Farm Credit Administration
Examination Workpaper

Investment Policies and Procedures

Institution Name: SCD:

NOTE: The online FCA Handbook is in process of being updated for the new investment regulations that became effective on January 1, 2019. Until that occurs, the links below will open the prior version of the regulations. In the interim, please refer to the Federal Register Notices for the final rule (83 FR 27486) and related correction (83 FR 30833) to view the new regulations.

Refer to the *Policy & Procedures* procedure in the Investments Examination Manual section for additional guidance on evaluating the quality of investment policies and procedures. Policy and procedures should be sufficiently detailed and commensurate with the amounts, types, and risk characteristics of the institution's investments.

Note: The questions below apply to both banks and associations unless clearly designated as relevant to only banks or only associations. Service corporations that engage in investment activities would need to meet the same policy and procedure requirements that apply to their owner-institution(s).

Question	Response	Comment
1. Do policies define the purposes and objectives of holding investments? 615.5133(b) *Note:* • *For associations, 615.5140(b)(1) states associations are authorized to hold investments only for the purpose of managing risks.* • *For banks, 615.5132(a) states banks are authorized to hold investments only for the purposes of liquidity, managing surplus short-term funds, and managing interest rate risk.* • *For banks and associations, policies or procedures should prohibit holding investments primarily for the purposes of speculating or generating gains from trading or otherwise make it clear that such purposes are not authorized. Such purposes are impermissible and inconsistent with regulatory authorities as discussed in the preamble to the 2018 investment rule. Institutions may generate earnings and build capital from investments so long as it is incidental and secondary to an authorized purpose.*		
2. *For associations*, do policies limit the types of eligible investments to securities that are issued by, or are unconditionally guaranteed or insured as to the timely payment of principal and interest by, the U.S. Government or its agencies as defined in 615.5140(b)(1)? 615.5133(c), BL-064 *Note: Association policies must also be consistent with 615.5140(b)(2), which states that U.S. Government-guaranteed loans purchased in the secondary market [that are not securitized or reported as investments] are ineligible under regulatory investment authorities.*		

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Question	Response	Comment
3. *For banks*, do policies limit the types of eligible investments to those listed in 615.5140(a)? 615.5133(c), BL-064 *Note: Bank policies must also be consistent with the following:* • *Resecuritizations that are not guaranteed by the U.S. Government or a government-sponsored enterprise (GSE) are ineligible unless individually approved by FCA under 615.5140(e). 615.5140(a)(2)* • *As discussed in the preamble to the 2018 investment rule, there is a presumption that private placement securities are not liquid, although they may be appropriate in limited circumstances. Consistent with the preamble, such investments must be approved by FCA through provisions in 615.5140(e).* • *For mortgage-backed securities (MBS) and asset-backed securities (ABS) that are not government or GSE-guaranteed, the bank is limited to holding only the senior-most position. A position is considered senior-most only if no other remaining position in the securitization has priority in liquidation. This senior-most criterion does not apply to priority of cash flows prior to default. Positions that have junior priority to claims on contractual cash flows in the ordinary course of business can still meet this senior-most criterion, so long as they retain a senior claim when defaults occur and credit support is depleted. (MBS and ABS purchased prior to January 1, 2019 are grandfathered and exempt from this requirement.)*		
4. Do policies or procedures describe prohibited or unsuitable investment types and practices (per board philosophy)? Sound Business Practice *Note: Defining unsuitable investments is a sound business practice that significantly helps clarify the limits of activities authorized by the board.*		
5. If the institution holds or plans on holding investments in Farmer Mac (FAMC) securities, do policies address the following: [615.5174](615.5174)		
a. Objectives for holding FAMC securities? *Note: Institutions are authorized to hold FAMC securities for the purposes of managing credit and interest rate risks and furthering their mission to finance agriculture.*		
b. Regulatory limit on volume of FAMC securities? *Note: 615.5174(a) limits the total value of FAMC securities to 100 percent of total outstanding loans (loans are defined in [615.5131](615.5131)).*		
c. Credit risk parameters on the following: o Quantities and types of FAMC mortgage securities collateralized by qualified agricultural mortgages, rural home loans, and loans guaranteed by the Farm Service Agency? o Product and geographic diversification for the loans that underlie the security? o Minimum pool size, minimum number of loans in each pool, and maximum allowable premiums or discounts on these securities?		

