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Best Practices for Credit Risk Management

This notice provides guidance for dealer members on the importance of being diligent in assessing and maintaining adequate credit risk policies and procedures given the recent credit and financial market crisis.

For each dealer member to properly manage its credit risks on an ongoing basis, IIROC expects that all dealer members ensure that their credit risk management practices continue to be adequate. To assist in this assessment, this notice provides both general guidance and lists some specific best practices for the management of credit risk.

Background

The management of credit risk is an important part of the overall risk management infrastructure of a dealer member. All dealer members should have credit risk policies and procedures in place that are designed to monitor and evaluate risk to counterparties with which they conduct securities related business transactions.

Credit risk is defined as the risk of economic loss from the failure of a counterparty or other obligor to perform according to the terms and conditions of a contract or agreement. Credit risk exists in all activities that depend on the economic performance of issuers, borrowers, or counterparties. Virtually all capital market and trading transactions involve credit exposure that requires a monitoring framework throughout the life of a transaction until a cash settlement occurs, customer indebtedness is repaid or the contract period expires.

Over-the-counter (OTC) derivative transactions such as foreign exchange, swaps, and options can involve particularly large and dynamic credit exposures due to the leverage and other unique features inherent in such products and the lack of central settlement facilities. Accordingly, dealer members should ensure that they identify, measure, monitor and control the various types of credit risks encountered in trading both derivative and non-derivative products.

The quantitative valuation of credit risk is comprised of two components: (1) the current replacement value of a security position or derivatives contract - where the replacement cost represents the current market prices or generally accepted approaches for estimating the present value of future payments required under each contract, and 2) the potential market exposure of the security position or a derivative contract in the future. For example, OTC derivatives, such as forwards or swaps, have a market value of zero when they are first entered into. Mark-to-market exposure which is based only on current market values does not capture the potential for market values to change over time. In this case, the potential exposure is measured more subjectively and is primarily a function of the expected volatility of the price of the security position or derivative contract, which may depend on key factors such as time remaining to maturity, expected interest rates or instrument underlying the contract. Within the IIROC regulatory capital framework, counterparty classifications and margin rules are used to quantitatively value credit risk.

Managing Credit Risk Exposure

Credit risk exposure should be managed by dealer members through a formal process which is independent of the sales office functions and is guided by appropriate policies and procedures for the firm and their business. These policies and procedures need to be endorsed by management and consistent with the firm's overall tolerance for risk. Credit risk measurement systems should provide appropriate and sound estimates of credit exposure. The development of customer credit limits and the monitoring of exposures against those

limits is a critical control function and should form the foundation of a dealer member's credit risk management process. The most common forms of credit risks encountered in trading activities are issuer credit risk and counterparty credit risk which are defined as follows:

> **Issuer risk** is the risk of default or credit deterioration of an issuer of instruments that are held as long positions in trading portfolios. While the short term horizon of trading activities often limits much of the issuer credit risk for relatively high-quality and liquid instruments, other less liquid instruments such as loans, emerging-market debt, leveraged derivative transactions and below-investment-quality debt instruments, may be the source of significant issuer credit risk.
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> **Counterparty risk** is the most significant component of credit risk faced in trading activities. Settlement risk is the risk of loss due to a counterparty's failure to perform on a contract or agreement during the life of a contract. For most cash instruments, the duration of this risk exposure is limited to hours or days from the time a transaction is agreed upon until settlement. Settlement cycles are often determined based on predefined market convention, although counterparties trading cash instruments may negotiate extended settlement periods. In the case of many derivative products however, this exposure can often exist for an extended period of time. Given this potentially longer-term exposure and the complexity associated with some derivative instruments, dealer members should have a full understanding of settlement credit risks that are involved with such instruments.

General Credit Risk Management Guidance

The following guidance outlines IIROC expectations on the key elements that should exist in the overall credit risk management infrastructure of a dealer member. The appropriate credit risk controls that should be implemented at each firm are dependant on the organizational structure and specific business activities of each dealer member. Each firm should ensure that their credit risk management oversight is specifically designed to oversee and control the risks of their particular business. Credit risk management is important for all dealer members, including introducing brokers. While carrying brokers impose their credit risk policies on client accounts introduced to them, introducers may implement even more stringent rules.

IIROC believes that as a minimum all dealer member credit risk practices should include the following:

1. ACTIVE OVERSIGHT OF THE BOARD (or Owner/Manager)

(i) Approve on an annual basis the credit policies and procedures of the firm.

(ii) Ensure that senior management (or owner/manager) regularly reviews and updates the credit policies and procedures.

(iii) Ensure the credit risk department's independence, authority and role in management of the firm is in place.

(iv) Receive reports on a regular basis on any significant potential loss exposures or delegates this review function. For example, this responsibility may be delegated to a credit risk review committee that reports directly to the Board (or supervised directly by the owner/manager).

2. MANAGEMENT TO ESTABLISH CREDIT POLICIES

(i) Establish internal guidelines to approve and review counterparty credit limits.

(ii) Establish security loan values specifying dollar limits for all products, concentration, leverage activities and transaction types. This includes having proper policies and procedures in place that establish limits on the amount the dealer member is willing to lend to a client or group of clients with respect to an individual security issue.

3. ESTABLISH REVIEW PROCEDURES FOR RETAIL ACCOUNTS

(i) Ensure regular review of the exception reports generated to reflect amounts which exceed the loan value limits, leverage amounts and individual account concentration limits to identify accounts that are not in compliance with the dealer member's credit policies.

