

Bank Name/City:	
Charter #:	
Exam Date:	
Performed By:	

# **#13 - Investment Securities**

## **Assignment Overview**

Investment decisions affect the asset quality, earnings performance, capital adequacy, and liquidity of a bank. With few exceptions, the investment securities constitute a significant part of a bank's total resources, generally acting as a secondary source of liquidity. Like loans, investment securities are extensions of credit involving risks that carry commensurate rewards. However, risks in the investment portfolio should be minimized to ensure that liquidity and marketability are maintained. Each type of investment security carries one or more type of risk: credit, liquidity, market, and interest rate. Management should evaluate each of these factors when making investment decisions to ensure that overall portfolio objectives, and an appropriate balance between safety and rate of return, are achieved. Management cannot rely exclusively on credit agency ratings (as per the rules which became applicable for all existing and future bond holdings on January 1, 2013). Factors which should be considered in performing a review of investment securities include: the complexity and liquidity of the bank's portfolio; the adequacy of policies and procedures given the circumstances; trends and effect of investment activity; and the propriety of accounting systems.

For additional guidance, refer to **FDIC Risk Management Manual of Examination Policies**, <u>Section 3.3</u> – Securities and Derivatives, <u>Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities</u>, <u>FRB Trading and Capital-Markets Activity Manual</u>, <u>FRB Commercial Bank Examination Manual – Section 2013.1 Allowance for Credit Losses</u> – Measurement of the ACL for Available-For-Sale Debt Securities, and the Reference Material document applicable to this procedure

## **Instructions**

IMPORTANT! These procedures are designed to promote critical thinking. Your comments should include what you looked at, what you found, and your conclusions. It is your narrative that should tell the story for a reader who may not be familiar with this bank. The reader/reviewer should have a thorough understanding of what was performed and conclusions made.

Examiners must follow the instructions below and the requirements in the Examiner Bulletin addressing Guidelines for Procedures and Work Paper Documentation for Commercial Examinations. If there is a conflict between these Instructions and the Examiner Bulletin, the Instructions prevail. Documentation should support weaknesses and criticisms. All examiners performing these procedures must be listed above in the "Prepared By" section.

Examiners are responsible for exercising sound judgment and utilizing reasonable investigative and analytical skills to arrive at an accurate assessment of the risk profile of this segment of the institution's operations.

#### **Evaluation Factors, Risk Guidance, and Comments**

The focus of this procedure is to evaluate and address each of the Evaluation Factors.

The Risk Guidance is provided to guide the examiner in developing a full and complete analysis for the Evaluation Factor. Examiners should consider the items under Risk Guidance and will use their discretion to determine when to comment on a risk guidance item. Examiners should consider what data or findings merit emphasis and which are secondary or of little importance.

The examiner is expected to write a comment in the Conclusions box that is complete and supportive of findings, recommendations, and ratings.

The examiner may also address areas not included in the Risk Guidance section as it is not intended to be all inclusive.



To view the Risk Guidance, click on the arrow to the left of the "Risk Guidance" text. To Hide the Factors, click on the "arrow" again.

#### **Documentation**

Supporting documentation should include the standard required documents identified in the Reference Documents section for each Evaluation Factor.

- Embedded documents should be named such that the reviewer will know the contents.
- If a required document will not be included for any reason, DO NOT DELETE the document title, instead, check either :
  - "Not Included" and add a reason why OR
  - o "N/A" if a document is not applicable".
- Any other relevant documents may be added to fully support the examiner's findings. These documents may be embedded in the Reference Documents section.
- If a document needs to be reference in more than one Evaluation Factor comment, include a reference in the comment indicating the Evaluation Factor where the document can be found.

Documentation is to be sufficient to allow an audit trail of the examiner's thought process and all significant findings.

#### Violations of Regulations

Violations of regulations should be addressed under the appropriate Evaluation Factor. Indicate compliance using the drop-down box next to the regulation in the Compliance section. Address non-compliance in the Comment section.

Yes = In compliance

**No** = Not in compliance

**Not Applicable =** Requirements in the regulation do not apply. For example, if there were no dividends paid, then the regulation related to approval of dividends would reflect "Not Applicable".

# **Nonconformance with Policy**

Adherence with best practices identified in Department and federal financial regulatory policy/guidance should be addressed under the Comments for the appropriate Evaluation Factor. Indicate if the bank adheres to the best practices using the drop-down box next to the appropriate policy in the Adherence to Policy section. Comments regarding best practices should be summarized in the Summary Comments.

#### **Summary Comments and Conclusions**

The Summary Comments and Conclusions should be a high-level summary that highlights the examiner's material findings and conclusions. A description of what to include in the Summary Comments and Conclusions is provided. These comments are not intended to be a report ready comment and will contain comments that may not be report worthy. Summary comments must support the Summary Rating.

The EIC will determine if the use of bullet points is appropriate for completing the Summary Comments and Conclusions. The SEIC/EIC will have discretion in determining what is included in the Report of Examination.

