FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. **10432**
February 8, 1991]

Securities Practices of State Member Banks

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

Following is the text of a statement issued by the Federal Financial Institutions Examination Council:

The Examination Council has announced that it is issuing for public comment a Supervisory Policy Statement on 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.

The Council requested that comments be received within 30 days of publication of the proposed Supervisory Policy Statement in the *Federal Register.*

The proposed Policy Statement is being issued to promote uniform treatment by the five agencies represented on the Council. It would amend the Supervisory Policy Statement issued by the Council in April, 1988 entitled "Selection of Securities Dealers and Unsuitable Investment Practices." This 1988 Policy Statement was adopted by the Federal Reserve Board, Federal Deposit Insurance Corporation, National Credit Union Administration, and Office of the Comptroller of the Currency. The Office of Thrift Supervision issued guidance in this area in 1988 through Thrift Bulletin 12, "Mortgage Derivative Products and Mortgage Swaps" and in 1989 through Thrift Bulletin 41, "Interim Guidelines for Securities Portfolio Policies and Strategies."

The Policy Statement on which comment is requested is divided into three sections: It:

- recommends procedures to be used in selecting securities dealers;
- requires the documentation of prudent securities policies and strategies;
- requires securities to be reported as held for investment, held for sale or held for trading in a manner consistent with the documented policies and strategies;
- identifies specific trading or sales practices that are considered unsuitable when conducted in an investment portfolio; and
- identifies the types of securities containing volatile price or other high-risk characteristics that may be unsuitable investments for depository institutions.

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In addition, the Council is requesting comment on the following specific matters relating to the guidelines in Section III of the Policy Statement:

- whether it should define CMO tranche types and residuals in precise, quantitative terms. In this regard, commenters are invited to submit quantitative criteria that could be used to separate "high-risk" tranches from all other tranches.
- what methods can be employed to determine whether a security that was purchased to reduce interest-rate risk is accomplishing that objective.
- what the economic and financial effects on financial markets and depository institutions would be if the proposed Policy Statement were implemented.

Printed on the following pages is the text of the Supervisory Policy Statement, which has been reprinted from the *Federal Register.* Comments thereon should be submitted by March 6, 1991, reflecting the FFIEC's extension of the period of time in which to submit comments (56 FR 3831); such comments may be sent to the Federal Financial Institutions Examination Council, as specified in the notice, or to our Multinational Banking Department.

E. Gerald Corrigan,
President.

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FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

Supervisory Policy Statement Concerning 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

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 proposing to update and revise the Supervisory Policy on the "Selection of Securities Dealers and Unsuitable Investment Practices" which was approved in April 1988 (the "April 1988 Supervisory Policy"). The proposed revised policy addresses the selection of securities dealers, requires depository institutions to establish prudent policies and strategies for securities transactions, defines securities trading or sales practices that are viewed by the Agencies as being unsuitable when conducted in an investment portfolio, indicates characteristics of loans held for sale or trading, and denotes certain types of securities with volatile price or other high risk characteristics that are generally not suitable investments for depository institutions.

The FFIEC's April 1988 Supervisory Policy was adopted by the FRB, FDIC, NCUA, and OCC. The OTS has issued guidance with respect to these issues in Thrift Bulletin 12, "Mortgage Derivative Products and Mortgage Swaps" and Thrift Bulletin 41, "Interim Guidelines for Securities Portfolio Policies and Strategies." If approved by the FFIEC, the revised Supervisory Policy would supersede the earlier version and the FFIEC would recommend to its member agencies that they adopt the revised policy. In the meantime, the member agencies will continue to apply their current supervisory policies on securities to the institutions they examine. In the interest of achieving uniformity among the member agencies in this area, the FFIEC is soliciting comments on the proposed changes to the April 1988 Supervisory Policy.

DATES: Comments must be received by February 4, 1991.

ADDRESSES: Comments should be directed to Robert J. Lawrence, Executive Secretary, Federal Financial Institutions Examination Council, 1776 G Street, NW., suite 850B, Washington, DC 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, Senior Accountant, Division of Banking Supervision and Regulation (202) 452-3502. At the FDIC: Robert F. Storch, Chief, Accounting Section, Division of Supervision, (202) 898-8906; William A. Stark, Assistant Director, Division of Supervision, (202) 898-6972. At the NCUA; Charles Felker, (202) 682-9640. At the OCC: Owen Carney, Senior Advisor for Investment Securities, (202) 447-1901. At the OTS: John M. Frech, Senior Accountant, Accounting Policy, (202) 906-5649.

SUPPLEMENTARY INFORMATION: The principal revisions and additions that the FFIEC is proposing to its April 1988 Supervisory Policy are summarized as follows:

Section I: Selection of Securities Dealers

Management of depository institutions must have sufficient knowledge about the securities firms, and personnel with whom they are doing business in order to conduct safe and sound securities transactions. The revised policy statement adds guidance providing that the board should also establish and periodically review dollar limits and limits on the types of transactions to be executed with each authorized securities firm.

