Module: Assets
Section: Investments
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Introduction

Investments, like loans, involve credit and interest rate risks. Risks in the investment portfolio should be minimized to ensure that liquidity and marketability are maintained. The investment account is primarily a secondary reserve for liquidity rather than a vehicle to generate profits. Speculation in marginal securities to generate more favorable yields is an unwarranted risk.

FCA Regulation 12 CFR Part 615, Subpart E, was adopted to allow Farm Credit System (System) banks flexibility in managing investments, but places limits and restrictions on investment activities to promote safety and soundness through portfolio diversification and interest rate risk management. System banks are allowed to use investments for the purposes of: (1) complying with the liquidity reserve requirements; (2) managing short-term cash flow needs; and (3) managing interest rate risk. The regulation establishes a ceiling on the amount of eligible investments not to exceed 30 percent of total outstanding loans and requires the banks to adopt investment policies and procedures. Although most investment activities are usually found at the bank level, associations of the System are allowed to hold investments as authorized by their supervising bank.

FCA Regulation 12 CFR Part 615, Subpart F, authorizes investments by banks in guaranteed Federal Agricultural Mortgage Corporation (Farmer Mac) securities up to 20 percent of their total outstanding loans. The 30-percent ceiling established for other investments, as mentioned above, does not apply to Farmer Mac securities. The regulation requires the adoption of policies to govern the investment practices, including exposures to interest rate risk. Although somewhat similar to other investments, the regulatory requirements for Farmer Mac securities are discussed separately in this section. **Examiners should note that the requirements for the management of other investments (Subpart E) do not pertain to Farmer Mac securities.**

The examination of investments should be conducted in conjunction with the asset review since investments may comprise a significant portion of an institution's assets. However, since investments are used for the purposes of managing interest rate risk and maintaining liquidity, the examiner should also refer to the additional guidance provided in the Liquidity and Asset/Liability Management sections of the Finance module of this manual.

This section is written primarily to address bank investment activities. It is important that each institution, whether a bank or association, has a sound investment management function tailored to fit its specific needs.

Examination Objectives

Assess the quality of management's performance in managing the investment function.

Determine if policies, internal controls, practices, and procedures regarding investments are in compliance with FCA Regulations.

Assess the risk in the institution's investment portfolio.

Investment Portfolio Management

The board of directors is responsible for ensuring that investment activities: (1) are conducted in a safe and sound manner; (2) are in accordance with written policies and procedures and FCA Regulations; (3) have appropriate controls in place; and (4) do not undermine the solvency and liquidity of the bank. The board may not delegate its responsibility to oversee and review the investment practices of the bank.

The board of directors must adopt a policy regarding the management of the bank's investments. This policy should address, at the minimum, the nine separate areas prescribed in FCA Regulation 12 CFR § 615.5133 and should be reviewed by the board on an annual basis to determine that current investment strategies are achieving the portfolio objectives. The board should also routinely review the quality and performance of all investments in the portfolio.

The banks are also responsible for monitoring and supervising the investment activities of associations. FCA Regulation 12 CFR § 615.5141 authorizes associations to hold eligible investments, subject to the bank's approval. With the exception of their investment in the banks, associations generally do not maintain large or permanent investment portfolios because excess funds are normally used to pay down direct loan balances. However, each bank is required to annually review the investment portfolios of every association in its district.

The following areas should be considered when reviewing an institution's investment policies, internal controls, and practices and procedures.

Board Policy and Risk Parameters

The first, and possibly the most important, area for review is the direction the board of directors has provided to management. A written board-approved investment policy should provide guidance on managing investment portfolio risks. In addition to meeting the requirements of FCA Regulation 12 CFR § 615.5133, the policy should provide adequate instruction to management, the investment committee, and others involved in the management of the investment portfolio regarding its:

- Purpose and Objectives--The board should clearly define the purpose and objectives of the investment function. The objectives should be measurable and clearly defined, both in general and as they relate to specific types of investments. Objectives established should also be supportive of the institution's business and capital plans.

- Portfolio Constraints--The board should establish the types and quality of investments management may purchase, as well as the size and diversification of the overall portfolio. These constraints should be established in consideration of the risk-bearing ability of the institution, liquidity needs, interest rate risk, and FCA Regulations. While the regulations establish general parameters, it is up to the board to set limits appropriate for the institution. Although generating a profit is not one of the primary purposes for investments, the board should strive to achieve the greatest return permitted by its policy and the regulations.

