's risk appetite must be dynamic, in other words, evolving with the institution's situation (particularly its solvency position), the health of the industry, market conditions and macroeconomic factors.

Furthermore, all events likely to significantly affect the institution or its environment should give rise to a reassessment of its risk profile.

Similarly, stress testing exercises[5] are critical when assessing resource adequacy against the institution's risk appetite. The assessment should review all material and probable risks, categorized by likelihood and impact. This approach provides senior management and the board of directors with an accurate picture of the potential consequences of all significant events on, for example, the solvency of the institution.

[5] Autorité des marchés financiers, *Stress Testing Guideline*, June 2012.

3. Integrated risk management governance

The AMF expects a financial institution's integrated risk management framework to be supported by a solid governance structure which, in particular, should enable it to clearly define the roles and responsibilities of the various stakeholders assigned to risk management.

It is the responsibility of the financial institution's senior management to give assurances to the board of directors that the risk appetite and tolerance levels are adequately established and respected, and that the measures taken to manage them are sufficient. Similarly, it is also up to the decision-makers to incorporate the opportunities identified within the risk management framework into the financial institution's strategic thinking and the resulting objective-setting process.

The board of directors and senior management therefore have primary responsibility for developing the management framework for the risks to which the institution is exposed. This framework must be supported by an organizational strategy focused on means of managing and optimizing risks.

In addition, effective and successful management depends on promoting a risk management culture within the institution and the tone set by its leaders. The objectives must be understandable and communicated across all levels of the institution. As stated above, risk management at a financial institution should not be considered a project, but rather should form an integral part of its corporate risk culture, a way of doing business.

3.1 Role of the board of directors[6]

Given the increased responsibility and accountability of directors, they have an interest in taking an active role in determining the risk appetite, and in choosing the integrated risk management strategies developed by senior management.

Optimal risk management should include obtaining the information necessary to understand the risks so the board of directors can properly carry out its mandate. Given that board ineffectiveness is often blamed when a financial institution is at fault or experiences problems, the board must ensure that the institution's financial objectives are compatible with its stated risk appetite and in line with its business plan and operational objectives.

Likewise, the self-assessment that the board of directors must perform routinely relative to its overall mandate should also cover the board's knowledge and understanding of the risks to which the financial institution is exposed.

[6] A reference to the board of directors can also include a board committee, such as a board committee established to examine specific issues.

In this context, the board of directors must be highly involved in integrated risk management and, in particular, should:

- Approve strategies in line with the risk appetite of the institution;

- Ensure senior management adopts policies and procedures to determine and maintain the appropriate level of capital in light of the institution's risks and strategic objectives;[7]

- Review and approve the risk management framework as well as the implementation of strategies to support it. This risk management framework should include mechanisms for delegating responsibilities and plans to be executed in the event of deficiencies;

- Review the proposed policies establishing the rules for accepting, monitoring, managing and reporting on the material risks to which the institution is exposed;

- Require senior management to report on the material risks to which the institution is exposed. The report should also discuss the procedures in place to manage these risks and the overall effectiveness of the procedures;

- Ensure that the institution's integrated risk management has a degree of independence, a status and sufficient visibility, and is reviewed periodically;

- Draw on its collective skills and experiences to understand the risks faced by the institution and the interrelations between these various risks, and be able to assess them and quantify them to senior management;

- Be aware of the processes[8] used to assess and quantify risks as well as the scenarios used and the stress tests performed. The stress tests may be based on past events and hypothetical developments, and include both the best and the worst expectations. In all cases, the board of directors should be aware of the limitations of the models, assumptions and tools used;

- Be apprised regularly of evolving trends, emerging risks and material changes likely to alter the financial institution's risk profile;

- Ensure regular communication with risk managers and the chief risk officer. This type of communication should include documented reports on all types of significant risks as well as the interrelationship between the risk management framework, the solvency position and the institution's strategic objectives. Plain language is particularly important, because it enables the board of directors to make use of the often detailed, technical and complex information provided to it, grasp that information and understand its scope and effects on the management of the institution.

[7] Autorité des marchés financiers, *Capital Management Guideline*, April 2015.
[8] Autorité des marchés financiers, *Capital Management Guideline*, April 2015.

3.2 Role of senior management

As part of integrated risk management, senior management of the financial institution should, in particular:

- Implement a risk management policy and risk management procedures that are appropriate in light of the financial institution's risk profile and business plan, and ensure that they are implemented efficiently and effectively at all levels;
- Designate appropriate individuals to be in charge of monitoring and controlling all material risks in line with the strategies adopted by the financial institution;
- Align each risk against the financial institution's objectives regarding the creation and preservation of value, including with respect to the business processes or specific segments in which such risks may materialize;
- Assess the potential effects of the risks identified on the financial institution's strategies and compliance as well as on the integrity of financial reporting;
- Identify the risks that may materialize with a view to establishing an order of priority based on the institution's characteristics and operating mode;
- Establish procedures for communicating with and drawing on higher reporting levels in response to the materialization of risks, the effectiveness of controls and changes likely to affect the financial institution's risk profile;
- Implement an effective compensation system that does not encourage risky practices such as the pursuit of higher returns through speculative position-taking.

