

FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. 10237]
May 4, 1988

Selection of Securities Dealers;
Unsuitable Investment Practices

To All State Member Banks, and Others Concerned,
in the Second Federal Reserve District:

The following statement has been issued by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has issued a supervisory policy statement regarding selection of securities dealers and unsuitable investment practices.

The purpose of this supervisory policy is to provide State member banks with recommended procedures to be used in the selection of a securities dealer and to advise them of certain securities practices that are viewed by federal banking regulators as unsuitable for an investment portfolio.

In addition, the supervisory policy discusses several types of securities with very volatile price and high risk characteristics and which, therefore, may be unsuitable for an institution's investment portfolio, particularly if held in significant amounts.

Printed below is the text of the policy statement, as published in the *Federal Register* of April 26. Questions thereon may be directed to Gerald P. Minehan, Assistant Chief Examiner, Multinational Banking Department (Tel. No. 212-720-5881), or Albert Toss, Assistant Chief Examiner, Domestic Banking Department (Tel. No. 212-720-5895).

E. GERALD CORRIGAN,
President.

FEDERAL RESERVE SYSTEM

**Supervisory Policy Concerning
Selection of Securities Dealers and
Unsuitable Investment Practices**

AGENCY: Board of Governors of the
Federal Reserve System.

ACTION: Supervisory Policy Statement.

SUMMARY: The purpose of this supervisory policy is to provide State member banks with recommended procedures to be used in the selection of a securities dealer and to advise them of certain securities practices that are viewed by federal banking regulators as unsuitable for an investment portfolio. In addition, the supervisory policy discusses several types of securities with very volatile price and high risk characteristics and which, therefore, may be unsuitable for an institution's investment portfolio, particularly if held in significant amounts.

EFFECTIVE DATE: April 20, 1988.

FOR FURTHER INFORMATION CONTACT: Robert S. Plotkin, Assistant Director, (202) 452-2782; Edwin Demoney, Manager, (202) 452-2434; or Rhoger Pugh, Manager, (202) 728-5883, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, Washington DC 20551. For the hearing impaired *only*, Telecommunication Device for the Deaf (TDD), Earnestine Hill or Dorothea Thompson, (202) 452-3544.

SUPPLEMENTARY INFORMATION: This supervisory policy was developed by the Federal Financial Institutions Examination Council (FFIEC) because of concerns over the use of investment portfolios by depository institutions as vehicles for speculative activities. Such speculative activity has in a number of cases resulted from the depository institution's investment portfolio manager following the advice of the

securities dealers who, in order to generate commission income, encourage speculative practices that are unsuitable for the investment portfolio.

The supervisory policy provides a list of standards that a depository institution should apply when selecting a securities dealer. These standards include: review of the securities firm's financial strength; inquiry into the dealer's reputation for financial stability and honest dealings with customer's; inquiry of regulatory authorities concerning the existence of any formal enforcement actions against the dealer; a review of the sales representative's background.

The supervisory policy states that investment portfolios are traditionally maintained to provide earnings, liquidity and a means of diversifying risks. It states that transactions entered into in anticipation of taking gains on short-term price movements are not prudent

investment practices and that such transactions should be conducted in the depository institution's closely supervised securities trading account and then only by institutions that have strong capital and earnings. The policy discusses trading practices—i.e., gains trading, when-issued securities trading, pair-offs, corporate settlement on U.S. government and Federal agency securities purchases, repositioning repurchase agreements, and short sales—that are unsuitable for investment portfolios.

The supervisory policy also describes the risk and price characteristics and appropriate accounting treatment for several extremely volatile instruments such as stripped mortgage-backed securities (interest-only strips, commonly referred to as "IOs", and principal-only strips, commonly referred to as "POs") and asset-backed securities residuals. The accounting treatment specified in the policy statement provides that depository institutions shall account for these instruments in accordance with Generally Accepted Accounting Principles (GAAP) as set forth in Financial Accounting Standards Board Statement #91. This statement requires that the carrying amount of these instruments be adjusted when actual prepayment experience differs from the prepayment estimates used in the initial valuation. Institutions not subject to GAAP are instructed to follow GAAP or, alternatively, to carry these instruments at market value or the lower of cost or market value.

