POLICY NAME	FINANCIAL RISK MANAGEMENT POLICY
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PURPOSE AND SCOPE

The University recognizes that certain risks (in the context of this policy, risk refers to financial risk) are incidental to normal business operations. It is the general philosophy of the University to avoid intolerable risk and to limit, as far as practical, the risks associated with business activities. Accordingly, the University has developed a framework within this policy to:

- Allow for a hedging policy to be aligned with its “business” objectives;
- Choose hedging products which are effective in managing risk;
- Make hedging decisions based on the institution’s objectives and tolerance for risk, rather than market conditions;
- Limit circumstances / activities that expose the University to risk from speculative activities;
- Discourage any activities that are not clear or may be interpreted as increasing risks; and

It is the general objective of the University to avoid unexpected losses and to minimize the potentially adverse impact that financial risk exposures may have on the University.

Financial management will be executed in accordance with the terms of and pursuant to the “Loi sur l’administration financière” (L.R.Q., Ch A-6.001).

Since the McGill investment Pool (MIP) is not subject to the same terms and conditions than the other McGill funds and that the Investment Committee is approving the risk management tools and the usage of derivatives, the MIP is excluded from this policy.

Refer to the Procedures for details regarding the implementation and interpretation of the following policies.

POLICY

P1. TO P3.

P1. It is the responsibility of the Office of Vice-President (Administration and Finance) ("VP (A&F)") to implement and maintain this policy and ensure its application. None of its units reporting into the VP (A&F) will engage in speculative use of derivatives.

P2. Derivatives are used for hedging purposes solely to mitigate risk.

P3. Office of Investments is the only unit allowed to engage in hedging activities involving the use of derivative instruments including the buying and selling of interest rate and foreign exchange derivative products. Procurement Services is the only group allowed to engage in risk management activities involving the use of derivative instruments to protect against commodity risks (including volatility associated with energy prices)

PROCEDURES

PR1. Audience

PR1.1. All employees of the University must adhere to this policy.

PR2. Administrative Process

PR2.1 Financial Risk Identification

This policy is primarily concerned with:

- Interest rate risk
- Foreign exchange risk
- Commodity risk (primarily energy related)

Interest rate, foreign exchange, and commodity management objectives are to protect the University against material economic exposures and variability of results due to these elements.

In order to achieve these objectives, the respective groups under the VP (A&F) are responsible for:

- Determining the University's risk position with respect to the above-mentioned risks and exposure;
- Working with affiliated entities and all units within the University to identify financial risks of the University;
- Hedging material exposures through effective use of derivative or underlying non-derivative instruments;
- Ensuring all counterparties of the University are creditworthy;
- Ensuring that exposure to any counterparty is limited to amounts established under this policy as up-dated from time-to-time;
- Reporting exposure to the VP (A&F); and
- Developing, and if deemed appropriate, implementing a hedging strategy.

PR2.2.Financial Risk Qualification

PR2.3.1. Interest Rate Risk

Interest rate risk emanates from financing and refinancing activities subject to current market rates such as swap transactions, debt maturities and floating-rate debt.

Managing interest rate risk requires an understanding of the amount at risk and the impact of changes in interest rates. The level of exposure should be determined for the University from budgeting and forecasting information supplied by operating units as part of the budgeting/forecasting process.

PR2.2.2. Foreign Exchange Risk

Foreign exchange risk emanates from foreign currency fluctuations that adversely impact the value of the University's assets, investments, capital expenditures, revenues, expenses, debt service, and other cash flows that affect earning and balance sheet accounts.

Managing foreign exchange risk requires an understanding of the amount at risk and the impact of changes in currency exchange rates. The level of exposure to be hedged should be determined between the Office of Investments and Financial Services.

PR2.2.3. Commodity Risk

Commodity risk emanates from the University's exposure to commodity markets, primarily those affecting energy prices. In a University environment, the risk is associated with electricity and natural gas price fluctuations, in excess of that assumed for budget / planning purposes.

Managing commodity risk requires an understanding of the amount at risk and the impact of changes in commodity prices. The level of exposure to be hedged should be determined in conjunction with the usage requirements forecasted by Facilities and in conjunction with Procurement Services.

Procurement Services will be the source of all commodity prices used for planning purposes. The specific commodity prices used for planning purposes are to be updated on a quarterly basis or as agreed to between Procurement Services and Analysis, Planning and Budget. The individual operating groups are to use this foreign exchange.

PR2.3. Financial Risk Mitigation

PR2.3.1. Use of Derivative Instruments to Mitigate Exposure

Derivative instruments will be used to mitigate exposures when they represent the most effective means of achieving the University's financial risk management objectives.

Wherever possible, financial risk exposures should be managed on a consolidated University basis to benefit from natural hedges.