- Performance Criteria--The regulations establish a variety of different performance and quality criteria for different types of investments. The board should adopt these criteria at a minimum. It is likely that a System institution may adopt even more conservative criteria based on its unique situations.

- Dealer Criteria/Approved Dealer Lists--Board policy should also contain specific criteria for selection of dealers with which institution management will be allowed to transact business. After management's evaluation of possible dealers, the board should formally approve the dealer list and the amount of exposure to each dealer. The dealers on this list will then be the only dealers with which management may conduct business. The board's policy should further delineate the frequency with which management must review the dealers' status and report to the board.

- Security Safekeeping--The board should have established standards for safekeeping securities internally and with the Federal Reserve Banks. By law, banks cannot store securities with dealers.

- Reporting Criteria--The board should also have established clear reporting requirements relating to the performance of investments, the investment activity during the period, and any policy exceptions which occurred during the period. The regulations require the investment positions to be evaluated, compared to their original purpose, and reported to the board on a quarterly basis.

Internal Controls

The investment function generally involves a limited number of individuals in the institution's operations. Consequently, the need for sound controls is very important. One form of control is the separation of duties/responsibilities of the individuals involved; for example, the separation of the investment decision from the trading function and the separation of both from the reporting function. Other areas of control include the use of the following:

- Internal and External Audit--Internal and external auditors should ensure that proper controls exist and are functioning. They should check for any ineligible practices, and ascertain compliance with the investment regulations and board-approved policies and procedures. External auditors are also expected to perform work in the investment area. Examiners should use the audits performed by the internal and external auditors to set the scope for the work conducted in this area.

- Management Information System--The management information system (MIS) is an essential control that management and the board utilize to obtain quality information and to monitor the investment function between established reporting timeframes. The MIS should be sufficient to evaluate management's performance in light of the investment policy set by the board. The investment information in the MIS should be easily accessible to management, current, meaningful, and accurate.

- Reporting--Reliable reporting should be available to the board to enable monitoring of the investment function. The regulations establish the minimum expectations of FCA regarding reporting; however, these are only minimums. Reporting and analysis supporting the reports should be sufficient to provide management and the board of directors with adequate information on the investment function. The reporting should address, at a minimum:

    - Composition and levels of the investment portfolio;
    - Analysis of current investment positions in relation to original purposes;
    - Comparisons to board-established portfolio constraints;
    - Exceptions to policy and actions taken and planned to correct the exceptions;
    - Status of any ineligible investments, the conditions causing ineligibility, and divesture plans;
    - Planned investment strategies during the next reporting period; and
    - Mark to market portfolio analysis.

    The reporting should also reflect classification of investments in conformance with the Statement of Financial Accounting Standards No. 115 (SFAS 115), "Debt Securities Categories." SFAS 115 ensures proper accounting for investments by defining three categories for debt securities held in bank investment portfolios. The categories include: (1) held-to-maturity; (2) available-for-sale; and (3) trading. Securities purchased with the intent of being held to maturity are placed in the held-to-maturity account and valued on an amortized cost basis. Securities purchased with the objective of generating short-term profits are placed in the trading account. Valued at market, the unrealized gains or losses on the trading account directly impact earnings and shareholder equity. Investments that do not fall into the held-to-maturity or trading accounts are assigned to the available-for-sale account. Because System institutions are to hold investments to meet cash flow and liquidity needs, most System investments should be assigned to the available-for-sale category. Like the trading account, the available-for-sale account is valued at market; however, unrealized gains or losses only affect shareholder equity. The SFAS 115 requirement to value this category of investments at market could introduce a level of volatility on the balance sheet. Management should be expected to control the volatility with investment strategies. It is possible that some System investments could be assigned to the held-to-maturity account. Such investments require documentation that the institution has the positive interest and ability to hold the investments to maturity.

Management Process and Procedures

The investment portfolio management process is the manner in which the functional operation of buying, selling, and monitoring the institution's investments is conducted. These day-to-day decisions and actions should be: conducted within a well defined set of procedures; handled by capable, well trained staff; adequately documented; and overseen by a committee of knowledgeable individuals, as well as the board of directors.