Section II: Securities Portfolio Policies and Strategies and Unsuitable Investment Practices

The April 1988 Supervisory Policy described characteristics of trading and gains trading, and stated that such activities were not suitable when conducted in a depository institution's investment portfolio. The revised Supervisory Policy adds guidance for safe and sound management of securities portfolios and activities, adds and defines a held for sale supervisory reporting classification and revises and adds to the list of unsuitable investment practices. The additions are described in more detail as follows:

(1) The additions provide that the board of directors should understand and approve the securities portfolio policy and review management's strategies and securities activities. Safety and soundness guidance for securities activities was added that increases the oversight responsibility of the board of directors. The strategies and securities activities must be reviewed no less than quarterly by the board of directors for consistency with the institution's portfolio policy and strategies. Also, the board of directors should establish appropriate systems and internal controls to ensure that securities activities are consistent with its policies and management's strategies.

(2) Safety and soundness documentation requirements were added that require the board of directors to document its approval of the overall portfolio policy, and require management to document its strategies for significant security portfolios.

(3) The additions describe the proper supervisory reporting of securities activities and describes the characteristics of securities trading, held for sale, and investment activities. The additions require securities holdings that do not meet the supervisory reporting criteria for either investment or trading portfolios to be reported as held for sale. Also, securities held for sale must be reported at the lower of cost or market value. The additions further provide that it is an unsafe and unsound practice to report securities held for sale using reporting standards applicable to securities held for investment.

(4) The additions provide that the substance of an institution's securities activities will determine whether securities reported as held for investment are, in reality, held for trading or for sale. Seven factors have been added to the policy statement that must be considered when evaluating whether the reporting of a depository institution's securities holdings is consistent with management's intent and actions. The examiner is instructed to scrutinize the pattern of securities activities to determine whether securities reported as held for investment are, in reality, held for sale or for trading.

(5) The policy statement was revised to include loans and provides that loans are required to be reported at the lower of cost or market value when an institution holds the loans for resale, or demonstrates a pattern of sales transactions that indicates that management does not have the intent or ability to hold the loans for investment purposes.

(6) In the list of nine unsuitable investment practices;

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Item 5. Repositioning Repurchase Agreements: was clarified to allow for safe and sound use of repurchase agreements to fund securities held for investment;

Item 7. "Adjusted Trading" or "Bond Swapping": was added;

Item 8. Delegation of Discretionary Investment Authority: was added; and

Item 9. Covered Calls: was added.

Section III: Stripped Mortgage-Backed Securities, Certain CMO Tranches, Residuals, and Zero-Coupon Bonds

Section III incorporates substantial additions to the April 1988 Supervisory Policy. That policy statement provided that the acquisitions of the various forms of zero coupon, stripped obligations, and asset backed securities residuals will receive increased regulatory attention and may be considered unsuitable. The following items describe the additions to the April, 1988 Supervisory Policy:

(1) High-risk collateralized mortgage obligation ("CMO") tranches, as defined in this section, have been added to the types of securities that are generally not suitable investments for depository institutions.

(2) Depository institutions that own or plan to purchase stripped mortgage-backed securities ("SMBSs"), high-risk CMO tranches, and residuals must be able to perform interest rate risk and price sensitivity analyses. It is unsafe and unsound for management to rely on analyses and documentation obtained from an outside party without preparing independent internal analyses.

(3) SMBSs, high-risk CMO tranches, and residuals that have not been purchased to reduce the interest rate risk of the institution and of designated assets or that failed to reduce the interest rate risk of the institution and of designated assets will be considered speculative holdings. The examiner will review the institution's documentation of the internal analyses prepared prior to purchase and prepared quarterly thereafter to demonstrate that the securities were effective in reducing interest rate risk.

(4) The purchase or retention of speculative holdings of SMBSs, high-risk CMO tranches, and residuals and disproportionately large holdings of long-term zero-coupon bonds is contrary to safe and sound practices. Examiners may criticize such holdings and seek their orderly divestiture, resulting in the reporting of the securities at the lower of cost or market value until their disposal.

Although the FFIEC invites comments on all aspects of the proposed updates to its April 1988 Supervisory Policy, the FFIEC particularly requests comments on the following specific issues relating to section III of the Supervisory Policy. The FFIEC is not soliciting comments on any guidance in the proposed policy statement that reiterates guidance in the April 1988 Supervisory Policy.

(1) Whether section III of the Supervisory Policy should define certain CMO tranches and residuals in precise quantitative terms. In this regard, the FFIEC is inviting commenters to submit quantitative criteria that could be used to separate "high-risk" CMO tranches from all other CMO tranches. If possible, commenters should estimate the effect that these criteria will have on depository institutions and financial markets.

(2) Whether the policy statement should be expanded to prohibit depository institutions from holding SMBSs, high-risk CMO tranches and residuals as investments due to their extreme price volatility and other factors.

