Reserve Bank of Fiji
Banking Supervision Policy Statement No. 19

NOTICE TO LICENSED FINANCIAL INSTITUTIONS UNDER THE BANKING ACT 1995

MINIMUM REQUIREMENTS FOR THE MANAGEMENT OF MARKET RISK FOR LICENSED FINANCIAL INSTITUTIONS

PART I: PRELIMINARY

1.0 Introduction

1.1 This policy is issued under Section 14(3) of the Banking Act 1995 as part of the Reserve Bank of Fiji's minimum requirements for the management of market risk of licensed financial institutions (LFIs) in Fiji.

1.2 The policy must be read in conjunction with the Reserve Bank of Fiji Banking Supervision Policy Statement No. 4, which sets out maximum limits and reporting requirements in relation to the management of Foreign Currency Exposures of licensed banks.

1.3 The objective of this policy is to ensure that each LFI establishes a comprehensive and effective market risk management framework to ensure that market risk is appropriately identified, measured, monitored and managed.

1.4 In preparing the requirements of this policy, reference has been made to the recommendations of the Basel Committee on Banking Supervision - Core Principles No. 22 and 23 (September 2012) and international best practices.

2.0 Background

2.1 Market risk is defined as, "the risk of losses in on and off balance sheet positions arising from movements in market prices, including interest rates, exchange rates and equity values[1]". There are many factors that influence market risk, but significant to the business of banking in Fiji are interest rate risk[2] and foreign exchange rate risk[3].

2.2 The market risk factors cited above are not exhaustive. Depending on the instruments traded by an LFI, exposure to other factors may also arise. LFIs are expected therefore when developing their market risk management framework to consider the nature, size and complexity of their operations.

2.3 LFIs should ensure that their risk processes are adequate for countering the impact of potential stress developments, including significant deterioration of market liquidity conditions.

2.4 It is essential that the LFIs capture appropriate sources of market risk and establish suitable measures for all market risks assumed.

PART II: REQUIREMENTS OF THE POLICY

3.0 Market Risk Management Framework

[1] The Supervisory Treatment of Market Risks, Consultative Proposal by the Basel Committee on Banking Supervision.
[2] Interest rate risk is defined as "the exposure of an institution's financial condition to adverse movements in interest rates."
[3] Foreign Exchange rate risk is "the potential impact of adverse currency rate movements on earnings and economic value."

3.1 LFIs are required to develop and implement an effective and comprehensive risk management framework to identify, assess, monitor and control market risk inherent in its operations.

3.2 The market risk management framework must comprise of market risk policies, market risk strategies and appropriate procedures and processes to implement the market risk policy and strategy.

4.0 Market Risk Management Policy

4.1 Each LFI must develop and document an in-house market risk management policy that is approved by its Board or its proxy[4]. The policy must appropriately define all the possible types of markets risks identified as inherent in its operations, and set out the principles for identifying, measuring, assessing and monitoring these risks.

4.2 The policy should clearly outline the lines of authority and responsibilities of the Board or its proxy, senior management and other functions responsible for managing market risk.

4.3 The policy must set out the risk management structure, the scope of activities and identify risk management issues, such as market risk control limits, delegation of approving authority for market risk control limit setting and limit excesses.

4.4 In developing its Market risk policies, the LFI must consider interest rate risk and foreign exchange rate risk.

Interest Rate Risk

4.4.1 In addressing its Interest rate risk policy, each LFI must consider at a minimum;

a) In measuring interest rate risk, the LFI should incorporate re-pricing risk[5], yield curve risk[6], and basis risk[7];

b) The LFIs systems should incorporate risk factors corresponding to interest rates in each currency in which the LFI has interest rate sensitive on balance sheet or off-balance sheet positions. In addition, interest rate risk in each currency should be calculated separately;

c) LFIs should establish an appropriate interest rate risk strategy for the management of its structural interest rate risk[8]. This strategy should also be reviewed on a regular basis;

d) Appropriate interest rate risk measurement systems and adequate management information systems should be established to identify, measure,

[4] For branch operations in Fiji, the Board of the LFI is required to declare who is delegated the responsibility for the oversight function of the LFI's market risk management framework. (i.e. the Board's proxy).
[5] Arising from differences between the timing of rate changes and the timing of cash flows
[6] Arising from changing rate relationships across the range of maturities.
[7] Arising from changing rate relationships among yield curves that affect the LFIs' activities.
[8] An economic condition that occurs when an industry or market changes how it functions or operates. A structural change will shift the parameters of an entity, which can be represented by significant changes in time series data.

monitor and report on a comprehensive basis, the LFIs' exposure to structural interest rate risks.

e) LFIs should consider the effect of interest rate risk on net income and net interest income.

