

# Blakes Bulletin

## Financial Services/Securities Regulation

### Quebec Financial Markets Authority Publishes Guideline on Risk Management of Derivatives by Financial Institutions

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Quebec's financial markets authority, the *Autorité des marchés financiers* (the Authority), recently published a Derivatives Risk Management Guideline (the Guideline), which will apply to financial institutions under the jurisdiction of the Authority, namely insurers governed by *An Act respecting insurance* (Quebec), portfolio management companies controlled by such insurers, mutual insurance associations governed by *An Act respecting insurance* (Quebec), financial services cooperatives governed by *An Act respecting financial services cooperatives* (Quebec), and trust companies and savings companies governed by *An Act respecting trust companies and savings companies* (Quebec) (FIs). The Guideline will apply to both Quebec-constituted FIs as well as other FIs licensed by the Authority (such as federally chartered insurance companies and trust companies carrying on business in the province of Quebec), and is broadly consistent with guidance of the Office of the Superintendent of Financial Institutions applicable to derivatives activities of federal FIs.

The Guideline sets out the Authority's expectations regarding sound and prudent derivatives risk management practices by FIs. Each FI is expected to develop strategies, policies and procedures based on its nature, size, complexity and risk profile.

The Guideline indicates that FIs should establish written policies and written procedures clearly defining their orientation in relation to derivatives risk management, and stipulates that the Guideline applies to FIs both as end users of derivatives and as derivatives traders.

While the Guideline takes effect on August 1, 2010, a two-year phasing-in period is given, during which FIs can ramp up their existing policies and procedures so as to ensure compliance with the principles underlying the Guideline.

The Guideline establishes eight principles, consistent with the principles-based approach favoured by the

Authority and the approach adopted under the *Derivatives Act* (Quebec) (for a discussion of this legislation, see our January 2009 [Blakes Bulletin on Securities Regulation – Quebec Derivatives Legislation in Force as of February 1, 2009](#)). The Guideline's principles are:

**Principle 1: Effective Governance** – The Authority expects a derivatives risk management framework to be supported by effective and efficient governance.

**Principle 2: Avoid Conflicts of Interest** – The Authority expects derivatives activities to be handled by independent and qualified staff. The compensation policy for these staff members should be established so as to avoid potentially encouraging excessive risk-taking.

**Principle 3: Set Limits on Derivatives Activities** – The Authority expects financial institutions to establish specific and unambiguous limits on their derivatives activities and ensure compliance therewith.

**Principle 4: Identify and Assess Risks** – The Authority expects financial institutions to identify and assess the specific risks related to their derivatives activities.

**Principle 5: Perform Stress Testing** – The Authority expects financial institutions to routinely carry out scenario analysis and stress testing so as to determine the potential impact of the use of derivatives on their financial health.

**Principle 6: Determine Eligibility of Counterparties** – The Authority expects financial institutions to ensure that the counterparties to their derivatives activities are accredited under the *Derivatives Act* (Quebec) and are eligible based upon the policy they have adopted.

**Principle 7: Analyse Pledged Collateral** – The Authority expects financial institutions to examine all aspects of pledged collateral to which they are a party either as a pledgee or pledgor.

**Principle 8: Appropriately Document Netting Agreements** – The Authority expects financial institutions to document the netting agreements to which they are parties for existing and future derivatives transactions and verify the legality of such agreements.

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The Guideline provides guidance on how to best comply with each of these principles, which must be considered in tandem with the principles contained in the Authority's Investment Management Guideline. The latter takes effect concurrently to the Guideline and contains principles applicable to investment management activities by FIs, some of which mirror the principles contained in the Guideline.

With respect to the effective governance principle, the Guideline places responsibility for derivatives activities with the board of directors and senior management, and highlights their respective roles and responsibilities.

Under the Guideline, an FI's board of directors should:

- approve the policy applicable to derivatives activities
- ensure that board members as a whole have the required knowledge to understand the risks related to the use of derivatives
- approve the risk appetite and risk tolerance levels the institution is prepared to assume with respect to derivatives activities
- inquire on a regular basis about the risks incurred by the institution with respect to activities involving derivatives
- ensure that internal controls and audit mechanisms relating to derivatives are in place.

As to an FI's senior management, it should:

- define the risk appetite and risk tolerance levels the institution is prepared to assume with respect to derivatives activities
- approve, limit or prohibit the use of derivatives in accordance with the existing policies and procedures, and ensure that the limits are followed on a continuous basis
- ensure that the institution has the ability to verify prices independently, particularly where over-the-counter (OTC) derivatives are used; otherwise, the institution should draw on the services of a specialized dealer
- ensure that relevant information is provided to it regarding the nature of the institution's derivatives activities and the risks tied thereto

- ensure compliance with the legal and regulatory provisions applicable to derivatives
- understand risk assessment methods and measures, and determine the relevance and consistency of the assumptions used to support analysis, in light of the institution's risk appetite
- ensure the institution has adequate and sufficient capital with respect to risk exposures related to derivatives
- ensure the institution has an independent and qualified staff whose compensation is based on long-term profit incentives.

The Guideline's principle on setting limits on derivatives activities indicates that the types of derivatives which the FI intends to use should be subject to prior approval by the board or a committee thereof. As well, limits on the use of derivatives by an FI should be established as part of its overall investment policy. The FI should set quantitative limits on its overall position with an issuer, as well as on all transactions where such issuer acts as a counterparty. Both reporting limits and hard limits must be established. Up-the-ladder reporting mechanisms must be in place where limits are exceeded. The Guideline emphasizes ensuring that adequate internal control mechanisms be in place and limiting or prohibiting the use of certain kinds of derivatives, for example where exposure cannot be reliably measured or the complexity of the product and its risks is not properly understood.

The Guideline provides an overview of the risks most typically associated with derivatives and addresses ways in which to mitigate such risks, for example, suggesting that the FI establish eligibility criteria for its counterparty in the context of OTC derivatives transactions in order to minimize credit risk. In that regard, the Guideline highlights a number of elements upon which eligibility of counterparties may be based. The principle pertaining to counterparty eligibility further indicates that the FI can impose position limits for each counterparty or impose an overall counterparty risk exposure limit for all its positions. The method used to measure counterparty risk should be based on the volume and complexity of its derivatives activities.

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The Guideline indicates that the Authority will assess the degree of compliance with the principles set forth in the Guideline based on the particular attributes of each FI. The boards of directors and senior management of FIs must therefore ensure that the strategies, policies and procedures adopted by their institutions are effective and appropriately responsive to the stated expectations of the Authority in the Guideline.

For the full text of the Derivatives Risk Management Guideline, the Investment Management Guideline and the related orders of the Authority adopting these guidelines, click [here](#).

**FOR FURTHER DETAILS**, or if you have questions regarding this bulletin, please contact [Michael Bantey](#) at 514-982-4003 or [michael.bantey@blakes.com](mailto:michael.bantey@blakes.com), or any other member of our [Securities Group](#), or [Nadine Bellefleur](#) at 514-982-5027 or [nadine.bellefleur@blakes.com](mailto:nadine.bellefleur@blakes.com), or any other member of our [Financial Services Group](#).

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