Acting pursuant to its supervisory authority over State member banks contained in Section 9 (12 U.S.C. 321, *et seq.*) and Section 11 (12 U.S.C. 248) of the Federal Reserve Act and the Financial Institutions Supervisory Act of 1966 (12 U.S.C. 1818(b)) and related provisions of law, the Board of Governors has adopted the following supervisory policy:

Supervisory Policy Concerning Selection of Securities Dealers and Unsuitable Investment Practices

Purpose

This supervisory policy is to provide recommended procedures to be employed by State member banks and other depository institutions when selecting securities dealers and to advise of certain securities activities that the depository institution regulators view as unsuitable in an investment portfolio.

Background

The depository institution regulators have become aware of speculative activity which has taken place in a number of depository institutions investment portfolios. Certain of these institutions have failed because of the speculative activities, and other institutions have been weakened significantly as their earnings and capital have been impaired and the liquidity of their securities has been eroded by the depreciation in their market value.

Speculative activity often occurs when a depository institution's investment portfolio manager follows the advice of securities dealers who, in order to generate commission income, encourage speculative practices that are unsuitable for the investment portfolio.

Recommendations Concerning the Selection of a Securities Dealer

It is common for the investment portfolio managers of many depository institutions to rely on the expertise and advice of a securities sales representative for: recommendations of proposed investments; investment strategies; and the timing and pricing of securities transactions. Accordingly, it is important for the management of depository institutions to know the securities firms and the personnel with whom they deal. An investment portfolio manager should not engage in securities transactions with any securities dealer that is unwilling to provide complete and timely disclosure of its financial condition. Management must review the dealer's financial statements and make a judgment about the ability of the dealer to honor its commitments. An inquiry into the general reputation of the dealer also is necessary.

The board of directors and/or an appropriate board committee should review and approve a list of securities firms with whom the depository's management is authorized to do business. The following securities dealer selection standards are recommended, but are not all inclusive. The dealer selection process should include:

—A consideration of the ability of the securities dealer and its subsidiaries or affiliates to fulfill commitments as evidenced by capital strength and operating results disclosed in current financial data, annual reports, credit reports, etc.;

- An inquiry into the dealer's general reputation for financial stability and fair and honest dealings with customers, including an inquiry of past or current financial institution customers of the securities dealer;
- An inquiry of appropriate State or Federal securities regulators and securities industry self-regulatory organizations, such as the National Association of Securities Dealers, concerning any formal enforcement actions against the dealer or its affiliates or associated personnel;
- An inquiry, as appropriate, into the background of the sales representative to determine his or her experience and expertise;
- A determination whether the depository institution has appropriate procedures to establish possession or control of securities purchased. Purchased securities and repurchase agreement collateral should only be kept in safekeeping with selling dealers when (1) The board is completely satisfied as to the creditworthiness of the securities dealer and (2) the aggregate value of securities held in safekeeping in this manner is within credit limitations that have been approved by the board of directors, or a committee of the board, for unsecured transactions (see FFIEC Policy Statement adopted October 1985).

As part of the process of managing a depository institution's relationships with securities dealers, the board of directors may wish to consider including in the financial institution's code of ethics of conduct a prohibition by those employees, who are directly involved in purchasing and selling securities for the depository institution, from engaging in personal securities transactions with the same securities firm that the depository institution uses for its transactions without specific board approval and periodic review. The board also may wish to adopt a policy applicable to directors, officers or employees concerning the receipt of gifts, gratuities or travel expenses from approved dealer firms and their personnel (also see in this connection the Bank Bribery Act, 18 U.S.C. 215 and interpretive releases).

Objectionable Investment Practices

Depository institution directors are responsible for prudent administration of investments in securities. An investment portfolio traditionally has been maintained by a depository

institution to provide earnings, liquidity and a means of diversifying risks. When investment transactions are entered into in anticipation of taking gains on short-term price movements, the transactions are no longer characteristic of prudent investment activities and should be conducted in a securities trading account. Securities trading of the types described in section I of the attached appendix will be viewed as unsuitable activities when they are conducted in a depository institution's investment account. Securities trading should take place only in a closely supervised trading account and be undertaken only by institutions that have strong capital and current earning positions. Acquisitions of the various forms of zero coupon, stripped obligations and asset backed securities residuals discussed in section II of the attached appendix will receive increased regulatory attention and, depending upon the circumstances, may be considered unsuitable for a depository institution.

State chartered financial institutions are cautioned that certain of the investment practices listed in the appendix may violate state law. If any such practices are contemplated, the appropriate state supervisor should be consulted regarding permissibility under state law.

