ALABAMA STATE BANKING DEPARTMENT **December 17, 2012**

Regulation No. 1 – Investment Securities

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

SUMMARY: The Superintendent of Banks, with the concurrence of the State Banking Board assembled on December 7, 2012, has amended Regulation No. 1 ("Regulation 1") which specifies investments suitable for Alabama, State-chartered banks and requires maintenance of credit information and documentation on investments. Broadly, the final amendments to Regulation 1 represent a complete revision of the Regulation while maintaining the principles of acceptable credit quality contained in the existing Regulation. In general, the changes reflected in the final Regulation No 1:

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 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 and Bank-Owned Life Insurance within specified limits.

EFFECTIVE DATE: January 1, 2013

FOR FURTHER INFORMATION CONTACT: Deputy Superintendent Trabo Reed by telephone at 334-242-3452, by mail at State of Alabama, State Banking Department, Post Office Box 4600, Montgomery, AL 36103 or by e-mail at Trabo.reed@banking.alabama.gov.

SUPPLEMENTARY INFORMATION:

I. Background

On August 24, 2012, the Superintendent of Banks solicited comments on proposed amendments to the existing Regulation No. 1. Those comments were due on or before October 15, 2012. Subsequently, the Superintendent extended the comment period to November 9, 2012.

Many thoughtful and constructive comments were received by the Superintendent during the comment period, and several of the comments and suggestions for improvement in the proposal have been adopted in the final Regulation No. 1. In the following section of this Notice, the comments and the responses to those comments are discussed.

As noted, the final Regulation No. 1 represents a complete revision of the Regulation while maintaining the principles of acceptable credit quality contained in the existing Regulation.

In part, this revision of Regulation No. 1 was 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 existing Regulation needed updating. The existing Regulation was adopted in 1977, and it was last amended in 1991. Significant revision was required to bring the Regulation up to date with current investment types and practices.

The final Regulation No. 1 is organized into six 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.
6. Bank-Owned Life Insurance ("BOLI") – which emphasizes the requirements for management of BOLI contained in existing guidance and places limits on the amounts purchased from a single issuer and the overall holdings of BOLI from all issuers.

II. Comments and Response

General Comments

Scope of Regulation and Parity with Federal Regulations

- We received comments that suggested the proposed Regulation adopted a "one-size-fits-all" approach that failed to acknowledge the full spectrum of risk management governance that may exist from bank to bank.

  We believe that this comment was primarily related to the corporate governance and investment risk management requirements of the proposed Regulation; however, we did not directly address this comment with changes to the final Regulation No. 1. We believe that the corporate governance and risk management requirements of the final Regulation No. 1 are consistent with existing regulatory guidance and industry best practices. We believe that the adoption of this final Regulation No. 1 will not significantly impose more sophisticated or complicated investment management practices than most banks, whether they are community or regional banks, currently employ. We do believe that the final Regulation No. 1 will help ensure that bank boards of directors are adequately informed of investment portfolio practices and positions and that such practices and positions are appropriately analyzed and documented. The final Regulation No. 1 also, through its dropping of rating agency ratings as the sole and final determinants of whether a security is considered to be sub-investment quality, allows more case-by-case analysis and consideration of individual banks' positions.

- We received general comments, as well as comments on specific provisions, that the proposed Regulation was stricter than the regulations of the Office of the Comptroller of the Currency ("OCC").

  There are certain provisions of the final Regulation No. 1 that include more stringent requirements than similar regulations by federal regulators. These additional requirements are included intentionally as safeguards.

  Among those is a prohibition on proprietary derivatives trading activity. This provision also includes a requirement that, before engaging in any type of portfolio hedging or hedging of aggregate exposures for credit risk, banks must seek the permission of the Superintendent.

  Similarly, the final Regulation No. 1 includes limits for certain investments such as BOLI that are more stringent than federal guidance. The single-issuer, general account limit on BOLI is set at 10 percent of Tier 1 Capital plus the allowance for loan and lease losses, and an aggregate BOLI limit is set at 25 percent of Tier 1 Capital plus the allowance for loan and lease losses. The federal interagency guidance contains suggested, prudent limits at 15 and 25 percent respectively.

