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BOOKLETTER

July 11, 2024

To: Chair, Board of Directors
Chief Executive Officer
Each Farm Credit System Institution

From: Vincent G. Logan
Chairman and Chief Executive Officer

Subject: Farm Credit System investment asset management (Revised bookletter 064)

The Farm Credit Administration is issuing this revised bookletter to provide guidance to Farm Credit System (FCS or System) institutions on sound investment management practices.

The revised bookletter incorporates relevant guidance from the previous version of the bookletter and includes updates to reflect changes in FCA regulations, best practices, and lessons learned from recent capital markets events. This revised bookletter supersedes the original version of this bookletter, which was published on December 9, 2010. It also rescinds BL-038 "Guidance Relating to Investment Activities," which was issued on November 26, 1997. It applies to all System banks and associations (institutions)[1] that hold eligible investments for the purposes set forth in §§ 615.5132 and 615.5140 of our regulations.

Farm Credit banks depend on investments to provide liquidity and to manage surplus short-term funds and interest rate risk. Farm Credit banks obtain funding by issuing Systemwide consolidated debt securities, but banks must keep enough cash, funds, and investments on hand to continue paying maturing obligations if access to the debt market becomes impeded. Associations may also use investments to manage their risks, including concentration exposures.

[1] This bookletter does not apply to the Federal Agricultural Mortgage Corporation (Farmer Mac). Farmer Mac is governed by separate investment regulations, which are found at § 652, Subpart A. This bookletter would also apply to any service corporations chartered under Part E of Title IV of the Farm Credit Act of 1971, as amended.

Whether your institution is a bank, association, or service corporation that holds eligible investments,[2] your board and management must have effective processes for managing investments and related risks. Given the impacts on capital, earnings, liquidity, solvency, and interest rate risk, you must implement effective processes for managing investments and related risks.

Risk management practices at System institutions can benefit from lessons learned during significant market stress events. Future events in financial markets are unpredictable, but lessons learned from past events can guide and enhance risk management practices at System institutions going forward.

The global financial crisis of 2008, COVID-19 market impacts in the spring of 2020, robust monetary policy actions in 2022 and 2023, and the role of investment securities in the spring 2023 commercial bank failures all demonstrate the importance of sound investment management practices and allocation strategies. These events provided lessons learned in areas of credit risk, liquidity risk, operational risk, and market risk.[3] We expect you to incorporate lessons learned from these events into your institution's current risk management practices.

The following sections outline sound practices for governance and management of investments at your institution. We recognize that approaches, investment strategies, portfolio size, complexity, and level of investment activity will vary among System institutions according to investment needs and regulatory requirements. However, your institution's investment planning, policies, procedures, reporting, processes, and controls should be commensurate with the level of activity and complexity of your investment activities and holdings.

1. Policies and procedures

Investment policies and procedures are a critical part of effective risk management and establish a framework for investment operations. Your board of directors is responsible for establishing a written investment policy for your institution. The policy must address your institution's investment purposes and objectives, risk tolerance, delegations of authority, internal controls, due diligence, and reporting requirements.[4]

Your board must tailor the investment policy and procedures to make them appropriate for the amounts, types, and risk characteristics of your institution's investments.[5] We expect institutions with large, complex, or more active investment portfolios to have more robust

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[2] We won't refer to service corporations for the remainder of this bookletter since no service corporations held material investments at the time of publication. However, if this were to change, this bookletter would apply.

[3] Although we recognize that market risk is a broader term that can imply any market factors (except movement in interest rates) that can change the price, we use the terms "market risk," "price risk," and "interest rate risk" interchangeably throughout this bookletter. This is consistent with language from the preamble of our 2018 investment rule. See 83 FR 27486 (PDF) (June 12, 2018).

[4] See § 615.5133(a) and (b).

[5] See § 615.5133(b).

policies and procedures. Your board must ensure that management complies with its investment policy and that appropriate internal controls are in place to prevent loss.[6]

Broadly, FCA regulations prescribe parameters for both banks and associations. However, because banks have broader authorities for investment holdings[7] and associations are more limited in the size and scope of permitted holdings,[8] more limitations and parameters are in place for banks than for associations.[9] As detailed below, the board's investment policy must establish your institution's tolerance for credit, market, and, as applicable, liquidity risk, within your investment portfolio.[10]

In addition, your investment policy should identify specific risk limits and establish liquidity and diversification requirements that are consistent with your institution's objectives, capital position, level of earnings, proportional size of the investment portfolio, and risk tolerance. To mitigate investment risks, you should consider all relevant factors when establishing risk limits. In addressing risk tolerance, your policy must establish risk limits and diversification requirements for the various classes of eligible investments and for the entire investment portfolio.[11] Your investment policy must cover the following:

- **Credit risk.** You must evaluate credit quality standards, concentration limits, criteria for selecting brokers and dealers, and collateral margin requirements on repurchase agreements.[12]
- **Market risk limits.** Your policy must address market risks for specific types of investments and for the portfolio as a whole.[13] These limits should account for an investment type's proportion of your overall portfolio as well as the size of the overall portfolio relative to your institution's size. Proportionally larger portfolios present a more material potential exposure, so it's important to set market risk limits according to portfolio size.
- **Stress tests.** Your policy must define the stress tests you will perform, including risk limits on stress test results, for each authorized security type.[14]
- **Investment liquidity.** Your policy must include observable and objective criteria for investment liquidity. As applicable to your institution, be sure to consider (1) the liquidity characteristics of eligible investments that System banks hold to meet liquidity needs and (2) the liquidity characteristics of eligible investments that System associations hold.[15]

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[6] See § 615.5133(e)(1).

[7] See §§ 615.5132(a) and 615.5140(a)(1) for authorities and eligibility of bank investment holdings.

[8] See § 615.5140(b) for eligibility, portfolio size limits, and general requirements of association investment activity.

[9] See table on page 13 of this bookletter detailing limitations on investment portfolios for banks versus associations.

[10] See § 615.5133(c).

[11] See § 615.5133(c) for the primary regulation on risk tolerance limits.

[12] See § 615.5133(c)(1).

[13] See § 615.5133(c)(2).

[14] See §§ 615.5133(b) and 615.5133(h)(4)(ii).

[15] See § 615.5133(c)(3).

- **Operational risk limits.** Your policy must address operational risks. These limits include internal controls and delegations of authority for specified personnel or committees.[16]

We expect you to review your risk profile frequently. You should establish portfolio limits that are not only within the regulatory framework but are also within your risk tolerance limits and investment objectives. Portfolio limits should also be reasonable based on the size and complexity of your investment portfolio. As part of your required annual review,[17] you should review the risk limits set forth in your policy and procedures. You need to ensure that the limits remain consistent with your institution's risk profile, operating environment, and risk-bearing capacity, as well as your board's risk tolerance and investment objectives.

You should implement board policies through appropriate operating procedures and related controls. Operating procedures and related internal controls should establish targeted portfolio ranges and trigger accelerated actions and reporting when risk exposures exceed those ranges so that you can take appropriate corrective actions before board policy or regulatory limits are violated.

The concentration limits that you establish in your policies and procedures for eligible investments[18] must be compatible with the overall portfolio caps imposed on System banks and associations by regulations. For a System bank, eligible investments must not exceed 35% of its total outstanding loans.[19] For a System association, the total amount of investments purchased and held must not exceed 10% of total outstanding loans.[20]

Risk limits in policies and procedures should be able to accommodate fluctuations in the size and composition of the balance sheet and allow for rebalancing actions without exceeding regulatory maximums. For example, bank boards and management should consider loan volume fluctuation when establishing internal risk limits in policies and procedures to ensure that the investment portfolio does not exceed the regulatory maximum.[21]

In addition, if your institution holds or intends to purchase Farmer Mac securities, your board must adopt and review annually a policy for these investments.[22] The policy should clearly identify the responsibilities of committees that oversee investments.

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[16] See § 615.5133(c)(4), (d), and (e).

[17] See § 615.5133(a).

[18] See § 615.5140(a) and (b) for eligible investments.

[19] See § 615.5132(a).

[20] See § 615.5140(b)(4).

[21] The association limit stated in § 615.5140(b)(6)(ii) permits an association to go over the 10% limit if the limit was exceeded because of normal loan volume fluctuations. In that situation, the association must freeze purchases until it complies with the limit, but it is not required to divest investments. In contrast, a bank must divest if it exceeds the regulatory limit.

[22] See § 615.5174(b) and (c).

In addition to the regulatory requirements addressed above, your policies and procedures should address the following aspects of sound investment operations:

- Processes for measuring and managing each type of risk, including liquidity, market, credit, concentration, and country risks as applicable
- Limits on other risks that your institution identifies but are not addressed in regulations
- Due diligence requirements to meet before purchasing investments and expanding into new types of investment
- Identifying investment holdings to sell for rebalancing and other purposes, and the impact of any sales of investment holdings on solvency, earnings, and liquidity
- Valuation and accounting processes, including processes for determining estimated credit losses
- FCA approval of any investments purchased under FCA regulation 615.5140(e), including any processes for ensuring compliance with conditions of approval
- Any other key processes that would have a material effect on your institution's capital, solvency, earnings, or liquidity

2. Plans and strategies

System institutions with investment activities should develop and document their investment plans and strategies. Your plans and strategies should be consistent with your board's risk appetite, help guide investment decisions, ensure that your investment portfolio achieves the board's objectives, and are commensurate with the complexity and size of the portfolio, as well as the level of investment activity. While board policy sets objectives and risk limits, sound planning practices establish strategies for the investment approach.

