

**Proposed Regulation No. 1 – Investment Securities**

**ACTION:** Notice of Extension of Comment Period on Proposed Rulemaking – Amendments to the Alabama Banking Board Regulation No. 1 – Investment Securities

---

**SUMMARY:** On August 24, 2012, the Superintendent of Banks solicited comments on proposed amendments to the existing Alabama Banking Board Regulation No. 1 (“Regulation 1”). Broadly, the proposed amendments to Regulation 1 represent a complete revision of the Regulation while maintaining the principles of acceptable credit quality contained in the current Regulation. Those comments were due on or before October 15, 2012. Many thoughtful and constructive comments were received by the Superintendent during that comment period; however, Superintendent of Banks John D. Harrison wishes to provide interested parties more time in which to submit additional comments on the proposed Regulation No. 1. Consequently, the Superintendent has extended the comment period to November 9, 2012. Additional comments should be submitted on or before November 9, 2012.

The following is a link to the original Notice of Proposed Rulemaking that describes the proposed amendments to Regulation 1 and to a summary of the issues and questions raised during the initial comment period through October 15, 2012:

[http://www.banking.alabama.gov/Regulations\\_Banking\\_Proposed2.aspx](http://www.banking.alabama.gov/Regulations_Banking_Proposed2.aspx)

**DATES:** Comments must be received on or before November 9, 2012.

**ADDRESS:** Comments may be submitted through the Alabama Banking Department website at [www.banking.alabama.gov](http://www.banking.alabama.gov). There are links for review of and comments on specific proposed regulations on the home page. Alternatively, comments may be e-mailed directly to [comments.reg1@banking.alabama.gov](mailto:comments.reg1@banking.alabama.gov). Comments may also be mailed to John D. Harrison, Superintendent of Banks, State of Alabama, State Banking Department, Post Office Box 4600, Montgomery, AL 36103 or faxed to John D. Harrison, Superintendent of Banks at 334-242-3500.

**FOR FURTHER INFORMATION CONTACT:** Deputy Superintendent Trabo Reed at 334-242-3452 or by e-mail at [Trabo.reed@banking.alabama.gov](mailto:Trabo.reed@banking.alabama.gov).

**Proposed Regulation No. 1 – Investment Securities**

**ACTION: Notice of Proposed Rulemaking – Amendments to the Alabama Banking Board Regulation No. 1 – Investment Securities**

---

**SUMMARY:** The Superintendent of Banks solicits comments on proposed amendments to the existing Alabama Banking Board Regulation No. 1 (“Regulation 1”) which: a) specifies investments suitable for Alabama, State-chartered banks, b) requires maintenance of credit information and documentation on investments, c) requires that banks’ investment securities that are rated by a nationally recognized rating service be rated in one of the four highest rating bands, and d) specifies that the ratings of any of four accepted rating services (Moody’s, Standard & Poor’s, Fitch, or Duff & Phelps) may be used to demonstrate credit worthiness of investments. Broadly, the proposed amendments to Regulation 1 represent a complete revision of the Regulation while maintaining the principles of acceptable credit quality contained in the current Regulation. In general, the changes reflected in the proposed Regulation:

1. Place substantial responsibility on banks’ boards of directors for establishing and maintaining sound corporate governance over banks’ investment functions and require robust credit risk management programs for all banks’ investment activities;
2. Specify eligible types of investments permitted for banks under the proposed Regulation;
3. Prohibit certain types of investments and place limits on certain types of eligible investments;
4. Delineate the characteristics of investment quality and sub-investment quality securities and the factors that, at a minimum, would be considered in adverse classification of investment securities;
5. Specify the methods of treatment of adversely classified and sub-investment securities on banks’ books;
6. Provide special requirements for the use of derivatives and the policies and documentation required for derivative positions; and
7. Allow investments in Community Development Securities within specified limits.