(3) If the policy statement permits depository institutions to hold SMBSs, high-risk CMO tranches and residuals as interest rate risk reduction tools, what statistical or analytical methods can be employed by examiners and depository institutions to determine whether, prior to its purchase, a security will reduce the interest rate risk of the institution and of designated assets and whether, subsequent to its purchase, the security has actually accomplished that objective?

(4) What will be the economic and financial impact on financial markets and depository institutions of implementing the changes in Section III of the proposed policy statement?

The text of the proposed revised Supervisory Policy follows.

Purpose

This supervisory policy informs insured depository institutions about:

- Recommended procedures to be used in the selection of a securities dealer;
- The need to document and implement prudent policies and strategies for securities, whether they are held for investment, for sale or for trading purposes;
- Securities trading or sales practices that are viewed by the federal financial institution regulators as being unsuitable when conducted in an investment portfolio. Securities held for trading must be reported at market value and securities held for sale must be reported at the lower of cost or market value; and
- Types of securities with volatile price or other high risk characteristics that *are generally not* suitable investments for depository institutions. Such securities may be subject to supervisory criticism, and depository institutions may be directed to establish a plan for disposal.

The guidance set forth in this supervisory policy statement with respect to securities held for sale or trading is also applicable to loans held for sale or trading.

Background

This supervisory policy supersedes an April 1988 supervisory policy statement on the "Selection of Securities Dealers and Unsuitable Investment Practices" that was developed by the Federal Financial Institutions Examination Council ("FFIEC"). The earlier policy statement dealt with certain regulatory concerns pertaining to speculative and other inappropriate activities improperly carried out in a depository institution's investment portfolio. This supervisory policy statement updates its predecessor by providing additional information on securities practices that are inappropriate for an investment account and emphasizes the requirement that securities held for sale, as well as loans held for sale, should be reported at the lower of cost or market value. It also incorporates guidance for stripped mortgage backed securities, certain CMO tranches, residuals, and zero coupon bonds.

In a number of cases where depository institutions engaged in speculative or other non-investment activities in their investment portfolios, the portfolio managers seemed to place undue reliance on the advice of a securities sales representative. Some depository institutions have failed because of their speculative securities activities. Other institutions have had their earnings or capital impaired and the practical liquidity of their securities eroded by market value depreciation. Many of the investment and speculative problems may have avoided had sound procedures been followed before using certain securities dealers.

Depository institutions must document prudent portfolio policies and strategies for loans and debt securities held as assets (hereinafter referred to as portfolio policy or strategies). The depository institution's board of directors is responsible for establishing and approving the portfolio policy. Securities must be recorded and reported in accordance with generally accepted accounting principles (GAA) [1] consistent with the institution's intent to

[1] In those cases where a difference in the interpretation of GAAP arises between an institution and its primary supervisory agency, the supervisory agency will require the institution to prepare its supervisory reports in accordance with the agency's interpretation.

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trade, to hold for sale or to hold for investment, and the use of amortized cost is prohibited for certain transactions.

Stripped mortgage backed securities, certain CMO Tranches, and residuals *are generally not* suitable investments *for depository institutions.* When holdings of these securities are not used to reduce interest rate risk, they should be disposed of in an orderly manner and reported on a lower of cost or market value basis.

Similarly, disproportionately large holdings of long-term zero coupon bonds are not suitable investments. Accordingly, they should be disposed of in an orderly manner and reported on a lower of cost or market value basis.

Detailed guidance is provided in the following three sections.

Section I: Selection of Securities Dealers

Many depository institutions rely on the expertise and advice of a securities sales representative for recommendations concerning proposed investments and investment strategies and for the timing and pricing of securities transactions. Many of the investment problems experienced by depository institutions may have been avoided had sound procedures been followed before using certain securities dealers.

It is essential that the management of depository institutions have sufficient knowledge about the securities firms and personnel with whom they are doing business. A depository institution should not engage in securities transactions with any securities firm that is unwilling to provide complete and timely disclosure of its financial condition. Management should review the securities firm's financial statements and evaluate the firm's ability to honor its commitments before entering into transactions with the firm and periodically thereafter. An inquiry into the general reputation of the dealer also is necessary. The board of directors (or an appropriate committee of the board [2]) should develop a list of securities firms with whom management is authorized to do business. The board should also establish and periodically review dollar limits and limits on the types of transactions to be executed with each authorized securities firm. At a minimum depository institutions should consider the following in selecting and retaining a securities firm:

(1) The ability of the securities dealer and its subsidiaries or affiliates to fulfill commitments as evidenced by capital strength, liquidity and operating results. This evidence should be gathered from current financial data, annual reports, credit reports, and other sources of financial information.

(2) The dealer's general reputation for financial stability and fair and honest dealings with customers. Other depository institutions that have been or are currently customers of the dealer should be contacted.