Your investment plans and strategies should be responsive to changes in market conditions and your institution's overall financial condition and performance. You will need to adjust plans and strategies to ensure that credit, liquidity, market risk exposures, and concentrations remain consistent with your board's risk tolerance and do not present undue risk to earnings, liquidity, capital, or solvency.[23]

In addition, you may need to shift strategies to ensure that investment objectives continue to be met. For example, banks should ensure that strategies change as needed to maintain a pool of high-quality liquid assets to withstand market disruptions and adverse economic or financial conditions.

Even during periods of stability, you should periodically revisit your investment strategies to ensure that your portfolio is performing as intended and is meeting your needs. The management reporting process should allow the board and management to identify areas where plans and strategies need to change.

FCA regulations do not prescribe specific implementation approaches for investment planning. However, for institutions with active investment portfolios, it's a sound business

[23] Banks' plans and strategies should be adjusted to ensure they do not present an undue risk to their statutory collateral ratio.

practice to develop a dynamic investment plan. Your investment plan should be commensurate with the complexity, size, and level of your investment activities, and it should include the following key elements:

- General investment philosophy and objectives
- Strategies to effectively manage and minimize risks in any ineligible investments, including compliance with divestiture and risk reduction plans[24]
- A strategy to achieve compliance if risk exceeds procedural, policy, or regulatory limits[25]
- Strategies for rebalancing your portfolio to achieve the target or benchmark portfolio allocations
- Investment strategies that are consistent with strategic business objectives, board-approved investment purposes, liquidity strategies, risk tolerance, risk diversification objectives, specialized expertise, risk management systems, and risk-bearing capacity
- For banks, the strategies necessary to deal with changes in the investment portfolio that may affect compliance with liquidity requirements[26] and related unfunded commitments, compliance with regulatory limits,[27] and asset-liability management (ALM) objectives
- The industry sectors, geographical regions, and types of securities in which your institution plans to invest
- Performance measures, including risk indicators[28] and target portfolio spread
- An appropriate target portfolio composition consistent with regulatory requirements,[29] the investment policy parameters, current market conditions, risk appetite, and the objectives of your institution

Plans and strategies must be consistent with the regulatory investment authorities that apply to your institution. If you are using investments *primarily* as a tool to generate earnings and profits rather than to manage risks, you are not adhering to FCA's investment regulations. We expect you to appropriately document how your investments effectively manage the specific risks that you have identified.

Banks may earn a profit on investments, but the focus on profitability must be incidental or secondary to the primary purpose of holding investments. For associations, investments

[24] See §§ 615.5143 and 615.5133(i)(8) and (9) for all institutions.

[25] See § 615.5140(b)(4) for associations and § 615.5132 for banks.

[26] See § 615.5133(c)(3), which requires banks to describe the liquidity characteristics of eligible investments that they will hold to meet their needs.

[27] See § 615.5133(f).

[28] Risk indicators should be relevant to the portfolio and institution. These could include, but are not limited to, prepayment levels, default rates, and bid-ask spreads.

[29] FCA regulations provide a list of eligible investments, including appropriate asset classes, maturity limits, portfolio limits, obligor limits, and other requirements. See § 615.5140(a) for banks and § 615.5140(b) for associations.

held to diversify earnings are appropriate, provided the risks to earnings presented by investment activities are not disproportionate to the diversification benefit derived.

Investment strategies that disproportionately focus on profits or spreads may indicate that investment strategies and risk appetite have become disconnected from primary investment purposes. Realizing gains on sales before investments mature is permissible when doing so is consistent with primary investment objectives outlined in FCA regulations,[30] such as achieving a targeted portfolio composition.

3. Risk management

System institutions must have processes to accurately and timely identify, measure, and manage all significant risks at the individual investment and investment portfolio levels. We expect institutions with larger and more complex investment portfolios to have more robust risk management processes and controls. However, institutions of any size must fully understand and manage the risks presented by their investment activities and ensure compliance with our regulatory requirements.

As stated earlier, your institution's processes should be commensurate with your investment risks and complexity, portfolio size, and the level of investment activity. Given the different investment objectives of banks and associations and the regulatory authorities that apply to them, their risk management processes will also differ. Banks must have sound processes to continually identify, measure, and manage all significant investment risks, including liquidity, market, credit, and country risks. These should be evaluated at the individual investment, segment, portfolio, and institution levels.

