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securities but are also applicable to FDIC-supervised institutions because state chartered banks and savings associations are generally prohibited from engaging in activities and investments that are not permissible for national banks. To meet the standard, management must determine that the risk of default by the obligor is low, and that full and timely repayment of principal and interest is expected. For structured securities (securities that rely on the cash flows and performance of underlying collateral, not the credit of the issuer), the determination that full and timely repayment of principal and interest is expected may be less influenced by the condition of the issuing entity, and influenced more by the quality of the underlying collateral, the structure of the security and the cash flows set out in the governing documents.

Liquidity risk reflects the possibility that an institution cannot immediately convert into cash an investment or offset a particular position at little or no loss of value. Assets that have high market or credit risk or are deeply subordinated will tend to be less liquid. High volatility and lengthy duration, along with difficulty and uncertainty of valuation are all characteristics that may reduce a security's marketability for liquidity purposes. For example, a security whose value is model dependent and conditional on the assumptions applied, will generally be less liquid, especially during times of stress. Less-marketable instruments also include securities such as obscure or thinly traded issues, complex instruments, defaulted securities, and instruments that have large unrealized holding losses.

Asset limits address concentration risk in assets that share similar characteristics, such as specific issuers, market sectors, and instrument types. When appropriately diversified, investment portfolios may have lower risk for a given yield or earn higher yields for a given risk level. Boards generally establish limits commensurate with the institution's individual circumstances, such as limiting total investments in a particular security type (e.g., municipal securities, corporate bonds, and private label mortgage backed securities) to a specific percentage of assets or capital.

Maturity limits balance an investment's maximum stated maturity, weighted average maturity, or duration (at an individual security or portfolio-wide level) with the individual circumstances of the institution. Considerations include items such as the board's risk appetite, current and anticipated loan demand, the stability and mix of deposits and other funding sources, and the risk of higher market interest rates. Prudent maturity limits complement market-risk and liquidity-risk limits and the board's overall investment goals.

Standardized risk-measurement systems and methodologies enhance management's ability to capture material risks and accurately calculate risk exposures. Comprehensive systems provide the board with consistent, accurate risk measurements in a format that directly illustrates compliance with established risk limits.

Internal Control Programs

Internal controls are critical components of effective investment programs and should be carefully evaluated by examiners. Effective internal controls include official lines of authority, appropriate separation of duties, prudent compensation that does not encourage inappropriate risk-taking, and independent reviews of investment activities.

Sound internal control programs are commensurate with the volume and complexity of investment activities, and independent from related operations. Examiners should review the separation of duties between individuals who execute, settle, and account for transactions, as well as those who generate and maintain board and management reports. Effective controls promote efficiency, reliable internal and regulatory reporting, and compliance with laws, regulations, and internal institution policies.

The board is responsible for establishing general internal control guidelines that management translates into clear procedures that govern daily operations. Effective internal control programs are commensurate with the volume and complexity of the institution's investment activity, and generally include procedures for the following:

- Portfolio valuation and monitoring,
- Personnel,
- Compensation,
- Settlement,
- Physical controls and documentation,
- Conflicts of interest,
- Accounting,
- Reporting, and
- Independent review.

A more detailed description of these elements of an effective internal control program follows:

Portfolio valuation and monitoring typically includes independent portfolio pricing. Independent pricing not only helps ensure accurate portfolio accounting and reporting but allows management to assess the liquidity and marketability of specific issues. For thinly traded instruments and other illiquid or complex instruments, independent pricing may be difficult to obtain. In such cases, estimated or modeled values may be used. Prudent management understands and verifies the methods and assumptions used to estimate values. Pricing provided solely by the broker who sold the security is not considered independent pricing.

- Validating the accuracy and adequacy of risk measurement systems;
- Ensuring investment strategies achieve board goals;
- Reporting portfolio activity and performance, policy exceptions, and strategy changes to the board; and
- Correcting policy exceptions and addressing supervisory recommendations.

At many institutions, especially those with non-complex or successful investment programs, the periodic evaluations result in few program alterations. Examiners should assess the periodic evaluations to determine whether the board and management effectively review the portfolio management program.