Derivative instruments are only authorized within the following parameters:

- Derivatives are not to be used for speculation;
- Derivatives are not to be used on a levered basis (the change in the value of the derivative should not be designed to outweigh the change in value of the underlying asset or obligation);
- Derivatives are to be used as a hedge or offset to an underlying asset or obligation only;
- Derivatives should not create new exposures;
- Derivatives are not to exceed the term of the underlying asset or obligation;
- Derivatives are not to exceed the amount of the underlying asset or obligation (except to adjust for differences in tax treatment of the derivative transaction versus that of the underlying asset or obligation).

PR2.3.2. Authorized Derivative Instruments

Office of Investments is authorized to use the following derivative instruments:

- Interest rate risk management:
  - Interest rate swaps
  - Forward rate agreements
  - Caps, floors and collars
  - Options and Swaptions

- Foreign exchange risk management:
  - Currency swaps
  - Foreign exchange forwards
  - Options

Procurement Services is authorized to use the following derivative instruments:

- Commodity price risk management:
  - Fixed price contracts
  - Forward contracts

PR3. Roles and Responsibilities

PR3.1. Roles and Responsibilities

There must be clear segregation between those who approve, transact and confirm derivative trades for each individual trade, as follows:

Derivative Transactions

- Authority to enter into derivative transactions is limited to the President or the VP (A&F) together with the CIO & Treasurer or Director Procurement Services, as dictated by the University's Signing Regulations and by-laws;
- When entering into a derivative transaction for the operational account of the University, the Minister of Finance must approve the terms and conditions of the transaction.
- Delegation, as outlined in the University's Signing Regulations and by-laws, which provides authority to execute any such transactions and to take such action as may be necessary or desirable to carry out the intent and purpose of the authorized hedging activity, may be permitted;
- Either Office of Investments or Procurement will confirm the specific terms and conditions of the derivative trade with the counterparty or investment manager, as applicable;

Interest Rate Transactions

- Trading authority is delegated by the CIO &Treasurer;
- Office of Investments will execute the derivative trade with the counterparty, supervised by the government as required;
- The counterparty will provide a confirmation, as referred to in the ISDA Master Agreement, as confirmation of the transaction to be signed by the VP (A&F), or delegate;
- Office of Investments will provide a copy of the appropriate documentation to Legal and Financial Services, as required.

Foreign Exchange Transactions

- Trading authority is delegated by the CIO &Treasurer;
- As soon as practically possible after executing a transaction in the market, the member of Office of Investments who executed the transaction will produce and sign a transaction confirmation term sheet outlining the terms and conditions of the transaction to be signed by that person's supervisor;
- Office of Investments will receive written confirmation from the counterparty of the terms and conditions of the transaction within one business day of the execution of the transaction;
- The written confirmation of the transaction will be signed by the CIO & or its delegates

Office of Investments is responsible for structuring, executing, and documenting all derivative transactions.

Office of Investments is also responsible for the calculation of all cash flow settlements, and future cash flow requirements once payment amounts become known. Office of Investments will effect all settlement payments or receipts and advise Financial Services accordingly.

Financial Services is responsible for determining the appropriate accounting treatment for each derivative transaction and for performing reconciliations of records and reports between Office of Investments and the University's records.

Commodity Transactions

- Trading authority is delegated by the Director Procurement Services;
- A draft of the originating agreement must be reviewed and approved by Legal Services in advance of Procurement Services entering into a derivative trade with the counterparty.
- As soon as practically possible after executing a transaction in the market, the member of Procurement Services who executed the transaction will produce and sign a transaction confirmation term sheet outlining the terms and conditions of the transaction;
- Procurement Services will receive a call from the counterparty on the same day to obtain independent verbal confirmation of the terms and conditions of the transaction;
- Procurement Services will confirm and sign the transaction confirmation term sheet and have it subsequently signed by the VP (A&F);
- Procurement Services will provide a copy of the signed term sheet to Financial Services; and
- The counterparty will provide a “contractual hard copy” confirmation of the transaction to be signed by the VP (A&F).

Procurement Services is responsible for structuring, executing, and documenting on not less than a quarterly basis, all derivative transactions to the VP (A&F).

Procurement Services is also responsible for the calculation of all cash flow settlements, and future cash flow requirements once payment amounts become known. They will affect all settlement payments or receipts and advise Financial Services accordingly.

Financial Services is responsible for determining the appropriate accounting treatment for each derivative transaction and for performing reconciliations of records and reports between Procurement Services and the University’s records.

Additional verification of Procurement Services compliance with this policy should be sought from time-to-time from an independent source such as Internal Audit.

PR3.2.Roles of Office of Investments and Procurement Services

Under the authority of the VP (A&F), Office of Investments and Procurement Services are responsible for:

- The identification and quantification of the principal financial risks facing the University;
- The development and implementation of risk management strategies designed to meet the University's risk management objectives; and
- Regularly monitoring and reporting, as described under this policy, on the financial risks under management.

PR3.3.Authorizations

As outlined in the University's Signing Regulations and by-laws, the various officers are authorized:

- to approve all hedging activities/derivative transactions as long as such transactions are within the scope of this policy;
- to delegate the authority to execute any such transactions and to take such action as may be necessary or desirable to carry out the intent and purpose of the authorized hedging activity.