An association's processes must demonstrate how the investment purchase contributes to the management of the association's overall risk profile. In addition, except as we otherwise authorize under FCA regulation 615.5140(e), associations are authorized to hold only investments that are fully and unconditionally guaranteed by the U.S. government and its agencies.[31] These investments generally have very limited or no credit or country risks, so processes for managing these risk exposures may be limited. Exceptions could exist, such as when an association acquires a non-guaranteed investment through the provisions in FCA regulation 615.5140(e).[32]

Pre-purchase analysis

FCA regulations require your institution to complete and document a pre-purchase analysis before purchasing an investment. The analysis must be commensurate with the complexity and risks of the investment.[33] It must address the investment's eligibility,[34] suitability, and consistency with your institution's investment policy[35] and investment plan, as applicable. FCA regulations also require you to evaluate any risk areas that may apply, such as credit, liquidity, market, and interest rate risk at the time of purchase.[36] You cannot disregard the

[30] See § 615.5132 and 615.5140(b).

[31] See § 615.5140(b)(1).

[32] FCA's approval of case-by-case requests may contain conditions pertaining to risk management.

[33] See § 615.5133(h)(1).

[34] For § 615.5140(a)(1)(ii)(E), the senior-most position is based on liquidation priority.

[35] See § 615.5133(h)(1)(i).

[36] See § 615.5133(h)(1)(iii).

regulatory pre-purchase requirements because you are under pressure to make a quick decision about an investment.

Our regulations do, however, give you the flexibility to expedite the decision process as long as you are not sacrificing sound risk management. For example, you might improve efficiency by completing a broad analysis of an investment class that identifies the unique risks that should be addressed when selecting investments from that class. You could also use a standardized risk analysis template tailored to a specific investment type to evaluate its unique risks. You should never purchase investments that exceed your risk management and measurement capabilities.

Credit risk

Each FCS institution must establish and maintain processes to evaluate credit risk and must monitor the credit quality of each investment in its portfolio, as well as its entire portfolio, on an ongoing basis.[37] Processes should be commensurate with the credit risk presented by investment holdings.

Some investments, like United States Treasury securities, present very little credit risk exposure. Securities issued or guaranteed by government-sponsored enterprises (GSEs) are not explicitly backed by the U.S. government, but credit support from the government is implied. As a result, the credit risk of these securities is significantly mitigated in most cases. The credit risks of all other types of debt securities (which we will call "non-agency securities'') run the gamut from low to high risk. The amount of credit risk in non-agency securities depends on the strength of the obligor(s), investment structure, underlying collateral, and other factors.

Methodologies for measuring credit risk on complex structured securities, including non-agency mortgage-backed securities (MBS) and asset-backed securities (ABS), should include analyses of underlying collateral, collateral performance and trends, and results of stress tests on collateral performance. Analyses of credit risk for these securities should also address changes in credit enhancements and the credit support provided by subordinate tranches.

Even for securities guaranteed by the U.S. government or GSEs, you should understand the underlying collateral and factors that could affect collateral performance. Defaults may not result in loss of principal, but they can result in prepayments, loss of premiums, or other risks. The 2008 global financial crisis highlighted the fact that both government-guaranteed and non-agency-backed securities can exhibit notable volatility in valuations and credit profiles.

Also, your credit risk analysis and monitoring processes cannot overly rely on ratings from nationally recognized statistical rating organizations. Overreliance on these ratings was a contributing factor to the global financial crisis of 2008.[38] While you may use these ratings

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[37] See § 615.5133(h)(3). For a securitization that tranches credit risk, if your institution is unable to demonstrate a comprehensive understanding of the factors that could materially affect the security's performance, you may be required to assign it a risk weight of 1,250% for regulatory capital purposes. See § 628.41(c).

[38] See Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111−203, 939A, 124 Stat, 1376, 1887 (July 21, 2010). We significantly amended our regulations to

to supplement your analysis, you are required to complete your own ongoing credit analysis.[39]

Interest rate risk (IRR)

FCA regulations[40] require institutions to establish processes to monitor, measure, and limit IRR in the investment portfolio.[41] To varying degrees, IRR is present in all investments, including those guaranteed by the U.S. government and its agencies. In general, longer-term fixed-rate investments are more sensitive to interest rate changes than shorter-term or floating-rate investments. IRR can be magnified in investments with embedded structures and options. As we saw in the commercial bank failures of spring 2023, IRR in the investment portfolio can result in unrealized losses that present an exposure to earnings, capital, solvency, and liquidity risks even if accounting does not immediately recognize the impacts.

At System banks, unrealized investment losses can threaten the adequacy of statutory collateral required to support debt issuance[42] and the quality of the liquidity reserve. Risk management, including the ability to measure IRR exposure, must be commensurate with the complexity and materiality of the portfolio's risks.

Your institution's risk management practices should ensure that you accurately measure exposure to IRR and keep it within the board's defined risk tolerance parameters. You should calibrate IRR limits according to investment portfolio size relative to the balance sheet, solvency, capital levels, and potential impacts to earnings.

