AUTORITÉ
DES MARCHÉS
FINANCIERS

INVESTMENT 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 execution, interpretation 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 the implementation of such management principles and to apply sound practices based on the nature, size and complexity of their activities.

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 forms part of that approach and sets out the AMF’s expectations regarding sound and prudent investment management practices.

Scope

This *Investment Management Guideline* is intended for insurers of persons (life and health), damage (P&C) insurers, holding companies controlled by an insurer, any federation of mutual insurance associations with respect to its investment fund, financial services cooperatives, trust companies, and savings companies governed by the following statutes:

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

This guideline applies to financial institutions operating independently and financial institutions that are members of a financial group.[1] As regards financial services cooperatives and mutual insurance associations[2] 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 prescribed by law and detailed in this guideline.

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

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[1] For the 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 with it.

[2] Mutual insurance associations are damage insurers covered by the scope of this guideline.

Effective date and updates

The *Investment Management Guideline* has been in effect since August 1, 2010.

With respect to the legal requirement imposed on institutions to follow sound and prudent management practices, the AMF expects each institution to have adopted the principles set out in this guideline in developing strategies, policies and procedures commensurate with the institution's nature, size, complexity and risk profile and to have implemented them since August 1, 2012.

To reflect the evolution of the principles of sound and prudent management emanating from international bodies and following the revocation of the *Derivatives Risk Management Guideline*, to be consistent with the *Governance Guideline* and the *Integrated Risk Management Guideline*, the *Investment Management Guideline* is revised effective March 31, 2019.

A one-year transition period has been set to enable financial institutions to comply with the new requirements. The AMF therefore expects financial institutions to have made the necessary changes by March 31, 2020. Where an institution has already implemented such a framework, the AMF may verify whether the framework complies with the requirements prescribed by law.

As mentioned in the original version of this guideline, developments in investment management and the AMF's observations in the course of its supervisory work could lead to other changes to this guideline.

Introduction

Investments can account for a large percentage of a financial institution's assets and a considerable source of its income. However, they can also result in significant losses potentially affecting an institution's financial soundness and even in major liquidity problems. Moreover, various factors, including the opacity of certain loan arrangements and uncertainty about the quality of information used for valuations, can also make it more difficult to measure investment risks. In order to protect consumers of financial products and users of financial services, it is therefore essential for financial institutions to follow sound and prudent investment management practices.

This guideline sets out the AMF's expectations regarding investment management performed by financial institutions. The AMF is empowered by the various sector-based statutes it administers[3] to give financial institutions guidelines that may pertain to any sound and prudent management practices.

The AMF's expectations are based on core principles and guidance issued by international organizations, including the Basel Committee on Banking Supervision and the International Association of Insurance Supervisors.[4] They also draw on lessons learned from past experience with the financial markets.

[3] *Act respecting insurance*, CQLR, c. A-32, ss. 325.0.1 and 325.0.2;
Act respecting financial services cooperatives, CQLR, c. C-67.3, s. 565;
Act respecting trust companies and savings companies, CQLR, c. S-29.01, s. 314.1.

[4] Basel Committee on Banking Supervision. *Supervisory Guidance for Assessing Banks' Financial Instrument Fair Value Practices*, April 2009, International Association of Insurance Supervisors. ICP 15 Investment, October 2011.

1. Sound and prudent investment management

Sound and prudent investment management requires an effective and efficient framework. As such, a financial institution should adopt practices that include clearly defining the roles and responsibilities of board members and senior management as well as developing a strategy backed by a policy and procedures.

As part of a dynamic and evolving management approach, an institution should implement mechanisms enabling it to proactively and prospectively monitor and control its investments on both individual investment and aggregate portfolio basis.

For the purposes of this guideline, a financial institution's investments generally refer to deposits, securities and derivatives. They may also be referred to as instruments, debt securities or financial instruments.[5]

[5] Under the sector-based statutes applicable to financial institutions, investments may be made in other ways, including by way of hypothecary loans, claims secured by hypothec or income-producing properties.

2. General framework for investment management

2.1 Roles and responsibilities assigned to the board of directors and senior management

The AMF expects investment management to be supported by effective and efficient governance.

