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INVESTMENT MANAGEMENT GUIDELINE

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Preamble

The *Autorité des marchés financiers* (“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 implementation of such management principles and to apply sound practices based on the nature, size and complexity of their activities.

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 investment management practices.

Introduction

Investments represent an important part of a financial institution's assets and a considerable source of its income. However, they can also cause significant losses that can threaten an institution's financial soundness and even give rise to major liquidity problems. Moreover, various factors, including the lack of transparency 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 services, it is therefore essential that financial institutions apply sound and prudent investment management practices.

This guideline sets out the expectations of the AMF regarding investment management performed by financial institutions. Under the various sector-based laws it administers,[1] the AMF has the authority to establish guidelines regarding any sound and prudent management practices for financial institutions.

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.[2] They also draw on the lessons learned from past experience involving the financial markets.

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

[2] Basel Committee on Banking Supervision, Supervisory Guidance for Assessing Banks' Financial Instrument Fair Value Practices, April 2009;

International Association of Insurance Supervisors, Guidance Paper on Investment Risk Management, October 2004;

International Association of Insurance Supervisors, Insurance Core Principles and Methodology, October 2003.

Scope

This investment management guideline is intended for insurers of persons (life and health), damage insurers, portfolio management companies controlled by an insurer, mutual insurance associations, any federation of mutual insurance associations with respect to its investment fund, financial services cooperatives as well as trust and savings companies governed by the following Acts:

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

This guideline applies to financial institutions operating independently as well as to financial institutions operating as part of a financial group.[3] 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 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.

[3] 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 investment management guideline will come into effect on month xx, 201X.

With respect to the legal requirement of institutions to follow sound and prudent management practices, the AMF expects each institution to develop strategies, policies and procedures based on its nature, size, complexity and risk profile, to ensure the adoption of the principles underlying this guideline by month XX, 201X (two years after coming into effect). Where an institution has already implemented such a framework, the AMF may verify whether it enables the institution to satisfy the requirements prescribed by law.

This guideline will be updated based on developments in investment management and in light of the AMF's observations in the course of its supervision of financial institutions.

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 that allow it to monitor and control its investments, individually and as a whole, in a proactive and forward-looking manner. It should also have appropriate internal control over its investment activities.

This guideline sets out six principles for achieving sound and prudent investment management. In light of this approach, the proposed principles do not impose quantitative requirements with respect to investment ratios or limits in addition to any requirements that might be stipulated under respective legislation.

For 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.[4]

2. General framework for investment management

Principle 1: Roles and responsibilities of 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[5]

The roles and responsibilities of the board of directors with regard to a financial institution's investment management should principally be as follows:

- participate actively in designing the investment strategy, approve it and ensure it is implemented;

[4] Under the sector-based laws 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.

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

- examine and approve the investment policy, while ensuring that senior management reviews the policy periodically and when required;

- ensure that the investment management is handled by competent and experienced persons of integrity who are entitled to compensation based on appropriate prudent performance measures;

- examine the reports on the quality and performance of the investment portfolio. As well, the board members should have a clear understanding of the investments in which the institution seeks to invest, including their characteristics and related risks.

  The examination could consider the following aspects, among others:

  - changes in the investments and their performance in light of market trends and the institution's risk profile;

  - major investment positions taken as well as the depreciation and write-off of investments;

  - investments issued or guaranteed in connection with transactions between affiliated legal persons or associates[6] as well as persons who could constitute a source of conflict of interests;

- follow-up on any activity, transaction or situation that is irregular or problematic;

- ensure that internal control mechanisms are in place;

- specify the scope and frequency of investment management reports to be submitted to the board.

Roles and responsibilities of senior management

The roles and responsibilities of senior management with regard to a financial institution's investment management should principally be as follows:

- develop and implement the investment strategy;

- develop the institution's investment policy, recommend its approval by the board of directors and see to it that it is applied;

- implement procedures with respect to investment activities;

[6] *An Act respecting insurance*, R.S.Q., c. A-32, ss. 1.3, 1.6 and 285.17;
An Act respecting financial services cooperatives, R.S.Q., c. C-67.3, ss. 115 and 121;
An Act respecting trust companies and savings companies, R.S.Q., c. S-29.01, ss. 9, 120 and 135.