Stress testing

IRR in investments is primarily measured through stress testing. You can also measure other types of risks, such as credit risk, through stress testing.[43] FCA regulations require you to stress-test investments with uncertain cash flows, including all mortgage- and asset-backed securities, before you purchase them regardless of whether the investments are guaranteed.[44] In addition, you must stress-test each investment and the overall portfolio at least quarterly.[45]

The stress tests must, at a minimum, measure the *price sensitivity* of investments over a range of possible interest rate scenarios.[46] Other factors may also need stress testing —

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implement changes mandated by the Dodd-Frank Act. See 76 FR 51289 (PDF) (Aug. 18, 2011) for the proposed rule and 77 FR 66362 (PDF) (Nov. 5, 2012) for the final rule.

[39] See § 615.5133(h)(3).

[40] See § 615.5133(c)(2) and (h)(4).

[41] We have outlined our broader expectations for IRR management in a bookletter (PDF) published on Jan. 9, 2020.

[42] See § 615.5050(a) and (b). Under part (b), the collateral value of eligible investments must be the lower of cost or market value.

[43] For further guidance on sound practices for stress testing, see our Sept. 8, 2023, informational memorandum (PDF).

[44] As described under § 615.5133(h)(4)(ii).

[45] As required under § 615.5133(h)(4)(i).

[46] See § 615.5133(h)(4).

such as changes in weighted average life, cash flows, premiums, and credit risk — depending on the types and risks of the investments.[47]

Stress testing should be tailored to the nature of the risk. For example, if investments were purchased at a premium price and are prepayable, stress testing must measure the potential premium losses and their impact on earnings if the premium could not be recouped. In addition, if cash flows are uncertain, changes in interest rates could result in a significant increase in investment duration and should be stress-tested. Our regulations also require pre-purchase and quarterly stress tests on mortgage securities issued or guaranteed by Farmer Mac and backed by loans the acquiring institutions did not originate.[48]

We have fewer expectations for stress testing on investments that do not pose a risk to capital, solvency, earnings, or liquidity. For example, stress testing may not be needed for investments that meet all of the following conditions:

- Are government-guaranteed
- Are floating rate
- Are classified as held-to-maturity (HTM)
- Are fully match-funded
- Are not prepayable
- Are not purchased at a premium price
- Have stable cash flows

The most important aspect of these components to indicate reduction in stress testing expectations is stable cash flows. Because such investments have locked-in spreads, they do not pose a risk to earnings, and their stable cash flows and market values significantly limit risk to capital, solvency, and liquidity.

Key stress test assumptions should be well supported. Stress tests must rely on verifiable, documented information to support assumptions,[49] particularly assumptions on prepayments, interest rate volatility, and credit factors/spreads. For prepayable investments or securities backed by prepayable collateral, prepayment assumptions are critical to measures of price sensitivity. If your assumptions are materially flawed, risk measures may not sufficiently capture exposure to prepayment or extension risks; as a result, you may materially over- or understate price sensitivity. The rate shocks you apply to measure investment IRR should be commensurate with the existing level of rates and interest rate cycle and should consider the potential impacts of more significant changes in market rates (up and down 300 and 400 basis points).

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[47] We describe risks in further detail under § 615.5133(h)(4)(i).

[48] See § 615.5174(d).

[49] See § 615.5133(h)(4)(ii).

Liquidity risk

FCA regulations require your institution to evaluate and monitor on an ongoing basis investment liquidity risk as appropriate for your investment objectives.[50] Ongoing monitoring is key during periods of market turmoil and volatility because the liquidity of your institution's investments can be affected. For example, at the beginning of the COVID-19 pandemic, the liquidity of even the highest-quality investments, such as long-duration U.S. Treasuries, declined, and the ability to pledge investments as collateral on repurchase agreements disappeared. The liquidity of all marketable securities during this time was highly dependent on central bank intervention.

The commercial bank failures in the spring of 2023 demonstrated how elevated levels of investment IRR and the resulting declines in investment values can undermine the liquidity value of otherwise high-quality investments and present a significant risk of loss in a rising rate environment. That's why it's important to make sure that your investment portfolios are diverse enough to address such scenarios.

Banks must establish marketability requirements for investments held in the liquidity reserve.[51] Investments in the liquidity reserve must exhibit low risk, be easily convertible into cash with little or no loss in value, and be easily bought and sold in active and sizeable markets without affecting prices (except for money market investments). We expect banks to periodically assess the marketability and liquidity of their investments to ensure they continue to meet regulatory marketability requirements. This assessment should address the depth, breadth, and liquidity of the market as well as other liquidity risk indicators. Banks should also consider the following items to evaluate the liquidity profile of their investment portfolios:

- Their ability to pledge the investment as collateral on a repurchase agreement or other source of funding.
- Their willingness to sell[52] the security at the current market value if cash is needed. This risk should be adequately addressed in the contingency funding plan (CFP).
- The duration of the liquidity investments.
- Whether the investments accomplish the liquidity purpose stated in the investments policy.
- The threshold of market value or volatility where an investment is no longer considered suitable for liquidity and should be removed from the liquidity reserve.

