

# Republic of Panama Superintendency of Banks

**RULE N°. 12-2019**  
(dated 15 October 2019)

**“Whereby provisions for the investment portfolio are prescribed”**

**THE BOARD OF DIRECTORS**  
in use of its legal powers and,

## **WHEREAS:**

Due to the issuance of Decree Law 2 dated 22 February 2008, the Executive Branch re-edited Decree Law 9 dated 26 February 1998 and all its amendments as a consolidated text, and this text was approved by means of Executive Decree 52 dated 30 April 2008, hereinafter referred to as the Banking Law;

Pursuant to paragraphs 1 and 2 of Article 5 of the Banking Law, safeguarding the soundness and efficiency of the banking system and fostering favorable conditions for the development of the Republic of Panama as an International Financial Center are objectives of the Superintendency of Banks;

Pursuant to paragraphs 3 and 5 of Article 11 of the Banking Law, approving general criteria for the rating of assets at risk and rules for the provision of reserves to cover them, and establishing the administrative interpretation and scope of the legal provisions and regulations on banking matters, are technical duties of the Board of Directors;

Pursuant to paragraph 10 of Article 11 of the Banking Law, issuing the technical standards required for compliance with the Law is a technical duty of the Board of Directors;

By means of Rule 7-2000 dated 19 July 2000, the rules for the rating of the investment portfolio and the recording of investments by banks were provided;

Rule 6-2012 dated 18 December 2012, amended by Rule 9-2019 dated 24 September 2019, established that the technical accounting standards used for accounting and reporting financial statements by reporting entities will be exclusively the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB);

Prudential regulation on hedging and provisioning for the investment portfolio must be in sync with the International Financial Reporting Standards (IFRS), specifically IFRS 9 and the Basel Committee’s Core principles for effective banking supervision;

During its working sessions, the Board of Directors determined it necessary and advisable to update the regulatory framework for the investment portfolio, pursuant to international regulatory standards.

## **RESOLVES:**

### **CHAPTER I SCOPE AND DEFINITIONS**

**ARTICLE 1. SCOPE AND APPLICATION.** The provisions herein are applicable to:

1. State-owned banks;
2. General license banks;
3. International license banks.

For banks that are branch offices of foreign banks or international license banks whose host supervisor is the Superintendency of Banks, compliance with Chapter II may be documented by an annual certification issued by the head office or responsible regional office. Should the Superintendency determine that these banks do not have the referred-to structure, organization or controls to comply with aforementioned Chapter, the Superintendency will require the banks' full compliance.

Nevertheless, the provisions of Chapters III, IV and V herein will be applicable to all banks.

**ARTICLE 2. TERMS AND DEFINITIONS.** For the application of the provisions herein, [the following terms] will be understood as:

1. **Borrower:** Any individual or legal entity with a contractual debtor relationship with which the financial entity has an asset and the borrower has a liability;
2. **Top management:** The highest executive authority (be that General Manager, Executive Vice President, Chief Executive Officer or other denomination), as well as the second highest executive authority (be there deputy general manager or any other denomination) and other managers and employees who perform key duties that must be directly reported to the former;
3. **Comprehensive risk management:** The process by means of which a bank identifies, measures, monitors, controls, mitigates and reports to operating units in the bank the different types of risks to which the bank is exposed according to the size and sophistication of its operations, products and services;
4. **Board of Directors:** The highest body direction and control of the bank, overseeing the achievement of the best interests of the bank without ever being involved in the direct management of the business activities of the bank;
5. **Counterparty risk:** Any chance that in a financial agreement in which the bank is a party, any counterparty totally or partially breaches its financial obligations, causing the bank to incur losses;
6. **Credit rating system:** Enables [the bank] to assign a grade, score or any other symbol defining the estimated degree of payment compliance by the borrower. The rating system includes the models, algorithms, rules, databases, forms, consultants, committees and working methods used.
7. **Securities:** Any bond, tradable commercial bond or any other debt, securities (including treasury securities), titled securities recognized in a custodial account, stock, stock certificates, security certificates, trust certificates, certificates of deposit, mortgage certificates, options or any other securities, instruments or rights commonly recognized as securities or that the Superintendency of the Securities Market determines is a security. This definition does not include the following:
  - (a) Non-tradable certificates or securities representing obligations issued by banks to customers as part of the usual banking services offered by these banks, such as non-tradable certificates of deposit. This exception does not include tradable banking acceptances or tradable commercial securities issued by banks;
  - (b) Insurance policies, capitalization certificates and similar obligations issued by insurance companies;
  - (c) Any other instruments, securities or rights the Superintendency of the Securities Market of Panama has determined do not constitute a security.