## **Navigating this Procedure**

This procedure can be easily navigated by clicking on View from the Word menu bar then selecting Navigation Pane found in the Show section. All headings in this document will appear on the left side of the screen, for easy navigation through the document.

Performing alternate or expanded procedures not listed with these guidelines may be necessary to complete this risk analysis.

# Summary of Findings

# **Investment Securities - Summary Comments and Conclusions**

Document conclusions regarding the adequacy of the bank's investment function in relation to the risk profile of the institution as well as management's ability to properly identify, measure, monitor, and control those risks. Include recommendations for implementing best practices from policies and management responses to weaknesses. The SEIC/EIC will determine what to include in the report of examination.

# **Summary Rating:** Click Here to Select Rating

Definitions for Summary Ratings – CAMELS: 1-Strong; 2-Satisfactory; 3-Less than satisfactory; 4-Deficient; 5-Critically deficient



# **Violations**

Prepare a comment for any violation cited. Include management's response.

# **Preliminary Review**

# Review the following items:

- Examination Scope Memo
- Prior Examination Investment comments
- Internal/external audit findings concerning Investments and management's response
- Audit scope for investment function
- Last State examination workpapers for investments
- Investment policy
- Investment/ALCO Minutes
- Investment/ALCO Packet
- Board Investment/ALCO Reports relating to investment:
  - o Bond Servicer Report
    - Listing of Securities
    - Transcript of investment activity since last examination
    - Maturity Report
    - Anticipated prepayments Mortgage-backed Securities
    - Weighted Average Life and Duration
    - Pledged Asset Report
  - o Interest Bearing Bank balances
  - Federal Funds Sold
  - o Listing of approved security dealers
- Strategic Plan and Budget projections related to investments

# **Investment Securities Analysis**

# **EVALUATION FACTOR 1**

Review the last examination and correspondence for recommendations, violations, Matters Requiring Attention, or regulatory enforcement actions. Determine Board and Management's efforts and corrective action to comply with or correct noted concerns.

<b>Reference Documents</b>	Conclusions – Evaluation Factor 1
Prior Examination Criticisms, and/or Audit Exceptions	
☐ N/A ☐ Not Included	
Management Response / corrective action, if applicable	
☐ N/A ☐ Not Included	
Other Supporting Documents:	

# **EVALUATION FACTOR 2:**

Evaluate the mix, volume, and yield for any substantial changes and concentrations in the investment securities portfolio.

## Risk Guidance

- 1. Utilizing the UBPR and other tools (e.g., bond servicer report), evaluate the mix, volume, and yield for any substantial changes in the investment securities portfolio. Consider the following:
  - a. Large compositional shifts
  - b. Investment in or divestiture of certain investment types
  - c. Changes in the weighted average life
  - d. Level of appreciation/depreciation
- 2. Based on the changes in the portfolio since the prior examination, detail the change(s) in the risk profile. Consider the following:
  - a. Market risk
  - b. Liquidity risk
  - c. Credit risk
  - d. Extension risk
  - e. Other risks

Refer to **Appendix** for additional guidance on portfolio risks.

- 3. Comment on key concentrations of risk in the securities portfolio. Consider concentrations in the following:
  - a. Individual security size
  - b. Same issuer
  - c. Industry type
  - d. Geographic location
  - e. Similar characteristics
  - f. Same credit enhancers
- 4. Evaluate the extent of any unrealized appreciation or depreciation on HTM and AFS debt securities in evaluating

whether the bank has an effective risk management system for securities.

- a. Consider the impacts to liquidity and capital.
- b. Discuss the impact with the appropriate examiners and EIC
- 5. If the bank's investment in any one obligor or maker exceeds 15% of Tier 1 capital, confirm compliance with <u>Texas</u> Finance Code (TFC) §34.101.

# 6. Call Report reconciliation

- a. Reconcile Schedule RC-B **only if** the bank's bond servicer report does not provide Call Report inputs.
- b. Verify that equity holdings without readily determinable values are reported in item 4 of Schedule RC-F.
  - i. Common examples include (but aren't limited to) Federal Reserve stock, FHLB stock, and bankers' bank stock.
- c. Verify that mutual funds and equity holdings <u>with</u> readily determinable values that aren't held for trading are reported as available-for-sale in Call Report Schedule RC-B.
- d. Include Call Report reconciliation in workpapers, if applicable

Compliance with Regulation	
TFC §34.101 Securities	Select Response

<b>Reference Documents</b>	Conclusions – Evaluation Factor 2
Bond Servicer Report	
☐ N/A ☐ Not Included	
Call Report Reconciliation, if performed	

<b>Reference Documents</b>	Conclusions – Evaluation Factor 2
Other Supporting Documents	

#### **EVALUATION FACTOR 3**

Determine the adequacy of the Investment Policy.