  Perhaps, the most significant difference between OCC regulations and the final Regulation No. 1 is caused by the fact that the federal bank regulatory agencies were required under Dodd-Frank to eliminate any reliance upon or reference to ratings of external credit rating agencies.

  In the final Regulation No. 1, we retain a presumption that a security may be sub-investment quality if a security's most recent rating by an external credit rating agency is not in the top four ratings banks. This, however, is not the final determinant, and banks may present information to show that their particular holding of the security is not, in fact, sub-investment quality. Similarly, examiners can no longer use a rating by an external credit rating agency as the sole justification for adversely classifying the security.

<u>Corporate Governance</u>

<u>Board Reporting and Responsibility</u>

- We received comments that the proposed regulation contained prescriptive guidance that dictated the frequency of reporting, but did not ensure the quality of reporting to the board.

We did not alter the board reporting requirements of the proposed Regulation in the final Regulation No. 1 due our interest in helping ensure that boards of directors are adequately informed and aware of their banks' portfolio positions and investment practices. The quality of information flow to boards of directors will be reviewed during the normal examination process going forward.

- We received a comment that the proposed Regulation placed excessive burden on banks' boards of directors and less reliance on appropriate management committees.

  We did not change our emphasis on the information flow to boards and on board responsibility for oversight of banks' investment activities in the final Regulation No. 1; however, we want to make clear that the role of boards is one of setting policy, risk limits, and directing management based upon accurate and complete information.

- We received a request to clarify the appropriate role of broker/dealers in a board or committee meeting at which investment decisions are made. A number of commenters questioned provisions of the proposed Regulation that seemed to prohibit a broker's, dealer's or consultant's participation in those meetings.

  We revised the language in the final Regulation No. 1 to make clear that boards of directors and committees may receive reports and recommendations from broker/dealers or third-party consultants, but the boards and committees may not rely solely on such advice and must retain their responsibilities for making the final investment and portfolio management decisions.

Internal Risk Rating and Post-acquisition Analysis of Investment Securities

- We received several comments concerning the proposed Regulation's requirement for banks to maintain an internal risk rating system. The comments centered around the difficulty of maintaining such an independent rating system over a large number of differing securities as well as questions concerning whether such a rating system should be as extensive as that required for loans.
  The final Regulation No. 1 makes clear that banks should conduct and maintain adequate documentation of pre and post-purchase analysis of investments, but that no internal risk rating system for investment securities is required.

- We received comments that, in some cases, bankers have very little time in which to do pre-purchase analysis of investments, particularly municipal securities, before needing to act to purchase those securities.

  We believe that bankers should require the broker/dealer selling a security to provide sufficient information in order for the banker to make an informed purchase decision. We believe that broker/dealers have the ability to provide such information. Consequently, the requirements for pre-purchase analysis are not altered in the final Regulation No. 1. We do believe that such pre-purchase analysis will not require significantly more time than current, prudent industry practice. The requirement will, however, require adequate documentation of the information considered prior to purchase.

- We also received a significant number of comments that banks encounter inability to obtain updated financial information needed to properly perform post-purchase analysis of smaller municipal issuers.

  We have recognized that banks may encounter this difficulty with regards to smaller municipal issuers. Consequently, in the final Regulation No. 1, we have modified the post-purchase analysis requirement on these securities to allow a bank to document that it has made a best effort to obtain the needed information.

<u>Eligible Types of Securities</u>

<u>Certificates of Deposit and Bankers Acceptances</u>

- We received a request that certificates of deposit and bankers acceptances be included as eligible investments under the Regulation.

  We have included bankers acceptances and certificates of deposit as eligible types of investments in the final Regulation No. 1, and we have also included a requirement that, for certificates of deposit exceeding the FDIC insurance limit, underwriting be performed as with any other security.