- Procedures--Examiners should expect to find a written set of detailed procedures which are followed by those involved in the investment function. Any variances to procedures should be documented by institution staff. The basis for variances should also be documented and available for review by examiners.

- Staff--Examiners should expect staff involved in the institution's investment function to be well trained and knowledgeable professionals. Due to the rapidly changing investment environment, it is important that staff have available the tools necessary to analyze and monitor investment positions and opportunities. Examiners may see institutions seeking the advice and guidance of external parties.

- Documentation--It is imperative that all institutions document the original purpose of the investment and the analysis behind each transaction, as well as subsequent monitoring and analysis. The information maintained should be sufficient to demonstrate that the board and management have exercised prudent judgment in making investment decisions. Depending on the type of investments held, the institution may maintain investment files which indicate: the purpose for the investment; an analysis in support of the decision (including other options considered); the external analysis used and considered, such as a prospectus; and subsequent monitoring and analysis completed. FCA Regulations provide further guidance as to the level and type of documentation expected.

- Investment Committee--Depending on the significance of the institution's investment activities, examiners should expect some form of committee oversight to exist for the investment function. This committee would approve investment activities and monitor both the actions taken and the subsequent performance of the action. This committee will often be either the Asset/Liability Management Committee (ALCO) or another committee made up of some of the same members. Whatever the group makeup, there should be regular communication between it and the ALCO given that one of the regulatory approved purposes for investing is interest rate risk management. Generally, this committee would be primarily responsible for reporting to the institution's senior management and the board.

Investment Purposes

System banks are allowed to hold eligible investments, which are discussed later in this section, in an amount not to exceed 30 percent of total outstanding loans (as defined by FCA Regulation 12 CFR § 615.5131 (i)) for the purposes of:

Liquidity Reserve Requirements

Liquidity reserves are an emergency source of funds that can be drawn upon to retire maturing debt obligations, make current interest payments, and pay normal operating expenses. Liquidity reserves are needed in the event that access to capital and financial markets is impeded as a result of a financial, economic, agricultural, or national defense crisis. Banks should not use their liquidity reserves for any other purpose. FCA Regulation requires all banks to use cash and eligible investments for maintaining a liquidity reserve sufficient to fund:

- Fifty percent of the bank's bonds, notes, Farm Credit Investment bonds, and interest due within the next 90 days divided by 3;

- Fifty percent of the bank's discount notes due within the next 30 days; and

- Fifty percent of the bank's commercial bank borrowing due within the next 30 days.

The regulatory formula for calculating the reserve requirement is intended to provide an amount of liquidity sufficient to cover a reasonable period of time to allow the banks to pursue alternative sources of funding. The formula is to be calculated as of the last day of each month, utilizing monthend data. Additionally, investments that are held for the purpose of meeting the liquidity reserve requirement must be separately identified and free of lien.

The value of the assets in the liquidity reserve may fluctuate from one month to the next as the result of the timing and deliberations required for the purchase and sale of assets and liabilities. Examiners should use discretion and not unfairly criticize an institution if the value of the assets in the liquidity reserve varies from the amount prescribed by the regulation.

<u>Management of Short-term Cashflows</u>

Excess funds created during the normal course of operations may be invested until such time as maturing debt and operating expenses become due. Because the banks have daily access to funds through the sale of short-term debt instruments and have little need for holding large amounts of operating funds, these excess funds should not result in large investment positions over extended periods of time. Funds held for cashflow purposes should be justified by historical analysis of cashflow needs.

<u>Management of Interest Rate Risk</u>

Investments may be used to help manage a part of a bank's interest rate risk (IRR). FCA Regulation requires each bank to adopt an interest rate risk management section of an asset/liability management (ALM) policy which establishes interest rate exposure limits, as well as the criteria to determine compliance with these limits. The IRR management section should require the institution to identify and analyze the causes of risks within its balance sheet, measure the potential impact of these risks, and explore and implement actions needed to obtain risk management objectives. The institution is required to document the objectives to be achieved by purchasing investments for IRR management. Finally, the IRR section should require the performance of a block of the IRR management investments to be evaluated and documented at least quarterly. The investments used for IRR management may not be used for maintaining the liquidity reserve.