## CHAPTER II INVESTMENT PORTFOLIO MANAGEMENT AND RESPONSIBILITIES

**ARTICLE 3. POLICIES AND PROCEDURES.** Banks must design and implement manuals, policies and procedures for investment portfolio management including, as a minimum, the following:

1. The duties and responsibilities of the board of directors, top management, risk committee, risk management unit, and areas involved in the operation and recording of investment operations;
2. A detailed breakdown of the techniques and models used for fair value estimation and risk measurement of the investment portfolio. These must be technically appropriate and validated in international banking practices;
3. Risk measurements and contingencies for the scenarios resulting from a retrospective stress and worst-case scenario analysis;
4. A detailed breakdown of the management process (identification, measurement, mitigation, monitor, control and information) of the risks endured by the entity in the investment portfolio;
5. The process that must be fulfilled for the approval of proposed new investments,
6. The form and frequency with which the board of directors, risk committee and top management must be informed, as well as the results of investment portfolio management;
7. The internal organization of the risk management process;
8. The profiles and recruitment criteria for the different parties responsible for and executing the [bank's] investments;
9. The criteria for the remuneration of the investment portfolio managers;
10. The strategic guidelines for determining the composition of the securities investments in different portfolios;
11. A detailed breakdown contained in manuals on the methodology, assumptions and input used for developing the rating systems and estimating expected losses.

**ARTICLE 4. RESPONSIBILITIES OF THE BOARD OF DIRECTORS.** The board of directors is responsible for approving and frequently reviewing the strategy on positioning and investment portfolio management and the policies and relevant processes for the identification, measurement, evaluation, monitor, disclosure and control or mitigation of risks to which the entity is exposed because of the investments. The board of directors must:

1. Approve and oversee the appropriate implementation of the objectives, strategies, policies, standards, procedures and measures for investment portfolio management. This essentially requires the identification, measurement, analysis, monitor, control, report and disclosure of risks, proportionate to the nature, relevance and sophistication of the investments in securities, whether or not they are quantifiable;
2. Approve the risk appetite for the investment portfolio according to the different types of instruments, risk rating, concentrations by issuer, concentrations by geographic location and economic sector, markets where the securities are traded, term, expiration, currency, maximum realized and unrealized losses, market risk exposures and all other characteristics of expected revenue and investment risk;
3. Approve red flags and internal exposure limits matching the established risk appetite, [both] overall and for each security category;
4. Establish the responsibility for the risk committee and the risk management unit;
5. Review the established objectives, strategies, policies, standards, procedures and actions at least once a year, and adjust them to significant environmental or in-house changes;
6. Oversee the appropriate implementation of an information system that permits the identification, collection and processing of useful information for investment risk

- management and to help the decision-making of the board of directors and of the other areas and committees related to investment portfolio management;
7. Approve the general guidelines for the remuneration and rewards policy for the experts involved in investment portfolio management that do not encourage risk taking other than those related to the risk appetite established by the board of directors;
  8. Promote compliance with the laws and regulations related to investment portfolios;
  9. Approve recruitment procedures for the experts responsible for investment portfolio risk management, [including] the minimum requirements in technical skills, suitability, knowledge and professional expertise;
  10. Approve policies, procedures and budget for an ongoing program of training and knowledge update for the professionals involved in investment portfolio risk management;
  11. When the issues contained herein are addressed or discussed during the board of directors meetings, a detailed breakdown of the discussion will be recorded in the meeting minutes;
  12. Approve the annual report containing the main facets and results of the investment portfolio.