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EXAMINATION CONSIDERATIONS

Special Mention

Examiners may list securities as Special Mention in the Report of Examination. Special Mention investment securities, similar to other types of assets, are typically based on emerging weaknesses related to the financial condition of the issuer/obligor or value/performance of the underlying collateral that are not well defined at the time of the supervisory evaluation. If the negative trends continue, the issuer of the security may eventually not have the capacity to meet the security's financial commitments. Reasons to list investment securities as Special Mention also rest, in part, on the type of security under review. For example, a corporate bond might be listed Special Mention given the obligor's negative operating trends or use of excess leverage that if not checked could eventually result in the deterioration of repayment capacity. For general obligation municipal bonds, negative operating trends, loss of a significant commercial taxpayer, or deteriorating local economic conditions may support a Special Mention listing. For structured instruments, like private-label mortgage back securities, a Special Mention listing may be supported by emergent negative trends that could eventually jeopardize repayment capacity as signaled by the structure's performance triggers (e.g., trends in overcollateralization tests), in the performance of the underlying collateral (e.g., declining LTVs, increasing delinquencies and defaults), or in the credit support levels backing the bank's tranched position (e.g., initial write-downs of subordinate bonds). Further, failure of bank management to identify and assess weaknesses through its due diligence and ongoing monitoring procedures could be a key factor in assigning an investment security or securities as Special Mention.

Classifying Investment Securities

Examiners should adversely classify subinvestment quality securities in the Report of Examination referencing the October 29, 2013 *Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions* (Uniform Agreement). The Uniform Agreement addresses the examination treatment for adversely classified assets and:

- Characterizes investment quality versus subinvestment quality securities;
- Defines Substandard, Doubtful, and Loss categories used for classifying assets;
- Presents various scenarios to guide examiners in how to classify securities with credit deterioration;
- Describes securities eligible or ineligible for purchase;
- Provides examiners the discretion to assess credit risk and assign a classification based on current information and circumstances independent of any assigned credit rating; and
- Provides information on upgrading previously classified assets.

Examiners should reference the definitions for classified assets as delineated in the Uniform Agreement when contemplating whether to adversely classify an investment security.

A <u>Substandard</u> asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

An asset classified <u>Doubtful</u> has all the weaknesses inherent in one classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Assets classified <u>Loss</u> are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future. Amounts classified Loss should be promptly charged off.

The Uniform Agreement defines an investment grade security when the issuer has adequate capacity to meet its financial commitments for the life of the asset. An issuer

has adequate capacity to meet its financial commitments if the risk of default is low and the full and timely repayment of principal and interest is expected. Note, however, this is the definition established in 12 CFR Part 1 for national banks. This definition will usually apply to state-chartered banks, but in some states investment grade may be defined differently across its laws and regulations and therefore a state bank may be subject to restrictions on investments that are more stringent than those in 12 CFR Part 1.

Institutions perform initial due diligence commensurate with an instrument's complexity to determine whether securities meet the investment grade standard. Potential investments that do not meet the definition of investment grade are ineligible for purchase. Management conducts ongoing due diligence and monitoring to determine whether securities continue to meet the standard.

A pass rating may be supported by appropriate credit analysis that documents the quality of an investment grade security, as well as an ongoing analysis that demonstrates the obligor's continued repayment capacity. Investment grade securities are generally not subject to adverse classification. Examiners may classify a security when justified by available credit risk information independent of any assigned credit rating.

Any subsequent upgrade in classification should follow a sustained period of performance and be based on improvement in credit conditions and analysis that indicates all future contractual payments will be received. Generally, the performance period should cover multiple payments as determined by the security's payment structure (i.e., monthly, quarterly, annually).

Regardless of a determination of adverse classification, examiners should consider an investment portfolio's depreciation (and the quality and support for its pricing) in their assessment of capital, asset quality, earnings, and liquidity. Significant rising market interest rates can cause significant unrealized losses at institutions with long-duration bond portfolios. Unrealized losses increase financial and liquidity risks and necessitate more robust examination coverage and ongoing monitoring. Among the potential risks facing affected institutions are a reduced stock of unencumbered liquid assets that can be sold or pledged with no or minimal losses incurred or discounts required; potential access limitations from wholesale funds providers such as the Federal Home Loan Bank, municipalities, deposit brokers, and other counterparties; challenges in executing contingency funding plans; and the possibility that depositors, particularly uninsured depositors, develop doubts about an institution's resilience and solvency, prompting withdrawals. In a rising rate stress scenario, examiners will need to look beyond the HTM and AFS accounting categorizations to the portfolio's economic substance to adequately assess its impact on liquidity, capital, and earnings.