Country risk

When applicable, a System bank's pre-purchase analysis must include an evaluation of country risk as part of its credit risk analysis.[53] A bank must meet one of the following two

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[50] See § 615.5133(c)(3) and (h)(1)(iii). In addition, § 615.5133(i) lists board reporting requirements that may necessitate further analysis of liquidity risk as applicable to your investment objectives.

[51] See § 615.5134(d).

[52] While many contingency funding plans include the use of secured short-term borrowing, banks should consider the potential for realized losses on investment sales, and potential impacts to earnings, solvency, and capital, when assessing the liquidity profile of their investment portfolios.

[53] See § 615.5133(h)(1)(iii). System associations do not have this authority unless an investment was submitted for prior approval and FCA consideration under § 615.5140(e).

conditions if the bank is relying on an obligor located outside the United States to honor its financial commitment under the investment:

1. The obligor's sovereign host country must have the highest or second-highest consensus Country Risk Classification as published by the Organization for Economic Cooperation and Development, or it must be an unrated member of that organization.
2. The investment is fully guaranteed as to the timely payment of principal and interest by a U.S. government agency.[54]

Concentration risk

Concentration in certain investment asset classes and securities contributed to failures in many financial institutions during periods of market uncertainty. The investment management practices of both banks and associations should ensure appropriate diversification and sound management of concentration exposures.

While associations can diversify by investing in different asset classes from the loans on their balance sheets, they should manage and control investment concentration risk by selecting investments carefully and ensuring diversification within their investment portfolios. System banks should effectively manage concentrations in any one investment issue or investment asset class; this is especially true for more complex, potentially illiquid, and higher-risk investments, such as securities with uncertain cash flows.

Based on investment complexity, the bank's board must establish in its policy concentration limits for the following (as applicable):

- Single or related obligors
- Sponsors
- Geographical areas
- Industries
- Unsecured exposures
- Asset classes or obligations[55]

FCA regulations outline several diversification requirements for banks.[56] The maximum concentration for various asset classes is listed below. However, as outlined in the "Policies and procedures" section above, you should generally set concentration limits below regulatory maximums because investment values fluctuate; you should also have a plan to rebalance to target ranges.

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[54] See § 615.5140(a)(1)(iii).

[55] See § 615.5133(c)(1)(ii).

[56] See §§ 615.5133(f)(2), 615.5133(f)(3)(ii), 615.5133(g), 615.5132(a), and 615.5174(a).

As shown in the table below, FCS institutions must limit their portfolio allocation in the following types of securities, consistent with marketability, liquidity, and risk management principles outlined in FCA regulations:[57]

Type of Investment	Banks[58]	Associations[59]
Overall investment portfolio	35% of total outstanding loans	10% of total outstanding loans
Any one asset class	15% (except for money market investments and investments guaranteed by U.S. government or a GSE)	Not applicable
Any one obligor	10% of total regulatory capital	Not applicable
Mortgage-backed securities fully guaranteed by GSEs	50%	Not applicable
Agricultural mortgage-backed securities issued or guaranteed by Farmer Mac	100% of total outstanding loans	100% of total outstanding loans

Economic conditions and emerging risks

Your portfolio monitoring practices should capture and identify emerging risks. Identifying these risks early can prompt you to evaluate exposures and determine whether adjustments to portfolio strategies are warranted. Market and economic conditions can change very quickly; therefore, you need robust and dynamic processes and tools in place to ensure that you can identify emerging risks and analyze and understand their potential effects on your institution. You can manage emerging risks by setting risk parameters and implementing the rebalancing strategies detailed in your investment policies and procedures.

Factors to consider in evaluating emerging economic risks and conditions include the following:

- Correlation risk
- Changes and trends in probability of loss and loss given default
- Volatility risk of ratings (the potential for downgrade)
- Market liquidity and price discovery
- Credit spreads and volatility
- Other relevant external factors affecting investments that an institution may acquire or hold

[57] See §§ 615.5133(c).

[58] Bank limit regulatory citations for this column: See §§ 615.5132(a), 615.5133(f)(2), 615.5133(g), 615.5133(f)(3)(ii), and 615.5174(a).

[59] Association limit regulatory citations for this column: See §§ 615.5140(b)(4) and 615.5174(a).