**ARTICLE 5. RESPONSIBILITIES OF TOP MANAGEMENT.** The top management is responsible for implementing risk management pursuant to that approved by the board of directors. The responsibilities of top management are listed below:

1. Ensure the consistency between the investment portfolio decisions and the risk tolerance levels;
2. Establish review programs for the risk management unit and the business units regarding the achievement of objectives, procedures and controls of the investment portfolio, as well as exposure limits and risk tolerance levels;
3. Ensure that the budget of the risk management unit is adequate for the performance of its duties;
4. Ensure the existence of appropriate data storage, processing and management systems,
5. Ensure training and updating programs are established for the risk management unit staff and any other personnel participating in operations involving investment portfolio risks for the bank;
6. Establish procedures that ensure the appropriate flow, quality and timeliness of information between the business units and the risk management unit, and for any other personnel involved in securities investment;
7. Create and promote an organizational culture of risk management of securities investments and establish the proper practices for internal control, including standards of conduct, integrity and ethics for all employees.

**ARTICLE 6. RESPONSIBILITIES OF THE RISK COMMITTEE.** The risk committee established in accordance with the Rule on comprehensive risk management issued by this Superintendency is the unit in charge of overseeing the sound management of the bank's risks, and will have the following functions, as a minimum:

1. Evaluate the manual, policies, procedures and methodology for the management of securities investment risk and present them to the board of directors for approval.
2. Ensure the maintenance of an adequate management process of the securities investment risk and keep the board of directors advised on its effectiveness.

3. Oversee that the risks of the securities investments are identified, measured, mitigated, monitored and controlled effectively and consistently. Compliance with this responsibility will be documented in the Minutes of the risk committee's meetings.
4. Monitor risk exposure and compare the exposure to the tolerance limits approved by the board of directors.
5. Define the scenarios and timeframes for the analysis of the behavior of securities investment risks.
6. Inform the board of directors on the risk exposure relative to the limits established and the main risks that have been assumed. For this, [the committee] will require the corresponding periodic reports from the risk administration unit.
7. Inform the board of directors of changes in the entity's risk profile and the results of the indicators of securities investment risk.
8. Review provisioning requirements;
9. Oversee and guide the work conducted by the risk management unit for the implementation of the investment portfolio risk management;
10. Faithfully document the matters discussed and the decisions made on the investment portfolio management in the risk committee meeting minutes;
11. Approve changes to credit risk rating models and make sure that these models reflect the bank's current situation regarding its nature and sophistication;
12. Any other duties and requirements established by the board of directors.

**ARTICLE 7. RESPONSIBILITIES OF THE RISK MANAGEMENT UNIT.** Pursuant to the provisions of the Rule on comprehensive risk management, the risk management unit has among its duties managing investment portfolio risks.

In addition to the responsibilities stipulated by the aforementioned Rule, the risk management unit must:

1. Submit a suitable structure for investment portfolio risk management to the board of directors through the risk committee, appointing the coordinators or persons responsible for the different functional units for the management of those risks;
2. Design and implement methods and tools for measuring investment portfolio risk, consistent with the degree of sophistication and the volume of financial instruments;
3. Ensure that the areas responsible supply the necessary information that will be used in the methods and tools for measuring investment portfolio risk;
4. Ensure that any deficiency detected in the quality, timeliness and integrity of information utilized by the risk management unit is reported to the areas responsible for their preparation and control;
5. Continuously evaluate the models and tools for measuring investment portfolio risk; the results must be reported to the risk committee;
6. Monitor the investment portfolio risk exposures and compare these exposures to the limits approved by the board of directors. Additionally, [the unit] should continuously evaluate the adequacy and performance of controls and limits over time;
7. Make proposals regarding the corrections that may be implemented as a result of deviations from the established tolerance levels;
8. Collect and report the historical evolution of investment portfolio risks taken by the entity in regards to the established tolerance levels;

9. Provide an opinion on the investment portfolio risks for new financial instruments, new trading markets and new hedging instruments prior to their acceptance;
10. Research and document the causes of deviations from the established limits and inform the risk committee, manager or administrator and the person responsible for internal auditing in a timely manner;
11. The duties and requirements established by the risk committee.

