SBD Opinion 2013-01 – Investment Governance and Analysis October 11, 2013

Investment Portfolio Governance

As stated in Regulation No. 1, a bank's board of directors shall establish and annually review and approve an investment policy that provides guidance to its investment officers, investment committee, and/or asset-liability management committee. Furthermore, Regulation No. 1 states that the policy shall contain acceptable investment portfolio limits as a percentage of Capital[1], Total Assets, and brokered deposits and other non-core deposit funding sources.

These portfolio limits serve to enhance diversification and limit concentrations within the investment portfolio. At a minimum, the following measures with board determined limits should be included in the investment policy.

- Each asset class as a percentage of the total investment portfolio.
- Each asset class as a percentage of Capital.
- The total investment portfolio as a percentage of Total Assets.

Management should document the purpose of all brokered deposits and other non-core funding sources (wholesale funding) as to their intended purpose. The board should establish limits for leveraged investment strategies where wholesale funding is used to purchase investment securities including leveraged securities as a percentage of the total investment portfolio.

In addition to the policy limits, concentration thresholds for some asset classes are listed below. Exceeding the thresholds is not a violation. The inclusion of concentrations in the Report of Examination is to inform the board of higher levels of risk in the investment portfolio. Furthermore, management should have adequate risk management procedures commensurate with the increased levels of risk.

The board should also establish an acceptable procedure for exceptions to policy limits, including documentation, reporting, and approval process to ensure that breaches of policy limits are thoroughly documented, discussed, and resolved by management and the board within reasonable timeframes.

Pre-Acquisition and Post-Acquisition Investment Analysis

As stated in Regulation No. 1, a bank's board of directors shall establish a robust risk assessment methodology (methodology) for pre-acquisition and post-acquisition analysis that is appropriate for each asset class and for the investment portfolio in total. The methodology should reflect the size, complexity, quality, and risk characteristics of the investment portfolio, and should be consistent with the overall risk profile of the bank and the expertise of its risk management staff.

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[1] The definition of Capital is the same as the definition contained in Alabama State Banking Board Regulation No. 14, Section 1, and includes: capital stock, surplus, undivided profits, subordinated capital notes or debentures, and the allowance for loan and lease losses. Reserves for contingencies that are not set aside to cover any specific expected losses may also be included. Specific contingency reserves and unrealized gains or losses on debt securities available for sale are not to be included.

The methodology established by the board of directors should allow bank management to implement an approved investment strategy and monitor the investment portfolio going forward. For each factor used, the board should establish acceptable parameters or limits.

Pre-acquisition analysis, at a minimum, should include an obligor's ability to perform, the structural complexity of the security, the type of collateral or underlying assets, debt service requirements, and external credit ratings.

Every analysis should begin with demonstrating an understanding of the security's general characteristics. Furthermore, the security should fit within the bank's board approved policy list of investments and should be consistent with management of overall interest rate, liquidity, and credit risk objectives. Investment securities that have higher risk characteristics warranting more in depth analysis should also have more in-depth pre-acquisition and post-acquisition analysis. Both pre-acquisition and post-acquisition analysis should be documented and include the factors and management's reasoning used to make the investment decision. Not having documented analysis commensurate with the level of risk would be considered a violation of Regulation No. 1.

Post-acquisition analysis, at a minimum, should document any adverse changes to the initial risk profile of the security. Management should review all holdings annually to ensure the investments still conform to the overall investment strategy defined in the investment policy. The level of review necessary for post-acquisition analysis will vary for each asset class, and additional standards for each class are listed below.

Management should also establish a process to document exceptions to the parameters established for the risk factors and how the exceptions are reported to the board of directors. In the event that current information is not available for a specific investment, management should document the steps taken to obtain the information.

Additional Considerations for Pre-acquisition and Post-acquisition Security Analysis

In performing pre-acquisition and post-acquisition analysis, management should appropriately consider duration, optionality, price sensitivity, yield, and expected maturity under stressed scenarios. Management should also consider the effects of the investment on policy, regulatory, and concentration limits. Furthermore, all investment securities should be accurately modeled in the bank's interest rate risk report. Unless specifically noted below, accurately modeling the investment security will be considered acceptable post-acquisition analysis.

The considerations listed below are additional standards for select asset types that management could integrate into a pre-acquisition and post-acquisition analysis methodology and use when determining the investment quality of a security.

1. **Bankers Acceptances**

    a. Confirm the obligor's capacity to pay and assess operating and financial performance and trends through internal credit analysis and/or other third party as appropriate for the particular security.
    b. Consider the underlying collateral.
    c. Post-acquisition analysis, update the factors that demonstrate the obligor's ability to pay.