4. Monitoring & controls

Effective internal controls are critical to safe and sound investment operations.[60] FCA expects your board members to take an active role in risk management by having an effective internal control environment and ensuring that your institution complies with applicable laws and regulations. We require your institution to have sufficient controls to monitor investment trades to ensure that they are appropriate and comply with our regulations.[61]

An effective system of internal controls in investment operations should include the following:

- Reliable reporting
- Effective committee oversight
- Reasonable separation of duties
- Appropriate delegated authorities
- Adequate staffing
- Reliable investment models and information systems

In addition, internal controls must be sufficient to detect and prevent loss, fraud, embezzlement, conflicts of interest, and unauthorized investments.[62]

Reporting

Reporting on investment activity to the board and management is a primary control mechanism to help monitor investment portfolio characteristics, risks, and performance. At least once a quarter, your management must report to your board (or a committee of the board) on the performance and risk of each class of investments your institution holds, as well as your entire investment portfolio.[63]

The reports must address whether investments are achieving their objectives.[64] They should also address specific investment risks. For example, if prepayable investments are purchased at significant premium prices, reporting should address and quantify the related risks.

During times of extreme market volatility or notable changes in market conditions, you should provide more frequent reporting, and your investment policy should include guidelines for increased or supplemental reporting during those times. The board should

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[60] See § 618.8430. Your board is responsible for ensuring sound systems and controls. Senior management is responsible for implementing an effective controls environment set by the board.

[61] See § 615.5133(e).

[62] See § 615.5133(e)(1).

[63] See § 615.5133(i).

[64] See § 615.5133(i)(2). For example, if an investment (such as a USDA-guaranteed loan security) was purchased for credit diversification, then your reporting would demonstrate whether the investment was meeting the objective.

also require a review of reporting and controls through your institution's internal audit program.[65]

While FCA regulations describe specific items that must be addressed for investment reporting,[66] your institution should ensure that its reporting to the board is appropriate for the current environment and for the risk, size, and complexity of its portfolio.

Committee oversight and effective challenge

Ensuring effective challenge to investment strategies and decisions is a key second line of defense control.[67] Most banks, associations that manage their own ALM, and large associations with more complex and active investment programs already have asset-liability committees to oversee interest rate risk and their investment activities. As the importance, volume, and complexity of investments grow, your institution may need to add expertise in the form of an investment committee or another structure to provide an effective challenge.

The asset-liability committee (ALCO) or investment committee should approve your institution's investment plan, ensure that purchases are consistent with the stated plan and strategy, evaluate and recommend changes in strategy as needed, and report to management and the board on investment activity. ALCO or investment committee members should feel empowered to challenge strategies, risk limits, holdings, and allocations. Your investment policy or committee charter should address this responsibility and explain the process for raising a challenge. Documenting the minutes of meetings in which you discuss strategies and allocations can help you implement this second line of defense effectively.

Delegations of authority and separation of duties

Your institution must establish delegations of authority for personnel and committees that oversee investments; these delegations should state the extent of the authority.[68] Delegated authorities should clearly identify prior- and post-approval requirements. Your institution should also have processes to monitor and ensure compliance with the authorities.

In addition, you must establish and maintain separation of duties between personnel who supervise or execute investment transactions and personnel who supervise or engage in all other investment-related functions.[69] It is particularly critical to separate the personnel who execute and purchase investment securities from personnel who conduct back-office accounting functions, such as posting accounting entries, reconciling trades with dealer confirmations and safekeeping reports, transferring cash, and determining market values. Additionally, the individuals who execute and purchase securities also should not be the same individuals who monitor and report compliance with policy, develop investment reports, analyze credit risk, and measure impairment.

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[65] See § 615.5133(e)(4).

[66] Refer to § 615.5133(i) for the full list of requirements for investment activity reporting.

[67] Refer to guidance from the Basel Committee on Banking Supervision's Revisions to the principles for the sound management of operational risk (PDF).

[68] See § 615.5133(d).

[69] See § 615.5133(e)(2).

Separation of the less critical duties may not always be practical from a cost-benefit perspective for small institutions with limited staffing, small investment portfolios, or low-risk investment portfolios. If separation of all duties is not practical for your institution, you should implement alternative internal controls, such as periodic verification and validation by independent, qualified personnel. Separation of duties and alternative internal controls should be commensurate with the complexity, level of activity, and risks in your investment operations.

Other aspects

Other aspects of internal controls over investment programs include staffing, training, outsourcing, compensation structure, information technology,[70] and model risk management (MRM). You should seek the advice and guidance of external consultants as needed, particularly when you are expanding into new, unfamiliar investment types. You should also have sufficient backup strategies and appropriate staffing to provide for the continuity of all significant investment functions. Any compensation incentive programs should be consistent with your investment objectives.[71]

You may outsource some or all investment functions to an outside investment management firm. Ultimately, your institution and its board are responsible for avoiding investment activities that expose the institution to undue risk or material loss; you're also responsible for ensuring that your activities comply with FCA investment regulations.