Failure to provide adequate pricing and impairment analysis may also negatively influence the management rating.

Declines in Fair Value

Accounting for credit losses on HTM and AFS debt securities under ASC Topic 326

ASC Topic 326, *Financial Instruments - Credit Losses* supersedes previous OTTI guidance. Institutions that have adopted ASC Topic 326 are required to follow its guidance for the measurement of credit losses for HTM and AFS debt securities.

The measurement of credit losses for HTM debt securities falls within the scope of ASC Subtopic 326-20, *Financial Instruments - Credit Losses – Measured at Amortized Cost*, commonly referred to as the current expected credit losses (CECL) methodology. In accordance with ASC Subtopic 326-20, management will report a provision expense for the amount necessary to adjust the allowance for credit losses (ACL) for the current estimate of expected credit losses. Management may measure expected credit losses on a collective pool basis when similar risk characteristics exist. Otherwise, an ACL on a HTM debt security will be measured on an individual basis.

The measurement of AFS debt securities falls within the scope of ASC Subtopic 326-30, *Financial Instruments - Credit Losses – Available-for-Sale Debt Securities*. Impairment for all AFS debt securities is measured at the individual security level.

The impairment of an AFS debt security occurs when the fair value of that security is below its amortized cost basis. When this occurs, management must determine whether the decline in fair value below the amortized cost basis has resulted from a credit loss or other non-credit factors, such as changes in interest rates or the market liquidity of the instrument. In assessing whether a credit loss exists, management will compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. Impairment relating to credit losses is recognized through an ACL, with the credit loss limited by a fair value floor (i.e., the ACL is limited by the amount that the fair value is less than the amortized cost basis). Changes in the ACL are recorded in the period of change as a provision expense or the reversal of a provision expense. The amount of impairment not recorded through an ACL (i.e., impairment related to non-credit factors) is required to be recorded through other comprehensive income net of tax.

If management intends to sell an AFS debt security, or it is likely that it will be required to sell the debt security before recovery of its amortized cost basis, any ACL should be written off and the amortized cost basis written down to the debt security's fair value at the reporting date, with any incremental impairment (i.e., any decline in fair value since the last reporting date) reported through earnings. Once an individual AFS debt security has been written down, the previous amortized cost basis less write-offs, including non-credit related impairment reported in earnings, becomes the new amortized cost basis of the debt security. The new amortized cost basis is not adjusted for subsequent recoveries of cash flows, but is reflected as a yield adjustment.

Subinvestment Debt Securities

Consistent with ASC Topic 320, AFS debt securities are marked-to-market and carried at their fair value on the balance sheet. The U.S. implementation of Basel III capital measures developed by the Basel Committee on Banking Supervision, reflected in Part 324 of the FDIC Rules and Regulations, gave most banking organizations with total assets below $250 billion a one-time election to opt out of the requirement to include AOCI components in the calculation of regulatory capital (AOCI opt-out). Therefore, the net unrealized holding gains (losses) on AFS debt securities, net of tax effects, are generally excluded from earnings. For institutions that have adopted ASC Topic 326, an exception to this rule occurs when credit impairment has occurred on an AFS debt security. In this case, only the non-credit impairment (i.e., the depreciation related to other factors) on the individual security is not recognized in earnings. The non-credit portion, net of applicable taxes, is reported in AOCI provided the AFS debt security will not be sold before recovery of the amortized cost basis.

For purposes of determining an institution's regulatory capital under Part 324 when there is an AOCI opt-out election, any net unrealized holding gains (losses) on AFS debt securities, including the non-credit portion of a fair value decline to an AFS debt security in the circumstances described above, that are included in AOCI, are ignored. As a result, the amount reported in AOCI normally is not deducted, but is neutralized (i.e., added back in the case of net unrealized losses) in determining regulatory capital.