<u>Pooled Trust Preferred Securities (“Pooled TPS”)</u>

- We received a comment questioning the exclusion of Pooled TPS as eligible investments in the proposed Regulation.

  We retained the exclusion of Pooled TPS in the final Regulation No. 1 due to the difficulties encountered prior to and during the recent financial crisis in being able to properly underwrite and adequately ensure performance of such Pooled TPS issues.

Preferred Stock

- We received a comment questioning the proposed Regulation's exclusion of preferred stock as an eligible investment. The commenter noted that the OCC allows investments in preferred stock if the preferred stock issue has the characteristics of debt.

  We have modified the final Regulation No. 1 to include preferred stock as an eligible investment if the preferred stock issue has the characteristics of debt.

Investments in Bank Service Corporations

- We received a question as to whether bank operating subsidiaries would be subject to the 10 percent of capital limit for bank investment in bank service corporations.

  The answer to this is generally no if the bank holds a majority ownership interest in the operating subsidiary. We have retained the 10 percent limit in the final Regulation No. 1, but the limit is for investments in corporations that are not wholly owned. Consequently, most bank operating subsidiaries, being wholly owned, would not be subject to the limit. Also, majority-owned operating subsidiaries would not generally be considered as "investments" subject to Regulation No. 1 since they would be consolidated with the bank for Call Report purposes.

  The final Regulation No. 1 has put in place a permissive limit where none existed in the previous Regulation. Prior to the adoption of the final Regulation No. 1, banks had to get explicit authorization from the Superintendent for any minority investment in a Bank Service Corporation. Investments up to 10 percent of Capital are now authorized by the final Regulation No. 1 eliminating the need for banks to obtain specific, written authorization from the Superintendent. This provision now allows, within the 10 percent limit, bank investment in Bank Service Corporations such as cooperative title insurance agencies. A bank wishing to make a minority investment in a Bank Service Corporation that exceeds 10 percent of the bank's Capital will still need to seek specific, written authorization for such investment from the Superintendent.

Equity Investments

- The question arose during the comment period as to whether the proposed Regulation's prohibition on equity (common stock) investments would apply to banks purchases of stock in a Bankers' Bank.

The final Regulation No. 1 retains the prohibition on equity investments for banks. Consequently, this prohibition applies to investments in Bankers' Banks as it does to equity investments in any other corporation. We noted, during the comment period, that some banks had been unaware of our long-held interpretation of this prohibition. Also, bank stock and bank holding company stock may only be held by a bank for debts previously contracted per Section 5-5A-27 of the Alabama Banking Code.

We noted, during the comment period, that a handful of banks may currently hold equity investments (as part of their membership) in Bankers' Banks. Consequently, we will consider such existing investments to be grandfathered under the provisions of the final Regulation No. 1. We do, however, want to reiterate our long-held position that a bank may not make a direct, equity investment in a Bankers' Bank. Such investments may only be made, subject to Federal Reserve authority, at the holding company level.

Municipal Securities - Definition of Marketable Obligation and Marketable Securities

- The proposed Regulation stated that "marketable" obligations of states and their political subdivisions are considered to be eligible investments. We received a request that "marketable" be defined.

  A definition of "marketable" and Marketable Securities is included in the final Regulation No. 1 that states that a Marketable Security is an equity or debt instrument that has a market value as determined by reliable and continuously available price quotations.

- We similarly received a question as to whether a municipal obligation that is structured as a bond but had characteristics of a loan would be considered a "marketable" investment subject to Regulation No. 1.

  We did not directly address the question under the final Regulation No. 1; however, whether a municipal obligation is structured as an investment security or a loan is somewhat dependent upon the obligation's marketability. Regardless, the municipal obligation that is considered to be a loan because it is not "marketable" under this investment Regulation would be considered as an exception to the credit exposure limits under Regulation No. 14 if it represents a general obligation of a state or political subdivision.