# **Risk Guidance**

- 1. Has the Investment Policy been reviewed and/or revised by the Board within the last year?
- 2. Does the policy address the following, if appropriate?
  - a. Investment objectives
  - b. Types of permissible investments
  - c. Risk diversification guidelines
  - d. Maturity parameters
  - e. Independent credit analysis of investment securities, both pre-purchase and on a periodic basis post-purchase (Refer to <u>Appendix</u> for guidance)
  - f. Minimum quality ratings
  - g. Documentation requirements
  - h. Valuation procedures and frequency
  - i. Guidelines for pledging securities
    - i. Guidelines for other money market instruments such as due from time deposits, Federal funds sold, commercial paper, securities purchased under agreements to resale, etc.

- j. Hedging, swaps, caps, repos, or other nontraditional investment activities, or the prohibition thereof, if applicable
- k. Accounting guidelines for securities
- 1. Periodic review of the securities portfolio to determine that investment objectives and FASB 115 (<u>FASB ASC Topic 320-Investments</u>) strategies remain appropriate, and objectives are being achieved
- m. Trading limits and guidelines, if applicable
- n. Personnel authorized to initiate transactions
- o. Investment authority limitations
- p. Guidelines for selecting and monitoring securities firms and salespersons to be utilized
- q. Analytical data to be provided to the board/investment committee
- r. Conflict of interest guidelines for employees who are directly involved in purchasing and selling securities, to the extent they also engage in personal securities transactions with these same securities firms
- s. Guidelines regarding the receipt of gifts, gratuity, or travel expenses by directors, officers, and employees from approved securities dealer firms and their employees.
- 3. Are there any exceptions to the Investment Policy that have not been approved by the Board or their designee?

<b>Reference Documents</b>	Conclusions – Evaluation Factor 3
Investment Policy ☐ N/A ☐ Not Included	
Other Supporting Documents	

## **EVALUATION FACTOR 4**

Evaluate the bank's investment strategy.

## Risk Guidance

- 1. What is the bank's investment strategy?
  - a. May be ascertained from the Investment Policy, Strategic Plan, Board minutes, and/or management interview.
- 2. Has the strategy materially changed since the prior examination?
  - a. If yes, discuss why the change has occurred.
- 3. Do the portfolio composition and management's actions reflect the current investment strategy?
  - a. If no, why has deviation occurred and has the Board approved the deviation?
- 4. Is the strategy appropriate for the expertise and knowledge of management and the Board?
- 5. Does the strategy consider and support the bank's earnings and capital positions?

<b>Reference Documents</b>	Conclusions – Evaluation Factor 4
Supporting Documents if any	

## **EVALUATION FACTOR 5**

Determine the effectiveness of internal controls and the independent review process over investments.

#### **Risk Guidance**

1. Evaluate the adequacy of the investments audit/independent review functions, considering the following:

a.	Scope,	
b.	Auditor qualific	eation,
c.	Auditor indeper	ndence, and
d.	Reporting.	
Re	efer to Appendix	for guidance on the scope of independent reviews.
2. Evalu	ate the adequac	y of internal control procedures over the investment function. Consider the following:
a.	Portfolio valuat	ion
b.	Personnel	
c.	Settlement	
d.	Physical control	and documentation
e.	Conflict of inter	rest
f.	Accounting	
g.	Reporting	
		for activities that create supervisory concern. Further guidance can also be found in the <u>FDIC Risk</u> al of Examination Policies Section 3.3
		dual has total control over the purchase, booking, and sales of investment securities. Comment on gnificant deficiencies.
Referen	ce Documents	Conclusions - Evaluation Factor 5
Review / /	ent Independent Audit of nt Securities	

☐ N/A ☐ Not Included

Other Supporting Documents	

#### **EVALUATION FACTOR 6**

Evaluate the effectiveness and the adequacy of Board (or committee) and management's oversight of the investment function.

#### Risk Guidance

- A. Evaluate management's process for selecting and annually reviewing securities firms/brokers.
  - 1. Discuss management's due diligence process with selecting securities firms/brokers.
    - a. May be ascertained from the Investment Policy and/or management discussion.
  - 2. Determine if existing firms are reviewed and approved annually. *Indicate last review/approval date in conclusions*.
  - 3. Determine if gifts and/or entertainment opportunities from firms/brokers are addressed in the COI policy.

Refer to Appendix for guidance on securities firm selection.

- B. Determine the adequacy of management's due diligence and ongoing analysis of investment securities, ensuring compliance with OCC 2012-18\*.
  - 1. Sample due diligence and post-purchase analysis from a judgmental selection of securities. Confer with EIC regarding an appropriate sample size. Refer to <u>Appendix</u> for guidance on sampling.
  - **2.** Determine the effectiveness of management's due diligence and ongoing analysis of investment securities. Consider the following:
    - a. Management adequately identifies the risks associated with each security prior to acquisition and periodically thereafter.