Eligible Investments

Regulatory restrictions are imposed on the investment portfolio composition, as well as maturity and credit rating requirements, to compel the banks to diversify risks and help ensure that only highly liquid investments with limited IRR are purchased. In general, investments should: (1) have short maturities; (2) maintain a high rating from a nationally recognized credit rating service; (3) be marketable pursuant to FCA Regulation 12 CFR § 615.5131 (j); and (4) be valuable as collateral. Where appropriate, banks are required to subscribe to at least one nationally recognized credit rating agency, such as Standard & Poors, Moody's Investor Service, Phelps Dodge, Finch, or an international credit rating service, in order to ensure the credit rating. In addition, all eligible investments must be denominated in United States dollars to avoid foreign currency exchange complications.

Other regulatory requirements have been imposed to promote diversity. With the exception of United States obligations and certain mortgage-backed securities as discussed below, banks are not allowed to invest more than 20 percent of their total capital in eligible investments issued by any single institution, issuer, or obligor. Furthermore, banks are required to perform ongoing evaluations of all such eligible investments, which should be supported by the most recent credit rating.

FCA Regulation 12 CFR § 615.5140 authorizes banks to invest in the following classes of investment instruments, with the indicated limitations and requirements:

Obligations of the United States, its Agencies, and Instrumentalities

Banks are authorized to hold obligations issued or fully guaranteed as to both principal and interest by the United States or any of its agencies or instrumentalities. Such obligations could include securities issued by the System, the Federal Home Loan Banks, the Federal Home Loan Mortgage Corporation (FHLMC), the Federal National Mortgage Association (FNMA), and the Tennessee Valley Authority. Some securities issued by the Small Business Administration (SBA) may be eligible investments as obligations of the United States. Others may qualify as mortgage-backed securities or as "other investments," as discussed below; however, some SBA securities may be ineligible. Banks should be vigilant so that they do not purchase or hold SBA securities that are not backed by the full faith and credit of the United States. Mortgage-backed securities issued by an instrumentality of the United States would not be included in this section because they must meet the requirements discussed below.

Other than the 30-percent ceiling for the total investment portfolio, no restrictions on the percentage of Federal obligations held are imposed as these obligations are inherently safe and sound. If the investment transactions are properly executed and the instruments are properly safeguarded, such obligations are considered to pose virtually no risk of default.

Mortgage-Backed Securities

The term "mortgage-backed securities" refers to securities backed by mortgages. A mortgage-backed security (MBS) represents a fractional undivided interest in a specific pool of mortgages. The mortgages in the pool collateralize the MBS. As the mortgages in the pool are repaid, both principal and interest payments are passed through to the investor in proportion to the investor's ownership interest in that pool. Each MBS has a stated maturity date, a weighted average life (WAL), and a coupon rate.

Collateralized Mortgage Obligations (CMOs) and Real Estate Mortgage Investment Conduits (REMICs) are derivative products of MBSs. A CMO is a multi-class pay-through bond representing a general obligation of the issuer backed by mortgage collateral. A REMIC is a nontaxable entity formed for the sole purpose of holding a fixed pool of mortgages secured by an interest in real property and issuing multiple classes of interests in the underlying mortgages.

Banks are authorized to hold MBSs, CMOs, and REMICs that are: (1) issued by the Government National Mortgage Association (GNMA) or backed by mortgages that are guaranteed as to both principal and interest by the full faith and credit of the United States; or (2) issued by and guaranteed as to both principal and interest by FNMA or FHLMC, and rated no lower than AAA. MBSs, CMOs, and REMICs that are issued by GNMA or are backed by mortgages that are guaranteed by the United States are not subject to portfolio amount restrictions; however, MBSs, CMOs, and REMICs that are issued or guaranteed by FNMA or FHLMC are not allowed to exceed 50 percent of the bank's total investment portfolio.

