Finansinspektionen’s Regulations

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Finansinspektionen’s General Guidelines governing management of market and liquidity risks in credit institutions and investment firms;

decided on 5 July 2000.

Finansinspektionen provides the following general guidelines.

Introduction

The purpose of these general guidelines is to promote professional management of market and liquidity risks in credit institutions and investment firms.

With regard to market risk, the general guidelines apply to banking companies, savings banks and members’ banks conducting business in accordance with the Banking Business Act (1987:617), credit market undertakings conducting financing activities in accordance with the Financing Business Act (1992:1610) and investment firms conducting securities activities in accordance with Chapter 1, section 3, first paragraph, point 3 of the Securities Business Act (1991:981). The general guidelines apply to all activities, including those outside the trading book in which the results can be directly and materially influenced by market risks.

However, these general guidelines do not include activities with market risks managed on behalf of a third party. Effects which entail that market risks influence credit risk exposure (counterparty risk) in financial instruments may be a part of the institution’s market risk management. The same relationship applies for settlement risks and operational risks which may lead to exposure to market risk.

With regard to liquidity risk, the general guidelines include credit institutions, investment firms and foreign companies conducting securities activities in accordance with Chapter 3, section 4, first paragraph, point 4 of the Securities Business Act (1991:981), and branches of foreign credit institutions conducting business in this country.

The regulations that apply to this type of business are set out in Chapter 7, section 10, first paragraph, point 2 of the Capital Adequacy and Large Exposures (Credit Institutions and Securities Companies) Act (1994:2004) for market risks, and Chapter 2, section 10 of the Banking Business Act (1987:617) and Chapter 3, section 5 of the Securities Business Act (1991:981) for liquidity risks.

Application

The institution’s specific conditions and the complexity and scope of the exposure to market and liquidity risks should be taken into account when applying the general guidelines.

Fundamental principles

Section 1 An important condition for efficient risk management is that control functions in all essentials are independent of and not inferior to position-taking functions or persons responsible for position-taking functions. This principle should apply up to and including the managing director.

Section 2 Where an institution is a parent company in a group, the parent company's board of directors should strive to establish group-wide guidelines for risk management and ensure that the guidelines set out in this document, where appropriate, are applied by other companies within the group. In a group, a joint risk control function may be provided by the parent company on the condition that it reports to each subsidiary's board of directors and managing director.

Definitions

Section 3 In these general guidelines, the following mean:

risk management: identification, management, follow-up and control of risk and risk-taking,

market risk: interest rate, currency, equity and commodity risk,

interest rate risk: net interest risk and interest price risk (risk for change in value),

net interest risk: the risk that a change in the general interest rate level will affect the net interest income for liabilities and interest-bearing assets, including interest-related off-balance sheet contracts,

interest price risk: the risk that a change in the general interest rate level affects the market value of assets, liabilities and interest-related off-balance sheet contracts,

liquidity risk: the risk of not being able to meet payment obligations on the due date without the cost of obtaining the funds increasing considerably,

liquidity risk in financial instruments: the risk that a financial instrument cannot immediately be liquidated without falling in value,

financial instruments: that set out in Chapter 1, section 1, paragraph 4 of Finansinspektionen's Regulations and General guidelines (2000:6) governing capital adequacy and large exposures, i.e. including financial instruments that are not subject for trading on a secondary market,

products: financial instruments and other services that may give rise to market and liquidity risks.

Identification and management of market and liquidity risks

Section 4 The board of directors is responsible for:

- ensuring that the scope and nature of market and liquidity risks in each part of the business are identified, including the risks that may arise when financial instruments/products are introduced or changed,

- establishing guidelines for risk management, limits and measurement methods which are in line with the institution’s business strategy,

- ensuring that the institution’s risk management has well-defined responsibility and task areas such that conflicts of interest are avoided or minimised, with a special focus on the control function’s independence and the design of the remuneration systems,

- actively and frequently evaluating information concerning utilised limits, exposures and results,

- evaluating the institution’s management of market and liquidity risks.

Section 5 The managing director is responsible for:

- ensuring that the business strategy and risk level are compatible,

- ensuring that guidelines and instructions for management of market and liquidity risks are established and decided on,

- ensuring that resources for follow-up and control of market and liquidity risks are available,

- allocating responsibility and authorisation for market and liquidity risks, including establishing limits for business areas,

- maintaining systems and standards for measurement of risks and results, reporting and internal control.

Market risks

Written guidelines and instructions, etc.

Section 6 For activities and functions that handle market risks, significant areas should have:

- guidelines and instructions that include allocation of responsibility and tasks, measurement methods, limits, follow-up and reporting and a routine for approval of new or changed financial instruments/products,

- instructions for accounting and valuation of financial instruments/products that include allocation of responsibility and tasks for the valuation process between risk control, financial control and front and back office,

- limitations/authorisation for individual traders or delegated team-wide limits, permitted financial instruments/products and currencies,

- instructions for trade, including approved counterparties, routines for management of incorrect transactions, etc.

Guidelines and instructions should be regularly reviewed and updated to reflect actual conditions, clearly define responsibility and task areas and, where necessary, contain rules for monitoring compliance.

Limits

Section 7 Limits for market risks should be compiled for the institution as well as for individual units, various trading desks, product areas or individual traders within position-taking units. The limits should be consistent with applied risk measurements and designed to restrict immediate and/or accumulated losses over a given period, e.g. a month or a year.

The procedure for the allocation of limits should include how, by whom and to whom limit breaches are reported and documented, on and about which conditions limits may be reallocated and which measures shall be taken in the event of transgressions.