In addition, it's important to remember that outsourcing does not release your institution from its responsibility to supervise, monitor, and control investment activities and risks. Any relationships with third parties that provide investment services, processes, applications, or models should be governed by third-party risk and MRM frameworks, as applicable.[72]

Various models may be used to manage investments and measure risks, such as to validate fair values and measure market and credit risks. Your investment models should be governed in accordance with your institution's MRM framework. You should include investment models in your institution's model inventory, which should accurately represent each model's risk, materiality, and validation status. Model validation, change controls, staffing, separation of duties, and new model development should be consistent with the guidance in your institution's MRM framework.

5. Accounting

The accounting for investments is an important consideration in financial reporting; the evaluation of investment performance, risks, and management; and the evaluation of capital adequacy, earnings adequacy, and liquidity management. Therefore, investment accounting and classifications should be consistent with generally accepted accounting principles (GAAP) and the authorized purposes for holding investments. In addition, you

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[70] As stated under 615.5133(e)(3), you must maintain management and technology information systems sufficient to support investment activities that are appropriate for the level and complexity of your investment portfolio.

[71] For example, if the primary objective of your investment portfolio is liquidity risk management, incentive compensation can consider spread but should not be unreasonably tied to yields and spreads.

[72] You can find further guidance on the management of third-party and model risk in the Direction & Control of Operations section (PDF) of the FCA Examination Manual.

should have processes for valuing investments in an accurate and timely way, measuring impairment, and determining expected credit losses.[73]

Accurate and timely valuation is essential for monitoring and reporting investment performance, risk, and compliance with the board's objectives and risk parameters. You must verify fair market values of investments with an independent source (i.e., not the originating broker or dealer) prior to purchase (unless it is a new issue) and prior to sale.[74] You must have sufficient processes for determining the market value of investments.

At least monthly, you must verify the fair market value of each investment, as well as the whole portfolio.[75] You must obtain independent verification from a source that was not involved in the transaction to confirm whether the broker's prices were reasonable. In situations where it is difficult to value certain securities on an ongoing basis, you should establish sound controls, including adequate documentation, to demonstrate the basis of valuation. In cases where pricing is only available from the originating broker or dealer, your institution's model may be used to estimate value if the model is supported by adequate systems and valid assumptions.

As previously mentioned, you should have investment processes in place to assign accounting classifications consistent with GAAP and authorized investment purposes. Per Accounting Standards Codification (ASC) 320, investments must be classified in one of three categories: available-for-sale (AFS), HTM, or trading. Classifying investments as trading would generally be inconsistent with the authorized purposes for holding investments.[76] The accounting classification is important because it determines how investment carrying amounts and unrealized gains and losses are reported in the financial statements.

6. Audit

Your institution's audit committee must implement an effective internal audit program to annually audit or review your investment management practices, including internal controls, reporting processes, and compliance with FCA regulations. The scope of the annual audit or review must be appropriate for the size, risk, and complexity of your investment portfolio.[77]

The scope and depth of work, including transaction testing, should cover the primary processes and controls within the area being audited or reviewed. The scope and depth of work should also be sufficient to determine whether internal controls are functioning properly, and regulatory requirements are being met. If the work performed deviated materially from the planned scope, internal audit staff should notify your board (or audit committee, if so delegated) of the reasons for the change.

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[73] You can find further guidance on determining expected credit losses on investments in an October 2022 FCA bookletter (PDF) and Accounting Standards Codification 326.

[74] See § 615.5133(h)(1)(ii) and 615.5133(h)(5).

[75] See § 615.5133(h)(2).

[76] See § 615.5132(a) for bank authorized purposes and § 615.5140(b) for association authorized purposes.

[77] See § 615.5133(e)(4).

7. Association investment oversight (banks only)

Banks play an important role in the supervision and oversight of investment activities at associations. Banks are required to review, approve,[78] and oversee the investment activities of affiliated associations.[79] While banks are not required to review and approve every investment made by every association, banks must approve any significant changes in investment strategy by any of their affiliated associations. For example, banks will need to approve an association's entry into investment activities and any expansion into new types or classes of investments.

Banks must also annually review association investment activities.[80] Banks should document their initial and ongoing review and analysis of the investment programs of all their affiliated associations. Bank analysis should demonstrate sufficient understanding of each association's investment program and objectives.

Contact

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[78] See § 615.5140(b)(5)(ii) for requirements of bank review of an association's request to purchase and hold investments.

[79] See § 615.5140(b)(5)(i).

[80] See § 615.5140(b)(5)(iii).