As investments, certain threshold requirements have been imposed for adjustable-rate mortgages (ARMs) and fixed-rate mortgages that back these securities. ARMs that back eligible securities shall have a repricing mechanism of 12-months or less tied to an index. Fixed-rate MBSs, CMOs, and REMICs must meet the three conditions cited in FCA Regulation 12 CFR § 615.5140(a)(2)(iii) at the time of purchase and each quarter thereafter. Banks are also allowed to invest in floating-rate CMOs. A floating-rate CMO is not subject to the first two above-mentioned regulatory conditions concerning the WAL if at the time of purchase, or each subsequent quarter, it bears an interest rate below the contractual cap on the instrument; however, a floating-rate CMO is subject to the third condition concerning the estimated change in price. Inverse floating rate debt class investments and stripped MBSs, including Interest Only and Principal Only classes, are not eligible for investment purposes.

World Bank

International Bank for Reconstruction and Development obligations must be denominated in dollars.

Bankers Acceptances

Bankers acceptances (BAs) are collateralized debt instruments issued by commercial banks. Collateral requirements for acceptances that are traded in the market are established by regulations issued by the Federal Reserve Board. Generally, the collateral is a fungible, or easily exchangeable, product. Sale of the collateral is the primary source of repayment. A BA is created when an obligor draws a draft on its depository bank. The draft and the necessary collateral documents are presented to the commercial bank. This bank "accepts" the draft by stamping "accepted" on its face. This accepted draft is then a negotiable instrument that can be sold in the marketplace. The bank's acceptance of the draft represents its promise to pay if the obligor is unable to do so. BAs are not to exceed 30 percent of a bank's total investment portfolio.

Negotiable Certificates of Deposit

These negotiable instruments represent deposits in commercial banks and thrift institutions and are evidenced by a definitive or book-entry form. A certificate of deposit (CD) is negotiable if the instrument contains no restrictions on its transferability. They are typically sold in $100,000 denominations with any maturity over 7 days. The obligor on these instruments is the commercial bank or thrift institution in which the funds were deposited.

Most CDs purchased are classified into three types: domestic CDs, which are issued by domestic institutions; Eurodollar (or Asian dollar) CDs, which are denominated in United States dollars but issued outside the United States; and Yankee CDs, which are issued by foreign bank branches in the United States and denominated in United States dollars. CDs held for investment purposes are limited to 25 percent of a bank's total investment portfolio and must mature within 1 year or less. To the extent that a domestic, Yankee, or Eurodollar CD is not insured by an agency of a Federal or national Government, FCA requires the depository institution to maintain at least a B/C or equivalent rating. Additionally, the foreign country where Eurodollar CDs are held is required to maintain an AAA rating for both economic and political stability.

Federal Funds Sold

Federal funds sold are excess reserves above reserve requirements held in a Federally insured depository institution. To attain a return on these excess reserves, the institution will lend them to other banks which need to meet reserve requirements or which need an additional funding source. Most transactions are done overnight because of the unpredictability of the amount of excess funds a bank may have from day to day. However, term Federal funds sold, or Federal funds sold for periods exceeding 1 day (generally 2 days to 1 year), may be written.

The banks are authorized to sell Federal funds and term Federal funds which mature within 1 business day to a maximum maturity of 100 days subject to a callable contract. The Federal funds must be sold to federally insured depository institutions that maintain a rating no lower than B/C, or with other Government-Sponsored Enterprises. Federal funds sold cannot exceed 25 percent of the total investment portfolio.

Prime Commercial Paper

The term "commercial paper," which includes finance paper, represents a secured or unsecured promissory note which matures within a timeframe that is usually less than 270 days. The difference between commercial and finance paper is determined by the issuer of the debt obligation. Commercial paper is issued by commercial corporations, such as public utilities and manufacturers, while finance paper is issued by financial intermediaries, such as financial and insurance companies. Commercial paper may be issued by both domestic and foreign corporations and is customarily backed by unused bank lines of credit sufficient to repay the liability.

The banks are authorized to hold only prime commercial paper rated P-1 or A-1, not to exceed 30 percent of the total investment portfolio. In cases where the commercial paper is issued by a foreign corporation, the country is required to maintain a AAA rating for both economic and political stability.

Corporate Debt Obligations and Asset-Backed Securities

Corporate debt obligations are corporate bonds issued as debt securities of a corporation. Corporate bonds may be secured or unsecured and usually have a higher yield than Government or agency bonds because of their relatively greater credit risk. Corporate debt must be registered under the Securities Act of 1933, unless it is exempted from registration as a private placement. Privately placed corporate debt is not an eligible investment.