Roles and responsibilities of the board of directors[6]

In addition to the roles and responsibilities described in the *Governance Guideline* and the *Integrated Risk Management Guideline*, the roles and responsibilities of the board of directors with regard to a financial institution's investment management should primarily be as follows:

- review and approve the investment strategy and ensure that it is implemented;
- review and approve the investment policy while ensuring that senior management reviews the policy periodically and as needed;
- ensure that investments are managed by competent and experienced persons of integrity who are compensated in a way that avoids potential incentives for excessive risk-taking;
- approve the risk-return profiles;
- monitor any irregular or problematic activity, transaction or situation.

Roles and responsibilities of senior management

Other than the roles and responsibilities described in the *Governance Guideline* and the *Integrated Risk Management Guideline*, the roles and responsibilities of senior management with regard to a financial institution's investment management should primarily be as follows:

- develop and implement the investment strategy;
- develop the institution's investment policy, recommend it to the board of directors and ensure its application;
- oversee the implementation of procedures relating to the various investment activities, particularly for compliance with authorizations, restrictions, prohibitions and limits;
- periodically analyze and assess the risk-return trade-off for investments on an individual investment and aggregate portfolio basis and report to the board regularly and at the board's request;

[6] References to the board of directors may include a board committee established, for example, to examine specific issues.

- ensure that the institution has independent valuation data, particularly when over-the-counter derivatives are used; in the absence of such capability, the institution should use the services of a specialized dealer;
- ensure that they are provided with the relevant information regarding the nature of the institution's involvement in derivatives activities and the related risks;
- ensure the sufficiency and adequacy of the institution's capital position considering the institution's exposure to the risks associated with derivatives.

2.2 Strategy, policy and procedures

The AMF expects financial institutions to have an investment strategy and to implement a policy and procedures to execute the strategy at the operational level.

Strategy

The financial institution's investment strategy should be supported by operational objectives, plans, an organizational structure and appropriate control measures.

In general, the investment strategy should allow the institution to:

- establish a policy and implement the procedures necessary for the institution to achieve sound investment management;
- aim for a risk-return balance based, in particular, on its business lines and its risk appetite.

  To this end, the institution should regularly determine and revise its investment risk tolerance levels based on the objectives it has set for itself.

When developing its investment strategy, the institution should take the following into consideration:

- the scope of investment risks, including market risk, credit risk, liquidity risk and operational risk;
- its capital requirements.

The investment strategy should be reviewed regularly and as needed, particularly in light of changes in the capital markets, the development of new financial products and the institution's commitments to its clients.

Policy

An institution's investment policy[7] should establish the principal parameters within which the institution should manage its investment activities. The policy should be sufficiently

[7] *Act respecting insurance*, CQLR, c. A-32, s. 248; *Act respecting financial services cooperatives*, CQLR, c. C-67.3, s. 483; Act respecting trust companies and savings companies, CQLR, c. S-29.01, s. 217.

supported to ensure effective management, particularly in respect of situations where the risk is considered high.

Consistent with the investment strategy developed by the institution, its investment policy should generally address the following elements:

- types and characteristics of its investments;
- expected returns and the purpose of its investments, such as liquidity, matching, pledging of collateral, hedging and trading;
- investment concentration limits;
- investment decision criteria, standards and other parameters. If necessary, an institution could establish:
  - investment authorization levels within its organizational structure and any conditions related thereto;
  - restrictions on or prohibitions from acquiring certain investments deemed to involve greater risk or issued or guaranteed in connection with transactions between affiliated legal persons or associates.
- choice of dealers, advisers and representatives as well as their remuneration methods;

  Remuneration incentives should not conflict with the achievement of the institution's objectives.
- processes relating to intra-group management of investment activities;
- procedures for analyzing and evaluating investments when deciding to make an investment and when carrying out a transaction;
- monitoring and control of investments.

Procedures

Investment management procedures should allow an institution to adequately govern its investment activities, particularly when investments are acquired or disposed of. Investment decisions should be based on analyses and valuations that take into account, in particular, the institution's investment risk tolerance levels and expected returns. They should also be supported by full documentation.