(3) Information available from 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, its affiliates or associated personnel.

(4) The background of the dealer's sales representative with whom business will be conducted to determine their expertise.

In addition, the board of directors (or an appropriate committee of the board) must determine that the depository institution has established appropriate procedures to obtain and maintain possession or control of securities purchased. In this regard, purchased securities and repurchase agreement collateral should only be left in safekeeping with selling dealers when: (1) The board of directors is completely satisfied as to the credit worthiness of the securities dealer and (2) the aggregate market value of securities held in safekeeping in this manner is within credit limitations that have been approved by the board of directors (or an appropriate committee of the board) for unsecured transactions (see the October 1985 FFIEC Policy Statement entitled "Repurchase Agreements of Depository Institutions with Securities Dealers and Others"). Federal credit unions, when entering into a repurchase agreement with the broker/dealer, are not permitted to maintain the collateral with the broker/dealer (see part 703 of the National Credit Union Administration rules and regulations).

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

Section II: Securities Portfolio Policies and Strategies and Unsuitable Investment Practices

Securities activities must be conducted in a safe and sound manner. The depository institution's board of directors should understand and approve the portfolio policy and review management's strategies and securities activities. Securities activities should be carried out consistently with the portfolio policy and strategies. The institution's board of directors or an appropriate committee of the board of directors should also oversee the establishment of appropriate systems and internal controls that will ensure that securities activities are consistent with the board-approved portfolio policy and management's strategies.

Policies and Strategies

A portfolio policy is a written description of authorized securities activities and the goals and objectives the institution expects to achieve through its securities activities. A strategy is a written description of the way management intends to achieve these goals and objectives. The portfolio policy and strategies should be consistent with the institution's overall business plan which may involve trading, held for sale, and investment activities. However, securities trading activity should only be conducted in a closely supervised trading account by institutions *with* strong capital and earnings. Each institution's portfolio policy and strategies must describe anticipated investment activities and either identify anticipated trading and held for sale activities or state that the institution will not enter into any trading or held for sale activities.

The board of directors must document its approval of the overall portfolio policy for the institution. Management must also document its strategies for significant security portfolios. The policy must be approved periodically (but no less than annually) by the institution's board of directors. Furthermore, the institution's strategies and securities activities must be reviewed no less than quarterly by the institution's board of directors or an appropriate committee thereof to ensure that securities activities are consistent with the strategies of the institution and that the strategies remain consistent with the portfolio policy.

The portfolio investment policy should take into account such factors as the

[2] An appropriate committee of the board is a committee whose membership includes outside directors or whose actions are subject to review and ratification by the board of directors.

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institution's asset/liability position, asset concentrations, interest rate risk and market volatility, liquidity, credit risk, management's capabilities and desired rate of return. If the board of directors of a depository institution fails to establish clear policies and strategies related to securities and lending activities or if an institution fails to adhere to the policies and strategies established by its board of directors, examiners may determine that some or all securities and loans are held for sale or held for trading. Held for sale securities must be reported at the lower of cost or market value and trading activities must be marked to market.

Proper Reporting of Securities Activities

Depository institution investment portfolios are maintained to provide earnings consistent with the safety factors of quality, maturity, marketability, and risk diversification. Securities that are purchased with these objectives may be reported at their amortized cost only when the depository institution has both the intent and ability to hold the assets for investment purposes. Transactions entered into in anticipation of taking gains or short-term price movements are not suitable as investment portfolio practices. Such transactions should only be conducted in a closely supervised securities trading account (by institutions that have strong capital and earnings). Securities holdings that do not meet the reporting criteria for either investment or trading portfolios must be designated as held for sale.

Trading in the investment portfolio is characterized by a high volume of purchase and sale activity that, when considered in light of a short holding period for securities, clearly demonstrates management's intent to profit from short-term price movements. In such situations, a failure to follow accounting and reporting standards applicable to trading accounts may result in a misstatement of the depository insitution's income and other published financial data and the filing of inaccurate regulatory reports. It is an unsafe and unsound practice to report securities holdings that result from trading transactions using reporting standards that are intended for securities held for investment purposes. Securities held for trading must be reported at market value, with unrealized gains and losses recognized in current income. Price used in periodic re-valuations should be obtained from sources that are independent of the securities dealer doing business with the depository institution. When prices are internally estimated by and obtained from the portfolio manager (when reliable external price quotations are not available), they should be reviewed by persons independent of the portfolio management function.

