# Securities and Derivatives Examination Procedures

Examiners should evaluate the above-captioned function against the following control and performance standards. The Standards represent control and performance objectives that should be implemented to help ensure the bank operates in a safe and sound manner, and that the entity's objectives are carried out. Associated Risks represent potential threats to the bank if the standards are not achieved and maintained. The Standards are intended to assist examiners in analyzing important functions that may warrant additional review. All of the following Standards may NOT need to be considered at every bank. Conversely, these do NOT represent all of the control and performance standards needed for every bank. Examiners should continue to use their judgement when assessing risk.

| Standards | Associated Risks |
|---|---|
| MANAGEMENT AND CONTROL | |
| The board approves a comprehensive, flexible investment policy that contains guidance and risk limits for management.<br><br>The policy should address identifying, measuring, monitoring, and controlling risk. | Management exercises authority that should rest with the board or engages in activities that expose the institution to excessive risk.<br><br>Management may engage in securities activities without understanding the potential risks.<br><br>An inflexible policy may result in increased risk or loss if management is unable to adjust quickly to changing market conditions. |
| The board periodically reviews and revises investment-related policies. | As circumstances change, policies may not provide effective guidance to management. |
| Board-approved policy delineates and properly segregates responsibilities for managing securities and derivatives activities. | Individuals may engage in securities activities without the board's knowledge or approval and increase the institution's risk exposure.<br><br>Inadequate duty segregation can result in fraud and misstatement of financial condition. |
| Senior management and staff possess the knowledge and ability to manage the risks associated with their portfolio strategies. | Management's investment strategies or activities could expose the institution to unnecessary or excessive risk.<br><br>Failure to understand and adequately manage the risks involved in investment activities, either through the lack of internal expertise or inadequate advice, may constitute an unsafe and unsound banking practice. |
| The board (or a designated board committee) periodically reviews and approves all securities activities.<br><br>A sufficient independent review of the investment function is completed, and results are communicated to the board | The board is unaware that management does not comply with policies or exposes the bank to risks that threaten safety and soundness.<br><br>The board may be unaware of operational deficiencies that could result in loss. |
| PERFORMANCE | |
| Bank officers comply with the board's established policies. | Officers may purchase unauthorized or unsuitable investments. |
| The institution adheres to applicable laws, regulations, policy statements, and accounting standards. | Violations can result in costly penalties and increased risk exposure. |

| Standards | Associated Risks |
|---|---|
| | Inaccurate financial statements can be prepared. |
| Management provides regular, accurate reports to the board that detail all securities and derivatives activities. The report should address risks, returns, and compliance with board policies. | The board is unaware of risk exposures that could negatively affect the institution's financial condition. |
| Management develops and implements reasonable strategies to achieve the board's goals. | Management may expose the institution to risks that the board did not approve.<br><br>The investment portfolio is not structured in accordance with the board's overall asset/liability management plans, which can increase risk and reduce earnings. |
| Management maintains effective operational and internal controls.<br><br>The bank's settlement practices reflect industry standards. | Ineffective controls may lead to increased expenses and significant losses.<br><br>Inadequate settlement practices can result in unnecessary costs to the bank. |
| Prior to purchasing instruments, and periodically thereafter, management conducts risk analysis that accurately measures market, credit, liquidity, and other risks. | Investment portfolio risk exceeds board limits, negatively impacts performance, or affects the institution's financial condition.<br><br>Poor investment decisions could result from inadequate pre-purchase analyses. |
| Management conducts periodic performance analysis that measures returns relative to the risks taken. | Management is unaware of the institution's risk exposure or the portfolio's performance.<br><br>Management may expose the institution to risk without earning a compensatory return. |
| Management maintains a quality investment portfolio that is adequately diversified. | Sub-investment quality securities could negatively impact capital, asset quality, earnings, and liquidity.<br><br>Inadequate diversification may result in unfavorable credit concentrations. |

# Securities and Derivatives Examination Procedures

## Core Analysis Decision Factors

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|---|
| Examiners should evaluate Core Analysis in this section for significance and to determine if an Expanded Analysis is necessary. Negative responses to Core Analysis Decision Factors may not require proceeding to the Expanded Analysis. Conversely, positive responses to Core Analysis Decision factors do not preclude examiners from proceeding to the Expanded Analysis if deemed appropriate. |

**Do Core Analysis and Decision Factors indicate that risks are adequately identified, measured, monitored, and controlled?**

**Core Answer: General Comment:(If any)**

**<u>Core Analysis Decision Factors</u>**

C.1. Are policies, procedures, and risk limits adequate?