(ii) Review any significant debit balance client accounts and the liquidity of the underlying significant securities held as loan value. The factors that should be considered in the review are:

  (a) The relative marketability of the significant position,

  (b) The relative credit quality of the significant position, and

  (c) The significant security positions' percentage of the overall loan value of securities held in the account or accounts.

(iii) Establish a process to ensure that any additional collateral requested from clients is received in a timely manner or positions are liquidated.

(iv) Establish a process of timely review for the treatment of accounts with ongoing credit policy violations and to escalate to senior management (or owner/manager).

(v) Establish a process that ensures that any exceptions to the firm's credit policies are approved by senior management (or owner/manager) and explanatory documentation is retained.

4. ESTABLISH INSTITUTIONAL CREDIT WORTHINESS REVIEWS

(i) Obtain approval of all counterparties prior to the account being opened.

(ii) Review periodically both credit ratings and limits, including any changes in the financial circumstances of any counterparty in the acceptable counterparty ("AC")/acceptable institution ("AI") list, which adversely affects their status as an AI or AC, should be considered by the dealer member in the ongoing credit risk assessment.

(iii) Ensure that a proper reporting mechanism exists, which identifies counterparties with a deteriorating credit rating.

(iv) Establish a process to monitor unsettled transactions and escalate that information to senior management (or owner manager).

Specific Credit Risk Management Best Practices

To assist dealer members in determining the adequacy of their current credit risk management procedures, IIROC has identified some best practices of its dealer members regarding the management of credit risk operations and the content of risk management policy and procedure manuals. The following are best practices and list of some of the better credit risk practices observed at dealer members:

Margin Accounts

- Requirement that customers wishing to execute a trade in a margin account must have the amount required to margin in the account **prior** to execution of the trade.
- Require margin calls to be obtained and maintained on a trade date basis as opposed to settlement date.
- Set "house" margin rates for a product group or specific product type to further restrict credit or leverage on such products at a level that is higher than the prescribed minimum regulatory margin rates.
- Credit risk policies and procedures that identify and set "house" margin rates on its EDP system for new products distributed by its salespeople.
- Loan values are adjusted lower than the maximum regulatory rates based on the estimated liquidation period of the account security position. For example, dealer members have used formulas such as "Individual security position size / average 50-day daily trading volume" to determine the reduction in loan value. This is performed on both an individual account basis and on an aggregate security basis.
- Requirement that a Registered Representative's customer margin account with an outstanding margin call is restricted to liquidating/covering transactions only. Trades executed that would otherwise increase an existing margin call in the account are reversed

and booked to a branch error account. Any resulting loss is charged against the Registered Representative commission payout.

- Debit limits are established in client margin accounts based initially on using credit rating scores. Large client accounts are reviewed annually and all other accounts are reviewed based on margin in the account.
- Debit limits over and above a predetermined threshold must be approved by a dedicated individual responsible for such approval and, for significantly higher limits by the head of the Credit Department Head and/or CFO/COO of the firm.
- Debit Limits on existing customer margin accounts that do not meet a minimum credit score or have otherwise experienced a decline in the credit history are subject to regular review and possible downward adjustment to their debit. Specified procedures are initiated for under-margined accounts greater than 5 business days after settlement date of the transaction such as: issuing margin calls advising the Registered Representative to collect from the customer, sell-out notices to customers followed by sell out orders.
- Margin calls are immediately communicated to the Registered Representative to advise the customer or in the case of discount brokers, the credit department follows up directly with the client. Control procedures are in place to detect and prevent practices by clients that sell the same security position that was purchased that created the margin call (i.e. also referred to as "free riding").
- Registered Representatives are held liable for client debits and uncollected reserve balances. Agreements between the dealer member and Registered Representatives are in place to hold-back commission payouts to reserve against unsecured client debit balances which may result in bad debt losses to the firm.

Cash Accounts

- Purchases in a cash account must be settled on (or before) the purchase settlement date or the account may be liquidated to cover the purchase debit created.
- Cash accounts carrying a debit balance for greater than 6 business days, the account is automatically restricted to liquidating transactions.
- Sales in a cash account that result in an unintended short position will result in the account being restricted to liquidating transactions until the stock is delivered.
- Cash account is credited and a hold is placed on the funds until the cheque has cleared the bank.
- For trades with no loan value, ensure there is sufficient equity in the account.
- For any cash accounts that are determined to be "free riding", any future trades will require that the cash or security position be delivered to the account **prior** to trade execution.

Security Concentrations in a Customer Account

- Procedures in place to identify customer accounts with concentrated security holdings. For example, if the debit balance in the account is greater than a set minimum dollar threshold and one security position comprises 25% or more of the total market value of the security collateral in the client's account; and/or the debit balance is greater than a set minimum dollar threshold and 25% or more of the total market value of the security collateral in the client's account is comprised of securities with inadequate liquidity;
- Individual security position loan values may be reduced for concentrations of individual security positions of a single issuer or group of related issuers based on the loan value of the security position(s) held compared to the aggregate loan value of the portfolio held.
- Procedure to regularly review accounts based on the status of the client relationship with the firm, quality of the client's holdings, commissions generated in the account, the total credit exposure, and general credit history of the account.

Institutional Accounts

- Counterparty debit limits are established and daily trading is monitored against these limits. Any trades greater than the limit established requires senior management approval.
- Monitoring of net worth reporting, credit rating alerts and downgrades of issuers and adjusts the debit limits for such customer accounts. This includes changes to the EDP class code of the customer account for purposes of regulatory margin calculation.
- Institutional account is credited and a hold is placed on the funds until the cheque has cleared the bank.