**ARTICLE 8. RESPONSIBILITIES OF THE INTERNAL AUDITING UNIT.** The internal auditing unit will assess compliance with the procedures and policies used for investment portfolio risk management prepared pursuant to the provisions of this Rule. Additionally, [the internal auditing unit] will evaluate the effectiveness of controls in accordance with the risk list and, upon the risk management unit's request, of those [risks] where the behavior of events and incidents require control assessment, making sure to inform the risk committee first.

In order to comply with this article, the internal auditing unit must ensure it makes the relevant reporting to the internal auditing committee.

**ARTICLE 9. OPERATIONAL REQUIREMENTS.** For the proper management of the investment portfolio, the entity must comply with the following operational requirements:

1. Have the technical and technological infrastructure fitted to the nature and sophistication of operations;
2. Have the ability to aggregate risk exposures in homogenous categories according to the different, relevant risk factors;
3. Have the ability to comprehensively measure portfolio investment risk, adding risks to the different instruments and portfolios and adding existing correlation relationships;
4. Have appropriate information and analysis systems to evaluate the impact of different economic and financial scenarios on revenues and investment portfolio risk;
5. Have the ability to preventively evaluate the impact of different hedging types and models for investment portfolio income and risk;
6. Have a credit rating system adapted to the provisions herein;
7. Have well-trained and experienced staff pursuant to the nature, sophistication and risks of securities investments.

### **CHAPTER III RECORDING, CLASSIFICATION AND MEASUREMENT OF THE INVESTMENT PORTFOLIO**

**ARTICLE 10. RECORDING, CLASSIFICATION AND MEASUREMENT OF THE INVESTMENT PORTFOLIO.** Securities investments will be recorded, classified and measured according to the current International Financial Reporting Standards (IRFS), based on the established business models and the nature of the contractual cash flows of each instrument.

For securities that are capital instruments, the entity will classify assets according to the business model chosen for its management and the feasibility of measuring them at fair value.

For instruments without periodic listings in a liquid market and valued with models, as well as derivatives whose underlying assets are not frequently listed in a liquid market, the Superintendency will evaluate their classification, recording and value during the supervisory process and, if necessary, make the observations it deems advisable for the bank to make the relevant corrections.

The reclassification of the investment portfolio must be substantiated to the Superintendency of Banks through a report explaining and describing the grounds for changing the business model. The report must be approved by the board of directors and documented in the meeting minutes. A copy of these minutes will be attached to the substantiated request for reclassification.

The Superintendency of Banks may require the reclassification of the investment portfolio if it determines the conditions established herein or in other prudential regulations provided by the Superintendency have not been met.

For the purposes of prudential reclassification of the capital requirements estimates, the unclassified values of the trading book will be part of the banking book, as defined by the Rule on "Capital requirements for financial instruments in the trading book."

**ARTICLE 11. VALUATION OF THE INVESTMENT PORTFOLIO.** The valuation of the investment portfolio, even if amortized, is a key element of the management process. The valuation of the investment portfolio must be governed by the following criteria:

1. Valuation techniques and models must prioritize the use of market information and minimize the use of discretionary parameters;
2. For market information, the relevance and commonality must be taken into consideration, avoiding the use of information based on the compulsory liquidation of operations or in the absence of transactions;
3. To evaluate the quality of market information, the following aspects must be considered:
  - (a) The frequency of the listed prices;
  - (b) The representativeness of the transactions;
  - (c) The similarity between the traded financial instruments in reference transactions and the instruments of the entity's portfolio;
  - (d) The requirement for the transactions to be made between independent parties to be considered representative.
4. In the event the valuation is made using models and certain techniques to estimate model parameters, the following conditions must be met:
  - (a) The models used should tend to be those generally used in the financial sector;
  - (b) When the entity uses its own model, it must justify the validity of the model theoretically and document the assumptions on which the model is based explicitly;
  - (c) The methods and data used to estimate the parameters of the evaluation models used must be documented.
5. The investments classified at fair value with changes in results must be valued on a daily basis;
6. The investments classified at fair value with changes in other comprehensive results must be valued on a monthly basis, as a minimum. Greater frequency of valuation must be linked to greater liquidity showed by the investment, until reaching the daily valuation.

**ARTICLE 12. REQUIREMENTS THAT CREDIT RATING SYSTEMS MUST MEET.** The requirements that credit rating systems must meet are:

1. There must be an appropriate methodology that permits the credit rating for all types of customers;
2. Any customer with a credit exposure must have an updated credit rating;
3. The historical and current credit ratings of a customer must be kept in the credit file and stored in a historical database as relevant information;
4. The level of detail in the system must be consistent with the information available, in order to optimize the ability to segment it into homogeneous risk groups;

5. The rating systems established for different borrower segments must match each other. Coherence must be set through the probabilities of default, which must be equally considered for borrowers belonging to different portfolios but with the same credit rating;
6. The ratings established must be robust. Small changes in risk factors should not cause major rating changes;
7. The risk factors that are used as the basis for ratings must be appropriately delimited before being accepted. [Risk factors] must not be changed hastily due to the discovery of "facts" not covered by the model;
8. The probability of default should be a good indicator to predict the frequency of default for each risk group (rating) established. A systematic divergence between observed frequencies and estimated probabilities should lead to the system's review;
9. Observed default frequencies should maintain the same priority as default probabilities assigned to each of the ratings;
10. Customer ratings must be validated by a unit other than the one that assigned it;
11. The credit rating system must be subject to controls within the scope of operational risk. Especially:
  - (a) Verification that the information used belongs to the design established;
  - (b) Validation of risk factors and their discriminant capacity;
  - (c) Default probabilities and observed default frequencies;
  - (d) Coherence of rating transition matrixes;
  - (e) Deficiencies in the system implementation process within the organization;
  - (f) Errors not purged from databases;
  - (g) Absence of an internal approval process by the board of directors for credit rating systems;
  - (h) Lack of credibility;
  - (i) Excessive sophistication;
  - (j) A minimum annual frequency for updated financial information for companies.

The guidelines provided herein will be applicable to securities investments and loan portfolios.

The banks using ratings issued by well-known external risk rating agencies for the investment portfolio must conduct an evaluation of the applied rating methods, to make sure that the methodologies and input used are robust and meet all of the requirements established herein. Additionally, the existence of this evaluation with all of the characteristics analyzed, as well as the approval by the board of directors, must be documented in a report.

**ARTICLE 13. EXPECTED CREDIT LOSSES AND EXPECTED LOSSES FROM THE INVESTMENT PORTFOLIO.** The investment portfolio for which the entity will make the expected credit losses calculation are:

1. The investment portfolio measured at amortized cost meeting the following conditions:
  - (a) The security is maintained within the business model whose objective is to obtain contractual cash flows, and
  - (b) The contractual conditions of the security provide cash flows on specific dates that are only payments of capital and interest on the amount of the outstanding capital.

2. The investment portfolio measured at fair value with changes in another integral result meeting the following conditions:
  - (a) The security is maintained within the business model whose objective is achieved obtaining contractual cash flows and selling financial assets, and
  - (b) The contractual conditions of the security provide cash flows on specific dates that are only payments of capital and interests on the amount of the outstanding capital.

An entity will recognize provisioning for losses in terms of expected credit losses on the investment portfolio established in items 1 and 2 above.

Provisioning for deterioration, in terms of expected losses for the cases listed below, will also be recognized:

1. An investment in stock instruments measured at fair value with changes in another integral result;
2. A structured product measured at fair value.