Appendix to Supervisory Policy Statement on the Selection of Securities Dealers and Unsuitable Investment Practices.

I. Trading in the Investment Portfolio

Trading in the investment portfolio is characterized by a high volume of purchase and sale activity, which when considered in light of a short holding period for securities, clearly demonstrates management's intent to profit from short-term price movements. In this situation, a failure to follow accounting and reporting standards applicable to trading accounts may result in a misstatement of the depository institution's income and a filing of false regulatory reports and other published financial data. It is an unsafe and unsound practice to record and report holdings of securities that result from trading transactions using accounting standards which are intended for investment portfolio transactions; therefore, the discipline associated with accounting standards applicable to trading accounts is necessary. Securities held in trading accounts should be marked to market, or

the lower of cost or market, periodically with unrealized gains or losses recognized in current income. Prices used in periodic revaluations should be obtained from sources that are independent of the securities dealer doing business with the depository.

The following practices are considered to be unsuitable when they occur in a depository institution's investment portfolio.

A. "Gains Trading". "Gains trading" is a securities trading activity conducted in an investment portfolio, often termed "active portfolio management." "Gains trading" is characterized by the purchase of a security as an investment and the subsequent sale of that same security at a profit within several days or weeks. Those securities initially purchased with the intent to resell are retained as investment portfolio assets if they cannot be sold at a profit. These "losers" are retained in the investment portfolio because investment portfolio holdings are accounted for at cost, and losses are not recognized unless the security is sold. "Gains trading" often results in a portfolio of securities with extended maturities, lower credit quality, high market depreciation and limited practical liquidity.

In many cases, "gains trading" has involved the trading of "when issued" securities and "pair offs" or "corporate settlements" because the extended settlement period associated with these practices allows speculators the opportunity for substantial price changes to occur before payment for the securities is due.

B. "When-Issued" Securities Trading. "When-issued" securities trading is the buying and selling of securities in the interim between the announcement of an offering and the issuance and payment date of these securities. A purchaser of a "when-issued" security acquires all the risks and rewards of owning a security and may sell the "when-issued" security at a profit before taking delivery and paying for it. Frequent purchases and sales of securities during the "when-issued" period generally are indications of trading activity and should not be conducted in a bank's investment portfolio.

C. "Pair-Offs". A "pair-off" is a security purchase transaction which is closed out or sold at, or prior to, settlement date. As an example, an investment portfolio manager will

commit to purchase a security; then, prior to the predetermined settlement date, the portfolio manager will "pair-off" the purchase with a sale of the same security prior to, or on, the original settlement date. Profits or losses on the transaction are settled by one party to the transaction remitting to the counter party the difference between the purchase and sale price. Like "when issued" trading, "pair-offs" permit speculation on securities price movements without paying for the securities.

D. Corporate Settlement on U.S. Government and Federal Agency Securities Purchases. Regular-way settlement for transactions in U.S. Government and Federal agency securities is one business day after the trade date. Regular-way settlement for corporate securities is five business days after the trade date. The use of a corporate settlement method (5 business days) for U.S. Government securities purchases appears to be offered by dealers in order to facilitate speculation on the part of the purchaser.

E. Repositioning Repurchase Agreements. Dealers who encourage speculation through the use of "pair-off" "when-issued" and "corporate settlement" transactions often provide the financing at settlement of purchased securities which cannot be sold at a profit. The buyer purchasing the security pays the dealer a small "margin" that is equivalent roughly to the security. The dealer then agrees to fund the purchase by buying the security back from the purchaser under a resale agreement. Apart from imprudently funding a longer-term, fixed-rate asset with short-term, variable-rate source funds, the purchaser acquires all the risks of ownership of a large amount of depreciated securities for a very small margin payment. Purchasing securities in these circumstances is inherently speculative and is a wholly unsuitable investment practice for depository institutions.

F. Short Sales. A short sale is the sale of a security that is not owned. The purpose of a short sale generally is to speculate on the fall in the price of the security. Short sales are speculative transactions that should be conducted in a trading account, and when conducted in the investment portfolio, they are considered to be unsuitable.

Short sales are not permissible activities for Federal credit unions.

II. Stripped Mortgage Backed Securities, Residuals and Zero Coupon Bonds

There are advantages and disadvantages in owning these products. A depository institution must consider the liquidity, marketability, pledgeability, and price volatility of each of these products prior to investing in them. It may be unsuitable for a depository institution to commit significant amounts of funds to long-term stripped mortgage-backed securities, residuals and zero coupon bonds which fluctuate greatly in price.

