

Investment Objectives and Operations in the Context of Deposit Insurance Funds

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Investment Management for Deposit Insurance Agencies



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निक्षेप बीमा और प्रत्यय गारंटी निगम
DEPOSIT INSURANCE AND CREDIT GUARANTEE CORPORATION
(भारतीय रिज़र्व बैंक की संपूर्ण स्वामित्ववाली सहयोगी Wholly owned subsidiary of the Reserve Bank of India)



CDIC
Canada Deposit
Insurance Corporation

SADC
Société d'assurance-dépôts
du Canada

BACKGROUND

- IADI Core Principle 11 - Funding:

Sound funding arrangements are critical to the effectiveness of a deposit insurance system. A deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims...Recent IADI research indicates that *ex-ante* funding has many more advantages than disadvantages particularly with respect to ensuring prompt reimbursement to insured depositors, the maintenance of public confidence and as a means to avoid the pro-cyclical effects of deposit insurance assessments

BACKGROUND

- IADI Guidance Paper “Funding of Deposit Insurance Systems” outlines broad Fund Management Principles as follows:
 - “When a DI System is primarily funded on an *ex-ante* basis, policy makers need to consider what investment or portfolio management policy to pursue; and
 - It is critically important that the governing body of the deposit insurer have clear oversight over the funding process and investment policy. Such a policy would set out the goals and objectives of funding management and include policies to dictate management of the Fund”.

INTRODUCTION

Objective

- Outline some issues with respect to investment objectives as well as operational issues/considerations
- Provide a Canadian context to these topics

PRESENTATION OUTLINE

- Background – Canadian context
- Investment objectives
- Investment operations
 - Investment Policy
 - Governance
 - Investment strategy
 - Investment management
 - Reporting

BACKGROUND – CANADIAN CONTEXT

- Insured deposits - \$646 billion
- Hybrid funding model– *ex-ante/ex-post*
- Current fund balance - \$2.5 billion (39 basis points of insured deposits)
- Minimum target fund - 100 basis points of insured deposits

INVESTMENT OBJECTIVES

- The investment objectives for the fund set out the results that the fund is expected to achieve
- Investment objectives are driven by the purpose of the fund
- Generally speaking the purpose of any *ex-ante* fund is to enable the timely reimbursement of insured depositors and mitigate pro-cyclical actions
- Funds may also support other forms of resolution as well as day to day operations of the insurer

INVESTMENT OBJECTIVES – CDIC

- At CDIC the Investment portfolio serves two purposes:
 - Fund intervention activities
 - Fund operating costs
- Primary investment objective is liquidity - to ensure that potential obligations can be met on a timely basis
- To support this objective the guiding principles of CDIC's investment policy are to preserve capital by limiting market and credit risk

INVESTMENT POLICY

- Any investment program can be successful only if it operates under a well defined framework that is aligned with the overall objectives of the fund
- The investment policy provides this framework
- A comprehensive investment policy addresses all aspects of the fund's operations
- In a broad sense the investment policy is a combination of investment philosophy or beliefs and tactical direction

INVESTMENT POLICY

- Policy articulates attitudes towards important investment management issues, including:
 - Why does the fund exist?
 - How does the organization define investment success?
 - To what extent is the organization willing to accept losses?
 - How will the performance of the investment program be evaluated?
- Policy sets the direction in terms of operational issues, including:
 - Governance
 - Investment strategy
 - Investment management
 - Reporting

GOVERNANCE

- The governance structure provides a framework for oversight and decision making
- Primary components
 - Roles and responsibilities
 - Authorities
- A strong governance structure includes the necessary elements of a strong internal control structure:
 - Checks and balances, including internal audit
 - Reporting
 - Transparency

GOVERNANCE - CDIC

- Management operates the fund in accordance with Board approved Financial Risk Policies relating to:
 - Credit Risk
 - Market Risk
 - Liquidity Risk
- Policies are subject to annual review as well as a comprehensive review every three years
- Operations are supported by Asset Liability Management Committee
- Regular reporting on policy compliance, fund performance

INVESTMENT STRATEGY

- Guides investment decisions based on the fund's objectives, risk tolerance and the future needs for capital
- Key elements include:
 - Risk tolerance
 - Allowable holdings and asset allocation
 - Investment approach

RISK TOLERANCE

- Key element of any investment strategy is a clear understanding of the risk tolerance of the organization
- Investment activity requires taking certain investment risks with the expectation of receiving positive returns over time
- Investment risk ultimately refers to the possibility of not achieving the fund's objectives

RISK TOLERANCE

- Investment risk tolerance:
 - A high investment risk tolerance means you can be patient in volatile markets and accept potential losses as you are confident markets will reward risk in the long-run
 - A low investment risk tolerance means you are uncomfortable with volatility and will forgo the potential for higher returns for more stability