**DATES:** Comments must be received on or before October 15, 2012.

**ADDRESS:** Comments may be submitted through the Alabama Banking Department website at [www.banking.alabama.gov](http://www.banking.alabama.gov). There are links for review of and comments on specific proposed regulations on the home page. Alternatively, comments may be e-mailed directly to [comments.reg1@banking.alabama.gov](mailto:comments.reg1@banking.alabama.gov). Comments may also be mailed to John D. Harrison, Superintendent of Banks, State of Alabama, State Banking Department, Post Office Box 4600, Montgomery, AL 36103 or faxed to John D. Harrison, Superintendent of Banks at 334-242-3500.

**FOR FURTHER INFORMATION CONTACT:** Deputy Superintendent Trabo Reed at 334-242-3452 or by e-mail at [Trabo.reed@banking.alabama.gov](mailto:Trabo.reed@banking.alabama.gov).

Proposed Regulation

## I. Background

Whereas, Section 5-2A-9 of the Alabama Banking Code specifies the procedures for adoption, amendment, or repeal of any regulation promulgated by the Superintendent of Banks, with the concurrence of the State Banking Board, pursuant to Section 5-2A-8; this notice of intended action to amend the Alabama State Banking Board Regulation No. 1 (“Regulation 1”) is hereby provided.

As noted, the changes to Regulation 1 represent a complete revision of the Regulation while maintaining the principles of acceptable credit quality contained in the current Regulation.

In part, this revision of Regulation 1 is needed due to provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) that reduce over-reliance on ratings by credit rating agencies and encourages investors and federal bank regulators to conduct their own analyses of investments. Consequently, the proposed Regulation requires consideration of credit ratings as only one of the factors in investment analysis, underwriting, and classification by State examiners.

Of equal importance, the current Regulation needs updating. It is old, and in some respects, it is outdated. The current Regulation was adopted in 1977, and it was last amended in 1991. Significant revision is required to bring the Regulation up to date with current investment types and practices.

The proposed Regulation is organized into five sections dealing with the following issues and subjects:

1. Corporate Governance – which outlines the responsibilities of banks’ boards of directors for establishing and maintaining sound corporate governance over banks’ investment functions and requires specific, robust credit risk management programs and procedures for all banks’ investment activities;
2. Eligible Types of Securities – which specifies eligible types of investments permitted for banks under the proposed Regulation and which prohibits certain types of investments and places limits on certain types of eligible investments;
3. Classification of Securities – which details the characteristics of investment quality and sub-investment quality securities and the factors that, at a minimum, would be considered in adverse classification of investment securities, and which specifies the treatment of adversely classified and sub-investment securities at examinations and on banks’ books;
4. Derivatives – which provides special requirements for the use of derivatives and the policies and documentation required for derivative positions; and

5. Community Development Securities – which defines Community Development Securities and allows investments in those securities within specified limits.

## II. Proposed Changes

The following discussion covers what the Department believes are the major, substantive provisions, changes and additions to the Regulation. It does not cover all, word-for-word changes. If a commenter is interested in looking at such word-for-word changes, it is recommended that they obtain a copy of the current Regulation No. 1 at:

[http://www.bank.state.al.us/pdfs/Regulations/Banking/Reg\\_1.pdf](http://www.bank.state.al.us/pdfs/Regulations/Banking/Reg_1.pdf)

### Page 1, Section 1. a. – Corporate Governance Requirements

This Section requires that banks' boards be knowledgeable of the investment portfolios and the risk characteristics thereof. The Section also prohibits excessive reliance on broker/dealers and restricts the role of broker/dealers in presenting information and making recommendations to boards or committees. There is no similar requirement in the current Regulation.

### Page 1, Section 1. b. – Corporate Governance Requirements – Investment Policy

This Section requires banks' boards to establish and annually review and approve investment policies which contain the minimum provisions established by this proposed Regulation. Footnote 1 to this Section, on page 2, contains capital definitions used for investment limits specified later in the proposed Regulation. There is no similar requirement in the current Regulation.