Asset-backed securities (ABSs) provide for ownership of a fractional undivided interest, or collateral interests, in specific assets of a trust that are sold and traded in the capital markets. ABSs are usually backed by collateral other than real estate mortgages.

Because these instruments pose a relatively greater credit risk, banks are authorized to hold corporate debt obligations and ABSs that meet specific criteria. To be eligible, corporate debt must: (1) qualify as a marketable investment; (2) mature within 5 years or less from the time of purchase; (3) not be convertible into equity securities; and (4) maintain at least a rating of AA, and, when applicable, the foreign country maintains a AAA rating for political and economic stability. Only those ABSs that are secured by either credit card receivables or automobile loans are eligible and they must: (1) mature with in 5 years or less from the time of purchase; and (2) maintain at least a AAA rating. Additionally, corporate debt and ABSs cannot represent more than 15 percent of the total investment portfolio. These limitations do not apply to a Bank for Cooperatives' purchase of an ownership interest in a foreign business entity that facilitates the export or import of agricultural products.

Repurchase Agreements

A repurchase agreement involves securities purchased under agreement to resell back to the initial seller at a future date for a specified price. The seller of the security continues to receive all interest and principal payments on the security, while the purchaser receives a fixed rate of interest on the short-term investment. Repurchase agreements are considered, in effect, secured loans unless the purchaser does not take the appropriate steps to perfect an interest in the collateral.

The banks are authorized to purchase securities under agreement to resell only on those eligible investments listed in this section that mature within 100 days or less.

State Obligations

State obligations include the full faith and credit obligations of a State, municipality, or political subdivision, including any agency, corporation, or instrumentality associated with the aforementioned. These obligations must be rated A or better, mature within 10 years, and be readily marketable.

Other Investments

Because new financial instruments are constantly being developed which may be suitable for investment purposes, banks are authorized to hold other investments subject to FCA approval. In addition to FCA approval, the other investments must: (1) have short maturities; (2) be marketable; and (3) maintain a high rating. FCA will determine on a case-by-case basis whether a new financial instrument meets regulatory requirements.

Disposal of Ineligible Investments

Investments that are not listed above or that do not comply with the required credit ratings and maturity deadlines are ineligible. Furthermore, an investment portfolio that exceeds the percentage limitation of 30 percent of gross loans is not in compliance with FCA Regulations. Banks are required to dispose of all prohibited investments within 6 months from the date the investment regulations became effective. Additionally, banks must dispose of investments that were eligible at the time of purchase, but subsequently became ineligible, within 6 months after the date that the investment became ineligible. However, if divestiture would create a financial hardship, the bank may submit a plan to divest itself of the ineligible investments. The plan must be in writing and submitted prior to the end of the 6-month period. The FCA Director of the Office of Examination must approve the plan. A satisfactory plan would enable a bank to divest ineligible investments as soon as possible, without substantial loss. Prior to the time that an investment is divested, management should report to the board of directors, at least quarterly, the status of the investment, the conditions causing ineligibility, and divestiture plans.

Federal Agricultural Mortgage Corporation Securities

In addition to Class B common stock, FCA Regulation 12 CFR Part 615, Subpart F, authorizes banks to purchase and hold mortgage-related securities issued or guaranteed by the Federal Agricultural Mortgage Corporation (Farmer Mac). The eligible mortgage-related securities include MBSs, CMOs, and REMICs, as defined above, that are issued and guaranteed as to both principal and interest by Farmer Mac. The mortgage-related securities may not exceed 20 percent of the total loans of the institution and must be backed by either adjustable rate mortgages or fixed-rate mortgages. The 20 percent ceiling for Farmer Mac securities is above and beyond the 30-percent ceiling for other investments. Stripped MBSs, including Interest Only and Principal Only classes, are not eligible. The board of directors must adopt policies and procedures for purchasing, holding, and managing Farmer Mac securities. The policy should address, at a minimum, the eight items required by the regulation, in addition to the three items regarding the management of IRR inherent in Farmer Mac securities. The board should receive quarterly reports about performance and should, on an annual basis, review the policies, procedures, and performance of Farmer Mac securities.