In other cases, a pattern of intermittent sales transactions in the investment portfolio may suggest that securities ostensibly held as long-term portfolio assets are actually held for sale. Securities held for sale must be reported at the lower of cost or market value with unrealized losses (and recoveries of unrealized losses) being recognized in current income. It is an unsafe and unsound practice to report securities held for sale using reporting standards that are intended for securities held for investment purposes. It is the substance of an institution's securities activities that deremines whether securities reported as being held as investment portfolio assets are, in reality, held for trading or for sale. Examiners will particulary scrutinize institutions that exhibit a pattern or practice of reporting significant amounts of realized gains on sales from their investment portfolio and that have significant amounts of unrecognized losses. If in the examiner's judgment such a practice has occurred, some or all of the securities reported as held for investment will be designated as held for sale or for trading. On the other hand, infrequent investment portfolio restructuring activities that are carried out in conjunction with a prudent overall business plan and that do not result in a pattern of gains being realized and losses being deferred will generally be viewed as an acceptable practice and thus would not result in the re-designation of securities held for investment as securities held for trading or for sale.

A number of factors must be considered when evaluating whether the reporting of a depository institution's securities holdings is consistent with management's intent for such holdings. Some of the factors for each reporting period include:

(1) The dollar amount of gains realized from sales in relation to the dollar amount of losses realized from sales and in relation to unrealized losses for other investment portfolio securities;

(2) The dollar amount of gains and losses realized from sales in relation to net income and capital;

(3) The number of sales transactions resulting in gains and the number resulting in losses;

(4) The gross dollar volume of securities purchases and sales;

(5) The rapidity of turnover, including consideration of the length of time securities are owned prior to sale, and the length of time securities are held after an unrealized gain is evident; and

(6) The reasons for the depository institution engaging in specific transactions, and whether these reasons are consistent with the portfolio policy and strategies.

Some of the factors that also must be considered to evaluate the depository institution's ability to continue to hold the securities include:

(1) The source and availability for funding for commitments;

(2) The ability to meet margin calls and over-collateralization requirements related to leveraged holdings;

(3) Limitations such as capital requirements, the legality of certain securities holdings, liquidity requirements, legal lending limits, and prudential concentration limits; and

(4) The ability to continue as a going-concern and to liquidate assets in the normal course of business.

Reporting of Loans Held for Sale or Trading

Historically, depository institutions have tended to hold loans until maturity. Consequently, the application of lower of cost or market accounting to portions of the loan portfolio has not been an issue except in those depository institutions that have regularly originated loans for purposes of subsequent resale. Nevertheless, as with debt securities, reporting loans at the lower of cost or market is required when the institution does not have both the intent and ability to hold these loans for investment purposes.

The factors listed above should also be considered when evaluating whether the reporting of loans is consistent with management's intent and ability to hold the loans. A pattern of originating loans at yields below market and subsequent sale at par once the yield approximates market is another factor that should also be considered when evaluating management's intent.

Unsuitable Investment Practices

The following activities raise specific supervisory concerns. The first six practices are considered unsuitable when they occur in a depository institution's investment portfolio. Such practices should only be conducted in an appropriately controlled and segregated trading or held-for-sale portfolio. The seventh practice is wholly unacceptable under all circumstances. Practices eight and nine involve an institution's transfer of control over individual assets, segments of the portfolio, or the entire portfolio to persons or companies unaffiliated with the institution. In such situations, the depository institution clearly no longer has the ability to hold the affected

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securities for investment purposes and such securities should be reported as held for sale. In addition, certain of the following practices may violate state law in certain states. State-chartered depository institutions are therefore cautioned to consult with their state supervisors.

1. "Gains Trading"

"Gains trading" is characterized by the purchase of a security as an investment portfolio asset and the subsequent sale of that same security at a profit after a short-term holding period. Securities that cannot be sold at a profit are retained as investment portfolio assets. These "losers" are retained in the investment portfolio because investment portfolio holdings are accounted for at amortized cost, and losses are normally not recognized unless the security is sold. Gains trading often results in a portfolio of securities with *one or more of the following characteristics*: extended maturities, lower credit quality, high market depreciation, and limited practical liquidity. Frequent purchase and sale activity, combined with a short-term holding period for securities, clearly demonstrates management's intent to profit from short-term price movements. This indicates that other securities held in the investment portfolio may also be held for trading or for sale.

In many cases, "gains trading" involves the trading of "when-issued" securities, the use of "pair-off" transactions (including transactions involving off-balance sheet contractual commitments), or " corporate" or "extended settlements" because these speculative practices afford an opportunity for substantial price changes to occur before payment for the securities is due.

2. "When-Issued" Securities Trading

"When-issued" securities trading is the buying and selling of securities in the period between the announcement of an offering and the issuance and payment date of the 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 having to take delivery and pay for it. Purchases and subsequent sales of securities during the "when-issued" period may not be conducted in a bank's investment portfolio, but are regarded instead as a trading activity.

3. "Pair-Offs"

A "pair-off" is a security purchase transaction or other contractual commitment that is closed-out or sold at, or prior to, settlement date or expiration date. For 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 transactions are settled by one party to the transaction remitting to the counterparty the difference between the purchase and sale price. Like "when-issued" trading, "pair-offs" permit an institution to speculate on securities price movements without having to pay for the securities. Such transactions are regarded as a trading activity. "Pair-offs" involving financial instruments with off-balance sheet risk such as swaps and other interest rate exchange agreements and optional forward commitments are also indicative of unsuitable investment activities.