### Page 2, Section 1. c. – Corporate Governance Requirements – Credit Risk Management

This Section requires the establishment of a robust credit risk management program suitable for size, complexity and risks associated with each bank's investment activities. It specifies required pre-purchase, underwriting procedures and analysis. It states explicitly that external credit ratings should not be the sole underwriting criteria. It also requires that banks evaluating purchase of asset-backed and other securities should determine whether the security and its underlying assets (loans) would be permitted by the bank's own lending policies if such asset were booked directly by the bank. The pre-purchase underwriting requirements of the current Regulation are expanded upon by this Section.

The latter two requirements mentioned above were placed in the proposed Regulation to: a) reduce banks' reliance on credit rating agencies and require their independent pre-purchase underwriting based on analysis of all pertinent factors and b) discourage banks from loading up their books with securities backed by pools of sub-prime mortgages or other low-quality assets that would not meet the underwriting criteria in the banks' own loan policies.

Page 3, Section 1. d. – Corporate Governance Requirements – Quarterly and Annual Board Investment Portfolio Reviews

This Section requires quarterly reviews of the quality, liquidity, structure, and performance of the investment portfolio. The quarterly reviews may be performed by the board or a committee thereof. An annual review by the entire board is required. The Section requires, at a minimum, review of specific items and factors. There is no similar requirement in the current Regulation.

Pages 3 and 4, Section 2. – Eligible Types of Securities

This Section of the proposed Regulation lists the eligible types of investment securities as does the current Regulation; however, the list is expanded in the proposed Regulation and contains limits on certain types of investments. Specifically, the current and proposed Regulation authorize United States and U.S. Agency obligations, State, county and municipal obligations, and obligations of publicly held private corporations. However, for private corporations, the proposed Regulation places a limit of 10 percent of the bank's capital invested in the obligations of a single obligor. This limit parallels the unsecured lending limit contained in Alabama Banking Board Regulation No. 14. In footnote 2 on page 3, a grandfather provision is included dealing with existing investments that may exceed the new limits in the proposed Regulation.

Beginning on page 4 (Sections 2. A. iv. - viii), the proposed Regulation also adds several types of securities as eligible that are not specifically listed in the current Regulation. Several of these eligible investments have specific per-obligor and aggregate investment limits. Among these are BOLI and TRUPS investments.

Page 5, Sections 2. a. ix., x. and xi. – Eligible Types of Securities – Prohibitions and Required Approval

Section 2. a. ix. adds an explicit prohibition on equity securities which is not contained in the current Regulation; however, this equity security prohibition has been a long-held

interpretation of the Department. Two exceptions to this prohibition are defined in the proposed Regulation.

Section 2. a. x. discusses the treatment of investments received for debts previously contracted (“DPC”). This general policy is contained in the current Regulation; however, the proposed Regulation adds language covering the holding of bank or bank holding company stock received for DPC in accordance with §5-5A-27 of the Alabama Banking Code.

Section 2. a. xi. of the proposed Regulation adds a provision requiring advance approval of the Superintendent for purchase of investments not specifically listed as eligible. No such approval provision exists in the current Regulation.

#### Page 5, Section 3. – Classification of Securities

Section 3. a., beginning on page 5, defines characteristics of investment quality and sub-investment quality securities. The language of the current Regulation for the basic requirement for a security to be considered investment quality is retained in this Section of the proposed Regulation. That basic requirement is “there is adequate evidence that the obligor will be able to perform all that it undertakes to perform in connection with the security, including debt service requirements...” This Section also defines characteristics of sub-investment quality securities and states that there will be a presumption that a rated security that is not rated in the top four rating bands is sub-investment quality. The listing of these characteristics is not contained in the current Regulation. Also, the position of the current Regulation regarding ratings is changed because, in the proposed Regulation, the rating is not the final determinant of whether a security is sub-investment quality. Banks have the opportunity to present other information to demonstrate that the security is, in fact, investment quality and should not be adversely classified in a Report of Examination. Conversely, State examiners may no longer justify the adverse classification of a security by simply stating that the security is rated below the four highest rating bands. State examiners, under the proposed Regulation, should evaluate all available financial and other information when determining and justifying a security’s classification.