Foreign Exchange Rate Risk

4.4.2 In addressing its foreign exchange rate risk policy, each LFI must consider at a minimum;

a) The incorporation of risk factors relating to the individual foreign currencies in which the LFIs' positions are denominated.

b) The risk arising from changes in values or asset-liability mismatch of foreign currencies to the domestic currency.

c) Specify the risk factors corresponding to the exchange rate between the domestic currency and each foreign currency in which its positions are denominated.

d) Furthermore, this policy must be read in conjunction with the Reserve Bank's Banking Supervision Policy Statement No. 4[9], which sets out maximum limits and reporting requirements in relation to the management of Foreign Currency Exposures of licensed banks.

5.0 Market Risk Management Strategy

5.1 Each LFI must develop a strategy that is approved by its Board or its proxy. The strategy must include the LFIs' risk appetite in relation to market risk.

5.2 In developing its market risk strategy, the LFI must consider, at a minimum:

a) the market, liquidity and economic conditions and its impact on market risk;

b) whether the LFI has the expertise to identify, measure, evaluate, monitor, report and control the market risk; and

c) the LFIs' portfolio mix and diversification.

5.3 The market risk strategy for each LFI must be periodically reviewed in order to take into account its financial performance and updated market developments.

6.0 Roles and Responsibilities of the Board

6.1 The Board has the ultimate responsibility for ensuring that the LFI has in place an effective market risk management framework.

6.2 At a minimum the responsibilities of the Board or its Proxy is to:

a) approve the market risk management framework;

b) approve the LFI's risk appetite for market risk;

[9] Foreign Currency Exposures.

c) establish a management structure capable of implementing the LFI's market risk management framework;

d) establish clear lines of accountability and reporting of market risk issues. This to ensure that sufficient resources are available for evaluating, monitoring and controlling market risk;

e) approve limits which should be reviewed; and

f) ensure that the market risk management framework is subject to a review.

7.0 Roles and Responsibilities of Senior Management

7.1 While the overall responsibility of market risk management rests with the board, it is the senior management's responsibility to implement the approved market risk management framework.

7.2 At a minimum, senior management should:

a) provide oversight of policies and procedures for managing market risk;

b) ensure adherence to the lines of authority, responsibility and limits that the Board has established and approved;

c) ensure that business activities relating to market risk are adequately resourced by staff with necessary experience, qualifications, technical capabilities and access to resources;

d) clearly communicate the market risk management policy to staff across all units that are responsible for market risk;

e) establish and ensure that there are adequate systems and controls to identify, measure and monitor market risk.;

f) report comprehensively on market risk management to the Board on a regular basis; This must include, reporting to the Board any material changes or exceptions from established policies; and

g) conduct regular review of the market risk framework.

8.0 Roles and Responsibilities of Asset and Liability Committee (ALCO)

8.1 ALCO is responsible for ensuring adherence to the market risk policies. They are also responsible for the oversight of the conduct of rate risk activities, the allocation and monitoring of market price risk limits and the management of the overall mix of assets and liabilities.

8.2 At a minimum, the ALCO responsibilities should include:

a) the monitoring of liquidity and interest rate risk arising from lending;

b) measurement and management of the forecast for liquidity;

c) overseeing the establishment of appropriate systems and internal controls made to ensure that rate risk exposures and rate risk management activities are consistent with the operation of the LFI;

d) decisions relating to interest rates and pricing;

e) review of policies and procedures for products;

f) developing interest rate and liquidity strategies that support the LFI's business objectives; and

g) regular review of approved delegated limits.

