FINANCIAL SUPERVISORY COMMISSION
OF THE
COOK ISLANDS

Banking Prudential Statement

BPS13

Investment Risk

Objectives and key requirements of this Prudential Statement

This Prudential Statement aims to ensure that all banks control investment risk by adopting a prudent investment risk management framework, centered on comprehensive policies and procedures. These policies and procedures must particularly apply to the recognition, measurement, reporting of and control of investment risk.

The key requirements of this Prudential Statement are that a bank must:

- have an effective investment risk framework that is supported by a robust system for the prompt identification, monitoring, measurement and control of its investment risk that is commensurate with the nature, scale and complexity of the institution;

- maintain a portfolio of high-quality investments that are well diversified, providing liquidity and earnings without undue risk to capital;

- regularly review its investment risk management systems, taking account of changing operating circumstances, activities and risks.

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Authority

1. This Prudential Statement is issued by the Financial Supervisory Commission (FSC) pursuant to Section 65, of the Banking Act 2011 (the Act).

Application

2. This Prudential Statement is applicable to all financial institutions licensed under the Banking Act 2011.

Definitions

3. This Prudential Statement has used the following terms, which unless otherwise indicated, have the meanings specified below:

   3.1. **Bank** – an entity licensed under the Banking Act 2011.

   3.2. **Equity investments –** acquisition by a licensee, individually or with 1 (one) or more other parties, of shares in a company.

   3.3. **Investment Risk** – risk of an adverse movement in the value of an institution's on-balance sheet assets and/or off-balance sheet obligations. Investment risk can be derived from a number of sources, including market risk, investment concentration risk, asset liability mismatch risk and credit risk.

   3.4. **Investment Risk Appetite** – a statement providing a clear direction from the Board of its expectations for the level of investment risk it is willing to accept in pursuit of its strategy and business objectives. A risk appetite is expressed in the form of both high-level qualitative statements and where appropriate, quantitative measures.

   3.5. **Investment Risk Management Framework** – systems, structures, policies, processes and people within a Bank that identify, measure, monitor and control investment risk.

   3.6. **Non-performing** - investment is non-performing when payments of interest and/or principal are past due by 90 days or more, or payments must be capitalised, refinanced, or delayed by agreement, due to inability to repay; or any investment that is current or past due that shows deterioration such that the likelihood of past due or default status is very high and warrants recognition of the deterioration. In addition, external events such as bankruptcy, debt defaults elsewhere and similar tangible signs of financial distress would likely lead to non-performing status recognition. This includes any time where there is doubt that payments will be made in full.

Board and Senior Management Responsibilities

4. It is the responsibility of the Board of Directors (Board) of each bank to ensure that appropriate systems are in place for the sound management of the bank's investment risk. They must ensure the bank has a robust investment risk management framework to manage this risk accordingly.

5. The Board must establish an investment risk appetite and adopt an investment risk strategy and policy commensurate with the investment risk appetite.

6. The Board and management must have a sound investment strategy that is properly communicated throughout the organisation. Approval and authorisations must be well developed, and provide the necessary controls to mitigate risk.

7. The Board and management must establish a system of independent ongoing investment review that provides the Board with regular information about the investment risk, asset quality, liquidity of the portfolio, concentrations, compliance with policies, trends in individual investments, portfolio segments, and the portfolio in aggregate.

8. A bank's senior management must, at a minimum:

    8.1. develop the investment management strategy, policies and processes in accordance with the Board-approved risk appetite;

    8.2. ensure that the bank maintains sufficient investment quality at all times;

    8.3. determine the structure, responsibilities and controls for managing investment risk and for overseeing the investment portfolio;

    8.4. ensure that the bank has adequate internal controls to safeguard the integrity of its investment risk management processes;

    8.5. establish a set of reporting criteria specifying the scope, manner and frequency of reporting for various recipients (such as the Board, senior management and the risk and investment committees) and the parties responsible for preparing the reports;

    8.6. establish the specific procedures and approvals necessary for exceptions to policies and limits, including the escalation procedures and follow-up actions to be taken for breaches of policy limits;

    8.7. closely monitor current economic trends and potential market developments that may present challenges for managing investment risk, so that appropriate and timely changes to the investment risk management strategy can be made as needed; and

    8.8. continuously review information on the bank's investment portfolio and report to the Board on a regular basis.

