FEDERAL RESERVE BANK
OF DALLAS

ROBERT D. McTEER, JR.
PRESIDENT
AND CHIEF EXECUTIVE OFFICER

August 12, 1991

DALLAS, TEXAS 75222

Notice 91-72

TO: The Chief Executive Officer of each member bank and others concerned in the Eleventh Federal Reserve District

SUBJECT

Request for Additional Comment on Policy on Securities Activities; Withdrawal of Proposal Related to Nonaccrual Loans

DETAILS

The Federal Financial Institutions Examination Council (FFIEC) has requested additional comments on a proposed supervisory policy statement on securities activities. The proposed Supervisory Policy Statement on Selection of Securities Dealers, Securities Portfolio Policies and Strategies and Unsuitable Investment Practices, and Stripped Mortgage-Bank Securities, Certain CMO Tranches, Residuals, and Zero-Coupon Bonds was issued for public comment on January 3, 1991 (our Notice 91-05). As a result of comments received, the FFIEC is seeking additional comments on two aspects of Section III of the proposed policy:

- whether the proposed quantitative criteria for determining high-risk mortgage securities effectively distinguishes those products from all other mortgage derivative products; and,

- the impact of the proposed reporting treatment required for high-risk mortgage securities.

The FFIEC must receive comments by September 1, 1991. Comments should be addressed to Robert J. Lawrence, Executive Secretary, Federal Financial Institutions Examination Council, 1776 G Street, N.W., Suite 850B, Washington, D.C. 20006.

On March 18, 1991, the FFIEC requested public comment (our Notice 91-26) on a proposal relating to the return of nonaccrual loans with partial charge-offs of principal to accrual status without first recovering the partial charge-off or becoming fully current in accordance with the contractual loan terms. In light of comments received on this proposal, the proposal has been withdrawn.

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ATTACHMENTS

Attached is a copy of the FFIEC's notice requesting comment on the proposed policy statement on securities activities. The notice also appears on pages 37095-99, Vol. 56, No. 149, of the Federal Register dated August 2, 1991.

Also attached is a copy of the FFIEC's press release withdrawing the proposal relating to nonaccrual loans; however, the text of the Federal Register referred to in the press release is not attached.

MORE INFORMATION

For further information, please contact at the Board of Governors of the Federal Reserve System, Rhoger H. Pugh, Manager, Policy Development (202) 728-5883, or Charles H. Holm, Supervisory Financial Analyst, (202) 452-3502, Division of Banking Supervision and Regulation; at the Federal Deposit Insurance Corporation, Sharon K. Lee, Capital Markets Specialist (202) 898-6789, or Robert F. Storch, Chief, Accounting Section (202) 898-8906, Division of Supervision; at the National Credit Union Association, Charles Felker (202) 682-9640; at the Office of the Comptroller of the Currency, Owen Carney, Senior Advisor for Investment Securities, or Jamie Newell, Senior Capital Markets Advisor (202) 874-5070; and, at the Office of Thrift Supervision, John M. Frech, Senior Accountant, Accounting Policy (202) 906-5649, or J. Douglas Gordon, Senior Financial Economist (202) 906-5728.

For additional copies of this Bank's notice, please contact the Public Affairs Department at (214) 651-6289.

Sincerely yours,

FEDERAL FINANCIAL INSTITUTIONS

EXAMINATION COUNCIL

Supervisory Policy Statement on Securities Activities

Agency: Federal Financial Institutions Examination Council.

Action: Request for Comment.

Summary: The five member agencies of the Federal Financial Institutions Examination Council (the "FFIEC"), which include the Board of Governors of the Federal Reserve System ("FRB"), the Federal Deposit Insurance Corporation ("FDIC"), the National Credit Union Administration ("NCUA"), the Office of the Comptroller of the Currency ("OCC"), and the Office of Thrift Supervision ("OTS") (collectively, the "Agencies"), are seeking additional public comment on Section III of the proposed supervisory policy statement that was initially published for public comment on January 3, 1991 (56 Federal Register 263). As now proposed, Section III defines "high-risk mortgage securities" and specifies that such securities are not suitable investment portfolio holdings for depository institutions. High-risk mortgage securities may only be acquired to reduce an institution's interest rate risk

and must be reported in the trading account at market value or as assets held for sale at the lower of cost or market value. Examiners will seek the orderly divestiture of high-risk mortgage securities that do not reduce interest rate risk. Other products with risk characteristics similar to high-risk mortgage securities may be subject to the same supervisory treatment. In addition, Section III further provides that disproportionately large holdings of long-term zero-coupon bonds are considered an imprudent investment practice. Such holdings will be subject to criticism by examiners who may seek their orderly disposal.