Section 3. b., on page 6, specifies the treatment of sub-investment quality securities in Reports of Examination and the requirements for classification and loss recognition by banks on sub-investment quality securities. There are no similar provisions in the current Regulation.

#### Page 7, Section 4. – Derivatives

This Section of the proposed Regulation is entirely new and is included due to the increasing use of derivatives for hedging purposes by Alabama, State-chartered banks since the adoption of the current Regulation in 1977.

#### Page 7, Section 4. a. – Derivatives – Hedging Practices, Reliance on Broker/Dealers, Trading and Portfolio Hedging Prohibitions

This Section requires that banks engaged in using derivatives for hedging do so: 1) as part of an overall strategy, 2) with adequate and knowledgeable staffing to monitor positions, 3) with simulations and stress testing, and 4) adequate board and committee consideration of the strategy's and positions' benefits and risks. Trading in derivatives is strictly prohibited as is excessive reliance upon advice of broker/dealers from whom the positions are purchased. By Footnote 5 on page 7, portfolio hedging of credit risk is prohibited, although portfolio hedging of interest rate risk and hedging of credit risk in specific individual exposures are permitted. It should be noted that, in connection with the "Volcker Rule" adopted in Dodd-Frank, there has been considerable discussion and controversy regarding the need for prohibitions on portfolio hedging. The Department takes the position that, in relation to credit risk hedges, only hedging of specific individual credit exposures is appropriate and can be effectively managed for bank and legal credit exposure limit purposes.

#### Page 7, Section 4. b. – Derivatives – Policy Requirements

This Section outlines minimum requirements for bank policy on the use of derivatives.

#### Page 7, Section 4. c. – Derivatives – Documentation Requirements

This Section states the minimum documentation required on each derivative position including analysis and a statement, made upon entering into a derivative transaction, as to the compliance of the derivative position with the credit risk limits contained in Alabama Banking Board Regulation No. 14.

#### Page 8, Section 5. – Community Development Securities

This Section of the proposed Regulation roughly corresponds to provision 5 of the current Regulation that allows investment in "Leeway Securities." In the current Regulation, Leeway Securities are defined as securities designated by a federal regulator that "...are securities of corporations which are engaged in providing capital to minority business enterprises, securities of foreign governments, or the securities of corporations which are not

merely private and entrepreneurial but whose objectives and purposes are primarily of a civic or community nature or seem socially desirable.” The current Regulation establishes a limit for such investments of 10 percent of the investing bank’s total capital accounts.

The proposed Regulation essentially keeps the definition used in the current Regulation but uses the term “Community Development Securities” for such investments and drops the requirement of official designation by a federal regulator. It also lists some specific examples such as investments in housing and historic tax credits, housing development and small business investment corporations. The proposed Regulation drops the aggregate limit on these types of investments to five percent of the investing bank’s capital (as defined previously in the proposed Regulation). Comment is specifically requested as to whether the reduced limit on these investments is appropriate or whether the limit should be increased or provision should be made for approval of such investments exceeding the limit.

### **III. Effective Date**

The proposed changes to Regulation No. 1 shall become effective January 1, 2013. Prior to such changes becoming effective, however, the Superintendent shall have fully considered all comments received on or before October 15, 2012, and obtained the concurrence of the Alabama State Banking Board.

