

## **Regulation No. 1 Investment Securities**

**WHEREAS**, Section 5-2A-8 of the Alabama Banking Code provides that the Superintendent of Banks may, with the concurrence of a majority of the members of the State Banking Board, promulgate reasonable rules and regulations;

**AND WHEREAS**, the Superintendent of Banks, with the concurrence of a majority of the members of the State Banking Board, recognizes the need of, and desirability for, rules and regulations pertaining to bonds, debt, equity, derivatives, and other securities for investment by any bank, person, firm, or corporation doing a banking business in the State of Alabama under the jurisdiction of the Superintendent of Banks;

**NOW THEREFORE**, be it known that the Superintendent, with the concurrence of the State Banking Board in official meeting assembled on December 7, 2012, does hereby promulgate the following regulation which amends and supersedes the previous Regulation No. 1 that was effective as of December 19, 1977 and amended June 23, 1982, and April 3, 1991.

### **1) CORPORATE GOVERNANCE**

- a. The investment authority within a bank originates with the board of directors. The directors should be knowledgeable of the bank's investments and the specific risk characteristics associated with the investment portfolio. Broker/dealers, consultants, and their representatives may participate in meetings and make recommendations as well as educate the board. However, boards may not delegate their responsibilities. Furthermore, boards of directors and bank management shall not place excessive reliance upon the advice of a broker/dealer, consultant, or their representative regarding the purchase and management of specific investments or the portfolio as a whole. It is the responsibility of boards to direct asset-liability management and/or investment committee meetings, with management being primarily responsible for presenting information and making recommendations.
- b. 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. The investment policy, at a minimum, shall establish the following:
  - i. Overall investment portfolio purposes and goals;
  - ii. Authorized investments and activities;
  - iii. Parameters and risk limits to identify, measure, monitor, and control all risks associated with investment activities including, but not limited to, concentration risk, credit risk, liquidity risk, and interest rate risk;

- iv. Acceptable investment portfolio limits as a percent of Capital<sup>1</sup> and Total Assets;
  - v. Acceptable investment portfolio limits as a percent of brokered deposits and other non-core deposit funding sources which may be used to leverage the investment portfolio and the balance sheet;
  - vi. Individual purchase and concentration investment authority limits for investment officers and/or investment committees, as well as internal controls for monitoring activity compared to the defined limits; and
  - vii. Board approval for opening broker/dealer relationships where securities will be purchased or held for safekeeping, along with annual reviews of investment relationships, ensuring compliance with Federal Reserve Board Regulation F: Limitations on Interbank Liabilities (12 CFR 206), as well as reports as to the percentage of portfolio purchased from each broker/dealer and the amount and percentage of securities purchased from each broker/dealer subsequently considered sub-investment quality.
- c. A bank's board of directors shall establish a robust risk assessment methodology for pre-acquisition and post-acquisition analysis, appropriate for each asset class, to support the investment activities of the bank. The methodology should be appropriate given 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 quality of its risk management staff.
- i. Appropriate pre-acquisition due diligence shall be performed and documented by qualified bank staff or a third party, and shall be based upon, at a minimum, an analysis of the 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. However, investment decisions shall not be based entirely upon external credit ratings by acceptable credit rating agencies listed in Appendix 1.
  - ii. Post-acquisition, qualified bank staff or a third party should review securities at least annually in accordance with the bank's methodology. The on-going review should document any adverse changes to the factors

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<sup>1</sup> The definition of Capital for Alabama State Banking Board Regulation No. 1 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. However, limits for investments in Bank-Owned Life Insurance (BOLI) products in this regulation are stated as a percent of Tier 1 Capital in accordance with the Interagency Statement on the Purchase and Risk Management of Life Insurance (FIL-127-2004), and the definition of Tier 1 Capital shall be the same as that contained in the Federal Financial Institutions Examination Council (FFIEC) Instructions for Preparation of Consolidated Reports of Condition and Income (Call Report Instructions), Schedule RC-R, Regulatory Capital.

considered during pre-acquisition analysis. The bank must make and document every reasonable effort to obtain the most recent financial and other information to estimate the obligor's ability to perform. On-going analysis should be updated no later than the end of quarter when the bank receives significant new information.