- b. Management adequately assesses whether the instrument's cash flow, risks, and potential returns continue to fit within the bank's investment strategy.
- c. Documentation is sufficient for management to make an informed investment decision.
- 3. Determine compliance with OCC Bulletin 2012-18. Refer to Appendix for additional guidance.
- \* FDIC-supervised banks generally are prohibited via FDIC Rules and Regulations, Part 362, from engaging in investment activities that are impermissible for a national bank, as determined by OCC guidance. Accordingly, the FDIC adopted the OCC guidance through release of FDIC FIL-48-2012.
- C. Determine if management appropriately assessed the AFS debt security portfolio for impairment (i.e., if the fair value of the security is lower than amortized cost) and whether impairment was credit-related or noncredit-related using individual evaluation (i.e., no pooling of assets).

Refer to Interagency Policy Statement on Allowances for Credit Losses (Revised April 2023). See excerpt in Appendix. FASB ASC Subtopic 326-30, Financial Instruments—Credit Losses—Available-for-Sale Debt Securities which describes the accounting for expected credit losses associated with available-for-sale debt securities.

- 1. Verify whether management determines at least each reporting period whether an individual AFS debt security's decline in fair value below amortized cost has resulted from a credit loss or other factors.
- 2. If management (or the examiner) has determined that some portion of the unrealized loss is due to credit loss:
  - a. Determine how management estimated the portion of the decline in fair value that was attributable to the credit loss (i.e., did management compare the present value of cash flows expected from the security with its amortized cost).
  - b. Determine whether the present value calculation included management's best estimate based on past events, current conditions, and a reasonable and supportable forecast. Verify the following:
    - i. The interest rate used to discount the cash flow is the effective interest rate on the AFS debt security when it was acquired (at inception) or the current accretable yield; and
    - ii. Forecasts of future cash flows, such as:
      - o The financial and operating condition of the issuer,
      - o Reasonableness of estimates of expected default and recovery rates,

- o The value and characteristics of any underlying collateral securing the AFS debt security, and
- o Remaining payment terms of the debt security.
- c. Determine whether the institution's credit loss estimate is limited to the amount that the fair value is less than the amortized cost on the security (i.e., the fair value floor).

# D. If applicable, determine whether management intends to sell an AFS debt security, or whether it is more likely than not management will be required to sell a security before the recovery of its amortized cost. (Applicable if there is credit loss)

- 1. If management does not intend to sell the AFS debt security, or if it is more likely than not management will not be required to sell the AFS debt security before recovery of its amortized cost basis, determine whether the estimate of credit loss is recorded through an ACL with a charge to the provision for credit losses for the credit loss component in the decline in fair value. Determine whether any non-credit component in the decline in fair value is properly recorded as a fair value adjustment in other comprehensive income net of tax.
- 2. If management intends to sell the AFS debt security or if it is more likely than not that management will be required to sell the AFS debt security before recovery of its amortized cost basis, determine whether management charged off any amount that was recorded as an ACL. Determine whether any additional decline in fair value that was not charged off through the ACL was charged down to fair value through earnings.

# E. Determine the adequacy of reports/reporting to management and board.

- 1. Determine the adequacy of reports used by management and reports provided to the Board/ALCO/or other assigned responsible party to monitor the bank's investment activity. Report contents may include but are not limited to:
  - a. Transactions
  - b. Composition
  - c. Maturity distributions
  - d. Ratings
  - e. Average yield
  - f. Weighted average life
  - g. Appreciation/depreciation
  - h. Policy and strategy compliance.

- 2. Determine if the frequency in which reports are reviewed by management and presented to the Board or other assigned responsible party is adequate. Consider the following:
  - a. Expertise of management and the Board to understand investment activities and implement strategies. Consider severity of weaknesses identified elsewhere in this procedure.
  - b. Appropriateness of the Investment Policy and risk limits, and management's enforcement thereof. Consider severity of weaknesses identified elsewhere in this procedure.
  - c. Implementation of reasonable internal controls and independent review process. Consider severity of weaknesses identified elsewhere in this procedure.

Adherence to Best Practices in a Policy		
Alternatives to the Use of External Credit Ratings in the Regulations of the OCC (OCC 2012-18)	Select Response	
Conformance with Accounting Standards		
FASB ASC Subtopic 326-30, Financial Instruments—Credit Losses—Available-for-Sale Debt Securities	Select Response	

<b>Reference Documents</b>	Conclusions – Evaluation Factor 6
Copy of Recent Investment- Related Board Reports	
☐ N/A ☐ Not Included	
Other Supporting Documents	

#### **EVALUATION FACTOR 7**

Determine compliance/conformance with applicable regulations and accounting standards not previously addressed.