Proposed Regulation

## **Proposed Regulation No. 1**

### **Investment Securities**

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

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

**NOW THEREFORE**, be it known that the State Banking Board in official meeting assembled on \_\_\_\_\_, does hereby promulgate the following regulation:

#### **1. Corporate Governance**

- a. The investment authority within a bank originates with the board of directors. The directors should be knowledgeable of the bank's investments and the specific risk characteristics associated with the investment portfolio. Furthermore, the board of directors and bank management shall not place excessive reliance upon the advice of a broker/dealer regarding the purchase and management of specific investments or the portfolio as a whole. It is the responsibility of the board to direct Asset-Liability and/or Investment committee meetings with management primarily responsible for presenting information and making recommendations. Broker/dealers and representatives from the bank's correspondent bank may be present, but they shall not conduct the meetings.
- b. A bank's board of directors shall establish and annually review and approve an investment policy that provides guidance to its investment officer, investment committee, and/or Asset-Liability Management Committee. The investment policy, at a minimum, shall establish the following:
  - i. Overall investment portfolio purpose and goals
  - ii. Authorized investments and activities
  - iii. Parameters and risk limits to identify, measure, monitor, and control all risks associated with the investment activity including, but not limited to, concentration risk, credit risk, liquidity risk, and interest rate risk

- iv. Acceptable investment portfolio limits as a percent of Capital<sup>1</sup> and Total Assets
  - v. Acceptable investment portfolio limits as a percent of brokered deposits and other non-core deposit funding sources, which may be used to leverage the investment portfolio and the balance sheet
  - vi. Individual purchase and concentration investment authority limits for investment officers and/or investment committees, as well as, internal controls for monitoring activity compared to the defined limits
  - vii. Board approval for opening broker/dealer relationships where securities will be purchased or held for safekeeping, along with annual reviews of investment relationships insuring compliance with Federal Reserve Board Regulation F: Limitations on Interbank Liabilities (12 CFR 206), as well as, reports as to the volume of purchases and sales for each broker/dealer, percentage of portfolio purchased from each broker/dealer, and the amount and percentage of sub-investment quality securities purchased from each broker/dealer
- c. A bank's board of directors shall establish a robust credit risk management program to support the investment activities of the bank that reflects the size, complexity, quality, and risk characteristics of the investment portfolio, the risk appetite and policies of the institution, and the quality of its credit risk management staff. The program shall have appropriate pre-acquisition credit due diligence performed by qualified bank staff, and shall be based upon, at a minimum, an analysis of the payment capacity of the issuer, the structural complexity of the security, the type of collateral or underlying assets, debt service requirements, and external credit ratings, if rated, resulting in the assignment of an appropriate internal risk rating. The security and the underlying assets, if any, should be underwritten in such a manner to meet the lending standards and policies of the bank. However, investment decisions shall not be based entirely upon external credit ratings by acceptable credit rating agencies listed in Appendix 1. Internal risk ratings should be reviewed at least

---

<sup>1</sup> The definition of Capital for State Banking Board Regulation 1 is the same as the definition contained in State Banking Board Regulation 14, Section 1, and includes: capital stock, surplus, undivided profits, subordinated capital notes or debentures, and the allowance for loan and lease losses. Reserves for contingencies that are not set aside to cover any specific expected losses may also be included. Specific contingency reserves and unrealized gains or losses on debt securities available for sale are not to be included. However, limits for investments in Bank Owned Life Insurance (BOLI) products in this regulation are stated as a percent of Tier 1 Capital in accordance with the Interagency Statement on the Purchase and Risk Management of Life Insurance (FIL-127-2004) and the definition of Tier 1 Capital shall be the same as that contained in the Federal Financial Institutions Examination Council (FFIEC) Instructions for Preparation of Consolidated Reports of Condition and Income (Call Report Instructions), Schedule RC-R, Regulatory Capital.

annually and updated no later than the end of the quarter when the bank receives significant new information, and reported quarterly to the board or a committee thereof.

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

## 2. Eligible Types of Securities

- a. The following are considered eligible types of securities for investment<sup>2</sup>; however, specific investments within these general securities types should be governed by the risk management guidance provided in this regulation:
  - i. Any bond, note, bill, or obligation of the United States Government or a U.S. Government Agency
  - ii. Any marketable<sup>3</sup> obligation of a state, or of any political subdivision of a state, including obligations of a county; city; township; other municipal corporation; board of education; public authority, board, corporation, or any public entity organized by authorization or determination by any

---

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

<sup>3</sup> Marketable Securities means any equity or debt instrument that has a quoted price, and can be readily bought or sold at a price reflective of an actually traded market for the particular asset class.

