BANK OF JAMAICA

STANDARDS OF SOUND BUSINESS PRACTICES

SECURITIES PORTFOLIO MANAGEMENT

Bank of Jamaica
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SECURITIES PORTFOLIO MANAGEMENT

A. PURPOSE

This document sets out the minimum policies and procedures that each licensee 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.

Securities portfolio management must be conducted in the context of a number of considerations such as, the nature of an institution's liabilities, its ability to absorb potential losses and the overall strategic business objectives of the institution. Although this document focuses on the licensee'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.

B. DEFINITIONS

For the purposes of this document, securities include debt and equity instruments held by an institution, both on- and off-balance sheet.

Position risk is the exposure of the institution to effect of price changes on the market value of the institution's portfolio of securities, both on- and off-balance sheet. 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-valuation or sale, as the case may be.

C. SECURITIES PORTFOLIO MANAGEMENT PROGRAMME

Managing the securities portfolio is a fundamental component in the safe and sound management of all institutions. Sound securities portfolio management involves prudently managing the risk/reward relationship and controlling and minimising 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 institutions depending upon the nature and complexity of their securities activities, a comprehensive securities portfolio management programme 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 programme is the development and implementation of clearly defined policies, formally established in writing, that set out the securities portfolio management objectives of the institution and the parameters under which securities activities are to be undertaken and controlled.

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

- the extent to which the institution is willing to assume position risk;

- general areas of securities activities in which the institution is prepared to engage or is restricted from engaging, including the institution's policy with respect to acquiring securities of related parties;

- minimum quality and rate of return expectations for the securities portfolio; and

- securities portfolio concentration and exposure limits.

Securities portfolio management objectives reflect an institution'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 as a means for profitability. 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.

In establishing securities portfolio management objectives, each institution needs to give consideration to a number of factors, including the institution's nature of liabilities, its liquidity needs, market volatility, the extent of other risks assumed (e.g. credit risk, interest rate risk, foreign exchange risk), the institution's ability to absorb potential losses and its overall strategic business objectives. In this context, a portfolio of securities with relatively high-risk characteristics such as equities and other types of debt instruments issued by subsidiaries and connected entities does not represent an optimal mix. Accordingly, such securities should not constitute a significant proportion of an institution's asset portfolio, both on- and off-balance sheet.

To be effective, securities portfolio management objectives must be communicated in a timely fashion, be implemented through all levels of the organization by appropriate procedures and revised periodically in light of changing circumstances.

i) Securities Portfolio Management Philosophy

The securities portfolio management philosophy is a statement about the willingness of the institution 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 an institution'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 an institution is prepared to engage usually specifies types of securities, issuers, industry sectors on which an institution may focus its securities investment activities, or may establish constraints on an institution's securities investment activities. This statement should include the institution'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 institution's securities portfolio management objectives, all licensees should consider maintaining a list of securities, categories, or issuers that the institution is authorised, 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 institution'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 meet the portfolio risk/return criteria, when combined with other securities or investments in like issuers, may yield an appropriate overall return.

iv) Selection of Securities Dealers and Other Counterparties

It is important that all licensees have sufficient confidence in the ability of the securities dealers and other counterparties with whom they are dealing to fulfill their commitments. Moreover, some institutions 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 an institution settles securities transactions with counterparties on a value for value basis, each institution needs to:

- establish in writing sound and prudent securities dealer selection and retention criteria;
- maintain a list of securities dealers and other counterparties with whom they are authorised to conduct business; and
- establish and periodically review sound and prudent limits on the dollar or volume amounts, or types of transactions they may be executed with each authorised securities dealer and counterparty.

v) Securities Portfolio Concentration Limits

Clearly defined and documented securities portfolio concentration limits ensure that the nature and level of an institution'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 an institution's securities portfolio contains an excessive level of exposure to:

- one type or class of security; or
- a single or group of associated issuers of securities.

Excessive concentration is contrary to the sound investment principle of adequate diversification and renders an institution vulnerable to adverse price changes in the area where exposures are concentrated. Determining whether or not 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.