Investment Risk Assessment

The limitations on eligible investments should result in a relatively conservative investment portfolio. If the institution is in compliance with the regulatory provisions and its own policies, and if the investment portfolio is adequately managed, the investments will usually meet the criteria for an Acceptable classification. However, in certain circumstances, investments can meet the criteria of a less than acceptable asset. Even with the limitations imposed by the regulations, the investment portfolios are subject to the following risks:

- Market risk--a possible reduction in value resulting from changes in market demand;
- Interest rate risk--a possible reduction in value resulting from increases in interest rate;
- Credit risk--a possible loss or reduction in value if the issuer defaults or the financial condition of the issuer deteriorates; and
- Operational risk--a possible loss due to failure to execute transactions properly or to safeguard investment instruments.

Therefore, when investments are classified by the examiner, they should be classified according to the credit classification standards provided in the asset classifications section of this module.

Examination Procedures

Examiners must exercise judgment when reviewing the investment function. Such factors as the size of the institution and complexity and volume of investment activities should be considered. The institution's policy, internal controls, and practices and procedures regarding purchases, sales, and servicing of the investment portfolio should be reviewed. The investment function should be documented in a complete, concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information. The most recent monthend list of the investment portfolio should also be reviewed to determine compliance with the regulations.

The following examination procedures are provided to assist examiners in reviewing investment policies, internal controls, practices, and procedures, and in assessing an institution's performance in managing its investment function. Consistent with risk-based examination principles, examiners should add, delete, or modify procedures as needed based on the particular circumstances of the institution.

Examiners should also coordinate their examination activities with other members of the examination team and the examiner-in-charge (EIC). Emphasis should be on identifying how examination findings in other areas impact the review, ensuring sufficient work is completed to support conclusions, and avoiding duplication of examination effort.

1. Determine that the board of directors, consistent with its duties and responsibilities, has adopted a written investment policy that:

    a. Clearly defines, in measurable terms, the purpose and objective of the investment function and specific types of investments.

    b. Addresses liquidity needs.

    c. Addresses interest rate risk management.

    d. Provides specific guidelines for permissible brokers, dealers, and institutions to be used in the purchase of investments and establishes dealer exposure limits.

    e. Establishes the size and quality of the investment portfolio.

    f. Provides diversification guidelines to prevent undue concentration.

    g. Establishes permissible types of investments, maturity schedules, and quality ratings that, at a minimum, comply with FCA Regulation 12 CFR § 615.5140.

    h. Delegates authority to manage investment to specific personnel or committees and clearly defines the extent of the authority and the responsibilities.

    i. Provides controls to monitor the performance of investments and requirements for security safekeeping.

    j. Requires at least quarterly reporting on the performance of investments.

2. Determine that the board of directors has assumed the responsibilities of ensuring that investment activities are conducted in a safe and sound manner with appropriate controls in place; are in accordance with written policies and procedures; and do not undermine solvency and liquidity. Determine if:

    a. The board of directors reviews the investment policy and the objectives and performance of the investment portfolio on an annual basis.

    b. The bank board of directors annually reviews the investment portfolios of each association in its district.

    c. Bank and association staff brief the board of directors on investment practices and results.

    d. There is regular communication between the Investment and Asset/Liability Management Committees if they are not the same committee.

3. Review the internal controls established for the investment function and determine if the controls are adequate. Consider if:

    a. The internal and external audits ensure that proper controls exist and are functioning.

    b. The internal audit reviews the investment function annually.

c. The MIS is adequate for monitoring and reporting on investment activities.

d. Limitations of authority are imposed on the Investment Committee and individual officers.

e. Security transactions require dual authorization.

f. Security records are reconciled to the general ledger by a third party not directly connected with the processing or recording of securities transactions.

g. Third parties review investments and report valuation changes to the board of directors or the Investment Committee and management.

h. Security price checks are done by a confirmed third party not directly connected with processing or recording securities transactions.

4. Determine if procedures for delivery, receipt, and storage of securities provide adequate controls. Consider if the following procedures are required and adhered to:

   a. Purchase confirmations are compared to the actual securities or safekeeping receipt.

   b. Brokers' receipts are verified to support all transactions by a third party.

   c. The preparation and posting of subsidiary records are performed or reviewed by persons who do not also have sole custody of securities.

   d. The custodian of securities is precluded from:

      - Having sole physical access to securities;
      - Preparing release documents without the approval of authorized persons;
      - Preparing release documents not subsequently examined or tested by a second custodian; and
      - Performing more than one of the following transactions: execution of trades; receipt or delivery of securities; or receipt and disbursement of proceeds.