- municipality or municipalities or county or counties or the governing body of any one or more thereof
- iii. Any marketable debt obligation or contract obligation of a publicly held private corporation including, but not limited to, Credit Default Swaps (CDS). These obligations shall be limited to 10 percent of Capital to any single issuer.
  - iv. Any contract obligation, including but not limited to, Bank Owned Life Insurance (BOLI). These obligations shall be limited to 10 percent of Tier 1 Capital to any single issuer. Total BOLI investments are limited to 25 percent of Tier 1 Capital in accordance with the FFIEC Interagency Statement on the Purchase and Risk Management of Life Insurance (FIL-127-2004).
  - v. Federal Reserve Bank debt
  - vi. Federal Home Loan Bank, Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and other U.S. Government Sponsored Entities' debt, including pass-thru residential and commercial mortgage backed securities. Prior to purchase, management shall ensure that the security is not going to conflict with concentration limits related to collateral types, locations, cash flows, or other inherent concentrations within the overall balance sheet structure.
  - vii. Collateralized Mortgage Obligations (CMO), Collateralized Debt Obligations (CDO), Real Estate Mortgage Investment Conduits (REMIC), Asset Backed Securities (ABS), and any other holding of private label residential or commercial mortgage backed securities. Prior to purchase, the bank shall ensure and document that the bank has adequate and knowledgeable staffing to understand and investigate the underlying borrowers and collateral to ensure that the security is not going to conflict with concentration limits related to collateral types, location, cash flows, or other inherent concentrations within the overall balance sheet structure. In addition, the underlying loans and assets of these securities shall be underwritten in such a manner to meet the lending standards and policies of the bank.
  - viii. Single Issuer Trust Preferred Securities (TPS). Prior to purchase, the bank shall document an analysis of the current financial condition of the underlying obligor which includes, but is not limited to, current and projected industry conditions. Investments in single issuer TPS shall not exceed 10 percent of the purchasing bank's Capital to any single issuer, with an overall aggregate limit of 25 percent of purchasing bank's Capital

on total TPS investments. Investment in TPS pools are specifically excluded as an eligible investment.

- ix. Equity investments are specifically prohibited for investment by a bank with the following exceptions:
  - 1. Equity stock investments in a Federal Reserve Bank, a Federal Home Loan Bank, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or U.S. Government Sponsored Entities (GSE) required for membership or access to various overnight, term, and other structured temporary funding sources. Preferred stock is specifically excluded as an eligible investment. Combined equity investments in all such entities are limited to 10 percent of Capital.
  - 2. Equity investments in bank service corporations are limited to 10 percent of capital for non-wholly owned corporations.
- x. Other obligations and equity investments are not acceptable unless received for debts previously contracted. When such non-acceptable obligations are received for debts previously contracted, they must be disposed of within two years from the date of receipt. Bank stock or bank holding company stock received for debts previously contracted must be disposed of within one year from the date of receipt, unless prior approval is received from the Superintendent in accordance with §5-5A-27 of the Alabama Banking Code.
- xi. Any bank intending to purchase an investment not specifically listed must receive prior written approval from the Superintendent.