## Risk Guidance

- 1. Determine if the bank complies with Texas Finance Code (TFC) §34.101 and §34.104 if the bank has an investment in any of the following products:
  - a. Corporate bonds/notes
  - b. Municipal revenue bonds
  - c. Privately issued mortgage-backed securities not government issued or guaranteed
  - d. Asset-back securities
  - e. Residual interests
  - f. Mutual funds not invested completely in U.S. Government or Government-sponsored agency issues
  - g. Adjustable-rate preferred stock
  - h. Money market auction-rate preferred stock
- 2. Determine if the bank complies with TFC §34.105 if the bank has a direct equity investment in any of the following products:
  - a. Bank service corporation
  - b. Agricultural credit corporation
  - c. Small business investment corporation
  - d. Banker's bank
  - e. Housing corporation.
- 3. Determine if the bank complies with Texas Finance Code (TFC) §34.106 regarding investments to promote community development.

4. For any transfers between AFS/HTM or any sales out of the HTM category, determine if transactions have occurred according to FAS 115 (FASB <u>ASC Topic 320-10-35</u> Investments).

Compliance with Regulation		
TFC §34.101 Securities	Select Response	
TFC §34.104 Mutual Funds	Select Response	
TFC §34.105 Other Direct Equity Investments	Select Response	
TFC §34.106 Investments to Promote Community Development	Select Response	

Conformance with Accounting Standards	
FAS 115 ( <u>FASB ASC Topic 320</u> – Investments)	Select Response

<b>Reference Documents</b>	Conclusions - Evaluation Factor 7
Supporting Documents if any	

#### **EVALUATION FACTOR 8**

If applicable, evaluate the adequacy of trading activities and risk management practices for nontraditional investments and structured notes. Determine compliance and conformance with regulations and policies.

# Risk Guidance

Refer to FRB Trading and Capital-Markets Activity Manual for guidance.

# **Trading**

- 1. Determine if management is conducting trading activities. Signs of trading include:
  - a. Trading assets reflect on Call Report/UBPR
  - b. Significant amount of realized gains/losses on sold securities
  - c. Transaction history shows brief holding periods between purchases and sales
    - i. Note: Brief purchase and sale of securities to offset franchise tax liability is generally not considered trading activity.
- 2. Describe activities and whether management and the Board monitor activity, have the needed expertise to understand and manage risks and rewards, and have appropriate policies, procedures, and controls in place.
- 3. Confirm that trading strategies concur with the Investment Policy.
- 4. Does trading activity pose undue risk to earnings and capital?
  - a. Note: Securities held for trading must be reported at fair value, with unrealized gains and losses recognized in the current earnings and regulatory capital.
- **5.** Refer to the following for Guidance on Trading Activities:
  - a. FRB Trading and Capital Markets Activity Manual
  - b. FDIC Capital Markets Resource Center

#### **Nontraditional Investment Activities**

Examples of non-traditional investment activities include standby contracts, dollar rolls, securities lending/borrowing, and other non-traditional investment activities.

- 1. Are recordkeeping systems adequate to indicate that stated policy guidelines are being followed?
- 2. Does the bank maintain general ledger memorandum accounts which include the type, amount, maturity, market price, and cost of each contract?
- **3.** Are these activities reasonably correlated to the bank's other activities and business needs?
- 4. Does management demonstrate adequate knowledge and expertise to sufficiently control the use of these activities?
- 5. Determine whether management conforms with FDIC's FIL 81-97 regarding Securities Lending.

#### **Structured Notes**

Examples of securities that require further analysis include those instruments that have unusual, leveraged, or potentially highly variable cash flows, and embedded options (such as structured notes or CMO/REMIC, MBS, CDOs, ABS).

A structured note is a derivative instrument based on the movement of an underlying index, stock price, interest rate benchmark, or other financial asset.

## 1. Determine the following for Structured Notes purchased since the last examination:

- a. Is there evidence that appropriate pre-purchase analysis was performed?
- b. Is there evidence that management understood the risks inherent in the bonds prior to purchase?
- c. How did the purchase fit into the bank's investment strategy at the time?
- 2. Does the bank have sufficient information in file to determine the coupon and characteristics of the securities?
- 3. Are any issues at, or approaching, nonaccrual due to index performance?

# 4. Are any issues subject to principal loss due an index amortizing or other feature?

For more information on CMO/REMIC, consult Section 3.3 of the <u>FDIC Risk Management Manual</u>, the <u>FDIC Capital Markets Resource Center</u>, and the <u>FRB Trading and Capital-Markets Activities Manual</u>

Adherence to Best Practices in Interagency Policy	
FIL 81-97 FFIEC Policy Statement: Securities Lending	Select Response

<b>Reference Documents</b>	Conclusions - Evaluation Factor 8
Supporting Documents if any	

#### **EVALUATION FACTOR 9**

If applicable, evaluate structured credits in the portfolio and risk management practices.

Examples of securities that require further analysis include those instruments that have unusual, leveraged, or potentially highly variable cash flows, and embedded options (such as structured notes or CMO/REMIC, MBS, CDOs, ABS).