4. Corporate or Extended Settlements

Regular-way settlement for transactions in U.S. Government and Federal agency securities (other than mortgage-backed and derivative products) is one business day after the trade date. Regular-way settlement for corporate and municipal securities and stripped U.S. Treasury securities and similar products is five business days after the trade date. The use of an extended or corporate settlement method for U.S. Government securities purchases and an extended settlement period (more than 5 business days) for stripped U.S. Treasury securities and similar products appear to be offered by securities dealers in order to facilitate speculation on the part of the purchaser, similar to the profit opportunities available in a "pair-off" transaction. The use of corporate or extended settlements to facilitate speculation is a trading activity.

Regular-way settlement for transactions in mortgage backed and mortgage derivative products varies and can be up to 30 days after trade date. Transactions with settlements in excess of 30 days following trade date are considered forward contracts and are to be reported accordingly.

5. Repositioning Repurchase Agreements

A repositioning repurchase agreement is a funding technique often used by dealers who encourage speculation through the use of "gains trading," "pair-off," "when-issued," and "corporate or extended settlement" transactions for securities which cannot be sold at a profit. The repurchase agreement is a service provided by the dealer so the buyer can hold the position until it can be sold at a gain, but it imprudently funds a longer-term, typically fixed-rate asset with dealer supplied short-term, variable-rate source funds. The buyer purchasing the security pays the dealer a small "margin" that approximates the actual loss in the security. The dealer then agrees to fund the purchase of the security by buying it back from the purchaser under a resale agreement. Any dealer financing technique such as repositioning repurchase agreements that are used to fund the purchase of securities may be indicative of securities that were acquired with the intent to resell at a profit at or prior to settlement or after a short-term holding period. This activity is inherently speculative and is a wholly unsuitable investment practice for depository institutions. Securities acquired in this manner should be reported as either trading account assets or as securities held for sale. The safe and sound use of repurchase agreements to fund securities held for investment is not typical of repositioning repurchase agreements.

6. 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 as a trading activity and when conducted in the investment portfolio, they are considered to be unsuitable.

A short sale that involves the delivery of the security sold short by borrowing it from the depository institution's investment portfolio should not be reported as a short sale. Instead, it should be reported as a sale of the underlying security with gain or loss recognized.

Short sales are not permissible activities for Federal credit unions.

7. "Adjusted Trading" or "Bond Swapping"

"Adjusted trading" or "bond swapping" is a practice involving the sale of a security to a broker at a price above the prevailing market value and the simultaneous purchase and booking of a different security, frequently a lower grade issue or one with a longer maturity, at a price greater than its market value. Thus, the broker is reimbursed for losses on the purchase from the institution and ensured a profit. Such transactions inappropriately defer the recognition of losses on the security sold and establish an excessive reported value for the newly acquired security. Consequently, such transactions are prohibited and may be in violation of 18

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U.S.C. sections 1001—False Statements or Entries and 1005—False Entries.

8. Delegation of Discretionary Investment Authority

Some depository institutions have delegated the purchase and sale authority for all or a portion of their investment securities portfolio to either an individual who is not an employee of the institution or one of its affiliates, or to a non-affiliated firm. Such a delegation of authority is intended to obtain a higher total return on the portfolio than the institution would realize if it managed the portfolio itself. When an institution has delegated such authority to individuals who are not employees of the depository institution, or its affiliates, then the depository institution no longer has the ability to control its own securities and all holdings where such authority has been delegated must be reported as held for sale.

9. Covered Calls

The writing of covered calls is an option strategy that, for a fee, grants the buyer of the call option the right to purchase a security owned by the option writer at a predetermined price before a specified future date. The option fee [3] received by the writing (selling) depository institution provides income and has the effect of increasing the effective yield on the portfolio asset "covering" the call.

Covered call programs have been promoted as hedging strategies because the fee received by the writer can be used to offset a limited amount of potential loss in the price of the underlying security. If interest rates rise, the call option fee can be used to partially offset the decline in the market value of a fixed rate security or the increased cost of market rate liabilities used to carry the security. However, there is no assurance that an option fee will completely offset the price decline on the security or the increased cost of liabilities and the resulting reduced spread between the institution's return on assets and funding costs.

As a practical matter, gains on the securities covered by the written call are limited to the amount of the difference between the carrying value of the security and the strike price at which the security will be called away. The potential for losses on the covered security is not limited. In an effort to obtain higher yields, some portfolio managers have mistakenly relied on the theoretical hedging benefits of covered call writing, and have purchased extended maturity U.S. government or Federal agency securities. This practice can significantly increase risks taken by the depository institution by contributing to a maturity mismatch between assets and funding.