Date: Comments must be received by [insert date 30 days from the date of publication in the Federal Register.]

Addresses: Comments should be directed to Robert J. Lawrence, Executive Secretary, Federal Financial Institutions Examination Council, 1776 G Street, NW, Suite 850B, Washington, D.C. 20006.

For Further Information Contact: At the FRB: Rhoger H Pugh, Manager, Policy Development, Division of Banking Supervision and Regulation (202) 728-5883; Charles H. Holm, Supervisory Financial Analyst, Division of Banking Supervision and Regulation (202) 452-3502. At the FDIC: Sharon K. Lee,

Capital Markets Specialist, Division of Supervision (202) 898-6789; Robert F. Storch, Chief, Accounting Section, Division of Supervision (202) 898-8906. At the NCUA: Charles Felker (202) 682-9640. At the OCC: Owen Carney, Senior Advisor for Investment Securities (202) 874-5070; Jamie Newell, Senior Capital Markets Advisor (202) 874-5070. At the OTS: John M. Frech, Senior Accountant, Accounting Policy (202) 906-5649; J. Douglas Gordon, Senior Financial Economist (202) 906-5728.

Supplementary Information: On January 3, 1991, the Federal Financial Institutions Examination Council issued for public comment a proposed Supervisory Policy Statement concerning the Selection of Securities Dealers, Securities Portfolio Policies and Strategies and Unsuitable Investment Practices, and Stripped Mortgage-Backed Securities, Certain CMO Tranches, Residuals, and Zero-Coupon Bonds. Under Section III of this proposal, stripped mortgage-backed securities, residuals, and "high-risk CMO tranches" were subject to the same supervisory treatment. However, many commenters indicated that the definition of high risk CMO tranches in Section III of the proposal was too vague. These commenters indicated that the definition should include specific quantitative criteria in

order to more precisely differentiate high risk CMO tranches from those with less risk. In consideration of the public comments on the January proposal, the FFIEC is now proposing to define "high-risk mortgage securities" in a quantitative manner. This definition will apply to all mortgage derivative products, including Collateralized Mortgage Obligations ("CMOs"), Real Estate Mortgage Investment Conduits ("REMICs"), CMO and REMIC residuals, and Stripped Mortgage-Backed Securities ("SMBSs"). In addition, other aspects of Section III have been changed from the January proposal.

Although the FFIEC invites comments on all aspects of Section III as it is now proposed, the FFIEC requests comment on the following specific issues relating to Section III.

(1) Whether the quantitative criteria proposed for determining high-risk mortgage securities in Section III effectively distinguishes "high-risk" mortgage derivative products from all other mortgage derivative products. If possible, commenters should provide estimates (with supporting data) of the portion of the existing CMO and REMIC products that will fall within the high-risk definition.

(2) The impact of the reporting treatment set forth in Section III for high-risk mortgage securities.

The text of the proposed Section III of the Supervisory Policy follows.

SUPERVISORY POLICY STATEMENT ON SECURITIES ACTIVITIES

SECTION III: MORTGAGE DERIVATIVE PRODUCTS, OTHER ASSET BACKED PRODUCTS, AND ZERO-COUPON BONDS

Summary

Mortgage derivative products include Collateralized Mortgage Obligations ("CMOs"), Real Estate Mortgage Investment Conduits ("REMICs"), CMO and REMIC residuals, and Stripped Mortgage-Backed Securities ("SMBSs"). The cash flows from the mortgages underlying these securities are redirected to create two or more classes with different maturity or risk characteristics designed to meet a variety of investor needs and preferences. However, many mortgage derivative products exhibit considerably more price volatility than standard mortgages or ordinary mortgage pass-through securities and can therefore expose investors to significant risk of loss if they are not managed in a safe and sound manner. This price volatility is caused in part by these mortgage derivative products' substantial prepayment risk and average life variability. In addition, because these products are complex, a high degree of technical expertise is required to understand how their prices and cash flows may behave under various

interest rate and prepayment expectations. Moreover, because the secondary market for most of these products is relatively thin, they may be difficult to liquidate should the need arise.