## Risk Guidance

A structured credit investment is a bond that is backed by a pool of assets such as residential or commercial mortgage loans, bank loans or a variety of other consumer loans. The asset pools are structured into classes with varying maturities, payment schedules and levels of risk. Examples include residential mortgage-backed securities, commercial mortgage-backed securities, consumer asset-backed securities and collateralized debt obligations. Refer to <a href="FRB Trading and Capital-Markets Activity Manual">FRB Trading and Capital-Markets Activity Manual</a> for additional information.

# 1. For CMOs purchased since last exam, verify that:

- a. there is evidence of appropriate pre-purchase analysis was performed;
- b. there is evidence that management understood the risks inherent in the bonds prior to purchase; and
- c. the purchase fits into the bank's investment strategy at the time.
- 2. Does the bank have a monitoring and reporting system in place to evaluate the expected and actual performance of any mortgage derivatives/mortgage-backed securities that appear to be of high volatility? (This may be covered under the bank's interest rate sensitivity report.)

<b>Reference Documents</b>	Conclusions - Evaluation Factor 9
Supporting Documents if any	

#### **EVALUATION FACTOR 10**

Determine if any securities should be considered for classification.

## Risk Guidance

Determine whether the bank has any instrument that is highly sensitive to changing interest rates, or subject to high prepayment risk, that may not return the initial principal investment (e.g., interest only stripped MBS and principal-linked structured notes) and classify as appropriate.

Determine whether the investment portfolio contains any non-investment grade assets. Classify these assets as appropriate.

Provide a list of securities considered for classification and the recommended grade to the AEIC/EIC, if applicable.

Refer to:

- Department of Banking Supervisory Memorandum 1007- Policy Regarding Investment Securities
- "Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institution" (A joint agency release on October 29, 2013. See FIL-51-2013 and SR 13-18)
- FDIC Manual for Examination Procedures -Section 3.3 Securities and Derivatives
- FRB Trading and Capital-Markets Activity Manual

<b>Reference Documents</b>	Conclusions - Evaluation Factor 10
List of Securities Considered for Classification	
□ N/A □ Not Included	

# **APPENDIX - Securities Portfolio Risks**

Refer to Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities

The following are excerpts from the FDIC Risk Management Manual of Examination Policies, Section 3.3)

#### Market risk

The possibility that an instrument will lose value due to a change in the price of an underlying instrument, change in the value of an index of financial instruments, changes in various interest rates, or other factors. Frequently, an instrument will increase a bank's market risk due to price volatility, embedded options, leverage factors, or other structural factors. The three principal types of market risk are price risk, interest rate risk and basis risk.

- <u>Price risk</u> is the possibility that an instrument's price fluctuation will unfavorably affect income, capital, or risk reduction strategies.
   Price risk is usually influenced by other risks. For example, a bond's price risk could be a function of rising interest rates, while a currency-linked note's price risk could be a function of devaluation in the linked currency.
- <u>Interest rate risk</u> is the possibility that an instrument's value will fluctuate in response to current or expected market interest rate changes.
- <u>Yield curve risk</u> is the possibility that an instrument's value will fluctuate in response to a nonparallel yield curve shift. Yield curve risk is a form of interest rate risk.
- <u>Basis risk</u> is the possibility that an instrument's value will fluctuate at a rate that differs from the change in value of a related instrument. For example, three-month Eurodollar funding is not perfectly correlated with Treasury bill yields. This imperfect correlation between funding cost and asset yield creates basis risk.

#### Credit risk

The possibility of loss due to a counterparty or issuer's default or inability to meet contractual payment terms. The amount of credit risk equals the replacement cost (also referred to as *current exposure*) of an identical instrument. The replacement cost is established by assessing the instrument's current market value rather than its value at inception.

In addition, default exposes a bank to market risk. After default, losses on a now unhedged position may occur before the defaulted hedge instrument can be replaced. Such losses would have been largely (or completely) offset if the counterparty had not defaulted.

## Liquidity risk

The possibility that an instrument cannot be obtained, closed out, or sold at (or very close to) its economic value. As individual markets evolve, their liquidity will gradually change, but market liquidity can also fluctuate rapidly during stress periods. In some markets, liquidity can vary materially during a single day. Some markets are liquid for particular maturities or volumes but are illiquid for others. For example, the Eurodollar futures market is liquid for contracts with maturities up to four years, but liquidity decreases for greater maturities (although maturities of up to 10 years are listed).

Many instruments trade in established secondary markets with a large number of participating counterparties. This ensures liquidity under normal market conditions. However, uniquely tailored or more thinly traded products may not have sufficient supply, demand, or willing counterparties in periods of market stress.

#### Operational risk

The possibility that inadequate internal controls or procedures, human error, system failure or fraud can cause losses. Operating risk can result in unanticipated open positions or risk exposures that exceed established limits.

The securities portfolio may also present **Legal Risk**, **Settlement Risk**, and **Interconnection Risk**. These risk types are discussed further in the <u>FDIC Risk Management Manual of Examination Policies Section 3.3.</u>

#### **Extension risk**

The possibility that rising interest rates will slow the rate at which loans in a pool will be repaid, thereby slowing the return of principal to investors who have committed funds to the pool. For example, rising interest rates will reduce the rate at which holders of mortgage-backed securities have their principal returned.