Asset-Backed Securities (ABS)

- The proposed Regulation indicated that holdings of Collateralized Mortgage Obligations (CMOs), Collateralized Debt Obligations (CDOs), Real Estate Mortgage Investment Securities (REMICs) and other types of Asset-Backed Securities (ABS) should meet the same underwriting criteria in force at a bank as if the bank had underwritten and booked the assets underlying the ABS directly as loans in its own loan portfolio. We received comments that this requirement failed to recognize additional risk mitigation provided by credit enhancements and other characteristics present in an ABS issue which would not be present to mitigate risk in a single loan booked by the bank.

  We recognized the validity of this comment and changed the language in the final Regulation No. 1 to require that, in the pre-purchase analysis and annual review of such investments, banks (and their boards) should review the holdings of such ABS backed by assets which would not comply with the bank's lending policies and understand whether the credit enhancements or other risk mitigation characteristics of the ABS holdings are sufficient. The absolute prohibition on purchasing such ABS backed by underlying assets that the bank could not make directly as loans is dropped in the final Regulation No. 1.

Classification of Securities

Sub-Investment Quality Securities

- We received a question as to whether non-rated securities would automatically be considered to be sub-investment quality.

  We have made no changes to the final Regulation No. 1, but want to make clear that the final Regulation No. 1 does not consider non-rated securities, by nature, to be sub-investment quality. As under the existing Regulation, all a bank needs to do is maintain sufficient information in file to demonstrate that the obligor will be able to perform all that it has undertaken to perform with the security.

- We also received a suggestion that, for a given security, a set number of ratings by external credit rating agencies should be required before the security is considered to be sub-investment quality.

  We did not change the wording of the final Regulation No. 1 as a result of this suggestion. We have had issues in the past where downgrades by certain credit rating agencies lagged reviews by the other agencies. Since this has been an issue,

we chose to retain the presumption that a security may be sub-investment quality upon its being downgraded to sub-investment quality by any one credit rating agency. We don't consider this to be a major issue; however, since the final Regulation No. 1 does not allow ratings by external credit rating agencies to be the final say in whether a security is considered sub-investment quality and adversely classified by examiners. Banks will have ample opportunity to present information to show that a given security is, in fact, investment quality. Examiners will no longer be able to use a rating by an external credit rating agency as the sole justification for adversely classifying a security.

<u>Adverse Classification of Securities</u>

- We received a comment that pointed out the new federal, interagency guidance is expected to be issued dealing with the exclusion of reliance on the credit rating agencies.

  We retained the clause in the final Regulation No. 1 that there would be a presumption that a security may be sub-investment quality if it is rated sub-investment quality by one of the rating agencies. However, as noted in the Regulation and above, a rating by an external credit rating agency will not be the final determinant or justification of whether a security is adversely classified.

- We received a question asking what will be required to demonstrate that a security is not sub-investment grade.

  We felt that the language in the proposed Regulation adequately stated the answer to this question and the language in the final Regulation No. 1 has not been changed or expanded upon in response. The bottom line on a bank showing that a security is not sub-investment grade is that it be able to show that the obligor on a given security will be able to perform all that it has undertaken to perform in connection with the security's issuance.

- We received a comment that the proposed Regulation's requirements were inconsistent with existing guidance on the write down of impairment and did not allow for the separation of credit and market related impairment.

  We have revised the discussion of impairment write-downs in the final Regulation No. 1 to be consistent with existing guidance.

Derivatives

- We received a comment that the prohibition on derivatives trading contained in the proposed Regulation should distinguish between proprietary derivatives trading and certain client accommodation derivatives activities that are also considered to be trading.

  In response to this comment, we have restated the prohibition to cover only proprietary derivatives trading activity. Client accommodation derivatives activities that are considered to be trading activities are not prohibited.

- We also received a comment that allowing hedging of aggregate credit exposures through use of an index can be less costly, more liquid, and without size limitations versus the hedging of specific credit exposures.

  The proposed Regulation contained an absolute prohibition against hedging of aggregate credit exposures. The final Regulation No. 1 requires banks to seek the approval of the Superintendent before engaging in any hedging for aggregate credit risk exposures.