At a minimum, securities portfolio diversification policies must place 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 institution 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 industrial sector. Such limits need to be established in the context of the institution's aggregate exposure to a single issuer or 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 maintain between the securities portfolio and credit risk management areas of the institution.

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

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

Securities Portfolio Management Process

To develop and maintain a sound securities portfolio, each institution 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 institution's securities portfolio management policies, and other corporate objectives and policies, such as the nature of the institution's liabilities and the need to maintain adequate liquidity;
- potential risks and returns related to a particular security within the overall context of the institution'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 an institution'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 as a minimum:

- the absolute and/or incremental securities transaction approval 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 institution's securities portfolio management objectives and overall risk philosophy;
- the quality of the securities portfolio;
- the ability of the institution to absorb losses;
- the size and types of securities and the complexities 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 institution 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 institution's securities activities and, at a minimum, need to include:

- Systems to measure and monitor securities positions;
- Controls governing the management of the securities portfolio; and
- Independent inspections or 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 institution needs to ensure that:

- effective information systems are developed and used to appropriately record, 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 institution; 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 is meeting the institution'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, particularly issuers connected to the institution.

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 institution's securities portfolio management policies and provide safeguards to protect an institution from potential losses by ensuring that unauthorised exposure does not occur from improper or uncontrolled securities activities.

Although the controls over securities activities will vary among institutions depending upon the nature and extent of their activities, the key elements of any securities portfolio management control programme 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;
  - ~ 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 institution;
  - ~ securities transactions are settled in a timely and accurate manner;
  - ~ unauthorised securities activity is promptly identified and reported to management; and
- controls to ensure that securities activities are monitored frequently against the institution's securities portfolio management policies and risk limits, and excesses reported.

Moreover, each institution needs to ensure that employees conducting securities trading activities on behalf of the institution do so with a written code of conduct or guideline governing securities dealing. Such a guideline or code of conduct should provide guidance respecting 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 institution deals.

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 institutions will need to use the full range of hedging techniques or instruments. Each licensee 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, each institution must ensure that they understand the hedging technique and that they are satisfied that the instruments meet 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 institution 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 institution 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.

iii) Independent Inspection/Audit

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

- ensure that securities activities are in compliance with the institution'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 authorised and accurately and completely recorded on the books of the institution;
- ensure that recorded securities are in safe custody and are conservatively valued on the books of the institution;
- ensure that securities hedging activities are consistent with the institution's securities portfolio management policies, strategies and procedures;
- confirm that securities held by depositories to the order of the institution conform with the records of the institution;
- ensure that management has established suitably designed controls over securities positions and that such controls operate effectively;
- ensure the adequacy and accuracy of management information reports regarding the institution's securities portfolio management activities; and
- ensure that personnel involved in securities portfolio management are provided with accurate and complete information on the institution's securities portfolio management policies and risk limits and have the expertise required to make effective decisions consistent with these policies.

Assessments of the securities portfolio management activities should be presented to the institution's Board of Directors on a timely basis for review.

D. ROLE OF THE BOARD OF DIRECTORS

The Board of Directors of each institution is ultimately responsible for the quality of the institution's securities portfolio and the integrity of the institution's securities portfolio management function. In discharging its responsibility, a Board of Directors usually charges management with developing securities portfolio management policies for the board's approval, and developing and implementing procedures to manage and control the structure and quality of the institution's securities portfolio, and the level of risk assumed, within these policies.

A Board of Directors needs to have a means of ensuring compliance with the securities portfolio management programme. A Board of Directors generally ensures compliance through periodic reporting by management and independent inspectors/auditors. The reports must provide sufficient information to satisfy the Board of Directors that the institution is complying with its securities portfolio management programme.

At a minimum, a Board of Directors should:

- review and approve securities portfolio management policies based on recommendations by the institution's management;
- review periodically, but at least once a year, the securities portfolio management programme;
- ensure the selection and appointment of qualified and competent management to administer the securities portfolio management function;
- ensure that an independent inspection/audit function reviews the securities portfolio management function to assess whether or not the institution's securities portfolio management policies and procedures are appropriate and are being adhered to;
- review significant securities positions, related party transactions and transactions in which potential conflict of interest exist;
- review trends in securities portfolio quality and value; and
- outline the content and frequency of management reports to the Board on securities portfolio management.