Institutions should only initiate a covered call program for securities when the board of directors or an appropriate board committee has specifically approved a policy permitting this activity. That policy must set forth specific procedures for controlling covered call strategies, including record keeping, reporting, and review of activity, as well as providing for appropriate management information systems to report the results. Since the purchaser of the call acquires the ability to call the security away from the institution that writes the option, the ability of that institution to continue to hold the securities rests with an outside party. Securities held for investment where call options have been written are therefore held for sale and reported at the lower of cost or market value.

Covered call writing is not a permissible activity for Federal credit unions.

Section III: Stripped Mortgage Backed Securities, Certain CMO Tranches, Residuals, and Zero-Coupon Bonds

Due to the significant price and yield volatility caused in part by the substantial prepayment and average life variability of stripped mortgage-backed securities ("SMBSs"), certain CMO tranches (high-risk CMO tranches [4]), and residuals, these securities are *generally* not suitable investments for *depository institutions*. However, SMBSs, high-risk CMO tranches, and residuals may be used as interest rate risk reduction tools by depository institutions with well managed securities portfolios that have specific interest rate risk policies and procedures governing the acquisition, retention and disposal of such instruments. Similarly, long term zero-coupon bonds exhibit significant price volatility and disproportionately large holdings of these securities are not suitable investments. Depository institutions that currently own or plan to purchase SMBSs, high-risk CMO tranches, residuals, and long-term zero-coupon bonds should possess appropriate managerial and financial controls and analytical models to effectively measure and monitor the risks associated with these instruments.

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. Generally, IOs will increase in value when interest rates rise, as contrasted to POs, which decrease in value. Accordingly, the purchase of an IO strip may serve theoretically, to offset the interest rate risk associated with mortgages and mortgage-backed securities held by a depository institution. Similarly, a PO may be useful to offset the effect of interest rate movements on the value of mortgage servicing. The uncertainty regarding the timing and amount of cash flows from the underlying the timing and amount of cash flows from the underlying mortgage collateral makes it difficult to use SMBSs as long-term risk reduction tools. SMBSs without a government or government-sponsored agency guarantee of payment for principal and interest have the added characteristic of potential credit risk.

B. Collateralized Mortgage Obligations ("CMOs") or Real Estate Mortgage Investment Conduits (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

[3] Recognition of option fee income should be deferred until the option is exercised or expires. The covered call writer shall value the option at the lower of cost or market value at each report date.

[4] For purposes of this supervisory policy statement, high-risk CMO tranches" are generally defined to include any tranche that contractually is responsible for a greater than normal share of the risk (such as prepayment or interest rate risk) inherent in the specific collateral supporting the CMO structure; for example, support/companion bonds, z-bonds, super POs, inverse floaters, and other CMO tranches, however labeled, with similar characteristics.

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segmented and paid in accordance with a predetermined priority to investors holding various CMO tranches (but not necessarily to those holding certain residuals). By prioritizing the principal cash flow from the underlying collateral among the separate CMO tranches, different classes of bonds are created, each with their own stated maturity, estimated average life, coupon rates, and unique prepayment risk characteristics. Many CMOs are designed to have one or more Planned Amortization Class ("PAC") tranches. PAC tranches commonly have a fixed monthly principal amortization which does not change over a range of prepayments on the underlying mortgages; thus, to a certain extent, limiting the prepayment risk to investors. This limiting process allows investors to more accurately predict the average life of the asset and, in general, reduces the potential price volatility that would be assumed if the underlying MBSs themselves had been purchased. Although a CMO tranche, such as a PAC, is designed to reduce the uncertainty associated with the prepayment risk of the MBSs collateralizing a CMO, the presence of a PAC bond in a CMO will result in the transfer of prepayment risk to one or more of the other tranches. These non-PAC tranches are sometimes referred to as "CMO support tranches" or "companion bonds." Unlike a PAC tranche that has been designed to provide a high degree of comfort regarding expected average life and final maturity, non-PAC CMO tranches have a more volatile expected average life, rate of return, and market price.

C. Residuals are claims on any excess cash flows from a CMO issue or an asset-backed security remaining after the payments due to bondholders 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. This cash flow is highly sensitive to prepayments and existing levels of market interest rates. Other factors affecting the market value of residuals include a lack of liquidity and a wide bid-offer price spread.

Certain CMO residuals, for example, may be acceptable as risk management tools to reduce variations in the value of a fixed-rate mortgage or MBS portfolio in a period of changing interest rates. However, the uncertainly regarding prepayments on the underlying collateral makes it very difficult to use these securities as an effective risk reduction tool. Under an environment of rapidly falling interest rates, the market value of a residual can disappear completely. In addition, the complexity of some CMO structures (e.q., multiple numbers or types of tranches) or unusual collateral characteristics (e.g., a blend of fixed and floating rates or unique demographic traits) can make evaluating and forecasting future cash flows of residuals even more difficult. Thus, it is extremely unlikely that a residual can be used as a long-term interest rate risk reduction tool.