- periodically analyze and assess the quality and performance of individual investments as well as the overall portfolio, and report to the board on a regular basis and upon request;

- establish internal control mechanisms so as to ensure that investments comply with the institution's policy and procedures and with legal and regulatory requirements.

Principle 2: Strategy, policy and procedures

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

Investment 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:

- elaborate 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 and solvency 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 supported to ensure effective management, particularly in respect of situations where the risk is considered to be high.

In light of the investment strategy developed by the institution, its investment policy should, in particular, address the following elements:

- the types and characteristics of its investments;
- expected returns and the purpose of its investments, such as liquidity, matching, collateral security, hedging and speculation;
- investment concentration limits;
- investment decision criteria, standards and other parameters. If necessary, an institution could establish:
  - investment authorization levels within its organizational structure and the conditions related thereto;
  - restrictions or prohibitions on the acquisition of certain investments deemed to involve greater risks or issued or guaranteed in connection with transactions between affiliated legal persons or associates;
- the selection of securities 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 intragroup management of investment activities;
- procedures for analyzing and evaluating investments when deciding to make an investment and when carrying out a transaction;
- the monitoring and control of investments.

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

Procedures

Investment management procedures should allow an institution to govern its investment activities properly, particularly with respect to acquisitions or disposals. They should include analysis and valuations supported by complete documentation for all investment decisions, giving consideration to the institution's investment risk tolerance levels and expected returns.

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, establish a comparative basis for determining values and avoid basing its decisions solely on the ratings attributed to investments.

The institution should establish investment analysis tools based, in particular, on the following elements:

- the nature, characteristics and liquidity of the investments;

- the degree of exposure to various risks for each type of investment and for the investment portfolio as a whole, particularly in light of concentration limits.

In order to ensure that ratings are reliable, the institution should apply various analysis methods to corroborate the ratings. Ideally, it should also obtain a rating from a different agency.

Principle 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 implemented for the institution and the entities in the group, including a security fund established at the request of a federation of credit unions, or a guarantee fund of which the 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 Guideline[8] sets out the AMF's expectations in this regard in greater detail.

[8] *Autorité des marchés financiers*, Outsourcing Risk Guideline, April 2009.

3. Monitoring and control of investments

Principle 4: 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 both individually and on a 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 sufficiently diversified and that concentration limits are respected.

Quality and performance

Uncertainty 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 consistent with its investment risk tolerance levels. As well, the institution should be able to draw on reliable and efficient information systems for such purpose.

When necessary and if certain unfavourable factors arise, such as a change in an issuer's rating or a significant variation in the trading volume of an investment as a result of market turmoil, the institution should carry out analysis, revalue certain investments and estimate their impact on the institution's profitability.

The selection of investments should be adjusted and thorough monitoring conducted as necessary, particularly when material discrepancies arise with respect to actual versus expected returns or a significant change takes place regarding the risk incurred for one or more investments. Furthermore, when necessary, large investments should be valued by an independent expert.

Diversification

Diversification of an investment portfolio seeks primarily to mitigate investment risks. Concentration limits should therefore be set in light of the institution's capital requirements. These limits could be expressed in relation to the following parameters, among others:

- the types of investments and their attributes (including 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 certain types of complex investments such as derivatives;
- the 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.

In addition, measures, including hedging, should be taken promptly to offset certain diversification gaps in the portfolio within the established investment concentration limits.

Principle 5: Scenario analysis and stress testing

> The AMF expects financial institutions to carry out scenario analysis and stress testing, on a regular basis so as to identify their 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 :

- use hedging strategies to mitigate its risk exposure;
- adjust its investment policy, particularly with respect to concentration limits;
- strengthen the control and monitoring mechanisms for certain large investments or those considered more vulnerable to risk.

Principle 6: Internal control

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, the 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 ensure that certain investment processes remain independent, including with respect to front office and back office functions, while also avoiding decision-making by a single person.

Internal investment controls should cover matters such as:

- concentration limits;
- the valuation and recording of investments. Special attention should be paid to investments used for arbitrage, speculation and hedging purposes;
- the responsibilities of custodians and the terms and conditions of safekeeping arrangements;
- cash inflows;
- the disclosure and publication of relevant and reliable information regarding investments, primarily for internal purposes.

Internal control shortcomings and material investment compliance deficiencies should be noted and reported to senior management and to the board of directors. Appropriate follow-up should be performed and the necessary measures should be taken in a timely manner. If warranted, the institution could seek external assistance.

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.