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Question	Response	Comment
d. Liquidity risk tolerance and the liquidity characteristics of FAMC securities that are suitable to meet institutional objectives? *Note: A bank may not include FAMC mortgage securities in its liquidity reserve.*		
e. Market risk limits based on risk to capital and earnings?		
f. Expectations for completing stress testing, in accordance with the requirements in 615.5133(h)(1)(iii) and (h)(4), on mortgage securities issued or guaranteed by FAMC that are backed by loans the institution did not originate? *Note: Stress testing is not required if FAMC securities are backed by loans the institution originated.*		
6. Risk tolerance and limits: 615.5133 *Note: Risk limits should be consistent with the objectives for holding investments, strategies for achieving those objectives, and the unique risks in the portfolio. Accordingly, institution policies may differ in how they address the requirements in this section. For example, for rows 6.a., 6.b., and 6.d. below, which refer to limits and requirements on credit risk, the cited regulations apply to both banks and associations. Since associations are limited to holding only U.S. Government guaranteed securities, credit risk is generally not a significant risk, so there may not be a need for credit risk requirements. The regulatory citations in these three rows would be applicable at associations that acquire a significant amount of non-government guaranteed securities under 615.5140(e), or purchase securities at a premium that would require immediate amortization if the security defaults and is recovered at par from the guarantor. Row 6.c. is applicable regardless of whether the securities held are guaranteed.*		
a. Do policies establish credit quality standards for single or related obligors, sponsors, secured and unsecured exposures, and asset classes or obligations with similar characteristics? 615.5133(c)(1)(i)		
b. Do policies establish concentration limits for single or related obligors, sponsors, geographical areas, industries, unsecured exposures, and asset classes or obligations with similar characteristics? 615.5133(c)(1)(ii)		
c. Do policies require the institution to buy and sell investments with more than one securities firm, and define the criteria for selecting brokers and dealers? 615.5133(c)(1)(iii)		
d. To the extent the institution engages in repurchase agreements, do policies address collateral margin requirements, require collateral be valued at fair market value regularly, and include appropriate controls over collateral? 615.5133(c)(1)(iv)		
e. Do policies set market risk limits for each type of investment as well as the investment portfolio? 615.5133(c)(2)		
f. <u>*For banks*</u>, do policies describe the liquidity characteristics of investments that the bank will hold to meet its liquidity needs and		

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	other objectives? 615.5133(c)(3)(i)		
g.	*For associations*, do policies describe the liquidity characteristics of investments that will be held? 615.5133(c)(3)(ii)		
h.	*For associations*, do policies limit investments to 10 percent of total outstanding loans? 615.5140(b)(4), 615.5133(c)		
i.	*For banks*, do policies limit investments to 35 percent of total outstanding loans? 615.5132(a), 615.5133(c)		
j.	*For banks*, do policies require the investment portfolio be well-diversified, which means that, at minimum, investments are comprised of different asset classes, maturities, industries, geographic areas, and obligors? 615.5133(f)(1) and (2)		
k.	*For banks*, do policies limit concentrations in any one asset class to 15 percent of the investment portfolio? 615.5133(f)(2) *Note 1: Money market instruments and investments that are fully guaranteed by the U.S. Government or a GSE are exempt from this limit.* *Note 2: Measurement of this diversification requirement must be based on the portfolio valued at amortized cost.*		
l.	*For banks*, do policies limit concentrations in MBS guaranteed by GSEs (excluding Farmer Mac securities) to 50 percent of the investment portfolio? 615.5133(f)(3)(ii)		
m.	*For banks*, do policies limit exposure to any one obligor to 10 percent of total regulatory capital? 615.5133(b) and (g) *Note: Investments that are fully guaranteed by the U.S. Government or a GSE are exempt from this limit.*		
n.	Do policies or procedures establish limits or guidelines on the maximum price premium that can be paid when purchasing securities? Sound Business Practice *Note: Large premiums can result in significant prepayment and market risks.*		
o.	*For banks*, do policies or procedures establish limits or guidelines on the underlying collateral for non-agency MBS and ABS securities, such as collateral type, minimum pool size, geographic diversification, underwriting requirements (e.g., loan-to-value, FICO score), and prepayment restrictions? Sound Business Practice *Note: Such factors significantly impact credit risk.*		
p.	If investment holdings contain significant unique risks that are not addressed by the above risk and concentration limits, do policies establish risk limits targeting the unique risks? Sound Business Practice		

