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Prudent Person Approach to Investment and Lending Guideline

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PRUDENT PERSON APPROACH TO INVESTMENT AND LENDING GUIDELINE

1. INTRODUCTION

1.1 Financial institutions[1] have a statutory as well as a fiduciary responsibility to prudently manage the funds entrusted to them by depositors, investors and policyholders. Therefore, the Board of Directors[2] and management of these institutions, in carrying out their obligations, should exercise the care, diligence and skill that a reasonably prudent person would exercise in similar circumstances.[3]

1.2 Prudence must be evident principally in the process by which investment and lending strategies are developed, implemented and monitored and must therefore be a main consideration in the institution's risk management system. This system should include a reasonable process for arriving at investment and lending decisions. Retrospective assessment of whether investment or lending decisions were successful is not sufficient.

1.3 The Financial Institutions Act, 1993 (FIA) and the Insurance Act Chap. 84:01 (IA) set out limits and restrictions relating to lending and investment with which financial institutions must comply. The Central Bank considers that these limits are to be regarded as a minimum standard and that the internal policies of financial institutions should be more stringent, depending on the institution's risk profile and risk tolerance levels so as to maintain a sound financial operation**.**

2. PURPOSE OF THE GUIDELINE

2.1 The purpose of this Guideline is to provide the Board of Directors and management of financial institutions with a framework for the establishment of policies and procedures for the prudent management and control of risk in their investment and lending portfolios. The framework will encompass statutory requirements and will also be used by the Central Bank of Trinidad and Tobago ('*the Central Bank'*) in its evaluation of a financial institution's investment and lending activities to determine whether it is in a sound financial condition.

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[1] For purposes of this guideline, financial institutions refer to institutions licensed under the Financial Institutions Act, 1993 (FIA) to carry on the business of banking and business of a financial nature as well as insurance companies and pension fund plans registered under the Insurance Act Chap. 84:01(IA).
[2] In this guideline, "Board of Directors" or "Board" shall, in the case of a pension fund plan, mean its trustees and includes a trust corporation in which a management committee shall be established.
[3] This represents a restatement of the prudent person rule which states that '*a fiduciary must discharge his or her duties with the care, skill, prudence and diligence that a prudent person acting in a like capacity would use in the conduct of an enterprise of like character and aims'.*

2.2 The Guideline refers to the investment and lending limits and/or restrictions set out in governing legislation and takes into consideration international best practice[4]. It is expected that certain aspects of the guideline (for example, the policies, procedures, risk management and internal controls) would be adapted to reflect the complexity and risks inherent in the institution's investment and lending business.

3. THE FRAMEWORK

3.1 Every financial institution should implement sound investment and lending management policies and frameworks which should comprise the following steps:-

3.1.1 Formulation and documentation of investment and lending policies, including a code of ethics and professional conduct;

3.1.2 Approval and implementation of the policies;

3.1.3 Risk management of investment and lending activities; and

3.1.4 Reporting procedures to the appropriate level of authority.

3.2 In developing investment and lending management frameworks, the Board and management of financial institutions should ensure that the investment and lending strategies adopted by the financial institution, including its risk-return profile, are compatible with the liability structure of the institution in terms of maturity and liquidity.

4. THE POLICY

4.1 Every financial institution should have written investment and lending policies which should satisfy statutory and regulatory requirements, and should be communicated to all staff involved in investment and lending activities. The policies should: -

4.1.1 Describe the objectives of the investment and lending program, which should be in accordance with the overall risk philosophy of the institution as outlined in its strategic plan. The policies should take into account the institution's ability to absorb potential losses.

4.1.2 Outline the expected composition of the portfolio by type, term (short or long), purpose (trading or nontrading), and liquidity[5]. In addition, permissible investments and loans for the institution[6]

[4] This guideline encompasses the minimum criteria outlined in the IA and the Second Schedule to the FIA and builds on the frameworks outlined by the International Association of Insurance Supervisors (IAIS), the Office of the Superintendent of Financial Institutions Canada (OSFI) and the Basel Committee on Banking Supervision.

[5] Section 29 of the FIA requires that, in placement of liquid assets, banks and non-banks give preference to short term instruments originating in Trinidad and Tobago.

[6] Section 22(2) (b) of the FIA restricts institutions from acquiring land except in circumstances as outlined in this section of the FIA. Permissible investments for insurance companies and pension funds are detailed in the Second Schedule of the IA.

should be detailed, including any restrictions as to markets (e.g., only securities[7] listed on specified stock exchanges), minimum rating requirements, etc.