**ARTICLE 14. ESTIMATE OF THE PARAMETERS OF THE EXPECTED LOSS MODELS.** The quality of estimates of the parameters of the expected loss models is a key factor for investment portfolio risk management. The parameters to which special attention must be paid are probability of default, exposures (especially for derivatives), default loss rate, correlations, volatilities and risk premiums.

Regarding the estimate of the parameters of expected loss models, entities must:

1. Document estimating procedures and methodologies;
2. Document databases and information used. Databases must be maintained;
3. Identify staff responsible for obtained results;
4. Describe validation procedures, tools and results both for estimates made and models used;
5. Document changes in validation methodologies and tools, data used and any other relevant information;
6. Define tolerable error margins in the estimates made and, whenever possible, the order of magnitude of the errors in the parameter estimates in terms of confidence intervals and other similar statistics.

**ARTICLE 15. INVESTMENT PORTFOLIO PROVISIONS.** There are three categories of provisions:

1. Provisions for losses expected at 12 months;
2. Provisions for expected losses during the life of the asset, motivated by a significant increase in risk;
3. Provisions for default.

Provisions for the three categories will be determined by each entity's internal methodologies and adapted to the provisions herein. The provisions for default cannot be less than those established in the Rule on credit risk management and administration inherent in credit portfolio and off-balance sheet operations.

For all implicit and explicit derivatives whose fair value is estimated from models due to a lack of market value, the expected loss should be recognized through an adjustment of the counterparty credit risk valuation.

## CHAPTER IV INFORMATION REQUIREMENTS

**ARTICLE 16. CUSTODY OF SECURITIES.** For the custody of securities, banks may choose between taking custody of securities themselves or procuring the services of a custodial agency or procuring those services through banking or brokering companies. The custodial companies and services procured by banks must be acceptable to the Superintendency.

Those companies must guarantee the maintenance and integrity of the securities instruments under their custody, whether the securities are held physically or in transit, by means of insurance policies acquired for these purposes.

The custodial agreements entered into with the aforementioned companies, as well as the reports the custodial companies send to banks, must be made available to the Superintendency.

**ARTICLE 17. DISCLOSURE OF INFORMATION ON THE INVESTMENT PORTFOLIO.** Banks must issue information on the investment portfolios. The reports must promote transparency and comparability, and provide the relevant information to all parties connected with the bank.

Banks must disclose in their audited financial statements the information that will permit the user to evaluate the risk profile of the bank's investment portfolio based on the criteria established by the International Financial Reporting Standards (IFRS) and the criteria provided herein.

**ARTICLE 18. REQUIREMENTS FOR INFORMATION.** Banks must submit the information referred to herein to the Superintendency at the frequency and in the form the latter establishes.

**ARTICLE 19. ADDITIONAL REQUIREMENTS.** Banks must make available to the Superintendency any and all information, databases, policies, processes, procedures, management systems, strategies, plans and others referred to herein, as well as the auditing or head office revisions for those institutions whose head office is abroad.

The Superintendency may also request any bank provide any additional information it deems necessary for the appropriate supervision of the management of the investment portfolio.

## CHAPTER V FINAL PROVISIONS

**ARTICLE 20. PENALTIES.** Failing to comply with the provisions herein will be penalized according to the provisions of Title IV of the Banking Law.

**ARTICLE 21. REPEAL.** This Rule repeals Rule 7-2000 dated 19 July 2000 and its amendments and Rule 5-2001 dated 3 December 2001 in their entirety.

**ARTICLE 22. ENACTMENT.** This Rule shall enter into force on 1 December 2019.

Given in the city of Panama on the fifteenth (15<sup>th</sup>) day of October, two thousand nineteen (2019).

**FOR COMMUNICATION, PUBLICATION AND ENFORCEMENT.**

**THE CHAIRMAN, a.i.**

**THE SECRETARY, a.i.**

Nicolas Ardito Barletta

Luis Alberto La Rocca