- Return to Eval Factor 2
- > Return to Eval Factor 3
- Return to Eval Factor 6

# **APPENDIX - Internal Controls**

Activities that create supervisory concern include:

- Gains trading, when-issued trading, pair-offs, extended settlements, repositioning repurchase agreements, short sales, or adjusted trading.
- Incomplete transaction documentation.
- Contravention of policy limits for transaction amounts or types with individual dealers.
- Inaccurate reporting or accounting.
- Failure to monitor personal investment activities of staff with securities activities responsibilities.
- Transactions completed by unauthorized personnel.
- Transactions which are prohibited by regulation or statute due to being excessive in amount, or of an impermissible type of instrument.

These may be determined through activity reviews and file sampling.

Return to Eval Factor 5

# **APPENDIX - Independent Review Scope for Investment Securities**

(Excerpt from Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities)

For institutions with significant investment activities, internal and external audits are integral to the implementation of a risk management process to control risks in investment activities. An institution should conduct periodic independent reviews of its risk management program to ensure its integrity, accuracy, and reasonableness. Items that should be reviewed include:

- Compliance with and the appropriateness of investment policies, procedures, and limits;
- The appropriateness of the institution's risk measurement system given the nature, scope, and complexity of its activities; and
- The timeliness, integrity, and usefulness of reports to the board of directors and senior management.

The review should note exceptions to policies, procedures, and limits and suggest corrective actions. The findings of such reviews should be reported to the Board and corrective actions taken on a timely basis.

# **APPENDIX - Sampling Recommendations**

When sampling the due diligence and post-purchase analysis of securities in the bank's portfolio, consider the following:

- Type and complexity of instrument
  - o Corporate bonds, municipal bonds (general obligation or revenue), and structured securities
- Securities purchased less than a year ago for due diligence
- Securities purchased over a year ago for post-purchase monitoring
- Size
- Credit rating
- Location of municipal bonds
- · Project type funded by municipal revenue bonds

Type 1 obligations include U.S. Treasuries, agencies, municipal government obligations, and for well-capitalized institutions, municipal revenue bonds. While Type 1 obligations do not have to meet the investment grade criteria to be eligible for purchase, all investment activities should comply with safe and sound banking practices. Under OCC rules, Treasury and agency obligations do not require individual credit analysis, but management should consider how those securities fit into the overall purpose, plans, and risk and concentration limitations of the investment policies established by the Board. Municipal bonds should be subject to an initial credit review consistent with the risk characteristics of the bonds and the overall risk of the portfolio.

Return to Evaluation Factor 6

# **APPENDIX - Determination of Permissible Investments**

(Excerpt from OCC's <u>Guidance on Due Diligence Requirements in Determining Whether Securities Are Eligible for Investment</u> issued June 13, 2012 as part of OCC Bulletin <u>OCC 2012-18</u>

Financial institutions are expected to be well acquainted with fundamental credit analysis as this is central to a well-managed loan portfolio. The foundation of a fundamental credit analysis – character, capacity, collateral, and covenants – applies to investment securities just as it does to the loan portfolio. Accordingly, banks should conduct an appropriate level of due diligence to understand the inherent risks and determine that a security is a permissible investment. The extent of the due diligence should be sufficient to support the institution's conclusion that a security meets the investment grade standards. This may include consideration of internal analyses, third party research and analytics including external credit ratings, internal risk ratings, default statistics, and other sources of information as appropriate for the particular security. Some institutions may have the resources to do most or all of the analytical work internally. Some, however, may choose to rely on third parties for much of the analytical work. While analytical support may be delegated to third parties, management may not delegate its responsibility for decision-making and should ensure that prospective third parties are independent, reliable, and qualified. The Board should oversee management to assure that an appropriate decision-making process is in place.

The depth of the due diligence should be a function of the security's credit quality, the complexity of the structure, and the size of the investment. The more complex a security's structure, the more credit-related due diligence an institution should perform, even when the credit quality is perceived to be very high. Management should ensure it understands the security's structure and how the security may perform in different default environments and should be particularly diligent when purchasing structured securities. For example, a bank should be able to demonstrate an understanding of the effects on cash flows of a structured security assuming varying default levels in the underlying assets.

Banks are expected to consider a variety of factors relevant to the particular security when determining whether a security is a permissible and sound investment. The range and type of specific factors an institution should consider will vary depending on the particular type and nature of the securities. As a general matter, a bank will have a greater burden to support its determination if one factor is contradicted by a finding under another factor.

The following matrix provides examples of factors for banks to consider as a part of a robust credit risk assessment framework for designated types of instruments. The types of securities included in the matrix require a credit-focused pre-purchase analysis to meet the investment grade or safety and soundness standards. Again, the matrix is provided as a guide to better inform the credit risk assessment process. Individual purchases may require more or less analysis dependent on the security's risk characteristics, as previously described.