C.2. Are internal controls adequate?

C.3. Are the audit or independent review functions adequate?

C.4. Are information and communication systems adequate and accurate?

C.5. Are portfolio risks appropriately identified and measured?

C.6. Do the board and management effectively oversee securities and derivatives activities?

# Securities and Derivatives Examination Procedures

## Expanded Analysis Decision Factors

This section evaluates the significance and materiality of deficiencies or other specific concerns identified in the Core and Expanded Analyses.

**Do Expanded Analysis and Decision Factors indicate that risks are adequately identified, measured, monitored, and controlled?**

**Expanded Answer: General Comment:(If any)**

**<u>Expanded Analysis Decision Factors</u>**

E.1. Are the deficiencies immaterial to securities and derivatives activities management?

E.2. Are the deficiencies immaterial to the institution's overall condition?

# Securities and Derivatives Examination Procedures

Consider the following procedures at each examination. Examiners are encouraged to exclude items deemed unnecessary. This procedural analysis does not represent every possible action to be taken during an examination. The references are not intended to be all-inclusive and additional guidance may exist. Many of these procedures will address more than one of the Standards and Associated Risks. For the examination process to be successful, examiners must maintain open communication with bank management and discuss relevant concerns as they arise.

**IMPORTANT**

**(Note: FDIC only: Examiners may contact their Regional Capital Markets and Securities Specialist or the Securities, Capital Markets, and Trust Branch for assistance in completing any section of this module.)**

## PRELIMINARY REVIEW

1 Review prior examination reports, pre-examination memorandum, and file correspondence for an overview of any previously identified investment deficiencies.

2 Review interim internal and external audit reports or other independent reviews and assess the adequacy of the scope.

3 Review remedial actions taken by management to correct audit and examination deficiencies.

4 Review the securities portfolio, certificates of deposit held for investment purposes, and end-use derivative contracts.

4A Identify securities that may require further analysis, which may include reviews of prospectuses, trade confirmations, and accounting.

4B Analyze the level and trend of securities and derivatives activities in the UBPR and IRRSA.

4C Review transactions since the last examination.

5 Discuss with management the investment philosophy, portfolio composition, and underlying business purpose for the institution's investment activity.

6 Review Investment Committee minutes.

## POLICIES, PROCEDURES, AND RISK LIMITS

7 Determine if the securities and derivative activities policies are adequate and the established risk limits are appropriate. Policies should be tailored to the bank's unique needs and should address:

7A The board's investment goals.

7B Delegation of investment authority.

7C Authorized activities and instruments.

7D Internal controls.

7E Audit and independent review.

7F Broker/dealer selection.

7G Risk limits.

7G1 1. Market risk.
2. Credit risk.
3. Liquidity risk.
4. Asset types.
5. Maturities.

7H Risk and performance measurement.

7 H1 1. Pre-purchase analysis.
2. Periodic monitoring.

7 I Reporting requirements.

7 J Accounting and taxation.

7 K When market risk modification strategies are employed, written policies should specify:

7K1 1. Risk limits.
2. Specific exposures needing modification.
3. Accounting treatment.
4. Monitoring requirements.
5. Approved strategies and instruments.
6. Counterparty credit risk requirements.
7. Activity limits.
8. Analysis and documentation standards.

8 Evaluate the frequency and timeliness of policy reviews and updates by the board of directors.

## INTERNAL CONTROLS

*(Note: When any of the following procedures have been conducted by the institution's independent review program, use all reliable, current work products for the examination.)*

9 Determine if the internal control program, at a minimum, includes the following elements:

9A Official lines of authority, including authorization requirements, joint custody arrangements, and dual control.