Community Development Securities

- We received a number of comments from banks and entities involved in providing affordable housing credits and other community development securities in which banks invest. These comments questioned the prudence and potential harmful impact of the reduction in the limit on such investment from the 10 percent of Capital limit contained in the existing Regulation to 5 percent in the proposed Regulation.

  In dropping the limit in the proposed Regulation, we had experienced some confusion regarding effective federal limits on such investments and were very interested in receiving comments on this limit. We received very informative and thoughtful comments on this limit and have modified the limit in the final Regulation No. 1. All such comments suggested that the limit be retained at 10 percent. Consequently, in the final Regulation No. 1, we have retained the existing Regulation's limit of 10 percent of capital.

Bank-Owned Life Insurance ("BOLI")

- As noted above, we received comments that federal Interagency Guidance does not set absolute per-issuer and aggregate limits on BOLI.

  We believed that it was important to set a per-issuer limit that is consistent with the unsecured Credit Exposure Limit of 10 percent of capital contained in Alabama Banking Board Regulation No. 14. We also considered it to be important to set an absolute limit of 25 percent of capital and reinforce the federal Interagency Guidance's prohibition on purchasing BOLI as an investment for yield rather than as a risk mitigation tool. We have observed excessive concentrations of BOLI investments that appeared to be purchased primarily with yield as a consideration.

- We received a comment that the per-issuer limit contained in the proposed Regulation did not distinguish between general and segregated and BOLI accounts.

  We have revised the final Regulation No. 1 to make this distinction that is consistent with the unsecured Credit Exposure Limit in Alabama Banking Board Regulation No. 14. The 10 percent limitation now applies to general BOLI accounts.

III. Final Regulation

The final regulation is attached to this Notice. Copies of this Notice and the final Regulation No. 1 should be distributed to all board members, committee member, and other personnel dealing with investment securities, derivatives, Community Development Securities, and BOLI. Additional copies may be obtained by contacting the Alabama State Banking Department at the address, e-mail address or telephone number provided on page 1 of this notice. Copies may also be obtained from the Alabama State Banking Department website at www.banking.alabama.gov

Regulation No. 1
Investment Securities

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

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

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

1. **CORPORATE GOVERNANCE**

    a. The investment authority within a bank originates with the board of directors. The directors should be knowledgeable of the bank's investments and the specific risk characteristics associated with the investment portfolio. Broker/dealers, consultants, and their representatives may participate in meetings and make recommendations as well as educate the board. However, boards may not delegate their responsibilities. Furthermore, boards of directors and bank management shall not place excessive reliance upon the advice of a broker/dealer, consultant, or their representative regarding the purchase and management of specific investments or the portfolio as a whole. It is the responsibility of boards to direct asset-liability management and/or investment committee meetings, with management being primarily responsible for presenting information and making recommendations.

    b. A bank's board of directors shall establish and annually review and approve an investment policy that provides guidance to its investment officers, investment committee, and/or asset-liability management committee. The investment policy, at a minimum, shall establish the following:

        i. Overall investment portfolio purposes and goals;
        ii. Authorized investments and activities;
        iii. Parameters and risk limits to identify, measure, monitor, and control all risks associated with investment activities including, but not limited to, concentration risk, credit risk, liquidity risk, and interest rate risk;

iv. Acceptable investment portfolio limits as a percent of Capital[1] and Total Assets;
v. Acceptable investment portfolio limits as a percent of brokered deposits and other non-core deposit funding sources which may be used to leverage the investment portfolio and the balance sheet;
vi. Individual purchase and concentration investment authority limits for investment officers and/or investment committees, as well as internal controls for monitoring activity compared to the defined limits; and
vii. Board approval for opening broker/dealer relationships where securities will be purchased or held for safekeeping, along with annual reviews of investment relationships, ensuring compliance with Federal Reserve Board Regulation F: Limitations on Interbank Liabilities (12 CFR 206), as well as reports as to the percentage of portfolio purchased from each broker/dealer and the amount and percentage of securities purchased from each broker/dealer subsequently considered sub-investment quality.