- d. A bank's board of directors, or a committee thereof, shall review, no less than quarterly, the overall quality, liquidity, structure, and performance of its investment portfolio and any policy exceptions. If the quarterly reviews are committee level, then the full board shall review, at least annually, the overall quality, liquidity, structure, and performance of the investment portfolio. The reviews, at a minimum, shall include analysis, with recorded discussion in the official minutes, of the following:
  - i. Local, state, and global economic environment with recognized concerns and notable impacts on overall bank performance;
  - ii. Investment portfolio performance, position, and liquidity as compared to board-approved goals, limits, and objectives;
  - iii. Deposit funding, loan growth, concentrations, and other matching considerations; and
  - iv. Position of investment portfolio relative to board-established limits regarding concentration risk, credit risk, liquidity risk, and interest rate risk and appropriateness of the established limits.

## 2) ELIGIBLE TYPES OF SECURITIES

- a. The following are considered eligible types of securities for investment<sup>2</sup>; however, specific investments within these general securities types should be governed by the risk management guidance provided in this regulation:
  - i. Certificates of deposit and bankers acceptances. Any certificate of deposit exceeding FDIC insurance limits shall be underwritten in accordance with the investment policy.
  - ii. Any bond, note, bill, or obligation of the United States Government or a U.S. Government Agency.
  - iii. Any marketable<sup>3</sup> obligation of a state, or of any political subdivision of a state, including obligations of a county, city, township, other municipal

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<sup>2</sup> While investment securities that are currently considered or become sub-investment quality are not grandfathered under this regulation, specific types of investments that were authorized under the prior Regulation No. 1, were specifically authorized in writing by the Superintendent, or which exceed the new limits above, but were not subject to limits when purchased, will not be cited as violations of this regulation. Any new purchases of ineligible investments will be cited as violations of this regulation.

<sup>3</sup> Marketable Securities means any equity or debt instrument that has a market value, as determined by reliable and continuously available price quotations.

corporation, board of education, public authority, board, corporation, or any public entity organized by authorization or determination by any municipality or municipalities or county or counties or the governing body of any one or more thereof.

- iv. Any marketable debt obligation or contract obligation of a publicly held, private corporation including, but not limited to, Credit Default Swaps (CDS) will be subject to the secured and unsecured Credit Exposure Limits in Regulation No. 14.
- v. Federal Reserve Bank debt.
- vi. Federal Home Loan Bank, Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and other U.S. Government-Sponsored Entities' debt, including pass-thru residential and commercial mortgage-backed securities. Prior to purchase, management shall ensure that the security is not going to conflict with concentration limits related to collateral types, locations, cash flows, or other inherent concentrations within the overall balance sheet structure.
- vii. Collateralized Mortgage Obligations (CMO), Collateralized Debt Obligations (CDO), Real Estate Mortgage Investment Conduits (REMIC), Asset-Backed Securities (ABS), and any other holding of private-label, residential or commercial mortgage-backed securities. Prior to purchase, the bank shall ensure and document that the bank has adequate and knowledgeable staffing to understand and investigate the underlying borrowers and collateral to ensure that the security is not going to conflict with concentration limits related to collateral types, location, cash flows, or other inherent concentrations within the overall balance sheet structure. At least annually, the board should review the securities and underlying assets and their performance. Generally, the underlying assets contained within these securities should meet the loan underwriting standards of the bank. However, the securities' overall structure and additional protections including, but not limited to, credit enhancements and senior cash flows should be considered.
- viii. Single-issuer, Trust-Preferred Securities. Prior to purchase, the bank shall document an analysis of the current financial condition of the underlying obligor which includes, but is not limited to, current and projected industry conditions. Investments in single-issuer, Trust-Preferred Securities shall not exceed 10 percent of the purchasing bank's Capital to any single issuer, with an overall aggregate limit of Trust-Preferred Securities investments not to exceed 25 percent of the purchasing bank's Capital. Investments in Trust-Preferred Securities pools are specifically excluded as eligible investments.
- ix. Equity investments are specifically prohibited for investment by a bank with the following exceptions:
  - 1. Common and/or preferred equity stock investments in a Federal Reserve Bank, a Federal Home Loan Bank, the Federal National

