In view of the 11 drops in the Fed Funds rate in 2001, the 50-year short-term interest rate lows of 2002 and the unusually steep yield curve, the OCC issued Bulletin 2002-19 to warn of the dangers of chasing yields by assuming “unwarranted levels of risk.” The bulletin states, “There is no ‘free lunch.’ To obtain higher yields, banks must take more credit risk, interest rate risk, liquidity risk or combinations thereof.”

The OCC’s primary concern is the purchasing of non-rated securities or securities that are at the lower end of investment grade. Although most community bankers do not engage in these practices, be aware that the following investment actions will trigger extra regulatory scrutiny:

- Purchasing high-yielding securities at the low end of the investment grade rating scale.
- Purchasing non-rated securities without “documenting . . . that the security is a strong ‘pass’ asset under its internal credit rating standards.”
- Purchasing complex security structures without understanding, evaluating and documenting the risks under a variety of possible scenarios.

The bulletin spells out that banks with securities that have defaulted or have other than temporary impairment must recognize the depreciation as a current period expense; that is, mark-to-market through income and capital.

Interest Rate Risk

The current yield curve is “very steep and upward sloping.” Some banks are chasing higher yields and “have purchased callable securities with long-stated maturities and short non-call periods,” the OCC states. These securities, its bulletin adds, “contain a combination of non-credit-risk factors that often produce very high yields, and very high risk.” Rising rates produce a high degree of extension risk, and falling rates generate cash to be reinvested at still lower rates.

The OCC does not say this is necessarily an unsound practice, but it does require banks to do pre-purchase analyses. The analysis is meant to avoid “material amounts,” to understand the structure and price sensitivity of the securities, and to know how the securities affect the bank’s overall interest rate risk profile, including stress-tested cash flows. This attention, the agency writes, “will help avoid the possibility that the investment portfolio will serve as a drag on earnings for years to come [emphasis added].”

Yield Chasing-Combinations

The OCC bulletin addresses yield chasing combinations to speak to trust preferred securities, equity-linked CDs as investments and bank-owned life insurance.

Very briefly, the OCC expresses concern that some banks have purchased these securities without giving sufficient consideration to their credit
Some banks are chasing higher yields and “have purchased callable securities with long-stated maturities and short non-call periods.”

—OCC Bulletin 2002-19

Equity-linked CDs as investments “generally have poor liquidity and pose a number of complex accounting and tax issues,” the bulletin advises. The instruments should be subjected to an internal risk management review to evaluate the associated accounting, liquidity, credit and operational risks.

Bank-owned life insurance holdings should be reviewed to verify that the contracts are associated with a legitimate insurance need and to divest those that are not. The bulletin is careful to say that these are not necessarily unsafe or unsound investments. It does, however, point out some of the potential problems and requires special attention and analyses of these complex securities.

Community banks that have purchased or are planning to purchase these securities should refer to the bulletin for more specific guidance. (See the OCC’s Web site at www.occ.treas.gov. Find the bulletin under the “What’s New,” as a document archived on May 22, 2002.

Risk Management Issues

The OCC bulletin also highlights the responsibilities of directors in shaping their bank’s portfolio investment objectives. “The board of directors,” the agency explains, “should review the bank’s risk management framework for investment risks and confirm that it provides appropriate controls over the current level of risk—for many banks it may be more prudent to accept somewhat lower than expected earnings for the near term in order to increase the likelihood of more favorable earnings for the long term. Banks should focus on long-term performance [emphasis added].”

Focusing on long-term investment performance may help reduce the likelihood of your bank’s short-term portfolio risks. Review the OCC bulletin. It offers lots of good advice in avoiding the regulator’s wrath and risky practices. Then talk with your securities investment adviser for further guidance.

C.J. Pickering is ICBA Securities’ president, and Mark Evans, CFA, is ICBA Securities’ director of strategies. ICBA Securities is SIPC-insured and an NASD-registered broker-dealer located at 775 Ridge Lake Blvd., Memphis, Tenn. 38120.

Equity-linked CDs as investments “generally have poor liquidity and pose a number of complex accounting and tax issues.”

—OCC Bulletin 2002-19

Get Risk Management Help

ICBA members are invited to call ICBA Securities at (800) 422-6442 for the following complimentary services:

- Sample policies (investment policy, asset-liability policy and liquidity policy);
- Pre-purchase stress tests;
- Sample purchase checklists;
- Performance profile reports including board reporting, portfolio analysis, and risk management, including asset/liability management;
- Management and board of directors training; and
- Portfolio value at risk reports, which shock the value of the investment portfolio.