E. ROLE OF MANAGEMENT

The management of each institution is responsible for implementing the institution's securities portfolio management policies and ensuring that procedures are put in place to manage and control the risk and quality of the securities portfolio in accordance with these policies.

Although specific position risk management responsibilities will vary from one institution to another, management at each institution is responsible for:

- developing and recommending securities portfolio management policies for approval by the Board of Directors;
- implementing the securities portfolio management policies and developing lines of communication to ensure the timely dissemination of securities portfolio management policies and procedures and other relevant information to all individuals involved in the securities portfolio management process;

- ensuring that the securities portfolio is managed and controlled within the securities portfolio management programme by:

  ~ ensuring the development and implementation of appropriate reporting systems with respect to the content, format and frequency of information concerning the securities portfolio, to permit the effective analysis and the sound and prudent management and control of existing and potential risk exposures;

  ~ monitoring and controlling the nature, composition and quality of the institution's securities portfolio;

  ~ ensuring that the securities portfolio is soundly and conservatively valued; and

  ~ ensuring that an independent inspection/audit function reviews and assesses the securities portfolio management programme; and

- reporting comprehensively on the securities portfolio management programme, and the composition and quality of the securities portfolio, to the Board of Directors at least once a year.

GLOSSARY

Asset / Liability Management

The management and control, within set parameters, of the impact of changes in the volume, mix, maturity, quality, and interest and exchange rate sensitivity of assets and liabilities on an institution.

Credit Risk

The risk of financial loss resulting from the failure of a debtor, for any reason, to fully honour financial or contractual obligations to an institution.

Foreign Exchange Risk

The exposure of the institution to the potential impact of movements in foreign exchange rates. The risk is that adverse fluctuations in exchange rates may result in a loss in Jamaican dollar terms to the institution.

Hedging

A risk management technique to reduce or eliminate price, interest rate or foreign exchange risk exposures. The elimination or reduction of such exposures is accomplished by entering into transactions that create offsetting risk positions. The concept is that when a licensee has an open position which entails a risk that it wishes to avoid or minimise, the institution can undertake a further transaction which compensates for the risk and acts as a hedge. If the hedge is effective, any gain or loss on the hedged risk position will be offset by a loss or gain on the hedge itself.

Interest Rate Risk

The potential impact of movements in interest rates on an institution.

Liquidity

Liquidity is the availability of funds, or assurance that funds will be available, to honour all cash outflow commitments (both on- and off-balance sheet) as they fall due. These commitments are generally met through cash inflows, supplemented by assets readily convertible to cash or through an institution's capacity to borrow. The risk of liquidity may increase if principal and interest cash flows related to assets, liabilities and off-balance sheet items are mismatched.

Position Risk

The exposure of the institution to the effect of price changes on the market value of the institution's portfolio of securities, both on- and off-balance sheet. Price changes may occur as a result of a number of factors, such as those solely related to the specific security (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 valuation or sale, as the case may be.

Prudent Risk Management

The duty to act with the care, skill and diligence that a person of ordinary prudence acting in a like capacity and familiar with such matters would exercise in dealing with the property of another person.

Risk Management

The process of controlling the impact of risk related events on the institution.

Risk Philosophy

A statement of principles and objectives that outlines an institution's willingness to assume risk. An institution's risk philosophy will vary with the nature and complexity of its business, the extent of other risks assumed, its ability to absorb losses and the minimum expected return acceptable for a specific level of risk.

Risk Position

The amount of the institution's exposure to a particular risk.

Securities Marketability/Liquidity Risk

The risk that a security cannot be sold quickly or that there is no market for the security.

Securities Portfolio Concentration

Concentration that occurs when an institution's securities portfolio contains an excessive level of exposure to a single issuer, a group of associated issuers, or a class of security.

Securities Portfolio Management Policy

A written description of authorised securities activities and the goals and objectives the institution expects to achieve through its securities activities.

Securities Portfolio Management Strategy

A written description of the way an institution intends to achieve its securities investment policies.