9 B Separation of duties (executing, posting, and reconciling).

9 C A review of investment activities that is independent from operational management and that reports directly to the board or designated board committee on a timely basis.

10 Determine if internal control procedures are commensurate with the volume and complexity of investment activity. Adequate procedures should address the following:

10A Portfolio valuation.

10B Personnel.

10C Settlement procedures.

10D Physical control and documentation.

10 E Conflicts of interest.

10F Accounting.

10G Reporting.

10 H Independent review.

11 Determine if management performs activities that create supervisory concern. This may be accomplished through activity reviews and file sampling. These activities include:

11A Gains trading, when-issued trading, pair-offs, extended settlements, repositioning repurchase agreements, short sales, or adjusted trading.

11 B Incomplete transaction documentation.

11 C Contravention of policy limits for transaction amounts or types with individual dealers.

11 D Inaccurate reporting or accounting.

11 E Failure to monitor personal investment activities of staff with securities activities responsibilities.

11 F Transactions completed by unauthorized personnel.

12 Assess management's procedures for payment, reconciliation, exception, and control of securities and derivatives positions.

13 Determine if investment activities are accurately reported in Consolidated Reports of Income and Condition schedules using bank-prepared work papers. If there are material errors, request that management submit an amended Consolidated Reports of Income and Condition.

14 Determine if transfers occur between the available-for-sale, held-to-maturity, or trading accounts.

15 Determine if security sales from the held-to-maturity account are consistent with SFAS 115 guidelines.

16 Determine if there are any securities purchased that have not been paid for.

17 Verify that settlement procedures conform with industry standards, including the Bond Market Association's "Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities."

18 Determine if management uses one dealer or representative for substantially all activity. This may be accomplished by sampling investment transactions.

## AUDIT OR INDEPENDENT REVIEW

19 Determine if the independent review provides sufficient coverage relative to the institution's size, scope of investment activities, and risk profile. The independent review should:

19 A Recommend corrective action, when warranted.

19 B   Verify that corrective action commitments have been implemented.

19 C   Assess separation of duties, internal controls, and supervision of investment activities.

19 D  Compare actual risk levels to board-approved limits.

19 E  Determine compliance with policies, procedures, and regulatory requirements.

19 F   Assess the adequacy and accuracy of management's risk measurement systems, including critical assumptions.

19 G   Assess the adequacy, accuracy, and timeliness of reports to senior management and the board.

19 H   Assess the accuracy and timeliness of management's price information, including the underlying assumptions.

19I    Verify correct accounting for securities and derivatives positions, including accrued interest, principal amortization, premium amortization, discount accretion, and valuation.

19K    Determine that off-balance sheet derivative transactions are properly documented.

19L  Verify securities trial balance reconciliations to the general ledger and safekeeping reports.  Consider the following items when determining the adequacy of reconciliations:

19L1  1. Frequency of reconciliations.
2.Disposition of reconciling amounts.
3.Separation of duties.

20  Determine that results are reported to the board or designated committee on a timely basis.

21  Determine if management's responses to recent audits or independent reviews are reasonable.

### RISK IDENTIFICATION, MEASUREMENT, AND REPORTING SYSTEMS

## SECURITIES AND DERIVATIVE DOCUMENTATION REVIEW

22  Review a sample of files that contain analysis of securities and derivatives positions entered since the last examination.

22 A    Determine if management adequately measures the risks associated with each security prior to acquisition and periodically thereafter, consistent with the bank's policies.

22 B    Determine if management adequately assesses whether the instrument's cash flows, risks, and potential return fit within its investment strategy.

22 C    Determine if documentation is sufficient for management to make an informed investment decision.

*(Note:  Not all investment instruments need to be subjected to a pre-purchase analysis.  Relatively simple or standardized instruments, the risks of which are well known to the institution, would likely require no or significantly less analysis than would more volatile, complex instruments.  For relatively complex instruments, less familiar instruments, and potentially volatile instruments, institutions should fully address pre-purchase analysis in their policies.)*

## MARKET AND INTERCONNECTION RISKS

23 Determine if market and interconnection risks are significant relative to earnings, capital, and the board's risk limits.