Risks

Before making an investment, a financial institution should know the source, scope and types of risks associated with an investment activity. Accordingly, adequate procedures should be implemented so as to manage investment risks, while giving consideration to the interrelationships and interdependencies between the risks to which the institution is exposed. Adequate methods should also be used to measure the institution's risk exposure and establish techniques for mitigating risks.

The institution should consider various internal and external factors that are likely to affect these risks—its risk tolerance levels, of course—but also its objectives, the general economic climate, interest rates, and legal and regulatory requirements.

Furthermore, reporting mechanisms should be established so that the risks encountered are clearly communicated, known and understood by all parties within the institution who are involved in its investment activities.

Analysis and valuation

An institution should determine the value of its investments in an objective manner and ensure that the information used to do so is reliable. Thus, it should use valuation models, as necessary, establish a comparative basis for determining values and, where applicable, avoid basing its decisions solely on ratings as the sole factor in valuing its investments.

Investment analysis tools should be established based, in particular, on the following elements:

- nature, characteristics and liquidity of the investments;
- degree of exposure to various risks for each type of investment and for the entire investment portfolio, particularly in light of concentration limits.

The institution should remain prudent with respect to any analysis conducted by rating agencies. Ideally, it should obtain ratings from at least two agencies. As well, it should ensure that the ratings are reliable, particularly where market conditions are unfavourable.

2.3 Intra-group management

> The AMF expects financial institutions to manage investments in accordance with the framework established for their group.

Investment concentration risk and the potential effect of contagion are the principal elements justifying a comprehensive and coherent investment management approach at the group level.

Accordingly, investment procedures should, if applicable, be set up for the institution and the entities in the group, including a security fund created at the request of a federation for the member credit unions, or a guarantee fund of which a federation and its mutual insurance associations are members. These procedures should cover certain situations that could entail greater risks for one or more entities in the group, or for the group as a whole. For example:

- when a financial institution and one or more of the entities in the group act both as investor and lender with respect to the same person outside the group;
- in a situation of conflict of interests where investments are made by an institution (or by one of the entities in the group) in a company related to an officer or a member

of senior management or of the board of directors of another institution (or another entity) forming part of the group.

Moreover, where a financial institution outsources its investment management to a specialized entity within the group or to an outside service provider, the AMF believes the institution continues to be responsible for ensuring that the risks related to its investments are managed in a sound and prudent manner. The *Outsourcing Risk Management Guideline*[8] sets out the AMF's expectations in this regard in greater detail.

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[8] Autorité des marchés financiers. *Outsourcing Risk Management Guideline*, December 2010.

3. Monitoring and control of investments

3.1 Investment portfolio practices

The AMF expects financial institutions to monitor and control their investment portfolio effectively and efficiently.

The financial institution should establish management practices to properly monitor and control its investments on both individual investment and aggregate portfolio basis.

The institution should therefore have a clear understanding of its investments and properly monitor changes therein involving the quality and performance of the portfolio. It should also ensure that its investment portfolio is diversified, the concentration limits are adhered to, and key risks are taken into consideration—in particular, market risk, credit risk and liquidity risk.

Quality and performance

Uncertainties resulting from major market fluctuations, from classes of investments becoming illiquid or from concerns about the reliability of information are some of the factors that may give rise to key questions regarding the quality of an institution's investments.

The institution should analyze and assess its portfolio on a regular basis and as needed to ensure the quality and performance of its investments. Consequently, it should ensure that the investments and the positions taken with respect thereto meet its objectives and are in line with its investment risk tolerance levels. As well, the institution should be able to draw on reliable and efficient information systems for such purpose.

The selection of investments should be adjusted and thorough monitoring should be conducted as necessary, particularly when material discrepancies are observed between actual and expected returns or there is a significant change in the degree of risk incurred for one or more investments. Furthermore, large investments should be valued by an independent expert when necessary, particularly with respect to illiquid assets.

Diversification, concentration limits and other risks

Diversification of an investment portfolio seeks primarily to mitigate investment risks. Concentration limits should therefore be set and cover all the institution's exposures to primarily issuers and counterparties. These limits could be expressed in relation to the following parameters, among others:

- types of investments and their attributes (including risk/returns, maturities, whether they are mortgage backed or secured by claims, rank in the event of winding-up, dividend policy, conversion feature).

