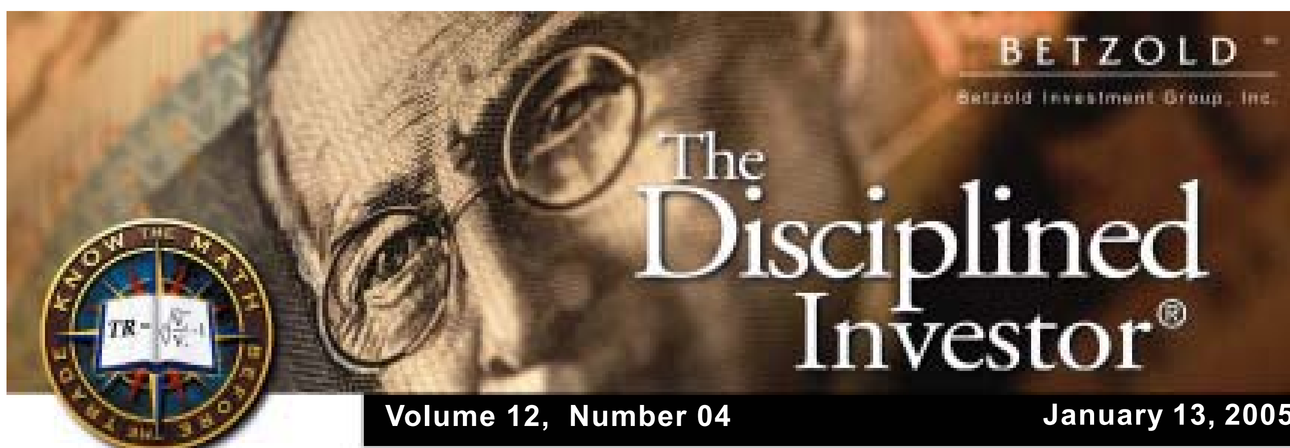

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Legislation That Will Knock Your SOX Off!

The Sarbanes-Oxley Act (often referred to as "SOX"), with its criminal penalties and broad impact on everyday corporate behavior, is the most far-reaching reform of corporate governance, financial practices, and reporting since the creation of the SEC as part of New Deal in the 1930s. While it is well understood that SOX impacts large publicly held financial institutions, few have recognized that it increasingly affects even small private financial institutions. Are ***all*** financial institutions (banks, credit unions, savings and loans, and other depositary institutions), regardless of size, focused and ready for the impact of SOX**?**

Regulatory bodies and accounting standards groups have, through their broad regulatory authority, made SOX applicable to non-public as well as public financial institutions. One of the first areas of impact was the increased scrutiny by auditors of the antifraud procedures adopted and practiced by all financial institutions.

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Regulatory Agencies and SOX

More far-reaching over time is the regulatory drive to assure that all financial institutions comply with such SOX provisions as auditor independence, corporate responsibility, and the *broad changes in day-to-day financial practices* and disclosures. Regulatory agencies such as the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) have made SOX applicable to all financial institutions subject to their oversight by importing SOX concepts into the definition of "best practices."

These regulatory bodies view SOX as either mirroring existing "corporate behavior policy guidelines" or as representing "sound governance practices" that financial institutions should implement. In applying SOX, regulators and auditors have read in the directive that the financial statements fairly present the company's financial condition, the requirement that institutions establish and maintain adequate internal control structures and procedures, and that they must comply with safe practices and soundness regulations.

To meet these new tests, CEOs, executive management and members of the Board of Directors must better understand and apply risk management tools in their oversight of the institution's interest sensitive assets and liabilities, especially its fixed income portfolio, consistent with best practices as overlaid with SOX. Part of a good "safe practices and soundness" program is administering the institution's portfolio consistent with proven analytical methodologies.

One recent manifestation of the impact of SOX on safe practices and soundness is OCC-Bulletin 2004-29. The Bulletin requires regulated institutions to have a system that effectively identifies the magnitude and sources of foreseeable interest rate risks and a program that proactively monitors and controls these. The OCC has emphasized that in "light of the highly uncertain interest rate environment," examiners "will evaluate how banks have identified, measured, and controlled interest rate risk."

Among the elements examiners will evaluate are:

1) the appropriateness of the tools used by portfolio managers, executive management, and boards to monitor and manage portfolio risk,

2) the procedures used (including the role of the portfolio manager, board and its ALCO) when contemplating the transfer of securities between "held-to-maturity" and "available-for-sale,"

3) whether executive management reviews at least quarterly potential variations of portfolio performance taking into account which securities have embedded options, potential cash flows (earnings) and market values (economic value of equity) under varying present and possible future market conditions,

4) how effectively does executive management perform these reviews and consult with the board, and

5) whether the policies and procedures adopted by the board and executive management adequately identify and control risks.

When executive management contemplates *their* SOX responsibility they should remember the Bulletin is addressed to the "management and boards of directors." Concerned that disclosure controls and internal procedures were not adequately improved to protect the long-term integrity of portfolios, the OCC sought to address this "structural problem." This concern applied to both a "rising and falling interest rate" environment as has been experienced over the past year and a half.

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It is significant from a SOX perspective that the Comptroller said: “It is unsafe and unsound to expose the earnings and capital . . . to heightened levels of interest rate risk without *demonstrating a thorough understanding of the risk* and an *ability to prudently manage the risk* with an *effective risk control process* . . . [B]anks should take a number of steps to ensure that they have properly identified, measured, and controlled interest rate risks.”