Mortgage Association, the Federal Home Loan Mortgage Corporation, or other U.S. Government-Sponsored Entities required for membership or access to various overnight, term, and other structured temporary funding sources.<sup>4</sup>

2. Preferred stock not required for membership is considered as an eligible investment if it has the characteristics of debt.
  3. Combined equity investments in all such entities are limited to 10 percent of Capital.
  4. Equity investments in bank service corporations are limited to 10 percent of Capital for non wholly owned corporations.
- x. Other obligations and equity investments are not acceptable unless received for debts previously contracted. When such non-acceptable obligations are received for debts previously contracted, they must be disposed of within two years from the date of receipt. Bank stock or bank holding company stock received for debts previously contracted must be disposed of within one year from the date of receipt, unless prior approval is received from the Superintendent in accordance with §5-5A-27 of the Alabama Banking Code.
- xi. Any bank intending to purchase an investment not specifically listed must receive prior written approval from the Superintendent.

### 3) CLASSIFICATION OF SECURITIES

- a. Investment quality securities are marketable securities in which the investment characteristics are not distinctly or predominantly speculative, for which there is adequate evidence that the obligor will be able to perform all that it undertakes to perform in connection with the security, including all debt service requirements, and which do not exhibit other weaknesses that justify an adverse classification rating<sup>5</sup>. For any rated security where the most recent rating by any of the accepted credit rating agencies is not in the top four ratings bands, there shall be a presumption that the security is sub-investment quality, and the bank holding the security must demonstrate that the security is not sub-investment grade, or the security shall be adversely classified for Report of Examination purposes. Sub-investment quality securities may also exhibit any of the following characteristics:
- i. Defaulted, illiquid, or unmarketable status.
  - ii. Investment characteristics that are distinctly or predominantly speculative.

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<sup>4</sup> This exemption does not allow a bank to make equity investments in a bankers' bank. Any investments currently owned are subject to the grandfathering provisions of this regulation.

<sup>5</sup> Definitions of adverse classifications for investment securities are contained in the Uniform Agreement on the Classification of Assets and Appraisal of Securities held by Banks and Thrifts, dated June 15, 2004, or any related regulatory guidance that supersedes this Uniform Agreement.

- iii. Inadequate protection by current sound worth or paying capacity of the obligor or collateral pledged, if any.
- iv. Well-defined weakness or weaknesses that jeopardize the liquidation of the debt.
- v. Distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.

b. Adverse Classifications

- i. Investment securities determined to be of sub-investment quality shall be adversely classified Substandard, Doubtful, or Loss for Report of Examination purposes.
- ii. Under generally accepted accounting principles (GAAP), an institution must assess quarterly whether a decline in fair value below amortized cost of a security is temporary impairment or other-than-temporary impairment (OTTI). The method used to determine impairment should be reasonable, well documented, and appropriate given the complexity and risk profile of the security, whether performed internally or by an independent third party.
- iii. If the impairment is determined to be other than temporary and credit related, the credit portion of the impairment must be written down, establishing a new adjusted book value. The amount of the write-down is to be recognized in current quarter earnings.
- iv. The amount adversely classified for a sub-investment quality security with temporary impairment shall be the amortized cost of the security.
- v. The amount adversely classified for a sub-investment quality security with OTTI shall be the adjusted book value, with the amount of credit-related impairment classified Loss if the bank has not previously recognized the amount of impairment through earnings.