D. Long-term (generally, maturities over ten years from date of purchase) Zero-coupon, "stripped" or 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 and/or principal portions of U.S. Government obligations, which are separated and sold to depository institutions in the form of stripped coupons, stripped bonds (principal), STRIPS, or such proprietary products as CATs or TIGRs. Also, OID bonds have been issued by a number of municipal entities.

Supervisory Policy

SMBSs, high-risk CMO tranches, and residuals are *generally* not suitable investments for *depository institutions* because of their substantial prepayment risk and interest rate risk which can cause significant price, yield, and average life volatility. Over time, these instruments may cause unintended changes in an institution's earnings and its interest rate, liquidity, and funding risk profiles. SMBSs, high-risk CMO tranches, and residuals that have not been purchased to reduce the interest rate risk of the institution and of designated assets or that did not perform as intended (i.e., the position failed to reduce the interest rate risk of the institution and of the designated assets) will be considered speculative holdings for all depository institutions. In addition, disproportionately large holdings of long-term zero-coupon/OID bonds will be considered an imprudent investment practice for all depository institutions. In such circumstances, the purchase or retention of these securities is contrary to safe and sound depository institution practices and may result in criticism by examiners. Examiners may also seek the orderly divestiture of such securities which will result in the reporting of the securities at the lower of cost or market value until their disposal.

SMBSs, High-risk CMO Tranches, and Residuals

Dud to the high degree of interest rate risk and price volatility exhibited by SMBSs, high-risk CMO tranches, and residuals, depository institutions that currently own or plan to purchase these securities must have the ability to internally perform interest rate risk and price sensitivity analyses.

Prior to purchase, the institution must conduct and document an analysis that showns that the proposed purchase of the security will reduce the interest rate risk of the institution and of the designated assets. In demonstrating whether the purchase of the security will reduce interest rate risk, the institution must show that over a wide range of plausible interest rate scenarios, the combined market value of the instrument to be purchased and the designated assets will be less variable than the market value of the designated assets alone. The institution must also demonstrate that the purchase will reduce enterprise risk (i.e., the overall interest rate risk of the institution). Subsequent to purchase, the institution must evaluate and document at least quarterly whether the securities have actually reduced the interest rate risk of the institution and of the previously designated assets. In determining the effectiveness of the security in reducing interest rate risk, the institution must show that since the time of he security's purchase, the combined market value of the security and the designated assets has been less variable than the market value of the designated assets alone. The institution must also show that over this same time period, the cumulative change in the market value of the security purchased has substantially offset the change in the market value of the designated assets. These analyses should include appropriate consideration of cash flows received since purchase of the security. The institution must also demonstrate that the security purchased has reduced and will continue to reduce enterprise risk.[5]

The institution's analyses performed prior to purchase and subsequently thereafter will be subject to examiner review. Analyses performed and records constructed to justify purchases on a post-acquisition basis are insufficient, are considered unacceptable management tools, 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 considered unacceptable and will be subject to

[5] Purchases *of SMBS, residuals and high risk CMO tranches* prior to the date of this supervisory policy statement *generally* will be *reviewed* in accordance with the previously existing policies.

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examiner criticism. In addition, a depository institution must document the following: (1) Written portfolio policies approved by the board of directors addressing the goals and objectives the institution expects to achieve through its securities activities, including interest rate risk reduction objectives with respect to SMBSs, high-risk CMO tranches, or residuals; (2) accounting and reporting policies for its SMBS's, high-risk CMO tranches, and residuals consistent with the provisions of Section II of this supervisory policy statement; (3) limits on the amount of funds that may be committed to these securities; (4) diversification policies; (5) specific financial officer responsibility and authority; (6) adequate information systems; (7) procedures for periodic evaluation; and (8) 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 securities pursuant to the portfolio policy to determine whether these instruments are adequately satisfying their objectives and to concur with the results of the analyses performed. The depository institution's senior management should be fully knowledgeable about the risk associated with prepayments and their subsequent impact on the securities.

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 these instruments (generally, maturities exceeding ten years from the date of purchase) have displayed extreme 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 such securities. Such action will result in the reporting of these securities at the lower of cost or market value until their disposal.

Other Considerations

The exercise of extreme caution is urged for investment portfolio owners and prospective purchasers of SMBSs, residuals, high-risk CMO tranches, long-term zero-coupon bonds, and other securities and financial derivatives with similar characteristics. It is the responsibility of each depository institution's management to continue exercising care and prudence in the selection of suitable investment products, irrespective of brand names and labels. Before purchasing any new or unfamiliar investment instrument, senior management should at the very least internally produce a detailed independent analysis of the security, in order to fully 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 prior to purchase and retained for examiner review. Securities with characteristics similar to the types of securities detailed in this surpevisory policy will 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 IO strips or other securities discussed above. Accordingly, state-chartered institutions should consult with their state regulator concerning the permissibility of these purchases.

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Robert J. Lawrence,

Executive Secretary, Federal Financial Institutions Examination Council.

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