Regulators under SOX expect institutions to consider a full range of approximate future outcomes as part of portfolio management. For bank grade securities, interest rate risk is a far greater unknown than credit risk. To avoid painful surprises, the Bulletin expects management to take into account: 1) unanticipated principal repatriation, 2) unplanned cash flow consequences of interest rate shifts and 3) principal losses caused by shifts in the rate environment. There are four conventional investing approaches which can cause these painful surprises: 1) economic forecasting, 2) parametric analysis (yield, duration, etc), 3) limits on asset classes, and 4) the ladder approaches or concentration in short duration investments.

To avoid such surprises the Bulletin obligates the board and management to “ensure a disciplined approach” to portfolio management and the steps required to control “interest rate” or other risks. An alternative to conventional investing approaches is a *disciplined* Shape Management® approach to understanding and assessing portfolio investment choices.

Realizing that today it is not unusual for securities to have “structurally complex cash flow profiles,” the Bulletin suggests that these “pose special risks.” To be SOX compliant, institutions should systematically conduct detailed analysis of potential portfolio performance “under various rate scenarios” to “identify” and “carefully assess the long-term implications” of their holdings and “consider risk mitigation strategies” to avoid exceeding “approved risk tolerances.”

SOX and best practices require a multidimensional proactive approach that takes into account not only a single fixed income security’s characteristic, but also a dynamic understanding of the interrelationship of each of the securities in the entire portfolio and how a variety of factors including interest rate sequences, changes, degrees, volatility, and curves, affect both individual securities and the portfolio as a whole. It is this type of multidimensional proactive approach that the Office of the Comptroller of the Currency views as affording “a robust interest rate risk measurement process.” Beyond this, the Bulletin suggests, that SOX requires applying such an approach to all of the interest sensitive assets and liabilities of the institution as a whole and taking that into account in determining the appropriate portfolio investment policy guidelines.

EITF 03-1 and SOX

Determining how to apply SOX is not all that easy even for the “experts.” Witness the collision between regulatory bodies and accounting standards groups brought to the forefront by the controversy over the Financial Accounting Standards Board (FASB)’s Statement No. 115, clarification – EITF Issue 03-1.

As noted above, one of the five elements which OCC examiners evaluate is the institution’s procedure (including the role of the portfolio manager, board and its ALCO) when contemplating the transfer of securities between “held-to-maturity” and “available-for-sale.” The risk that steps taken by FASB to improve the accuracy of financial reporting will have the unintended consequence of promoting unsound portfolio investment decisions and prevent an institution’s financial statements from fairly presenting the institution’s financial condition was never more clearly apparent than now. This is reflected in the controversy over EITF Issue 03-1 involving the definition of phrases like “*other-than-temporary impairment,*” “*held-to-maturity*” and “*available-for-sale*.”

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At one extreme, FASB's commentary on EITF Issue 03-1 pushes institutions to invest only in instruments that mature within one year to avoid *"impairment"* rules because even slight shifts in interest rates could cause the write down of asset values. At the other end of the spectrum, regulators increasingly stress using portfolio methodologies with a broader long-term view. Most egregious was FASB's focus on individual securities rather than on the interrelationship of the securities in the portfolio as a whole, or the relationship of the portfolio to the rest of the institution's activities. FASB completely overlooked the fact that early reporting of losses based on *impairment* could cause substantial distortion of reported earnings when subsequent interest rate shifts cause principal appreciation at the time of sale.

Based on the flood of negative comments, FASB, on November 12, 2004, postponed implementation of EITF Issue 03-1 saying it will "take a broad view" as it studies the more than 250 negative comment letters it received.

Rather than focus on FASB *"temporary impairment"* type concepts, the Bulletin directs banks to "[o]btain and review current investment portfolio valuations and conduct portfolio sensitivity analyses to estimate the potential exposure to interest rate changes, especially scenarios of non-parallel changes in the yield curve. Banks should ensure that portfolio sensitivity is consistent with the policy limits outlined in bank policy." "Finally, [the OCC recognizes something the FASB ignored that] the investor community looks at depreciation in fixed income portfolios when evaluating the financial health of a banking company."

Shape Management® and SOX

Consistent with the Bulletin, properly applying Shape Management® provides the tools to identify, measure, and control "the potential exposure to earnings and capital that may arise from a scenario of rising interest rates." Total return and market value really matter.

The good news is that applying a disciplined analytic methodology can provide the five critical regulatory SOX elements for your institution:

1) appropriate tools for portfolio managers, executive management, and boards to monitor and manage portfolio risk,

2) appropriate identification procedures to use (including the role of the portfolio manager, board and its ALCO) when contemplating the transfer of securities between "held-to-maturity" and "available-for-sale,"

3) appropriate identification procedures for executive management to review at least quarterly potential variations of portfolio performance taking into account which securities have embedded options, potential cash flows (earnings) and market values (economic value of equity) under varying conditions,

4) demonstrated effectiveness of executive management's performance of these reviews and appropriate consultation with the board, and

5) appropriate policies and procedures for the board and executive management to adequately identify and control risks.

With these elements in place, the regulators won't knock your SOX off!

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