To appropriately reflect regulatory capital, the amount of the credit impairment or write-downs recognized in earnings based on U.S. GAAP is classified Loss, with the remaining balance classified Substandard. Therefore, only the credit loss portion on a subinvestment debt security should be deducted in determining tier 1 capital.

For subinvestment AFS debt securities with fair values below its amortized cost, the amortized cost (rather than the lower amount at which these securities are carried on the balance sheet, i.e., fair value) is classified Substandard. This classification is consistent with the regulatory capital treatment of AFS debt securities when there is an AOCI opt-out election. As mentioned above, under U.S. GAAP, net unrealized holding gains (losses) on AFS debt securities are excluded from earnings, unless a credit loss is recognized, and reported in a separate component of equity capital. In contrast, these net unrealized holding gains (losses) are excluded from regulatory capital. Accordingly, the amount classified Substandard on these subinvestment quality AFS debt securities (i.e., amortized cost) also excludes the balance sheet adjustment for unrealized holding losses.

Determining Fair Value

As currently defined under U.S. GAAP, the fair value of an asset is defined as the price that would be received to sell an asset or the amount paid to transfer a liability in an orderly transaction between willing market participants (i.e., other than in a forced or liquidation sale). Quoted market prices are the best evidence of fair value and must be used, if available, as the basis for measuring fair value. If quoted market prices are not available, the estimate of fair value must be based on the best information available in the circumstances. The estimate of fair value must consider prices for similar assets and the results of valuation techniques, to the extent available in the circumstances.

Examiners must ascertain a security's fair value to properly classify or make needed regulatory capital adjustments. Hence, examiners should review management's fair value measurements for all adversely classified securities. When management's valuation is reasonable, examiners will use that value to classify the security. If unreasonable or unsupported, examiners should discuss their concerns with management and request that management provide a reasonable and supportable valuation. When management cannot provide a reasonable valuation during the examination, examiners should use the information and pricing services provided by RMS Capital Markets to estimate values for examination purposes.

Qualitative Capital Adequacy Considerations

Net unrealized holding gains (losses) on AFS debt securities are not normally recognized in calculating an institution's regulatory capital ratios as discussed. However, examiners should consider the extent of the net unrealized gains or losses, as well as the appreciation and depreciation on HTM debt securities in the overall assessment of the institution's capital adequacy, liquidity position, and risk management system.

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OTHER ISSUES

Investment Trading Account Risk Management

Trading activities involve strategies or transactions designed to profit from short-term price changes. Trading activities usually employ active strategies, which assume that management can consistently outperform the market. Trading programs can generate earnings, but can expose institutions to different and increased risks.

The FDIC Rules and Regulations (Parts 351 and 324) discuss trading-related requirements and restrictions. Regardless of capital requirements contained in Part 324 and prohibitions contained in Part 351 (Part 351 does not apply to most community and regional institutions), there are risk management considerations for any institution with an investment trading account.

The board and management have the responsibility to identify, measure, monitor, and control trading activity risks. Failure to adequately understand and manage trading activity risks may constitute an unsafe or unsound banking practice. Financial institutions' risk management programs governing trading activities typically address:

- Board oversight, approval, and periodic review requirements;
- Management qualifications;
- Management oversight procedures;
- Policy standards, operational procedures, and risk limits;
- Segregated accounting and reporting requirements;
- Conflict of interest and code of ethics guidelines;
- Compensation practices;
- Internal controls; and
- Risk measurement systems and requirements for reporting material risks such as potential trading losses and performance relative to established benchmarks.

Effective risk measurement systems identify and measure all material risks, including potential trading losses, for defined periods. For example, the system might measure potential one-day trading loss for a given set of statistical assumptions.

The reliability of a risk measurement system is enhanced when management uses reasonable, supportable, and consistent assumptions and translates system results into terms that evidence compliance with the board's trading risk limits.

When measuring the performance of the institution's trading activities, trading desks, or individual traders, management compares actual results to performance benchmarks that provide realistic comparative values. For example, management may compare actual results against the returns that could have been obtained by adopting a passive investment strategy in a similar class of investments. Additional performance benchmarks may include market indexes such as the Standard & Poor's 500 Index, the Russell 2000 Index, the Barclays Capital Aggregate Bond Index, or the Bloomberg U.S. Treasury Index.