9.0 Market Risk Function

9.1 Each LFI should have a separate market risk function which is functionally independent from trading and should report directly to the senior management. The function is to commensurate with the nature, size and complexity of the LFIs' operations.

9.2 The function is responsible to assist senior management in the design and implementation of the LFI's market risk management framework.

9.3 The responsibilities of the function includes but is not limited to:

a) the selection and testing of the LFIs' market risk management system;

b) the production and analysis of reports based on approved methodologies/models for measuring market risks;

c) the conduct of a regular back testing programme to verify the accuracy and reliability of the LFIs' systems;

d) the identification, assessment, control and monitoring of market risks inherent in the operations of the LFI; and

e) the on-going review of activities, and changes to the LFI's market risk management system.

10.0 Identification and Assessment

10.1 Specific market risk identification and assessment may vary across different institutions, however, at a minimum, each LFI should:

a) identify risks promptly and take quick corrective actions in response to adverse changes in market factors;

b) identify and assess the market risk inherent in all products, activities, processes and systems;

c) ensure that before new products are introduced or undertaken, the market risk related to them are subject to effective assessment procedures; and

d) maintain accounting and management information systems to measure and monitor changes in market risk factors.

11.0 Monitoring

11.1 Effective monitoring process is important for early detection, correction of errors and prevention of the possibility of a loss event. At a minimum, each LFI's monitoring process should:

a) implement procedures to ensure frequent monitoring of market risk and material exposures to losses;

b) identify early warning risk indicators that monitor key material risks of future losses, reflect possible sources of market risks that can allow action that appropriately counter these risks;

c) enable reports to be distributed to appropriate levels of Board and Senior management, identifying problem areas and should drive timely corrective action on identified problem areas; and

d) notify the Reserve Bank of any material developments relating to market risk factors.

12.0 Control

12.1 Control processes are designed to mitigate and control identified risks. For effective control processes, each LFI should have, at a minimum:

a) appropriate processes and procedures to control and mitigate material or identified market risks;

b) establish control procedures to ensure compliance with internal policies concerning the market risk management system;

c) clear and effective assignment of roles and responsibilities, appropriate segregation of duties and ensure that personnel are not assigned responsibilities which creates a conflict of interest;

d) verification process to check for compliance with management controls;

e) establish processes and procedures concerning the review, treatment and resolution of non-compliance issues; and

f) maintain safeguards for access to, and use of systems and records.

13.0 Internal Audit

13.1 Each LFI must ensure that the Internal Audit Unit is established to ensure compliance with market risk procedures and policies. The Unit should be operationally independent, appropriately trained and competent.

13.2 The Internal Audit Unit should regularly carry out, an independent review of the market risk management framework and address, at a minimum:

a) the scope of market risks captured by the market risk management process;

b) the reliability of the management information system;

c) the accuracy and completeness of records;

d) the effectiveness of management controls in place, including effective lines of authority and segregation of duties; and

e) the adequacy and accuracy of management reports regarding the market risk activities.

PART III: IMPLEMENTATION ARRANGEMENTS

14.0 Oversight by Reserve Bank of Fiji

14.1 For the purpose of this Policy, all LFIs' are required to submit to the Reserve Bank of Fiji, its Market Risk policy within 30 calendar days from the date of implementation. Each LFIs' market risk policy must be reviewed on a regular basis. Any changes to the LFIs' market risk policy must be provided to the Reserve Bank within 30 calendar days.

14.2 Exceptions to the market risk policy should be given prompt attention of and authorisation by, the appropriate level of management and the Board where necessary. These exceptions must be reported to the Reserve Bank immediately.

14.3 The Reserve Bank will assess compliance with the requirements of this Policy during the normal course of its supervision.

14.4 LFIs' are required to report to the Reserve Bank, any material[10] market risk incidents no later than 24 hours of its occurrence.

14.5 Any non-compliance with the requirements of this Policy may result in sanctions as specified in Section 15 of the Banking Act, 1995.

15.0 Implementation Arrangements

15.1 This policy applies to all licensed financial institutions licensed under the Banking Act, 1995 and proposes to be effective from 02 January 2015.

Reserve Bank of Fiji
October 2014

[10] Any incident that would be flagged or reported to Senior Management and Board.