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Question			Response	Comment
7.	Do policies address the following pre-purchase due diligence requirements: 615.5133(b)			
	a.	Analysis to ensure eligibility and compliance with board policy as addressed in 615.5133(h)(1)(i)?		
	b.	Analysis of credit, country, liquidity, market, and interest rate risks, including underlying collateral, as applicable, to ensure compliance with 615.5133(h)(1)(iii)?		
8.	Do policies require the institution's due diligence to include verifying fair market values of investments with an independent source prior to purchase (unless it is a new issue) and prior to sale, and updating values at least monthly on each investment and the overall portfolio? 615.5133(b), 615.5133(h)(1)(ii), (2), and (5) *Note: While not specifically required by regulations, the process for obtaining reliable estimates of fair market value should also be clearly defined in policies or procedures.*			
9.	Do policies address due diligence processes for monitoring and evaluating changes in the credit quality of individual investments and the overall portfolio on an ongoing basis? 615.5133(b), 615.5133(h)(3) *Note: This is applicable at associations that hold a significant amount of non-government guaranteed securities under 615.5140(e), or purchase securities at a premium that would require immediate amortization if the security defaults and is recovered at par from the guarantor.*			
10.	Stress Testing: *Note: In applying and documenting in policy the following regulatory requirements, the quarterly stress tests (and any pre-purchase stress tests) must at minimum address price sensitivity. Beyond this minimum requirement, stress testing should be commensurate with the unique risks, complexity, structure, cash flows, purpose for holding investments, and size of the portfolio. For example, if the portfolio is exposed to significant premium risk from prepayments, stress tests should be expanded to address that risk. If the portfolio is held for liquidity or designated available-for-sale, stress tests must address price sensitivity of each investment as well as the overall portfolio. If the portfolio is held for the purpose of diversifying various balance sheet risks and is designated held-to-maturity, price sensitivity of the overall portfolio must still be measured each quarter, but stress testing each individual investment could be less frequent or not needed depending on unique characteristics and risks.*			
	a.	Do policies require that the pre-purchase due diligence include stress testing on structured investments with uncertain cash flows prior to purchase, including all MBS and ABS securities? 615.5133(b), 615.5133(h)(1)(iii)		
	b.	Do policies require that each investment and the overall portfolio be stress-tested at the end of each quarter and a plan developed if risk exceeds investment policy limits? 615.5133(b), 615.5133(h)(4)(i)		