RISK TOLERANCE

- Deposit insurance organizations should manage to a low risk tolerance for greater stability
- Need to ensure funds are available when needed and guard against the loss of principal

FUND STRUCTURE – ALLOWABLE HOLDINGS

- Allowable holdings considers risk tolerance, counterparties and term
- Issues to consider:
 - Where to place funds – e.g. invest in members, government securities
 - Term – liquidity considerations
- Allowable holdings may be driven by legislation

FUND STRUCTURE – ALLOWABLE HOLDINGS

- Investing in members?
 - An argument supporting this approach is that it places the capital withdrawn from the banking system through premiums back into the industry
 - However, from a risk management perspective is not prudent to place the fund in the risk that is being insured

FUND STRUCTURE – ALLOWABLE HOLDINGS - CDIC

- Governed by CDIC's Financial Risk Policies as well as Canada's Minister of Finance Financial Risk Management Guidelines for Crown Corporations
- Policies and guidelines specify permissible investments, allocation limits and term
- CDIC's investments limited to obligations of Government of Canada or Canadian Provincial Governments
- Maximum term is 5 years
 - Term of < 3 years – minimum credit rating A
 - Term of 3 – 5 years – minimum credit rating AA-
- To help manage liquidity risk, minimum issue size \$250 million

INVESTMENT APPROACH

- **Buy and hold** – hold securities to maturity regardless of market fluctuations
- **Passive Management** – consists of holding a portfolio of maturities in the same proportion as an appropriate benchmark index in order to replicate the performance of the index
- **Active Management** – consists of actively trading the portfolio in an effort to outperform an appropriate index
- Given purpose of the fund and risk tolerance, buy and hold or passive management are likely the most appropriate for deposit insurers

INVESTMENT APPROACH – BUY AND HOLD

Advantages	Disadvantages
Portfolio not rebalanced thereby avoiding transaction costs as well as the need for professional manager	Difficult to monitor performance against benchmark - portfolio will “drift” away from benchmark over time
Freedom to invest across the spectrum of allowable securities	More subjectivity combined with lack of performance measures could make it difficult to support investment decisions – may increase reputational risk
Limits financial statement volatility – no mark-to-market accounting	

INVESTMENT APPROACH – PASSIVE MANAGEMENT

Advantages	Disadvantages
Minimizes discretion – more defensible decisions reduce reputational risk	Transaction costs incurred with rebalancing
Allows performance monitoring against benchmark	May introduce more financial statement volatility – mark-to-market accounting
Fund characteristics are expected to remain in line with benchmark	May lead to more frequent realized gains and losses
Provides framework for use of external manager	

INVESTMENT APPROACH - CDIC

- CDIC currently follows a buy and hold approach
- CDIC's sale transactions are limited to those cases where an existing investment no longer meets policy constraints (e.g. credit rating downgrades) or to fund an intervention
- Currently considering moving to a passive management approach

INVESTMENT MANAGEMENT

- **Internal investment management** – all investment actions are made and executed internally
- **External investment management** – the management of the fund is outsourced to a professional manager operating under a specified mandate
- **Hybrid** – Individual investment decisions are made internally but executed by an external manager

INVESTMENT MANAGEMENT

- Considerations:
 - Internal capabilities
 - Systems and people
 - Fund size
 - Larger funds may be subject to increased scrutiny and reputational risk
 - Investment holdings and approach
 - Difficult for external manager to add value under a buy and hold approach with “vanilla” investments

INVESTMENT MANAGEMENT – CDIC

- Current approach is internal management – given current investment approach (buy and hold) and make up of portfolio it is difficult to make the business case to shift to external mandate
- Investment management needs to be considered with possible shift to a passive management investment approach

REPORTING, PERFORMANCE MONITORING

- Reporting and performance monitoring are critical components that enable appropriate oversight
- Regular reporting required with respect to:
 - Compliance with Policies
 - Effectiveness of Policies
 - Investment performance

REPORTING, PERFORMANCE MONITORING – CDIC

- Board is engaged through Audit Committee
- Semi-annual comparison of performance against a reference portfolio
- Semi-annual reporting on holdings by counterparty
- Annual detailed assessment and quarterly updates of CDIC's Financial Risks (part of Enterprise Risk Management reporting)
- Comprehensive review of treasury policies every three years
- Relevant Internal Audit reports

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SUMMARY

- The management of deposit insurance funds can and will vary from insurer to insurer. The key elements that should exist to guide this management are:
 - A clear understanding of the **Fund's Objectives** provides the roadmap for the fund – *"If you don't know where you are going, you're liable to end up somewhere else."*
 - A well articulated **Investment Policy** to guide operations is the vehicle to get you to where you want to go

THANK YOU

QUESTIONS OR COMMENTS
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