Key Factors	Corporate Bonds	Municipal Govt General Obligations	Revenue Bonds	Structured Securities
Confirm spread to U.S. Treasuries is consistent with bonds of similar credit quality	Х	X	Х	Х
Confirm risk of default is low and consistent with bonds of similar credit quality	Х	Х	Х	Х
Confirm capacity to pay and assess operating and financial performance levels and trends through internal credit analysis and/or other third-party analytics, as appropriate for the particular security	Х	Х	Х	х
Evaluate the soundness of a municipal's budgetary position and stability of its tax revenues. Consider debt profile and level of unfunded liabilities, diversity of revenue sources, taxing authority, and management experience		Х		
Understand local demographics/economics. Consider unemployment data, local employers, income indices, and home values		х	Х	
Assess the source and strength of revenue structure for municipal authorities. Consider obligor's financial condition and reserve levels, annual debt service and debt coverage ratio, credit enhancement, legal covenants, and nature of project			Х	
Understand the class or tranche and its relative position in the securitization structure				Х
Assess the position in the cash flow waterfall				Х
Understand loss allocation rules, specific definition of default, the potential impact of performance and market value triggers, and support provided by credit and/or liquidity enhancements				х
Evaluate and understand the quality of the underwriting of the underlying collateral as well as any risk concentrations				Х

#13 Investments (v9.6.23) Texas Department of Banking

Key Factors	Corporate Bonds	Municipal Govt General Obligations	Revenue Bonds	Structured Securities
Determine whether current underwriting is consistent with the original underwriting underlying the historical performance of the collateral and consider the effect of any changes.				х
Assess the structural subordination and determine if adequate given current underwriting standards.				Х
Analyze and understand the impact of collateral deterioration on tranche performance and potential credit losses under adverse economic conditions				Х

Return to Risk Guidance for Eval Factor 6

# **APPENDIX - Securities Firm Selection**

Management's due diligence should consider the following:

- The ability of the securities firm to fulfill commitments as evidenced by capital strength, liquidity, and operating results (based on current financial statements, annual reports, etc.);
- The firm's general reputation for financial stability and fair and honest dealings (based upon general inquiries);
- The salesperson's general reputation, including background check (or resume); and
- Information available from state or federal securities regulators and securities self-regulatory organizations, such as National Association of Securities Dealers, regarding formal enforcement actions against the brokerage firm, salesperson, and affiliates.
- Return to Risk Guidance for Eval Factor 6

# APPENDIX - AVAILABLE FOR SALE DEBT SECURITIES

Excerpt: Interagency Policy Statement on Allowances for Credit Losses (Revised April 2023)

Measurement of the ACL for Available- for-Sale Debt Securities FASB ASC Subtopic 326–30, *Financial Instruments—Credit Losses—Available-for-Sale Debt Securities* (FASB ASC Subtopic 326–30) describes the accounting for expected credit losses associated with available-for-sale debt securities. Credit losses for available-for-sale debt securities are evaluated as of each reporting date when the fair value is less than amortized cost. FASB ASC Subtopic 326–30 requires credit losses to be calculated individually, rather than collectively, using a discounted cash flow method, through which management compares the present value of expected cash flows with the amortized cost basis of the security. An ACL is established, with a charge to the PCL, to reflect the credit loss component of the decline in fair value below amortized cost. If the fair value of the security increases over time, any ACL that has not been written off may be reversed through a credit to the PCL. The ACL for an available-for-sale debt security is limited by the amount that the fair value is less than the amortized cost, which is referred to as the fair value floor.

If management intends to sell an available-for-sale debt security or will more likely than not be required to sell the security before recovery of the amortized cost basis, the security's ACL should be written off and the amortized cost basis of the security should be written down to its fair value at the reporting date with any incremental impairment reported in income.

A change during the reporting period in the non-credit component of any decline in fair value below amortized cost on an available-for-sale debt security is reported in other comprehensive income, net of applicable income taxes.<sup>23</sup>

When evaluating impairment for available-for-sale debt securities, management may evaluate the amortized cost basis including accrued interest receivable, or may evaluate the accrued interest receivable separately from the remaining amortized cost basis. If evaluated separately, accrued interest receivable is excluded from both the fair value of the available-for-sale debt security and its amortized cost basis.<sup>24</sup>

31

Return to Risk Guidance, EF 6

<sup>&</sup>lt;sup>23</sup>Non-credit impairment on an available-for-sale debt security that is not required to be recorded through the ACL should be reported in other comprehensive income as described in ASC 326–30–35–2.

<sup>&</sup>lt;sup>24</sup>The accounting policy elections described in the "Accrued Interest Receivable" section of this policy statement apply to accrued interest receivable recorded for an available-for-sale debt security if an institution excludes applicable accrued interest receivable from both the fair value and amortized cost basis of the security for purposes of identifying and measuring impairment.