4.1.3 *Specify statutory limits and restrictions and establish limits to prevent excessive concentrations and ensure sufficient diversification of the investment and lending portfolios. Limits[8] should be established for investments and loans, which may be based on ratings, markets, currency, industries and sectors. Limits[9] should also be established for investments and loans with counterparties and related parties.*

4.1.4 *Establish authorization procedures, limits and accountabilities for investment and lending activities. The framework of accountability for all investment and lending transactions should include details on who is authorised to undertake investment and lending transactions and procedures for approval of new investment instruments and loans. The approval process for loans and investments should also include the review and approval of legal documentation prior to the execution of the transaction.*

4.1.5 *Outline the circumstances in which derivative instruments – or structured products that have the economic effect of derivatives or any creative or innovative financial instrument – can be used. Limits should be established by type of instrument (e.g., swaps, options, and futures) and by counterparty.*

5. OPERATIONAL PROCEDURES

5.1 Every financial institution is expected to have written internal procedures outlining how the investment and lending policies will be implemented and monitored. The details of the procedures should be consistent with the size and complexity of the financial institution's investment and lending activities. The financial institution should:-

5.1.1 *Address exposures arising from both balance sheet and off-balance sheet items.*

5.1.2 *Identify potential sources of conflict of interest and establish procedures to ensure that those involved in the investment and lending process understand where these situations could arise and how they should be addressed.*

5.1.3 *Establish procedures for the measurement and assessment of the performance of the investment and lending portfolios.*

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[7] Section 22(2) (d) of the FIA sets out restrictions with respect to a licensee acquiring, dealing, underwriting or providing of finance for underwriting or dealing in its own shares. There is a similar provision in section 48 of the IA. In addition, Section 22(2)(j) of the FIA sets out a limit on the acquisition and holding in the aggregate of any part of the share capital of any commercial, agricultural or industrial undertaking not including a financial institution.

[8] Section 47 of the IA sets out a local assets ratio with which insurance companies must comply and the Second Schedule prescribes limits for investment in specified assets. In addition, the proposed Agreed Minute on the Operation of the Foreign Currency Market (amended August 14, 2000) requires commercial banks and other authorised dealers that accept foreign currency deposits to maintain a liquid assets ratio of 20% on foreign currency deposits.

[9] Refer to Section 22(2)(e)-(i) of the FIA. The Insurance (Admissible Assets and valuation of Assets) Regulations #14 prescribes limits for investment in related parties.

5.1.4 *Establish a comprehensive investment and lending risk management process[10], including procedures to monitor and control the institution's exposure to fluctuations in interest rates, foreign exchange rates and market prices.*

5.1.5 *Establish procedures for the administration of impaired loans and investments, including methodologies for estimating the recoverable amount of these assets.*

5.1.6 *Establish the type and frequency of reports to be generated.*

5.1.7 *Establish procedures for the selection and approval of new counterparties, brokers, external valuators and external asset managers. An independent process should be established to review all advice received from agents, brokers and external asset managers on the acquisition and disposal of investments and loans.*

5.1.8 *Establish criteria and procedures for the custody and safekeeping of investment and lending documents, for example, those evidencing indebtedness and title. In addition, procedures should be established for obtaining independent confirmation of custodian statements which should be reconciled to the institution's investment records on a regular basis.*

5.1.9 *Detail the actions to be taken by the Board and/or senior management in cases of violations and non-compliance with established internal or regulatory limits and procedures, whether committed deliberately or by inadvertence.*

5.2 Additionally, with respect to investments the institution should :-

5.2.1 *Address exposures arising from the trading and non-trading portfolios.*

5.2.2 *Describe methodologies for valuing unlisted investments. Valuations should be conducted by individuals independent of those responsible for trade execution or, if this is not possible, valuations should be independently checked or audited on a timely basis.*

5.2.3 *Specify the accounting[11] and taxation treatment for investment instruments.*

5.2.4 *Establish and maintain separate front and back office operations and procedures governing same.*

6. RESPONSIBILITY OF THE BOARD OF DIRECTORS

6.1 The Board of Directors is responsible for the establishment and approval of the institution's investment and lending policies developed by senior management. The Board of Directors or a subcommittee of the Board (i.e., the Investment and Credit Committees) should, at least annually, review and approve

[10] Refer to Section 8 of this guideline.

[11] IAS 39 requires that purchases and sales of each broad category of financial assets be accounted for consistently using either trade date or settlement date accounting. If settlement date accounting is used, IAS 39 requires recognition of certain value changes between trade and settlement dates. In addition, IAS 39 requires that trading and available for sale securities should be reported at current market prices, while held to maturity investments should be reported at cost.

the investment and lending policies. Deviations from the policies should be reported immediately to the Board.

6.2 The Board should delegate the responsibility for the implementation of policies and day to day monitoring to management; however, ultimate responsibility rests with the Board.

6.3 In the case of long term insurance business and pension fund plans, actuarial valuations are required. Therefore, the Board of Directors or the trustee of the pension fund plans should ensure that actuaries use prudent assumptions in the valuation of assets and liabilities. Additionally, the trustee of a pension fund plan may delegate investment functions to a knowledgeable and experienced fund manager. In such a case, the trustee must monitor the performance of the fund manager.