PR4. Controls and Procedures

PR4.1. Derivative Transaction Process

Explicit objectives and performance parameters must be established and documented before execution for all approved transactions.

The derivative transaction process will be as follows:

- Identification of financial exposure;
- Quantification of financial exposure;
- Design or selection of risk mitigation derivative strategy;
- Presentation of risk mitigation derivative strategy to the VP (A&F) and/or Finance Committee, as deemed appropriate;
- Receive approval for execution of derivative strategy transaction, as required;
- Select counterparties for derivative strategy execution;
- Execution and documentation of transaction;
- Regular monitoring and reporting of financial position and derivative position as described under this policy.

Counterparties must meet credit quality criteria as outlined in this policy.

PR4.2. Reporting and Monitoring

Appropriate systems will be maintained in order to identify, quantify and control exposures. Office of Investments and Procurement Services will record all trades, monitor derivative positions and follow market movements and will report on such to the AVP Financial Services and/or to the Finance Committee as deemed appropriate.

In order to ensure that all hedges qualify for hedge accounting treatment when applicable, each qualified transaction will be fully documented prior to inception in accordance with the prescribed documentation as required by Financial Services. This documentation must meet all requirements of Canadian Generally accepted Accounting Principles (GAAP). Calculations to determine whether derivative instruments qualify for hedge accounting under GAAP and subsequent measurements of hedge effectiveness will be made in accordance with standard practices for accounting for Derivative Instruments.

PR5. Appendix – Glossary of terms

Cap
The buyer of a cap pays an upfront premium for interest rate protection (obligation) and receives funds if rates go above a certain level but does not give up potential savings if rates go down.

Collar
Combination of buying a "cap" and selling a "floor" (obligation), effectively putting a "collar" on future interest rates.

Currency swap
Agreement (obligation) with counterparty to exchange interest and principal payments in one currency for payments in another currency.

Derivative
Financial instrument whose value is derived from the value of some underlying assets such as government bonds, equities or currencies.

Effectiveness
Generally, will be measured as the correlation between the change in value of an underlying asset and the change in value of a derivative instrument over a time series of data points.

Exposure
Outstanding position in a particular type of security, market, or industry.

Fair value
Also known as the mark-to-market value, the fair value of a derivative instrument is the cost (gain) that would be incurred to enter into a derivative contract today that has the same features as the instrument being valued. The mark-to-market value is also the cost (gain) that would be incurred to unwind the derivative instrument today at current market conditions.

Financial risk
A risk that may impact the financial performance of the University but that is not operational in nature. Sources of financial risk include

- Counterparty risk (Credit risk)
- Foreign exchange risk
- Interest rate risk
- Equity risk

Foreign exchange forwards
Obligation to buy/sell another currency at a future date.

Foreign exchange risk
Emanates from foreign currency fluctuations that impact the value of the University's assets, investments, capital expenditures, revenues, expenses, debt service and other cash flows that affect earnings and balance sheet accounts.

Forward Rate Agreement
Contract between two parties where one party will pay a fixed rate and the other party will pay a reference interest rate at a future time.

Hedge
Hedging means mitigating financial risk exposure. To qualify as a hedge, an activity should be expected to produce a measurable economic offset to the risk relating to an asset, liability, committed transaction or probable forecasted transaction. For derivative securities, offset generally will exist if a derivative position is relatively equal and opposite of the item being hedged. To qualify in part as a hedging activity, the derivative should be structured to provide a high degree of correlation in price or cash flow movement from market changes between it and the hedged item.
Hedge example: the equity risk of owning a $100 stock can be hedged by a 'put' which is the right to sell that stock at $100.

Interest rate risk
Emanates from financing activities subject to re-pricing such as commercial paper programs, accounts receivable securitization programs, swap transactions, debt maturities, floating-rate debt and preferred equity issues.

Interest rate swap
Agreement (obligation) to exchange interest payments (fixed into floating/floating into fixed) on a "notional" amount of principal (no principal is exchanged).

Mark-to-market value
See Fair value

Natural hedges
Existing positions that are impacted in opposite directions by changes in market conditions, thus negating the positive (negative) impact of one of the positions taken alone (i.e. the University's US$ denominated assets are naturally hedged by the University's US$ denominated debt).

Option
The right to purchase or sell an underlying asset at a specified price at a future date.

Potential Credit Risk
Time and volatility statistical estimate of the maximum mark-to-market of a transaction during its term with a 95% level of confidence

Speculation
A profit-seeking activity unrelated to the primary business of the University and/or inconsistent with the protection of earnings, cash flows or value from adverse fluctuations in financial market variables. Any risk that is engaged in for its own sake and is not a business risk. For example, the use of a currency option on the future direction of a currency when the University's earnings or asset values are not otherwise affected by fluctuations in that currency. Speculative risk includes all forms of activities in which a market position is taken with the intent of profiting solely from market movements.

Swaption
An option (right) to enter into a swap at a later date.