2. **Municipal Obligations**

    a. <u>For General Obligation Bonds:</u>
        i. Evaluate the soundness of a municipal's budgetary position and stability of its tax revenue, including the debt profile, level of unfunded liabilities, diversity of revenue sources, taxing authority, and management experience.
        ii. Understand local demographics and economics, including unemployment data, local employers, income indices, and home values.
    b. <u>For Revenue Bonds:</u>
        i. Assess the source and strength of revenue structure for municipal authorities, including reserve levels, annual debt service and debt coverage ratio, credit enhancement, legal covenants, and nature of project.
        ii. Understand local demographics and economics, including unemployment data, local employers, income indices, and home values.
    c. Consider the impact of the security on concentration levels.
        i. Concentration Thresholds as a percentage of capital.
            1. Total municipal obligations– 100 Percent
            2. Single municipal issuer – 25 Percent
    d. Post-Acquisition Analysis Requirements
        i. For all municipal holdings, management should update the factors used for pre-acquisition analysis. If current information is not available, management should document their efforts to obtain updated information in the investment file. Management may use information from third-party providers.

3. **Corporate Debt or Obligation**

    a. Confirm the spread to U.S. Treasuries is consistent with bonds of similar credit quality and commensurate with the expected level of risk.
    b. Confirm the obligor's capacity to pay and assess operating and financial performance and trends through internal credit analysis and/or other third party as appropriate for the particular security.
    c. Concentration Thresholds as a percentage of capital.
            1. Total corporate debt and obligations – 100 Percent
            2. Single corporate debt issuer – 10 Percent
    d. Post-Acquisition Analysis Requirements.
        i. Update the factors that demonstrate the obligor's ability to pay
        ii. Post-acquisition analysis will include all corporate debt and obligations.

4. **Mortgage Backed Pass Thru and Pool Securities**

    a. Expected prepayments
    b. Collateral type and geographic location

5. **Asset-Backed Securities, including CMO, CDO, REMIC**

    a. Confirm the spread to U.S. Treasuries is consistent with bonds of similar credit quality and commensurate with the expected level of risk.
    b. Confirm the obligor's capacity to pay and assess operating and financial performance and trends through internal credit analysis and/or other third party as appropriate for the particular security.
    c. Understand the class or tranche and the structural subordination.
    d. 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.
    e. Evaluate and understand the quality of the underwriting of the underlying collateral as well as any risk concentrations.
    f. Determine the changes in prepayment, performance, severity, or other assumptions under stressed scenarios
    g. Analyze and understand the impact of collateral deterioration on tranche performance and potential credit losses under adverse conditions.
    h. Concentration threshold: Total corporate debt and obligations – 100 percent of capital
    i. Post-Acquisition Analysis Requirements
        i. Update the factors listed above
        ii. Post-acquisition analysis will include all asset-backed securities.

6. **Single Issuer Trust Preferred Securities**

    a. Confirm the obligor's capacity to pay and assess operating and financial performance and trends through internal credit analysis and/or other third party as appropriate for the particular security.
    b. Concentration threshold: Total trust preferred securities – 100 percent of capital
    c. Post-Acquisition Analysis Requirements
        i. Update the factors that demonstrate the obligor's ability to pay
        ii. Post-acquisition analysis will include all trust preferred securities.

7. **Preferred Stock**

    a. Other Preferred Stock not required for membership
        i. Confirm the obligor's capacity to pay and assess operating and financial performance and trends through internal credit analysis and/or other third party as appropriate for the particular security.
        ii. Confirm that the issuance has the characteristics of debt such as:
            1. Stated Maturity
            2. Cumulative dividends

3. No voting rights
4. Not convertible to common equity
5. Senior to common equity

b. Concentration threshold: Total other preferred stock – 100 percent of capital
c. Post-Acquisition Analysis Requirements
   i. For Other Preferred Stock, update the factors that demonstrate the obligor's ability to pay
   ii. Post-acquisition analysis will include all Other Preferred Stock

Annuities

Regulation 1 does not specifically address the use of annuities as a risk management strategy. However, this guidance permits banks to purchase fixed-rate, defined-benefit annuity structures for the purpose of hedging employee expenses and benefits. In accordance with Section 2)(a)(xi) of Regulation 1, banks must request the prior, written approval of the Superintendent before purchasing annuities for purposes other than hedging employee expenses and benefits.

Annuity purchases for hedging employee expenses and benefits will be treated in the same manner as Bank Owned Life Insurance (BOLI) for Regulation 1 purposes, and should be in compliance with guidance in the Interagency Statement on the Purchase and Risk Management of Life Insurance dated December 7, 2004. The bank's investment policy must authorize the use of annuities, and management should comply with all Corporate Governance requirements in Regulation 1.

Annuities are general obligations of the issuing company, and management must analyze and document the financial capacity of the issuer at the time of purchase and must update the analysis annually. All annuity purchases should follow Generally Accepted Accounting Principles (GAAP) and Call Report instructions. Also, annuities will be subject to Regulation 1 Section 2)(a)(iv) relative to the secured and unsecured Credit Exposure Limits in Regulation 14 as well as the credit quality requirements of the annuity and the obligor contained in Regulation 1, Section 3). Management should also consider and document its review and analysis of potential impacts to bank liquidity as well as the impact of expenses, fees or penalties to cancel or redeem the annuity contract.