### **3. Classification of Securities**

- a. Investment quality securities are marketable securities in which the investment characteristics are not distinctly or predominantly speculative, for which there is adequate evidence that the obligor will be able to perform all that it undertakes to perform in connection with the security, including all debt service requirements, and which do not exhibit other weaknesses that justify an adverse classification rating<sup>4</sup>. For any rated security where the most recent rating by any of the accepted credit rating agencies is not in the top four ratings bands, there shall be a presumption that the security is sub-investment quality, and the bank

---

<sup>4</sup> Definitions of adverse classifications for investment securities are contained in the Uniform Agreement on the Classification of Assets and Appraisal of Securities held by Banks and Thrifts, dated June 15, 2004, or any related regulatory guidance that supersedes this Uniform Agreement.

holding the security must demonstrate that the security is not sub-investment grade, or the security shall be adversely classified for Report of Examination purposes. Sub-investment quality securities may also exhibit any of the following characteristics:

- i. Defaulted, illiquid, or unmarketable status
- ii. Investment characteristics that are distinctly or predominantly speculative
- iii. Inadequate protection by current sound worth or paying capacity of the obligor or collateral pledged, if any
- iv. Well-defined weakness or weaknesses that jeopardize the liquidation of the debt
- v. Distinct possibility that the bank will sustain some loss if the deficiencies are not corrected

b. Adverse Classifications

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

#### 4. Derivatives

- a. These investments shall only be used as a part of an overall hedging strategy, where the risks associated with specific assets or liabilities are being hedged<sup>5</sup>. Derivatives trading activity is inconsistent with all regulatory guidance, and will be considered an unsafe and unsound practice. Total or excessive reliance upon broker/dealer advice regarding the purchase and management of derivative positions is unacceptable and will be the subject of criticism during regulatory examinations. The bank's board of directors shall insure and document that the bank has adequate and knowledgeable staffing to understand, investigate, and alter/modify investment positions. Prior to purchase, any hedging position must be simulated and stressed for the effects to net interest income (NII) and the economic value of equity (EVE). Subsequent simulations must show the effects to NII and EVE with and without the hedge in place. The bank's board of directors and the Asset-Liability Committee minutes should reflect sound risk management practices evidenced by discussions of hedging strategy, benefits, and risks.
- b. The bank's board of directors should establish policies for the use of derivatives, either as part of the investment policy or separately, that includes, at a minimum, the following:
  - i. Designated individuals authorized to execute transactions and limits of authority
  - ii. Position limits
  - iii. Maturity parameters
  - iv. Approved counterparties and clearing houses
  - v. Counterparty credit guidelines and collateral requirements
  - vi. Procedures for the monitoring of collateral positions
  - vii. Guidelines for effectiveness testing
- c. The bank shall maintain files to support each derivative position that includes, at a minimum, the following:
  - i. Executed International Swap and Derivatives Association (ISDA) agreement
  - ii. Hedge description and objective
  - iii. Hedge Designation, either Cash Flow or Fair Value
  - iv. FAS 133 Statement of Compliance

---

<sup>5</sup> Under this regulation, credit risk portfolio hedging is not permitted; however, credit risk hedging against specific individual exposures is permitted. No such prohibition on the hedging of portfolio interest rate risk is intended provided that the other risk management requirements of this regulation are followed.

- v. Analysis of and statement regarding compliance with derivative, counterparty credit risk limits contained in Alabama Banking Board Regulation No. 14
- vi. Transaction summary
  - 1. Notional amount
  - 2. Fixed rate
  - 3. Variable rate and corresponding index
  - 4. Maturity date
  - 5. Payment dates
- vii. Effectiveness testing and measurement guidelines
- viii. Fair value measurements

## **5. Community Development Securities**

- a. Community Development Securities are securities of corporations which are engaged in providing capital to minority business enterprises, securities of foreign governments, or the securities of corporations which are not merely private and entrepreneurial, but whose objectives and purposes are primarily of a civic or community nature, or seem socially desirable including, but not limited to, housing tax credits, historic tax credits, housing developments, and small business investment corporations. Aggregate investments in Community Development Securities of all obligors shall not exceed 5 percent of capital, and must be identified as Community Development Securities in the official minutes of the bank's board of directors.

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

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

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

Moody’s Investor Services (Moody’s)

Fitch Ratings (Fitch)

DBRS (Dominion Bond Rating Service)

Kroll Bond Rating Agency (KBRA)

Proposed Regulation