c. A bank's board of directors shall establish a robust risk assessment methodology for pre-acquisition and post-acquisition analysis, appropriate for each asset class, to support the investment activities of the bank. The methodology should be appropriate given the size, complexity, quality, and risk characteristics of the investment portfolio, and should be consistent with the overall risk profile of the bank and the quality of its risk management staff.

i. Appropriate pre-acquisition due diligence shall be performed and documented by qualified bank staff or a third party, and shall be based upon, at a minimum, an analysis of the obligor's ability to perform, the structural complexity of the security, the type of collateral or underlying assets, debt service requirements, and external credit ratings. However, investment decisions shall not be based entirely upon external credit ratings by acceptable credit rating agencies listed in Appendix 1.
ii. Post-acquisition, qualified bank staff or a third party should review securities at least annually in accordance with the bank's methodology. The on-going review should document any adverse changes to the factors

[1] The definition of Capital for Alabama State Banking Board Regulation No. 1 is the same as the definition contained in Alabama State Banking Board Regulation No. 14, Section 1, and includes: capital stock, surplus, undivided profits, subordinated capital notes or debentures, and the allowance for loan and lease losses. Reserves for contingencies that are not set aside to cover any specific expected losses may also be included. Specific contingency reserves and unrealized gains or losses on debt securities available for sale are not to be included. However, limits for investments in Bank-Owned Life Insurance (BOLI) products in this regulation are stated as a percent of Tier 1 Capital in accordance with the Interagency Statement on the Purchase and Risk Management of Life Insurance (FIL-127-2004), and the definition of Tier 1 Capital shall be the same as that contained in the Federal Financial Institutions Examination Council (FFIEC) Instructions for Preparation of Consolidated Reports of Condition and Income (Call Report Instructions), Schedule RC-R, Regulatory Capital.

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

d. A bank's board of directors, or a committee thereof, shall review, no less than quarterly, the overall quality, liquidity, structure, and performance of its investment portfolio and any policy exceptions. If the quarterly reviews are committee level, then the full board shall review, at least annually, the overall quality, liquidity, structure, and performance of the investment portfolio. The reviews, at a minimum, shall include analysis, with recorded discussion in the official minutes, of the following:

    i. Local, state, and global economic environment with recognized concerns and notable impacts on overall bank performance;
    ii. Investment portfolio performance, position, and liquidity as compared to board-approved goals, limits, and objectives;
    iii. Deposit funding, loan growth, concentrations, and other matching considerations; and
    iv. Position of investment portfolio relative to board-established limits regarding concentration risk, credit risk, liquidity risk, and interest rate risk and appropriateness of the established limits.

2. **ELIGIBLE TYPES OF SECURITIES**

a. The following are considered eligible types of securities for investment[2]; however, specific investments within these general securities types should be governed by the risk management guidance provided in this regulation:

    i. Certificates of deposit and bankers acceptances. Any certificate of deposit exceeding FDIC insurance limits shall be underwritten in accordance with the investment policy.
    ii. Any bond, note, bill, or obligation of the United States Government or a U.S. Government Agency.
    iii. Any marketable[3] obligation of a state, or of any political subdivision of a state, including obligations of a county, city, township, other municipal

[2] 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.

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

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

iv. Any marketable debt obligation or contract obligation of a publicly held, private corporation including, but not limited to, Credit Default Swaps (CDS) will be subject to the secured and unsecured Credit Exposure Limits in Regulation No. 14.

v. Federal Reserve Bank debt.

vi. Federal Home Loan Bank, Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and other U.S. Government-Sponsored Entities' debt, including pass-thru residential and commercial mortgage-backed securities. Prior to purchase, management shall ensure that the security is not going to conflict with concentration limits related to collateral types, locations, cash flows, or other inherent concentrations within the overall balance sheet structure.