24 Management's market risk measurement system should identify and measure all material risks. The system should:

24 A Identify and measure the price sensitivity of embedded options.

24 B Use interest rate shocks large enough to measure realistic potential market movements and risk (such as 100, 200, and 300 basis points).

24 C Include adjustments to accurately measure price changes when interest rate movements exceed 100 basis points.

24 D Subject instruments to nonparallel interest rate shocks when those instruments are exposed to risk from changes in the yield curve's shape.

25 Determine if management's analysis of the effectiveness of risk reduction strategies is adequate.

26 Assess current appreciation or depreciation relative to the board's risk limits, earnings, and capital.

## CREDIT RISK

27 Determine if credit risk exposure is significant relative to earnings, capital, and the board's risk limits.

28 Determine if management maintains a current credit analysis on all non-rated holdings.

*(Note: FDIC only - Examiners may provide a sample of the portfolio to SCMT to obtain credit rating information.)*

29 Determine if management's credit analysis of non-rated instruments is adequate when the institution holds a material volume of debt from those issuers.

30 Determine if management's credit analysis and risk limits for repurchase agreements and counterparties are appropriate. (Note: Refer to the FFIEC Policy Statement on Repurchase Agreements of Depository Institutions with Securities Dealers and Others.)

31 Determine if management's counterparty credit analysis is adequate for off-balance sheet derivatives.

31 A Identify counterparties with material credit risk.

31 B Review management's treatment of netting agreements for capital calculations.

32 Determine if management's process for setting credit limits for issuers and counterparties is appropriate.

33 Determine if management's process for monitoring ongoing credit risk exposure is appropriate.

34 Determine if concentrations of credit exist.

35 Determine if management's method of evaluating and selecting authorized securities dealers, investment bankers, and brokers is adequate. Management should demonstrate that transactions are conducted in accordance with board-approved activity limits for each authorized firm. When selecting a dealer, investment banker, or broker, management should, at a minimum:

35 A Review the firm's current financial information, such as annual reports and credit reports, and evaluate its ability to honor commitments.

35 B Inquire into the general reputation of the firm by contacting previous or current customers.

35 C Review information from state or federal securities regulators and industry self-regulatory organizations such as the NASD Regulation, Inc., concerning any formal enforcement actions against the dealer, its affiliates, or associated personnel.

## LIQUIDITY RISK

36 Determine if liquidity risk is significant relative to earnings, capital, and the board's risk limits.

37 Determine if management's pricing process provides timely, accurate, and objective data.

38 Determine if management periodically reviews assumptions used to calculate the fair value for instruments without readily observable market prices.

39 For off-balance sheet derivatives, determine if management assesses the market, number of market makers, transaction volume, and contract liquidity before conducting transactions.

40 Determine if instruments that have limited liquidity, including pledged securities and securities with significant depreciation, affect the institution's overall liquidity position.

40 A Analyze management's plans for holding or liquidating instruments with significant depreciation.

40 B For material volumes of potentially illiquid instruments, verify that management's valuation methods address liquidity risk.

41 Determine if management's process for periodically valuing derivatives positions is adequate.

42 Determine if the cash flows from the investment portfolio will enable the institution to meet its liquidity objectives.

## LEGAL RISKS

43 For off-balance sheet derivatives, determine if management properly documents contracts and ensures, through legal review, that contracts are enforceable.

## SECURITIES AND DERIVATIVES CLASSIFICATIONS

44 Determine if the investment portfolio contains any sub-investment quality assets.

44 A Consider the following if any subinvestment quality securities are accounted for as available-for-sale:

44 A1 Banks do not need to charge-off the amount classified Loss if the impairment represented by the depreciation is deemed to be temporary and management properly reports the unrealized holding gains (losses) according to SFAS 115.

2. If the depreciation represents an impairment that is other then temporary, management should write down the amortized cost of the securities to market value and take a charge against earnings.