Finally, there is additional uncertainty because new variants of these instruments continue to be introduced and their price performance under varying market and economic conditions has not been tested.

A general principle underlying this section is that mortgage derivative products possessing average life or price volatility in excess of a standard fixed rate 30-year mortgage-backed pass-through security are "high-risk mortgage securities" and are not suitable investments for depository institutions. All high-risk mortgage securities, as defined in detail below, held by depository institutions must be carried in the institutions' trading account or as assets held for sale. Institutions that hold mortgage derivative products

that meet the definition of a high-risk mortgage security must do so to reduce interest rate risk in accordance with safe and sound practices.[1] Furthermore, depository institutions that purchase high-risk mortgage securities must demonstrate that they understand and are effectively managing the risks associated with these instruments. Levels of activity involving high-risk mortgage securities should be reasonably related to an institution's capital, capacity to absorb losses, and level of in-house management sophistication and expertise. Appropriate managerial and financial controls must be in place and the institution must have the ability to use analytical modeling techniques to monitor and prudently adjust its holdings of high-risk mortgage securities in an environment of changing price and maturity expectations.

1.Notwithstanding the provisions of this supervisory policy requiring the use of high-risk mortgage securities to reduce interest rate risk, this supervisory policy is not meant to preclude an institution with strong capital and earnings and adequate liquidity that has a closely supervised trading department from acquiring high-risk mortgage securities for trading purposes. The trading department must operate in conformance with well-developed policies, procedures, and internal controls, including detailed plans prescribing specific position limits and control arrangements for enforcing these limits.

Prior to taking a position in any high-risk mortgage security, an institution should evaluate the risk exposure resulting therefrom to ensure that the position will lead to a reduction in the institution's overall interest rate risk. An institution should also consider the liquidity and price volatility of these products prior to purchasing them.

Circumstances in which the purchase or retention of high-risk securities is deemed by the appropriate federal regulatory authority to be contrary to safe and sound practices for depository institutions will result in criticism by examiners, who may require the orderly divestiture of high-risk mortgage securities.

Securities and other products, whether carried on or off the balance sheet, having risk characteristics similar to high-risk mortgage securities may be subject to the same supervisory treatment as high-risk mortgage securities.

Long-term zero coupon bonds also exhibit significant price volatility and may expose an institution to considerable risk. Disproportionately large holdings of these instruments may be considered an imprudent investment practice, which will be

subject to criticism by examiners. In such instances, examiners may seek the orderly disposal of such securities. Assets slated for disposal are reported as assets held for sale at the lower of cost or market value.

Overview of the Securities

A. SMBSs consist of two classes of securities with each class receiving a different portion of the monthly interest and principal cash flows from the underlying mortgage-backed securities ("MBS"). In its purest form, an MBS is converted into an interest-only ("IO") strip, where the investor receives all of the interest cash flows and none of the principal, and a principal-only ("PO") strip, where the investor receives all of the principal cash flows and none of the interest.

IOs and POs have highly volatile price characteristics based, in part, on the prepayment variability of the underlying mortgages and consequently on the maturity of the stripped securities. Therefore, IOs and POs will nearly always meet the definition of high risk in this policy.

From a market perspective, IOs and POs have relatively wide bid/ask spreads compared to mortgage-backed securities. This decreases the effectiveness of SMBSs as interest rate risk

reduction tools because interest rates and prepayments need to change by a significant amount before the price at which the security can be sold (i.e., the bid price) will exceed the price at which the security was purchased (i.e., the ask price).