**4) DERIVATIVES**

- a. These investments shall only be used as a part of an overall hedging strategy, where the risks associated with specific assets or liabilities are being hedged<sup>6</sup>. Proprietary derivatives trading activity is inconsistent with all regulatory guidance and will be considered an unsafe and unsound practice. Total or excessive reliance upon broker/dealer advice regarding the purchase and management of derivative positions is unacceptable and will be the subject of criticism during regulatory examinations. The bank's board of directors shall

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<sup>6</sup> Under this regulation, credit risk portfolio hedging is permitted with prior written approval from the Superintendent. No prior approval is needed for credit risk hedging against specific individual exposures. No such prohibition on the hedging of portfolio interest rate risk is intended, provided that the other risk management requirements of this regulation are followed.

ensure and document that the bank has adequate and knowledgeable staffing to understand, investigate, and alter/modify investment positions. Prior to purchase, any hedging position must be simulated and stressed for the effects to net interest income (NII) and the economic value of equity (EVE). The bank's board of directors and the asset-liability management committee minutes should reflect sound risk management practices evidenced by discussions of hedging strategies, benefits, and risks.

- b. The bank's board of directors should establish policies for the use of derivatives, either as part of the investment policy or separately, that includes, at a minimum, the following:
  - i. Designated individuals authorized to execute transactions and limits of authority,
  - ii. Position limits,
  - iii. Maturity parameters,
  - iv. Approved counterparties and clearing houses, and appropriate approved credit limits,
  - v. Counterparty credit guidelines and collateral requirements,
  - vi. Procedures for the monitoring of collateral positions, and
  - vii. Guidelines for effectiveness testing.
  
- c. The bank shall maintain files to support each derivative position that includes, at a minimum, the following:
  - i. Executed International Swap and Derivatives Association (ISDA) agreement,
  - ii. Hedge description and objective,
  - iii. Hedge Designation, either Cash Flow or Fair Value,
  - iv. Compliance with ASC Topic 815,
  - v. Analysis of, and statement regarding, compliance with Derivative and Counterparty Credit Exposure Limits contained in Alabama State Banking Board – Regulation No. 14,
  - vi. Transaction summary:
    - 1. Notional amount
    - 2. Fixed rate
    - 3. Variable rate and corresponding index
    - 4. Maturity date
    - 5. Payment dates,
  - vii. Effectiveness testing and measurement guidelines, and
  - viii. Fair value measurements.

## 5) **COMMUNITY DEVELOPMENT SECURITIES**

Community Development Securities are securities of corporations which are engaged in providing capital to minority business enterprises, securities of foreign governments, or the securities of corporations which are not merely private and entrepreneurial, but whose objectives and purposes are primarily of a civic or community nature, or seem socially desirable including, but not limited to, housing tax credits, historic tax credits, housing developments, and small business investment corporations. Aggregate investments in Community Development Securities of all obligors shall not exceed 10 percent of Capital, and must be identified as Community Development Securities in the bank's records and the official minutes of the bank's board of directors.

## 6) **BANK-OWNED LIFE INSURANCE ("BOLI")**

While BOLI is not considered to be an investment for yield or income purposes but is considered as a vehicle to protect banks against risk of loss, banks have invested substantial sums in BOLI products. Banks are expected to comply with all of the guidance contained in the Interagency Statement on the Purchase and Risk Management of Life Insurance dated December 7, 2004, including the requirement that banks not purchase BOLI simply as an investment vehicle; that is, for speculation, and/or in excess of its risk of loss.

It is also important that banks establish appropriate aggregate and per-issuer limits on such investments. Consequently, the following limits shall apply to BOLI. Any BOLI obligation shall be limited to 10 percent of Tier 1 Capital plus the allowance for loan and lease losses to any single issuer for general accounts. Total BOLI investments, including general and separate accounts, are limited to 25 percent of Tier 1 Capital plus the allowance for loan and lease losses.

The effective date of this regulation shall be January 1, 2013.

## **Appendix 1 – Acceptable Credit Rating Agencies**

Standard and Poor's Ratings Services (S&P)

Moody's Investor Services (Moody's)

Fitch Ratings (Fitch)

Dominion Bond Rating Service (DBRS)

Kroll Bond Rating Agency (KBRA)