6.4 The Board has responsibility for ensuring that senior management carries out the functions and responsibilities set out in section 7 of this guideline.

7. RESPONSIBILITY OF SENIOR MANAGEMENT

7.1 Senior management is responsible for developing, documenting and seeking Board approval for the investment and lending policies, setting out the operational procedures for their implementation and ensuring that relevant personnel are informed of changes in the investment policies within a specified time frame.

7.2 Senior management should ensure that all individuals conducting, monitoring and controlling investment and lending activities are suitably qualified, with appropriate levels of knowledge and experience. Remuneration policies should be structured to avoid potential incentives for unauthorised risk taking.

7.3 Investment and lending policies and procedures should be reviewed and, if necessary, updated on an annual basis to ensure consistency with the institution's strategic plans and to respond to the changing environmental and market conditions.

8. RISK MANAGEMENT, INTERNAL CONTROLS AND REPORTING

8.1 Risk Management

8.1.1 The responsibilities of the risk management function include:

8.1.1.1 Monitoring compliance with the approved investment and lending policies and promptly reporting any non-compliance to the Board and management of the institution;

8.1.1.2 Reviewing risk mitigation activity and results; and

8.1.1.3 Reviewing the asset / liability and liquidity positions.

8.1.2 The risk management function should assess the appropriateness of the established investment and lending limits. Regular stress testing of the investment and lending portfolios should be undertaken for a wide range of market scenarios and conditions to determine the impact on the institution. It is imperative that events that pose significant risk be identified and appropriate amendments to the policies and procedures adopted to manage those risk situations effectively.

8.1.3 Information systems should be configured to enable timely and accurate reporting to management. The financial institution should develop comprehensive, accurate and flexible systems, which allow the identification, measurement and assessment of investment and lending risks, and the aggregation of those risks at various levels, as appropriate. Such systems will vary among institutions, but should be sufficiently robust to reflect the nature of the risks and the extent of the investment and lending activity undertaken.

8.2 Internal Controls

8.2.1 Internal control procedures should be documented and adequate systems instituted to ensure that investment and lending activities are properly supervised and transactions are in accordance with the financial institution's approved policies and procedures.

8.2.2 Internal controls should include techniques such as the segregation of duties, approvals, verifications and reconciliations. The extent and nature of internal controls adopted by each financial institution should be adapted to the size and complexity of the institution's operations and also the nature of its investments and loans, but should include:

8.2.2.1 Adequate and timely communication of information on investment and lending activities among all levels within the financial institution;

8.2.2.2 Procedures to ensure that documentation are completed promptly and accurately;

8.2.2.3 Rigorous and effective audit procedures and monitoring activities to identify and promptly report weaknesses in investment and lending controls and non-compliance with policy and procedures;

8.2.2.4 Procedures to identify and control the institution's dependence on and vulnerability to key personnel and systems;

8.2.2.5 Procedures to ensure that investment and lending transactions are carried out in conformity with prevailing market terms and conditions; and

8.2.2.6 Procedures to ensure the independent checking of currency and interest rates and market prices.

8.2.3 In the case of investments, internal controls should also include :

8.2.3.1 Procedures to ensure the separation of front and back office functions with frequent reconciliation among front and back office and accounting systems;

8.2.3.2 Procedures to ensure that the sending, receiving and matching of confirmations are independent of the front office function; and

8.2.3.3 Procedures to ensure that trade positions are properly settled and reported, and that late payments or late receipts are identified.

8.2.3.4 Procedures to ensure that interest and dividend income are matched against expected income and differences, if any, are investigated and cleared.

8.2.4 Where external asset managers are used, the financial institution should regularly monitor and evaluate each asset manager's compliance with its investment mandate.

8.3 Reporting

8.3.1 Regular and timely reports of investment and lending activities should be produced for review by the Board of Directors and senior management of the institution. These reports should describe the exposure in clearly understandable terms and include quantitative and qualitative information.

8.3.2 The frequency of reporting to the Board by senior management should be commensurate with the complexity and risks inherent in the institution's investment and lending portfolios. Reports to the Board should provide adequate information to judge the changing nature of the institution's investment and lending profiles, the risks that arise and the consequences for the institution.

8.3.3 More frequent reporting should be required for problem loans and investments, which represent a significant adverse impact to the institution.

9. SUPERVISORY OVERSIGHT

9.1 The Central Bank's monitoring process comprises off-site surveillance and on-site risk based examination to ensure that financial institutions have adequate systems, policies and procedures to identify, measure, control, and report the risks in their investment and lending portfolios. In addition, the Central Bank would routinely check for compliance with statutory limits and/or restrictions.

9.2 The Central Bank may from time to time introduce reporting requirements on the investment and lending portfolios in pre-determined frequency and format. The accuracy of this reporting would be periodically verified by the Central Bank.

9.3 Central Bank's evaluation of the investment and lending programs will also include analysis of the risk profile, composition and quality of the investment and lending portfolios and their impact on the institution's earnings and condition.