B. CMOs and REMICs, hereafter called CMOs, have been developed in response to investor concerns regarding the uncertainty of cash flows associated with the prepayment option of the underlying mortgagor. A CMO can be collateralized directly by mortgages, but more often is collateralized by MBSs issued or guaranteed by GNMA, FNMA or FHLMC and held in trust for CMO investors. In contrast to MBSs in which cash flow is received pro rata by all security holders, the principal cash flow from the mortgages underlying a CMO is segmented and paid in accordance with a predetermined priority to investors holding various CMO tranches (but not necessarily to those holding certain residuals). By allocating the principal cash flows from the underlying collateral among the separate CMO tranches, different classes of bonds are created, each with its own stated maturity, estimated average life, coupon rate, and unique prepayment risk characteristics. Notwithstanding the importance of the CMO structure to an evaluation of the timing and amount of cash flows, it is equally essential to understand the coupon

rates on the mortgages underlying the CMO to assess the prepayment sensitivity of the CMO tranches.

C. Residuals are claims on any excess cash flows from a CMO issue or other asset-backed security remaining after the payments due to the holders of the other classes and after trust administrative expenses have been met. The economic value of a residual is a function of the present value of the anticipated excess cash flows under assumed prepayment speeds based upon the underlying collateral of the CMO. These cash flows are highly sensitive to prepayments and existing levels of market interest rates; and the mortgages underlying the CMO must be understood in order to assess this sensitivity. Accordingly, most residuals meet the definition of high-risk in this policy. Other factors affecting the market value of residuals include a lack of liquidity and a wide bid-ask price spread.

D. Zero-coupon, "stripped" and certain Original Issue Discount ("OID") securities are priced at large discounts to their face value prior to maturity and exhibit significant price volatility. "Stripped" securities are the interest or principal portions of U.S. Government obligations (which are separated and sold to depository institutions in the form of

stripped coupons or stripped bonds (principal)), STRIPS, and such proprietary products as CATs or TIGRs. Also, deep discount OID bonds have been issued by a number of municipal entities.

Definition of "High-Risk Mortgage Security"

In general, any mortgage derivative product (including a CMO floating rate debt class) that exhibits greater price volatility than a standard fixed rate thirty-year mortgage-backed pass-through security will be deemed to be high risk. For purposes of this policy statement, a "high-risk mortgage security" is defined as any mortgage derivative product that at the time of purchase, or at a subsequent testing date, meets at least one of the following three tests. Once a mortgage derivative product is defined to be high risk, the product will be considered as high-risk as long as it is held by the institution.

(1) Average Life Test. The mortgage derivative product has an expected weighted average life greater than 8.0 years.

(2) Average Life Sensitivity Test. The expected weighted average life of the mortgage derivative product:

a. extends by more than 4.0 years, assuming an immediate and sustained parallel shift in the yield curve of plus 300 basis points, or

b. shortens by more than 5.0 years, assuming an immediate and sustained parallel shift in the yield curve of minus 300 basis points.

(3) Price Sensitivity Test. The estimated change in the price of the mortgage derivative product is more than 16 percent, due to an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points.

For purposes of determining whether a particular mortgage derivative product meets any of the above tests, all of the underlying assumptions including prepayment assumptions for the underlying collateral must be reasonable. Examiners will review all of the underlying assumptions used by the institution. For example, if an institution's prepayment assumptions differ significantly from the median prepayment assumptions of several major dealers as selected by examiners, the examiners may use their own prepayment assumptions in determining if a particular mortgage derivative product is high risk.

The federal financial institution regulatory agencies will monitor the changes in the level of interest rates and market innovations. The above tests may be adjusted in the event of a significant movement in market interest rates or to fairly measure the risk characteristics of new mortgage-backed products. Furthermore, each federal financial institution regulatory agency reserves the right to take such action as it deems appropriate to avoid evasion of the standards set forth in this policy statement, including the definition of high risk mortgage security.

Generally, a CMO floating-rate debt class bearing a rate that, at the time of purchase and each subsequent testing date, is 125 basis points or more below the contractual cap on the instrument is not subject to the average life and average life sensitivity tests described above. For purposes of this policy statement, a CMO floating-rate debt class is a debt class whose rate adjusts at least annually on a one-for-one basis with the debt class's index. The index must be a conventional, widely-used market interest rate index such as LIBOR. This exception does not apply to inverse floating rate debt classes.

A mortgage derivative product that does not meet any of the

above tests will generally not be considered a high-risk mortgage security. However, any mortgage derivative product (including a CMO floating rate debt class) that, in an examiner's judgment, exhibits greater price volatility than a standard fixed rate 30-year mortgage-backed pass-through security will be deemed to be high risk.