5. Evaluate the investment process and procedures to determine if they are well defined, detailed, and followed by those involved in the investment function. Consider if:

   a. Variances to investment procedures are documented with the basis for the variance explained.

   b. The staff involved in the investment function are adequately trained and knowledgeable.

   c. The staff involved in the investment function receive reports adequate to monitor investment activities.

6. Review the most recent monthend list of the investment portfolio to determine that:

   a. Investments are eligible under FCA Regulations and board policy.

   b. The institution took appropriate action in accordance with FCA Regulation 12 CFR § 615.5142 on any ineligible investments.

7. Review investment files to determine that the following items are adequately documented:

   a. Each investment's original purpose.

   b. Analysis supporting the decision and demonstrating that the board of directors and management exercised prudent judgment in making the investment decision.

c. The external analysis used and considered in making the investment decision.

d. Monitoring and analysis of the investment subsequent to the investment transaction.

e. Who in the institution gave approval for each security.

8. Through a review of the recent monthend list of the investment portfolio, investment files, and other pertinent information, determine that:

   a. All dealers used were included on the institution's approved list.

   b. Investments are properly accounted for in accordance with SFAS 115.

9. If fixed-rate MBSs, CMOs, REMICs, and floating-rate CMOs are held by the institution, determine that the instruments satisfy the following three tests at the time of purchase and each quarter thereafter:

   a. The expected WAL of the instrument does not exceed 5 years.

   b. The expected WAL does not extend for more than 2 years assuming an immediate and sustained parallel shift in the yield curve of plus 300 basis points, nor shorten for more than 3 years assuming an immediate and sustained parallel shift in the yield curve of minus 300 basis points.

   c. The estimated change in price is not more than 10 percent due to an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points.

10. If floating-rate CMOs are held by the institution, determine that:

    a. At the time of purchase, or each subsequent quarter, the CMOs bear a rate of interest that is below the contractual cap on the instrument.

    b. If the interest rate is not below the contractual cap on the instrument, the CMOs meet the tests stated in procedures 9a and 9b above.

    c. The estimated change in price is not more than 10 percent due to an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points.

11. If fixed-rate MBSs, CMOs, REMICs, and floating-rate CMOs are held by the institution, determine that:

    a. The institution relies on verifiable information to support all assumptions concerning the collateral mortgages that back the security.

    b. All assumptions that form the basis for the analysis of the security and its underlying collateral are available for review.

    c. Subsequent changes in assumptions are documented in writing.

    d. The analysis of each security is performed prior to purchase and each quarter subsequent to purchase.

    e. The institution took appropriate action in accordance with FCA Regulation 12 CFR § 615.5142 on any ineligible MBSs, CMOs, and REMICs.

12. If Farmer Mac mortgage-related securities are held by the institution, determine that:

a. The mortgage-related securities are eligible and do not exceed 20 percent of total loans.

b. The board of directors has adopted policies and procedures that address, at a minimum:

- Purpose and objectives;
- Parameters concerning size, characteristics, and quality;
- Delegation of authority to specific personnel or committees, including the extent of authority and responsibility;
- Permissible brokers, dealers, and other intermediaries;
- Controls to monitor performance;
- Management of IRR;
- Procedures to prevent losses to capital and earnings; and
- Procedures for the orderly sales of the securities prior to maturity.

c. The board of directors has adequately managed IRR in the Farmer Mac securities and has adopted a policy for IRR management that complies with regulatory requirements.

13. Examine the institution's investments to determine the overall quality and degree of credit risk in the investment portfolio.

14. Conclude on the adequacy of management's performance in managing the investment function, the quality of the investment portfolio, and compliance with FCA investment regulations.

15. Discuss items of concern, scope of work performed, and conclusions with the EIC and with the appropriate institution manager. Obtain a response regarding the cause(s) of deficiencies or weaknesses and anticipated corrective actions.

16. Discuss tentative conclusions and examination findings with examiners assigned areas which may be affected by the findings.

17. Prepare a leadsheet or other summary document to provide workpaper support for the work performed and the conclusions reached.