9. The Board and senior management must be able to demonstrate a thorough understanding of the links between investment risk and other risks within the bank including credit, liquidity, market, operational and reputational risks.

Investment Risk Management Framework

10. The bank's investment risk management framework must be commensurate to the size and complexity of the bank's current and planned investment portfolio, and include, at a minimum:

    10.1. a statement of the bank's investment risk appetite, representing the amount of investment risk that the Board is willing to accept in the bank to meet its strategic objectives;

    10.2. a robust management information system that produces data and other information required for adequately assessing the investment risk exposure of the institution, including but not limited to ongoing market valuations of the investment portfolio, counterparty repayment capacity, realised and unrealised gains and losses, and when necessary levels of impairment, and reporting to FSC;

    10.3. a defined organisational structure for investment risk management;

    10.4. the investment management strategy and policy;

    10.5. policies, procedures and controls, for identifying, measuring, monitoring and controlling its investment risk in accordance with its investment risk appetite;

    10.6. senior management and other relevant personnel that have the necessary experience to manage investment risk;

    10.7. regular reporting on the existing investment risk of the bank and, information on new or emerging investment risks; and

    10.8. annual review and approval by the Board.

11. A bank's investment risk management framework must include documented policies, procedures and controls addressing at a minimum the following:

    11.1. board and senior management responsibilities;

    11.2. investment policies;

    11.3. investment administration;

    11.4. diversification;

    11.5. investment risk monitoring;

    11.6. investment risk rating system;

    11.7. portfolio review and valuation;

    11.8. asset classification; and

    11.9. management of problem investments.

12. A bank's investment risk management framework must clearly set out the organisational structure as it relates to investments for the bank, and define the roles and responsibilities of management and staff involved.

13. The investment management strategy must be appropriate for the nature, scale and complexity of the bank.

14. The investment management strategy, key policies for implementing the strategy, and the investment risk management structure must be communicated throughout the organisation by senior management.

15. A bank must have adequate policies, procedures and controls in place to ensure that the Board and senior management are informed immediately of new and emerging investment concerns. These include a significant decline in the quality of underwriting, high or increasing exceptions to policy, noncompliance with policy, material or persistent breaches of limits, or changes in external market conditions that could signal future difficulties.

16. The investment risk management framework must be subject to effective independent review on an ongoing basis. In most cases, the independent reviews could be facilitated by a bank's internal audit function but may require the engagement of independent parties outside of this function.

Investment Policies

17. The bank must adopt investment policies that clearly outline the bank's view of business development priorities and the terms and conditions that are necessary for investments to be approved.

18. The investment policies must be updated at a regular interval to reflect changes in the economic outlook and the evolution of the bank's investment portfolio.

19. The investment policies must be communicated timely and be implemented by all levels of the bank through appropriate procedures. It should be distributed to all approval personnel and investment officers.

20. At a minimum, the investment policy must include:

    20.1. the identification of investment risk, both on and off the balance sheet, by counterparties, portfolio, investment types, sectors, and geographic segments;

    20.2. acceptable and unacceptable investments by type, counterparties, tenor, liquidity and geographies;

    20.3. guidelines and limits on level of diversification and concentration;

    20.4. laddering of maturities;

    20.5. acceptable and unacceptable financial quality and repayment performance measures appropriate to the investment;

20.6. the bank’s' formal investment approval process - detailed and formalised investment evaluation and appraisal process, administration and documentation;

20.7. accounting treatment;

20.8. laddered investment approval authority;

20.9. roles and responsibilities of staff involved in investment;

20.10. guidelines on monitoring and reporting system, including minimum reporting requirements to management and the board, content of reports, frequency and recipients;

20.11. internal risk grading criteria;

20.12. criteria for past due, non-accrual, and restructuring of investments;

20.13. identification, reporting, and approvals of exceptions to policy and procedures;

20.14. additional policy details, and restrictions the bank will consider if it makes equity investments;

20.15. quantitative and qualitative targets; and

20.16. the use of and reliance on external investment advisors.

21. The investment risk policy must define the bank’s system of managing their problem assets. Once an investment is identified as a problem, it should be managed under a dedicated remedial process. The process should include:

21.1. development of an account action plan or recovery strategy;

21.2. monitor compliance with the action plan, adjusting the plan as necessary;

21.3. pursue all options to maximise recovery, including placing customers into legal proceedings or liquidation as appropriate;

21.4. ensure adequate and timely investment loss provisions are made based on actual and expected losses; and

21.5. regular reporting to the Board on the overall problem investment portfolio and in particular, the large and complex investments.