vii. Collateralized Mortgage Obligations (CMO), Collateralized Debt Obligations (CDO), Real Estate Mortgage Investment Conduits (REMIC), Asset-Backed Securities (ABS), and any other holding of private-label, residential or commercial mortgage-backed securities. Prior to purchase, the bank shall ensure and document that the bank has adequate and knowledgeable staffing to understand and investigate the underlying borrowers and collateral to ensure that the security is not going to conflict with concentration limits related to collateral types, location, cash flows, or other inherent concentrations within the overall balance sheet structure. At least annually, the board should review the securities and underlying assets and their performance. Generally, the underlying assets contained within these securities should meet the loan underwriting standards of the bank. However, the securities' overall structure and additional protections including, but not limited to, credit enhancements and senior cash flows should be considered.

viii. Single-issuer, Trust-Preferred Securities. Prior to purchase, the bank shall document an analysis of the current financial condition of the underlying obligor which includes, but is not limited to, current and projected industry conditions. Investments in single-issuer, Trust-Preferred Securities shall not exceed 10 percent of the purchasing bank's Capital to any single issuer, with an overall aggregate limit of Trust-Preferred Securities investments not to exceed 25 percent of the purchasing bank's Capital. Investments in Trust-Preferred Securities pools are specifically excluded as eligible investments.

ix. Equity investments are specifically prohibited for investment by a bank with the following exceptions:

   1. Common and/or preferred equity stock investments in a Federal Reserve Bank, a Federal Home Loan Bank, the Federal National

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

2. Preferred stock not required for membership is considered as an eligible investment if it has the characteristics of debt.
3. Combined equity investments in all such entities are limited to 10 percent of Capital.
4. Equity investments in bank service corporations are limited to 10 percent of Capital for non wholly owned corporations.

x. Other obligations and equity investments are not acceptable unless received for debts previously contracted. When such non-acceptable obligations are received for debts previously contracted, they must be disposed of within two years from the date of receipt. Bank stock or bank holding company stock received for debts previously contracted must be disposed of within one year from the date of receipt, unless prior approval is received from the Superintendent in accordance with §5-5A-27 of the Alabama Banking Code.

xi. Any bank intending to purchase an investment not specifically listed must receive prior written approval from the Superintendent.

3. CLASSIFICATION OF SECURITIES

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

   i. Defaulted, illiquid, or unmarketable status.
   ii. Investment characteristics that are distinctly or predominantly speculative.

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

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

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

b. Adverse Classifications

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

4. DERIVATIVES

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

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

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

b. The bank's board of directors should establish policies for the use of derivatives, either as part of the investment policy or separately, that includes, at a minimum, the following:

    i. Designated individuals authorized to execute transactions and limits of authority,
    ii. Position limits,
    iii. Maturity parameters,
    iv. Approved counterparties and clearing houses, and appropriate approved credit limits,
    v. Counterparty credit guidelines and collateral requirements,
    vi. Procedures for the monitoring of collateral positions, and
    vii. Guidelines for effectiveness testing.

c. The bank shall maintain files to support each derivative position that includes, at a minimum, the following:

    i. Executed International Swap and Derivatives Association (ISDA) agreement,
    ii. Hedge description and objective,
    iii. Hedge Designation, either Cash Flow or Fair Value,
    iv. Compliance with ASC Topic 815,
    v. Analysis of, and statement regarding, compliance with Derivative and Counterparty Credit Exposure Limits contained in Alabama State Banking Board – Regulation No. 14,
    vi. Transaction summary:
        1. Notional amount
        2. Fixed rate
        3. Variable rate and corresponding index
        4. Maturity date
        5. Payment dates,
    vii. Effectiveness testing and measurement guidelines, and
    viii. Fair value measurements.

5. **COMMUNITY DEVELOPMENT SECURITIES**

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

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

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

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

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

Appendix 1 – Acceptable Credit Rating Agencies

Standard and Poor's Ratings Services (S&P)
Moody's Investor Services (Moody's)
Fitch Ratings (Fitch)
Dominion Bond Rating Service (DBRS)
Kroll Bond Rating Agency (KBRA)