Risk measurement and valuation

Section 8 Requirements for specific methods of measurement should be based on the institution's business strategy and the complexity and volumes of financial instruments/products.

In general, the measurement methods should:

- include all material market risks for assets, liabilities and off-balance sheet contracts, including basis, twist and option risks,

- reflect potential variation in valued (realised and unrealised) results and net interest income, and thereby be able to form an accurate basis for analysing results in relation to risk,

- be based on generally accepted financial risk measurements and techniques and have well-documented assumptions and parameters,

- consist of a number of supplementary measurements, both general, e.g. Value-at-Risk, and detailed, e.g. positions, gap analysis, sensitivity analysis, etc., in institutions with extensive and complex exposures.

Any Value-at-Risk model should be evaluated against both realised and expected results, i.e. back-testing, and be supplemented with stress tests and scenario analyses to analyse extreme market changes or correlation patterns with multiple aspects not considered in the standard measurement methods.

Section 9 An independent mark-to-market of financial instruments/products from position-taking units should occur daily for the trading book and as needed in other operations for internal control purposes, among others. The valuation should be based on complete, exact and updated position information.

The institution should consider to what extent it is reasonable to incorporate price adjustments into the valuation process. This applies in particular to OTC derivatives and to cases where the valuation is based on quotes falling between the bid and offer rate. Adjustments that should be considered primarily include:

- net close-out cost for open positions,

- future, unearned, credit margins,

- future administrative costs.

In addition, price adjustments for illiquid markets and financial instruments/products, portfolios with long maturity and little turnover and any uncertainty in valuation models for new financial instruments/products should be considered.

Follow-up and reporting

Section 10 The institution should have a system in place for daily follow-up and reporting of market risks in the trading book and as required for other operations.

Local exposures, limits and information regarding profit/loss should be aggregated at a centralised level.

Section 11 Reporting to the board of directors and the managing director should include as a minimum:

- risk exposure and limit utilisation,

- information about results,

- results from any stress tests and back-testing,

- compliance with guidelines and instructions.

Risk control

Section 12 The institution should have a centralised function for independent control of market risk that reports to the managing director or a member of senior management not responsible for position-taking units and who has knowledge about financial instruments and methods for management and control of market risks. The function should have sufficient resources and expertise regarding market risks.

The centralised market risk control function should be responsible for:

- monitoring implementation of guidelines and instructions for market risks throughout the entire institution,

- reporting to the board of directors and managing director,

- daily follow-up and active, preventive control of aggregated market risk, including identifying and reporting breaches,

- monitoring the effects of remuneration systems connected to risk-taking in order to assist senior management in evaluation of such systems.

Active and preventive control includes stress tests, evaluation (back-testing) of risk models, validation of price models as well as evaluation and supervision of limit structures.

The centralised market risk control function should have the authority to:

- express opinions about trade of new financial instruments/products,

- recommend reduction of limits.

Section 13 Where an institution has a local market risk control function in position-taking functions, it should report to the centralised function for control of market risk.

The local risk control function's independent position in relation to the local position-taking unit and its management should be ensured. For example, the function should not be included in a bonus system that is dependent on the risk level within the unit. Where the local risk control function reports to both the centralised function for market risk and the manager for the local position-taking unit, it should be clearly stated under which circumstances the risk control function reports to the centralised function and the local unit, respectively.

Managers in position-taking units

Section 14 Managers in position-taking units should report to the managing director or one of the members of senior management not responsible for the risk control function.

Liquidity risks

Section 15 An ability to meet payment obligations may be achieved, among other things, by:

1. maintaining sufficient liquid funds that are immediately available or assets that are easy to convert into cash,
2. matching cash flows and maintaining a stable and well-diversified funding base.

Written guidelines and instructions, etc.

Section 16 Guidelines and instructions for liquidity risk ensuring that future liquidity needs are monitored and met should include both normal day-to-day management and crisis situations as well as provide instructions regarding allocation of responsibility and tasks, measurement methods, limits, follow-up and reporting.

Guidelines and instructions should refer to institutions in their entirety as well as in local units and their internal coordination where applicable, and should be communicated to the entire organisation.

Section 17 A contingency plan for crisis management containing different types of scenarios, stress tests, concrete action plans and alternatives should be in place.

Limits

Section 18 Limits and/or benchmarks for liquidity risk should include where applicable:

- minimum levels for liquidity reserves,

- accumulated net flows for different time intervals applying different assumptions concerning outflows for deposit accounts, for institutions in their entirety, in different currencies and for individual units,

- diversification of sources of funding.

Measurement methods

Section 19 Requirements for specific measurement methods should be based on the institution's business strategy and position.

In general, measurement methods should, where applicable:

- include maturity profiles, liquidity reserves and available sources of funding,

- include all of the institution's commitments, both on and off the balance sheet,

- differentiate between liquidity risks in different currencies for all currencies where the institution has significant commitments,

- to a reasonable degree base the maturity profile on conservatism, i.e. that liabilities shall be paid at the earliest possible due date while assets may first be received at the latest possible due date,

- provide specific assumptions concerning outflows for different types of deposit accounts in different scenarios,

- provide specific assumptions for calculation of availability of liquidity reserves,

- exclude use of securities issued within the group as liquidity reserves.

Follow-up and reporting

Section 20 Within the organisation a system should be in place for follow-up and reporting of the liquidity status for the near future, e.g. the following week and month.

Liquidity risk reports should regularly be presented to the board of directors and managing director.

Conditions for risk measurement and different types of limits should be reviewed regularly.

Independent review

Section 21 Liquidity management should be subject to regular and independent review.

These general guidelines enter into force on 1 September 2000.

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