



**STATE OF WYOMING**  
**DEPARTMENT OF AUDIT**

**DIVISION OF BANKING**

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**MEMORANDUM**

**TO:** Chief Executive Officer  
All State Chartered Banks

**FROM:** L. Bruce Hendrickson, Commissioner  
Division of Banking

**DATE:** September 2, 1998

**TO:** New Supervisory Policy Statement on Investment Securities

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Attached, is the Federal Financial Institutions Examination Council's (FFIEC) May 25, 1998, Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities. Following is a brief summary of this new policy and the approach this office will use when examining the investment portfolio of your institution.

This policy does not remove any of the requirements for the management of the investment portfolio; however, it does eliminate the limitations of the types of investments an institution may add to its portfolio. The new statement of policy removes the specific constraints in the 1992 Statement concerning investments by insured depository institutions in "high-risk" mortgage derivative products (MDP). Prudent banking standards dictate that management understands **all the risks** related to the institution's investment portfolio.

As a result, the pass/fail criteria of the high-risk tests as applied to specific instruments alone does not constitute effective supervision of investment activities; therefore, the new policy eliminates the high-risk tests as a binding constraint on MDP purchases. An effective risk management program, through which an institution identifies, measures, monitors, and controls the risks of investment activities, provides a better framework for portfolio management.

Effective risk management addresses risks across all types of instruments on an investment portfolio basis and ideally, across the entire institution. The complexity of many financial products, both on and off the balance sheet, has increased the need for a more comprehensive approach to the risk management of the investment portfolio and the institution. It is the belief of all regulators, that stress testing of MDP investments along with other investment types has a significant value as a risk management tool. Institutions should employ valuation methodologies that take into account all of the risk elements necessary to evaluate these investments. As a matter of sound practice, management should know the value, price sensitivity, and net yield of the investment prior to purchase and on an ongoing basis. Failure to understand and adequately manage the risks in these areas constitutes an **unsafe and unsound practice**.

Risk management needs to be a focal point of the institution and is the principal center of our examination process. Examiners from this office will continue to evaluate the skills/knowledge or expertise of management based upon the complexity of the institution's investment portfolio. Examiners will focus on documentation in board minutes of purchased or sold securities, adoption of investment policy and compliance with policy, limitations and types of investments approved for purchase, parameters for price limitations by the investment officer, ratings of securities, processes and procedures for the selection of dealers, and **management evaluation methodologies**. Examiners will scrutinize written documentation and reports to evaluate the management evaluation methodologies to compare with the complexity of the institution's investment portfolio. Effective management evaluation methodologies will give management the ability to identify, measure, monitor, and control portfolio risks, and the effect on areas such as: 1) bank earnings, 2) specific investment price, and 3) specific change in average life, given a change in interest rates. When management reviews and evaluates the investment portfolio, methodologies should not be limited to only what is considered "high risk securities," but to all securities with the portfolio.

The above areas give you an abstraction of what our examiners will evaluate; yet, the evaluation is not limited to only the above areas. Should you have any questions regarding the above matter, please feel free to contact this office.