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	c. Do policies define the stress tests that will be performed, including parameters (i.e., risk limits on stress test results) for the security types purchased? 615.5133(b), 615.5133(h)(4)(ii)		
11.	<u>*For banks*</u>, on securitizations that tranche credit risk, do policies address the following due diligence requirements: 615.5133(b), 628.41(c) *Note: If the bank does not demonstrate a comprehensive understanding of these exposures and comply with the following requirements, it must assign a 1,250 percent risk weight to the security under the risk-based capital measurement. The bank is not required to complete separate due diligence under 628.41(c) to the extent it overlaps 615.5133(b).*		
	a. Pre-purchase analysis of structural features of the securitization that would materially impact the performance (e.g., contractual cash flow waterfall, waterfall-related triggers, credit enhancements, liquidity enhancements, fair value triggers, the performance of organizations that service the exposure, and deal-specific definitions of default)?		
	b. Pre-purchase analysis of the performance of underlying credit exposures (e.g., past dues, default rates, prepayment rates, foreclosures, property types, occupancy, average credit scores, average loan-to-value ratios, and industry and geographic diversification)?		
	c. Pre-purchase analysis of market data (e.g., bid-ask spread, sales price, historic price volatility, trading volume, implied market rating, and market size, depth, and concentration)?		
	d. At least a quarterly evaluation, review, and update of the above analysis for each securitization exposure, as appropriate?		
12.	Do policies or procedures address the due diligence, reporting, and approvals required before expanding into new types and classes of investments? Sound Business Practice *Note: Expanding into new types of investments (particularly complex investments) must be done with caution and after sufficient research to understand characteristics and risks. Policies or procedures should address this process.*		
13.	Do policies or procedures define a standardized template or other tool for documenting due diligence on individual investment purchases to ensure all relevant information is documented and analyzed in accordance with policy, procedure, and regulatory requirements? BL-064, Sound Business Practice		
14.	<u>*For banks*</u>, do policies or procedures define the ongoing process for testing and measuring security impairment, and define mechanisms for escalating reviews and due diligence on investments with deteriorating credit quality or increasing risks (e.g., watch lists)? Sound Business Practice *Note 1: After the Current Expected Credit Loss (CECL) accounting standard is implemented, institutions will be required to establish an allowance as opposed to*		

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	recognizing other-than-temporary impairment on impaired securities. *Note 2: <u>Associations</u> may also need to establish a process for measuring security impairment if they acquire a significant amount of non-guaranteed securities under 615.5140(e).*		
15.	Operational risk and internal controls: 615.5133(b), (c)(4), (d), and (e) *Note: 615.5133(b) requires that policies address delegations of authority and internal controls. 615.5133(c)(4) requires that policies address operational risks, including delegations of authority and internal controls under 615.5133(d) and (e). The questions below address each of these items, along with some additional key controls to ensure compliance with other regulations.*		
	a. Do policies address audit requirements and require at least annual audits of investment operations?		
	b. Do policies address delegated authorities?		
	c. Do policies address controls to detect and prevent loss, fraud, embezzlement, conflicts of interest, and unauthorized investments?		
	d. Do policies require separation of duties consistent with regulatory requirements?		
	e. Do policies address records and information system requirements?		
	f. Do policies or procedures define the processes related to divesting or continuing to hold investments that are ineligible, no longer satisfy the conditions of FCA approval, or have become unsuitable under board policy? *Note: The defined process needs to ensure compliance with 615.5143.*		
	g. *<u>For associations</u>*, do policies or procedures establish control processes for complying with the 615.5140(b)(5) requirement for obtaining bank approval before engaging in investment activities or making significant changes in investment strategy?		
	h. *<u>For banks</u>*, do policies or procedures establish control processes for supervising association investment activities, and are the defined processes consistent with the requirements in 615.5140(b)(5)?		
16.	If the institution holds or plans on holding investments that require FCA approval under 615.5140(e), do policies or procedures address processes for obtaining FCA approval and monitoring compliance with any conditions of approval? Sound Business Practice		
17.	Do policies address board reporting requirements? 615.5133(b) *Note: 615.5133(i) identifies specific items that must be reported to the board or designated committee at least quarterly. Also, 615.5174(b) requires quarterly reports to the board on the performance of all investments in FAMC securities.*		

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Question		Response	Comment
18.	Does the board (or a designated committee of the board) require and complete a review of investment policies at least annually? 615.5133(a), 615.5174(b)		

Other Comments:

This workpaper is not intended to create any rights, substantive or procedural, enforceable at law or in any administrative proceeding. While the workpaper was carefully reviewed for applicability and accuracy, changes may occur in the wording or interpretation of laws and regulations. If a situation arises where the workpaper becomes inconsistent with applicable laws or regulations, the requirement of the laws or regulations will prevail. Examination scope may vary between institutions. On a particular examination activity, the workpaper may not pertain to all factual situations or interpretations, additional concerns or issues may be addressed that are not covered in the workpaper, and some portions of the workpaper may not be used.