  For example, more restrictive limits could be placed on some types of complex investments such as certain derivatives.
- liquidity and negotiability of the securities;

- geographic zones and industry sectors, particularly as regards foreign securities;
- counterparties, such as public issuers, private issuers, affiliated legal persons and associates of a director and the institution;
- foreign currencies.

An institution should be able to measure its market risk exposure across its entire portfolio and across risk factors (notably interest rates, equites and currencies).

Investment activities involving credit risk in which a financial institution is prepared to engage should be identified in its investment policy. The type of credit activity, type of collateral or real estate, and types of borrowers on which the financial institution may focus should also be specified in its investment policy.

Particular attention should be given to embedded transactions of credit risk, such as credit derivatives, whose value depends on exogenous factors. Financial institutions that engage in the use of instruments such as derivatives should take into consideration that counterparty exposures could change depending on the mark-to-market value of the underlying financial instrument. Effective measures of potential future exposure are therefore essential for the establishment of meaningful limits. In addition, credit risk of investment activities should be co-ordinated with credit risk of other activities of the financial institution.

As for liquidity risk management, a financial institution should structure its assets in such a way that it has enough cash and marketable securities to cover its obligations.

3.2 Scenario analysis and stress testing

> The AMF expects financial institutions to routinely carry out scenario analysis and stress testing so as to identify vulnerabilities and assess their impact.

Economic conditions and market volatility can influence the value of a financial institution's investments at any time.

As part of a dynamic and evolving management approach, an institution should consider various assumptions, design scenarios and carry out stress testing in order to assess the impact of adverse market conditions on its investments, while taking into consideration the risks tied to investments such as interest rate risk, liquidity risk, foreign exchange risk, credit risk and counterparty risk.

Scenario analysis and stress testing should be discussed among the board of directors, senior management and staff assigned to managing the institution's investments. They should also be supported by appropriate documentation.

Once it has identified any vulnerabilities that could have an impact on the financial institution, actions could be considered with respect to investment management such as:

- using hedging strategies to mitigate its risk exposure;

- adjusting its investment policy, particularly with respect to concentration limits;
- strengthening the control and monitoring mechanisms for certain large investments or those considered more vulnerable to risk.

3.3 Internal control[9]

The AMF expects a financial institution to establish internal control mechanisms specifically with respect to its investment activities.

In order to achieve effective and efficient investment management, a financial institution should establish internal control mechanisms to ensure that investments comply with the institution's policy and procedures and with legal and regulatory requirements.

When establishing these mechanisms, the institution should, in particular, ensure that front office, back office, middle office and risk management functions remain independent of one another.

Internal investment controls should cover matters such as:

- concentration limits;
- valuation and recognition of investments in accordance with Canadian generally accepted accounting principles. Particular attention should be given to investments used for arbitrage, trading and hedging purposes.
- responsibilities of depositaries and the terms and conditions of safekeeping arrangements;
- cash flows generated through investments such as income, repurchases and redemptions at maturity;
- disclosure and publication of relevant and reliable information regarding investments, for both internal and external purposes.

When entering into or varying an outsourcing[10] arrangement for aspects of investment-related activities, a financial institution should implement controls that describe how the proposed outsourcing arrangement will:

- affect its risk level;
- consider the concentration and liquidity risk implications.

Internal control deficiencies and breaches significantly affecting investment compliance should be noted and reported to senior management and the board of directors. Appropriate follow-up should be performed and necessary measures should be taken in a timely manner. With this in mind, a financial institution should have its investment risk

[9] For more details regarding internal controls, see the *Governance Guideline*, September 2016.

[10] For more details regarding outsourcing, see the *Outsourcing Risk Management Guideline*, December 2010.

management processes independently assessed on a regular basis. The results should be communicated directly to the board of directors, its audit committee or senior management according to their materiality.

Supervision of sound and prudent management practices

To foster the establishment of sound and prudent management practices within financial institutions, the AMF, acting within the scope 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. Consequently, it will examine the effectiveness and relevance of the strategies, policies and procedures adopted by financial institutions as well as the quality of oversight and control exercised by their board of directors and senior management.

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