44 B Determine if the institution has any instrument that is highly sensitive to changing interest rates and subject to high prepayment risk which may not return the initial principal investment (e.g., interest only stripped MBS and principal-linked structured notes).

44B1. Where permanent impairment has occurred, the instrument should be written down to fair market value with the Loss amount reflected in regulatory capital.
2. If it is likely that market risk factors may lead to additional impairment, the remaining balance should be classified Substandard.

45 Determine if there are any material accounting errors that warrant adverse classification.

46 Estimate the potential loss for all derivative contracts whose counterparty performance is not well assured.

**BOARD AND SENIOR MANAGEMENT OVERSIGHT**

## GENERAL

47 Determine if management complies with the board policies and risk limits.

48 Determine if management's reports to the board appropriately identify and measure risk exposure and performance. Management's reports to the board should:

48 A Summarize all investment activity.

48 B Illustrate investment portfolio risk and return.

48 C Indicate management's compliance with investment policy and all risk limits.

48 D List exceptions to internal policy and regulatory requirements.

48 E Illustrate the effectiveness of derivatives that management employs as part of a market risk modification strategy.

49 Determine if board minutes and relevant committee minutes indicate appropriate oversight of securities and derivatives activities.

50 Through discussion with management, determine if management understands the related risks in the investment portfolio and how those risks fit within the overall business strategy.

51 Determine if current and planned investment strategies are consistent with the bank's overall strategic plan.

52 Determine if senior management collaborates with the board to periodically evaluate and, when warranted, modify the risk management process.

53 Determine if the board or senior management has established an agreement delegating investment authority to a third party. Prior to establishing such an agreement, management should evaluate the third party's reputation, performance, creditworthiness, and regulatory background. If such an agreement exists, the following should be addressed:

53 A Compensation.

53 B Approved broker/dealers.

53 C Investment goals.

53 D Approved activities and investments.

53 E Risk limits.

53 F Risk and performance measurement.

53 G Reporting requirements.

53 H Settlement practices.

53 I Independent review.

## COMPLIANCE WITH LAWS AND ACCOUNTING STANDARDS

54 Determine if management adheres to correct accounting standards. Issues include application of SFAS 115 and SFAS 80, interest accruals, principal amortization, premium amortization, and discount accretion.

54 A Consider sampling trade tickets and validating purchase and sale price accuracy.

55 Determine if management complies with applicable policy statements and regulations, which may include the following:

55 A FFIEC Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities (Financial Institutions Letter 45-98).

55 B FFIEC Supervisory Policy Statement on Securities Lending (Financial Institutions Letter 81-97).

55 C FFIEC Supervisory Policy Statement on Repurchase Agreements of Depository Institutions with Securities Dealers and Others (Financial Institutions Letter 22-98).

55 D Government Securities Act of 1986 (in the Miscellaneous Statutes and Regulations), and regulations issued thereunder by the Department of Treasury. These regulations address requirements relating to financial responsibility, protection of customer securities and balances, and recordkeeping and reporting of brokers and dealers in government securities.

55 E Sections 23A and 23B of the Federal Reserve Act (12 CFR 250). Sections 23A and 23B place certain restrictions on the direct investment, loans, or other transactions between a bank and an affiliate.

55 F (FDIC ONLY) Part 362 of the FDIC Rules and Regulations, Activities and Investments of Insured States Bank, contains certain restrictions and prohibitions on the activities and investments of banks and their subsidiaries.

# Securities and Derivatives Examination Procedures

Generally, procedures used in the Expanded Analysis should target concerns identified in the Core Analysis and Decision Factors. Expanded procedures associated with Core Analysis and Decision Factors of no concern need not be used. The flexible guidelines specified for the Core Analysis also apply here.

## POLICIES, PROCEDURES, AND RISK LIMITS

1 Investigate why the policy deficiencies identified in the Core Analysis exist. Discuss recommendations with management. Possible reasons for policy deficiencies may include the following circumstances:

1A Management overlooked these issues.

1 B Management is unfamiliar with prudent guidelines and procedures for securities and derivatives.

1 C Management is unwilling to create or enhance policies and procedures.

2 If poor compliance with policies and procedures exist, determine the reasons. Possible reasons are detailed below:

2A Poor internal communication of policy and procedures or subsequent revisions.