Supervisory Policy

Mortgage Derivative Products

Prior to purchase, a depository institution must determine whether a mortgage derivative product that it is considering acquiring is high-risk, as defined above. An institution may only acquire a high-risk mortgage derivative product to reduce its overall interest rate risk. (See footnote 4 regarding the use of high-risk mortgage derivative products as trading assets.)

An institution that has acquired high-risk mortgage securities in order to reduce interest rate risk needs to actively manage its holdings of these securities because of their substantial prepayment and average life variability. Such active management implies that the institution does not have both the intent and ability to hold high-risk mortgage securities for

long-term investment purposes. Accordingly, high-risk mortgage securities that are being used to reduce interest rate risk should not be reported as investments at amortized cost, but must be reported as trading assets at market value or as held-for-sale assets at the lower of cost or market value.

Examiners will seek the orderly divestiture of high-risk mortgage securities that do not reduce interest rate risk. These securities must be reported as held-for-sale assets at the lower of cost or market value until their disposition.

Mortgage derivative products that do not meet the definition of high-risk mortgage securities at the time of purchase should be reported as investments, held-for-sale assets, or trading assets, as appropriate. A mortgage derivative product that was not a high-risk mortgage security when it was purchased as an investment may later fall into the high-risk category. Institutions must ascertain from a source independent of the party from whom the product was purchased and document, no less frequently than annually, that any nonhigh-risk mortgage derivative products that are held for investment remain outside the high-risk category. Such documentation will be subject to examiner review. If a mortgage derivative product that was not a high-risk mortgage

security when it was purchased as an investment later meets the high-risk definition, it normally must be redesignated as held for sale.

An institution that owns or plans to acquire high-risk mortgage securities must have a monitoring and reporting system in place that provides the documentation necessary to evaluate the expected and actual performance of such securities. The institution must use this system to conduct and document an analysis that shows, prior to purchase, that the proposed acquisition of a high-risk mortgage security will reduce the institution's overall interest rate risk. Subsequent to purchase, the institution must evaluate and document at least quarterly whether this high-risk mortgage security has actually reduced interest rate risk.

The institution's analyses performed prior to purchase and subsequently thereafter must be fully documented and will be subject to examiner review. This review will include an analysis of all assumptions used by management regarding the interest rate risk associated with the institution's assets, liabilities and off-balance sheet positions. Analyses performed and records constructed to justify purchases on a post-acquisition basis are unacceptable and will be subject to examiner criticism. Reliance on analyses and documentation

obtained from a securities dealer or other outside party without internal analyses by the institution are also unacceptable and reliance on such third-party analyses will be subject to examiner criticism.

Management should also maintain documentation demonstrating that it took reasonable steps to assure that the prices paid for high-risk mortgage securities represented fair market value. Generally, price quotes should be obtained from at least two brokers prior to executing a trade. If, because of the unique or proprietary nature of the transaction or product, or for other legitimate reasons, bids cannot be obtained from more than one broker, management should document the reasons for not obtaining such quotes.

In addition, a depository institution that owns high-risk mortgage securities must demonstrate that it has established the following:

(1) A board-approved portfolio policy which addresses the goals and objectives the institution expects to achieve through its securities activities, including interest rate risk reduction objectives with respect to high-risk mortgage securities;

(2) Limits on the amounts of funds that may be committed to these high-risk mortgage securities;

(3) Specific financial officer responsibility for and authority over securities activities involving high-risk mortgage securities;

(4) Adequate information systems;

(5) Procedures for periodic evaluation of high-risk mortgage securities and their actual performance in reducing interest rate risk; and

(6) Appropriate internal controls.

The board of directors, or an appropriate committee thereof, and the institution's senior management should regularly (at least quarterly) review all high-risk mortgage securities to determine whether these instruments are adequately satisfying the interest rate risk reduction objectives set forth in the portfolio policy. The depository institution's senior management should be fully knowledgeable about the risks associated with prepayments and their subsequent impact on its high-risk mortgage securities.

Failure to report high-risk mortgage securities in accordance with the above policy, or failure to maintain adequate documentation demonstrating that the product was intended to reduce the institution's interest rate risk, will be viewed as an unsafe and unsound practice.
Purchases of high-risk mortgage securities prior to the date of this supervisory policy statement generally will be reviewed in accordance with previously-existing supervisory policies.