3.3 Role of the chief risk officer

Ideally, overall responsibility for integrated risk management should be entrusted to a chief risk officer in charge of developing and managing a strategy in this area. Failing the existence of such a position—assuming the size of the financial institution does not warrant it, for example—this responsibility should be entrusted to a member of senior management.

However, this role is not "exclusive," since the person in charge must be able to rely on all people involved in risk management. The chief risk officer is responsible for developing and implementing the risk management strategy. In more complex institutions, he is responsible for co-ordinating the risk management approach.

The chief risk officer's primary role is coordination and being able to synthesize and communicate information effectively. He should be able to explain matters in a manner tailored to various audiences.

The chief risk officer's objectives should be holistic and foster notably the following:

- Promoting a risk culture by taking into account and incorporating risks in the institution's strategic decisions;
- Developing and implementing the risk management framework and strategies using, in particular, the expertise of risk managers at various levels of the institution;
- Constant discussions with business unit managers about their exposure to greater risks in order to ensure that their governance practices comply with the risk management framework;
- Advising members of the management team and the board of directors and communicating information to interested parties, in particular with regard to objectives of optimal risk-based capital allocation and risk appetite;
- Understanding by senior management and the board of directors of the issues and the interrelationship between the institution's strategic objectives, solvency position, risk management framework and stress testing exercises;
- Mitigating risks that could be harmful to the institution.

4. Dynamic and evolving integrated risk management framework

The AMF expects financial institutions to establish a framework to adequately manage all of their risks based on their risk appetite. This framework should be dynamic, evolving and implemented considering the nature, size and complexity of the institution's activities.

The AMF recognizes that implementing a risk management framework is largely influenced by the nature, size and complexity of a financial institution's activities. Thus, the institution must implement strategies, policies and procedures that are adequate for managing its risks effectively and efficiently in light of its specific attributes.

In general, an integrated risk management framework should:

- Be taken into consideration when formulating the organizational strategy;

- Give senior management and the board of directors an acceptable level of confidence and comfort regarding their understanding and management of the full range of risks related to the fulfillment of the institution's objectives;

- Provide senior management and the board of directors with guidance in decision-making and facilitate their understanding of the interrelationship between this framework, the capital management framework and the institution's strategic objectives;

- Be implemented at all levels within the institution in order to generate an overall view of risk exposures;

- Help identify potential events likely to affect the financial institution and enable the institution to manage them in light of its risk appetite;

- Focus on risks (independent or overlapping) that hinder the achievement of the financial institution's objectives and strategies and are likely to significantly affect its functions and processes.

While a financial institution must implement an integrated risk management framework enabling it to pinpoint risks and benefit from the management of those risks, the framework must be dynamic. In this regard, it must allow for modifications in light of changes in the institution's risk profile. In particular, it should allow a financial institution to have:

- A better ability to prevent, detect, remedy and report problems related not only to inadequate risk management, but also to events or problems caused by elements that could come from outside the institution;

- Reduced risk management costs through enhanced sharing of risk-related information and a better integration of existing risk management processes;

- The means to increase strategic flexibility in the event of situations that prove more favourable or unfavourable than expected.

In addition to being dynamic, the risk management framework should be able to evolve. A financial institution has every reason to continue refining its risk management framework to an optimal level and always in line with its specific attributes.

Becoming efficient and intelligent with respect to risk management can be achieved in particular through decompartmentalizing risk management and adopting more integrated and co-ordinated measures. For example, this method of managing risks involves a transition from a minimal risk management framework, in which risks are considered on an individual basis, to a risk portfolio outlook.

This method also involves documenting, in an aggregated and synthesized manner,[9] observations and decisions made based on the risk management framework and stress testing exercises (for example, adjustments made to the risk appetite statement and strategic plans).

Through the various stages of identifying, assessing, quantifying, controlling, mitigating and monitoring risks, the approach adopted should be an evolving one. For example, the approach should shift from considering all risks to considering material risks, from merely mitigating risks to optimizing them, and from quantifying risks fortuitously (or randomly) to quantifying and monitoring them in a structured and rigorous manner.

Finally, a dynamic and evolving risk management framework enables optimization of capital use and exposure to the different types of risks of the financial institution. Consequently, capital management activities should be integrated within the framework of integrated risk management, in particular through an internal risk and solvency assessment process.[10]

[9] The AMF may, if it deems it appropriate, provide more specific expectations concerning the documentation required to support the risk management framework.

[10] To learn about expectations in this regard, see the *Capital Management Guideline*, April 2015.

Supervision of sound and prudent management practices

In fostering the establishment of sound and prudent management practices within financial institutions, the AMF, as part of its supervisory activities, intends to assess the degree of compliance with the principles set forth in this guideline in light of the specific attributes of each institution. Similarly, it will examine the effectiveness and relevance of the strategies, policies and procedures adopted by financial institutions as well as the quality of supervision and control exercised by their boards of directors and senior management.

Risk management practices are constantly evolving. The AMF expects decision makers at financial institutions to remain current with best practices and to adopt them, to the extent that they address their needs.