A. Stripped Mortgage Backed Securities (SMBS). Stripped Mortgage Backed Securities 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. In its purest form, an SMBS is converted into an interest-only (IO) strip, where the investor receives 100% of the interest cash flows, and a principal only (PO) strip, where the investor receives 100% of the principal cash flows.

All IOs and POs have highly volatile price characteristics based, in part, on the prepayment of the underlying mortgages and consequently on the maturity of the stripped security. Generally, POs will increase in value when interest rates decline while IOs increase in value when interest rates rise. Accordingly, the purchase of an IO strip may serve, theoretically, to offset the interest rate risk associated with mortgages and similar instruments held by a depository institution. Similarly, a PO may be useful as an offset to the effect of interest rate movements on the value of mortgage servicing. However, when purchasing an IO or PO the investor is speculating on the movements of future interest rates and how these movements will affect the prepayment of the underlying collateral. Furthermore, those SMBS that do not have the guarantee of a government agency or a government-sponsored agency as to the payment of principal and interest have an added element of credit risk.

As a general rule, SMBS cannot be considered as suitable investments for the vast majority of depository institutions. SMBS, however, may be appropriate holdings for depository

institutions that have highly sophisticated and well managed securities portfolios, mortgage portfolios or mortgage banking functions. In such depository institutions, however, the acquisition of SMBS should be undertaken only in conformance with carefully developed and documented plans prescribing specific positioning limits and control arrangements for enforcing these limits. These plans should be approved by the institution's board of directors and vigorously enforced.

In those depository institutions that prepare their published financial statements in accordance with Generally Accepted Accounting Principles, SMBS holdings must be accounted for in accordance with Financial Accounting Standards Board Statement #91 (FAS #91) which requires that the carrying amount be adjusted when actual prepayment experience differs from prepayment estimates. Other institutions may account for their SMBS holdings under FAS #91 or alternatively at market value or the lower of cost or market value.

Several states have adopted, or are considering, regulations that prohibit state chartered banks from purchasing IO strips. Accordingly, state chartered institutions should consult with their state regulator concerning the permissibility of purchasing SMBS.

B. Asset Backed Securities (ABS) Residuals. Residuals are the excess cashflows from an ABS transaction after the payments due to the bondholders and the trust administrative expenses have been satisfied. This cashflow is extremely sensitive to prepayments, and thus has a high degree of interest rate risk.

Generally, the value of residual interests in ABS rises when interest rates rise. Theoretically a residual can be used as a risk management tool to offset declines in the value of fixed rate mortgage or ABS portfolios. However, it should be understood by all residual interest purchasers that the "yield" on these instruments is inversely related to their effectiveness as a risk management vehicle. In other words, the highest yielding ABS residuals have limited risk management value usually due to a complicated ABS structure and/or

unusual collateral characteristics that make modeling and understanding the economic cashflows very difficult.

Alternatively, those residuals priced for modest yields generally have positive risk management characteristics.

In conclusion, it is important to understand that a residual cashflow is highly dependent upon the prepayments received. Caution should be exercised when purchasing a residual interest, especially higher "yielding" interest, because the risk associated over the life of the ABS may warrant an even higher return in order to adequately compensate the investor for the interest rate risk assumed. Purchases of these equity interests should be supported by in-house evaluations of possible rate of return ranges in combination with varying prepayment assumptions.

Residual interests in ABS are not permissible acquisitions for Federal credit unions. Holdings of ABS residuals by other institutions should be accounted for in the manner discussed under stripped mortgage-backed securities and should be reported as "Other Assets" on regulatory reports.

C. Other Zero Coupon or Stripped Products. The interest and/or principal portions of U.S. Government obligations are sometimes sold to depository institutions in the form of stripped coupons, stripped bonds (principal), STRIPS, or propriety products, such as CATs or TIGRs. Also, Original Issue Discount Bonds (OIDs) have been issued by a number of municipal entities. Longer maturities of these instruments can exhibit extreme price volatility and, accordingly, disproportionately large long-maturity holdings (in relation to the total portfolio) of zero coupon securities may be unsuitable for investment holdings for depository institutions.

By order of the Board of Governors of the Federal Reserve System, this 20th day of April, 1988.

William W. Wiles,

Secretary of the Board.

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