2 B Lack of awareness of policy existence.

2 C Disregard for established policies.

2 D Misunderstanding of policy and procedures.

3 Determine if management commits to and supports proper controls and monitoring to ensure policy guidelines are followed in the future. Determine if proposed controls, if any, are reasonable.

## INTERNAL CONTROLS

4 When concerns with internal controls are identified in the core analysis, independently evaluate whether the internal control weaknesses expose the bank to material risks.

5 Determine if purchase and sale prices are accurate by sampling trade tickets.

6 Confirm clearing account reconciliations.

7 Verify that confirmations are reconciled against trade tickets in a timely fashion.

8 Review a sample of general ledger tickets to test entry accuracy.

## AUDIT OR INDEPENDENT REVIEW

9 Investigate why audit or independent review deficiencies identified in the Core Analysis exist.

10 Perform the Core Analysis procedures that were not adequately addressed during the audit or independent review.

11 Determine if the operations staff is knowledgeable of the procedures and controls.

**RISK IDENTIFICATION, MEASUREMENT AND REPORTING SYSTEMS**

## MARKET AND INTERCONNECTION RISKS

12 Assess management's methods for measuring and forecasting price sensitivity and market risk.

12A Determine if the measurement methods are appropriate for the instrument's or portfolio's cash flow characteristics.

12 B Determine if management's assumptions, including interest rate shocks, prepayment forecasts, and current prices, are reasonable and supported.

12 C Compare assumptions used for risk analysis with assumptions used for accounting.

13 If necessary, request improved management analysis during the examination. Use management's improved analysis to assess market risk relative to the board's risk limits, earnings, and capital.

## CREDIT RISK

14 Determine if management's credit analysis is accurate by obtaining credit ratings on a portfolio sample. If ratings were obtained on a portfolio sample in the core analysis, expand the sample.

15 Evaluate the risk of loss from non-rated debt issuers when the institution holds a material volume of debt from those issuers. Management should maintain the needed financial information (annual reports, SEC filings, etc.) on file.

16 Determine the overall credit risk from off-balance sheet derivatives activities.

16 A Perform credit analysis of counterparties for all material positions. Management should maintain financial information (e.g., annual reports and SEC filings) on file.

## LIQUIDITY RISK

17 Verify management's price information.

17 A Obtain independent prices on a sample portfolio. If prices were obtained on a portfolio sample in the core analysis, expand the sample.

17 B For instruments valued using the institution's or selling dealer's model, ascertain whether management can adequately support the assumptions. If management cannot support the assumptions, or the assumptions appear unrealistic, request a revised valuation using assumptions that are more appropriate.

18 Assess management's ability to hold instruments with significant depreciation.

**BOARD AND SENIOR MANAGEMENT OVERSIGHT**

## COMPLIANCE

19 Determine the cause of violations or contraventions to statements of policy and responsible party or parities. Consider the following items:

19 A Lack of familiarity with laws, regulations, or policy statements.

19 B Negligence.

19 C Misinterpretation.

19 D Willful disregard and noncompliance.

# Securities and Derivatives Examination Procedures

Impact Analysis reviews the impact that deficiencies identified in the Core and Expanded Analysis and Decision Factors have on the bank's overall condition. Impact Analysis also directs the examiner to consider possible supervisory options.

1 Assess the effect on the institution's safety and soundness of any supervisory concerns regarding management.

2 Determine the effect that market, interconnection, credit, liquidity, operational, and legal risk exposures from securities and derivatives have on the institution's safety and soundness.

3 Evaluate the effect that current and planned securities and derivatives activities may have on capital, asset quality, earnings, liquidity, and sensitivity to market risk.

4 Gauge management's willingness and ability to correct deficiencies.

5 Determine if formal or informal administrative actions are warranted, formulate specific recommendations, and advise the appropriate supervisors on the nature of the concerns. (FDIC Only: Field Office Supervisor, Regional Office)

6 Investigate potential recommendations for civil money penalties.