Investment Approval

22. A bank must have a well-defined investment approval strategy, in line with its stated investment risk appetite, and well-defined criteria for approving an investment.

23. Before approving an investment, a bank must receive sufficient information to enable a comprehensive assessment of the true risk profile of the counterparty, including up to date financial information.

24. At a minimum, the factors to be considered and documented in approving investments must include:

    24.1. the purpose of the investment, the source of repayment and the consistency between these two elements;

    24.2. the integrity and reputation of the counterparty;

    24.3. the current risk profile (including the nature and aggregate amounts of risks) of the counterparty and its sensitivity to economic and market developments;

    24.4. the counterparty's repayment history and consistency, financial trends, current capacity to repay, the stated source of repayment, and financial and cash flow projections;

    24.5. for commercial/equity investments, the counterparty's business expertise and the status of its economic sector and position within that sector; and

    24.6. the adequacy and enforceability of collateral or guarantees.

Investment Administration

25. The investment administration function provides the physical aspects of approving and maintaining investment.

26. A typical investment administration unit should perform the functions of investment documentation, disbursement and monitoring; and maintenance of investment files, collateral and security documents. It ensures compliance with prescribed management policies and procedures as well as applicable laws and regulations.

27. Investment administration must ensure completeness of documentation (investment agreements, location of physical documents, etc.). This includes keeping the investment file up to date, and obtaining current financial information.

28. The bank must ensure:

    28.1. the efficiency and effectiveness of investment administration operations, including monitoring documentation, contractual requirements, legal covenants, collateral recordation;

    28.2. the accuracy and timeliness of information provided by management information systems; and

    28.3. the adequacy of controls over all investment administration procedures.

29. Senior management must understand and demonstrate that it recognises the importance of this element of monitoring and controlling investment risk, to help ensure the various components of investment administration function appropriately.

Investment Risk Monitoring

30. A bank's investment risk management framework must provide for the systematic and regular monitoring of investment risk, to assist the Board and senior management in obtaining, on a regular basis, a view of trends and other changes in the overall nature and levels of investment risk, and in assessing the adequacy of provisions and capital.

31. A bank's investment risk monitoring must include measures that:

    31.1. enable the Board and senior management to readily understand the current (and changing) financial condition of its investment counterparties, individually and in aggregate;

    31.2. ensure that all investments are in compliance with existing policy;

    31.3. prevent adverse concentrations;

    31.4. identify and classify potential problem investments on a timely basis;

    31.5. ensure current and accurate valuations of the investment portfolio performance; and

    31.6. ensure the accuracy of the information submitted to the Board and management.

Investment Risk Rating System

32. A bank must have an established portfolio review system that is aimed at identifying investment quality in the portfolio by risk rating the individual investments and reviewing the accuracy of those ratings over time.

33. As with other counterparty risk assets, investments are subject to risk classifications and should be assigned a risk rating. A bank must have an internal risk rating system for its investment risk assets or may utilise the risk classification criterion that is detailed in the Prudential Statement – Credit Risk. The risk rating should categorise all investments into various classes on the basis of underlying investment quality and ability to repay.

34. Banks policies and procedures must include a process to aggregate the total exposures within the investment and credit portfolios to a party or parties and ensure compliance with the Prudential Statements on Large Exposures, Credit Risk, and Connected Lending and Activities and Direct Ownership Interests and the Act.

35. Banks that hold only high-quality investment grade assets (such as rated domestic government instruments or similar) that are subject to rating systems that are provided by internationally recognised rating agencies may use these ratings for identification of investment quality.

36. When deterioration in repayment ability is noted, the bank should use the risk rating criteria and interest accrual standards set out in the Prudential Statement – Credit Risk.

37. Where the bank has an equity investment as provided for in the Act it must make all reasonable efforts to obtain current valuations on at least an annual basis or more frequently if there are any signs of deterioration.

Record-keeping Requirements

38. Each bank shall maintain adequate records in support of its evaluation of portfolio quality. Such records shall be made available to the FSC and its examining personnel upon request to assess the reasonableness of the bank's procedures, the reliability of the information on which estimates are based, and the appropriateness of investment book value and accounting treatment.

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