Other Zero-Coupon, Stripped or Original Issue Discount (OID) Products

Although considered free from credit risk if issued directly by the U.S. Government, longer maturities of zero coupon, stripped, and deep discount OID products (generally, maturities exceeding ten years from the date of purchase) have displayed extreme price volatility. Therefore, disproportionately large long-maturity holdings of these instruments, in relation to the total investment portfolio or total capital of the depository institution, are considered an imprudent investment practice. Such holdings will be subject to criticism by examiners who may seek the orderly disposal of some or all of these securities. Securities slated for disposal must be reported as held-for-sale assets at the lower of cost or market value until their disposition.

Other Considerations

Depository institutions should exercise extreme caution with respect to high-risk mortgage securities (as defined above) and securities with similar characteristics, irrespective of brand names and labels. Before purchasing any new or unfamiliar instrument, senior management should at a minimum produce internally a detailed analysis of the security in order to understand the performance characteristics, price volatility, and potential hazards inherent in owning the security under various interest rate scenarios. A prospectus supplement that fully details the cash flows covering each of the securities held by the institution should be obtained and analyzed prior to purchase and retained for examiner review. Securities and other products (whether carried on or off the balance sheet) with characteristics similar to those of high-risk mortgage securities and long-maturity zero-coupon products described in this supervisory policy may be treated in the same manner by the financial regulatory agencies.

Several states have adopted, or are considering, regulations that prohibit state-chartered banks from purchasing interest-only strips or other securities discussed above. Accordingly, state-chartered institutions should consult with their state regulator concerning the permissibility of these purchases.

Dated:

Signed: ______________________________

Robert J. Lawrence
Executive Secretary
Federal Financial Institutions Examination Council

Federal Financial Institutions Examination Council

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Press Release

For immediate release July 30, 1991

On March 18, 1991, under the auspices of the Task Forces on Supervision and Reports of the Federal Financial Institutions Examination Council (FFIEC), the four federal regulators of banks and thrift institutions published in the Federal Register a request for public comment on a proposal relating to nonaccrual loans. The proposal would establish criteria under which a federally supervised bank or savings association, for purposes of the Reports of Condition and Income (Call Reports) or the Thrift Financial Report (TFR), would be permitted to return nonaccrual loans with partial charge-offs of principal to accrual status without first recovering the partial charge-off or becoming fully current in accordance with the contractual loan terms.

The agencies have reviewed the comment letters received during the comment period that ended on May 2, 1991. The majority of commenters expressed concerns about consistency with generally accepted accounting principles (GAAP), and a number of commenters expressed concern that differences

between regulatory reporting requirements and GAAP in the area of loans to borrowers experiencing financial difficulties would likely be viewed negatively by bank analysts and other market participants. (While noting these concerns, the agencies also observed that, in some respects, where the proposal differed from GAAP -- such as in the areas of loss recognition and disclosure -- the proposal was more conservative than GAAP.) At the same time, as a longstanding practice, the agencies have attempted to minimize differences between regulatory reporting requirements and GAAP.

The agencies have also noted that certain clarifications presented in their March 1, 1991 joint agency policy statements provided a number of the potential benefits that would have been provided by the proposal. The clarifications are consistent with GAAP. They addressed the cash-basis recognition of interest income on nonaccrual loans, the restoration of formally restructured loans to accrual status, and the disclosure of formally restructured loans that yield a market rate of interest. The clarifications also suggested enhanced disclosures of important characteristics of nonaccrual loans.

Furthermore, the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA) have projects underway which will attempt to develop guidance on the recognition of interest

income and loan losses on loans to borrowers experiencing financial difficulties. The staffs of the agencies intend to work with the FASB and the AICPA to attempt to develop a consistent and objective reporting framework in this area.

In light of these considerations, the agencies have decided that the proposal should be withdrawn. In keeping with the joint agency policy statements of March 1, 1991, the agencies will continue their efforts to clarify supervisory and reporting policies for depository institutions.

The reasons for withdrawal by the agencies are further discussed in the "summary" and "supplementary information" sections of the attached draft Federal Register notice that is being separately published. The attached draft Federal Register notice also presents a summary of the comments that the agencies received on the proposal.

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