

NCUA-IR - 92-1 SUPERVISORY POLICY STATEMENT ON  
SECURITIES ACTIVITIES 4/92

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Part 703

Interpretive Ruling and Policy Statement No. 92-1; Supervisory Policy Statement on  
Securities Activities

AGENCY: National Credit Union Administration (NCUA).

ACTION: Interpretive Ruling and Policy Statement No. 92-1

SUMMARY: With certain modifications, the NCUA Board has adapted for federal credit unions (FCUs) the Federal Financial Institutions Examination Council (FFIEC) supervisory policy statement entitled "Supervisory Policy Statement on Securities Activities." This policy statement updates and revises the previous statement to better serve FCUs in today's complex investment environment. The FFIEC has recommended that its constituent members adopt the policy statement.

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SUPPLEMENTARY INFORMATION: The FFIEC, an interagency group, has recommended that its constituent members -- the Federal Reserve Board, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Comptroller of the Currency, and the Office of Thrift Supervision -- adopt its supervisory policy statement entitled "Supervisory Policy Statement on Securities Activities." The NCUA Board approved the FFIEC supervisory policy statement with certain modifications, on April 23, 1992, for inclusion in NCUA's official system of policy statements.

The FFIEC policy statement mainly updates and revises its Supervisory Policy Statement on the "Selection of Securities Dealers and Unsuitable Investment Practices" which was approved by the FFIEC in April 1988. The NCUA Board subsequently adapted the April 1988 statement with certain modifications and issued it as Interpretive Ruling and Policy Statement No. 88-1 entitled "Policy on Selection of Securities Dealers and Unsuitable Investment Practices."

The April 1988 statement emphasized the importance of a depository institution knowing the securities firms with which it does business and dealt with certain regulatory concerns pertaining to speculative and other activities improperly carried out in an institution's investment portfolio. It also identified risks associated with Stripped Mortgage Backed Securities (SMBSs), Asset-Backed Securities (ABS) Residuals, and other zero coupon or stripped products, and concluded that they

may be unsuitable investments for a depository institution.

The new policy statement supersedes the April 1988 statement. The new policy statement 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 the investment portfolio, indicates characteristics of loans held for sale or trading, and establishes a framework for identifying when certain mortgage derivative products are high risk mortgage securities which must be held in either a trading or held-for-sale account.

The policy statement is divided into three sections. Section I, which addresses the selection of securities dealers and applies without modification to FCUs. Section II which addresses securities portfolio policy and strategies and unsuitable investment practice, apply with certain modifications to FCUs. The modifications were made to ensure that the policy statement complies with the investment powers and limitations contained in sections 107(7), 107(8), and 107(15) of the Federal Credit Union Act (12 U.S.C. 1757(7), 1757(8), and 1757(15), and part 703 of NCUA's Rules and Regulations (12 CFR part 703). Section III, which addresses mortgage derivative products, other asset backed products, and zero coupon bonds, does not apply to FCUs because those securities are addressed comprehensively in part 703 of NCUA's Rules and Regulations. NCUA has included section III in this interpretive ruling so that the ruling will be consistent with the statement published by the other members of the FFIEC.

In addition, where the rules set forth in section III are more restrictive than those in part 703, FCUs may choose to consult the rules in section M for additional guidance.

Interpretive Ruling and Policy Statement No. 92-1

#### 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 trading or for sale, and to establish systems and internal controls that are designed to ensure that securities activities are consistent with the policies and strategies;
- Certain securities trading and sales practices that are viewed by the federal financial institution regulators as being unsuitable when conducted in an investment portfolio, thereby precluding the use of the amortized cost basis of accounting for securities holdings resulting from such practices.

The substance of an institution's securities activities determines whether securities reported as investments are, in reality, held for trading or for sale. 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. The guidance regarding securities held for sale or trading is also applicable to loans held for sale or trading;

-- High-risk mortgage securities that are not suitable investment portfolio holdings for depository institutions. These 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 may 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; and

-- Disproportionately large holdings of long-term zero-coupon bonds that are considered an imprudent investment practice. Such holdings will be subject to criticism by examiners who may seek their orderly disposal.

## Background

In a number of cases where depository institutions engaged in speculative or other non-investment activities in their investment portfolios, the portfolio managers placed 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 these problems could have been avoided had sound procedures been followed.

These factors led to the development of a supervisory policy statement on the "Selection of Securities Dealers and Unsuitable Investment Practices" that was approved by the Federal Financial Institutions Examination Council ("FFIEC") in April 1988. That policy statement emphasized the importance of a depository institution knowing the securities firms with which it does business and also dealt with certain regulatory concerns pertaining to speculative and other activities improperly carried out in an institution's investment portfolio.

In addition, it identified risks associated with Stripped Mortgage-Backed Securities (SMBSs), Asset-Backed Securities (ABS) Residuals, and other zero-coupon or stripped products and concluded that they may be unsuitable investments for the vast majority of depository institutions.

This supervisory policy statement supersedes the April 1988 Policy Statement by providing additional information on the development of a portfolio policy and strategies for securities and on securities practices that are inappropriate for an investment account. It also discusses factors that must be considered when evaluating whether the reporting of an institution's investment portfolio holdings is consistent with its intent and ability. In addition, this policy statement contains expanded guidance on the suitability of acquiring and holding mortgage derivative products, other similar products, and zero coupon bonds.

Detailed guidance is provided in the following three sections:

### Section 1: 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 problems depository institutions have experienced with their securities

activities could have been avoided had sound procedures been followed.

It is essential that the management a depository institution have sufficient knowledge about the securities firms and personnel with whom they are doing business. A depository institute 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 statement 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 is also necessary. The board of directors or an appropriate committee of the board /1 should periodically review ar approve a list of securities firms with which management is authorized to do business. The board or an appropriate committee thereof should also periodically review and approve limits on the amounts and types of transactions to be executed with authorized securities firm. Limits to be considered should include dollar amounts of unsettled trades, safekeeping arrangements, repurchase transactions, securities lending and borrowing, other transactions with credit risk, and total credit risk with an individual dealer.

/1 An appropriate committee of the board whose activities are subject to review and ratification by the board of directors.

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 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) In those cases when the institution relies upon the advice of a dealer's sales representative, the background of the sales representative with whom business will be conducted should be evaluated in order to determine his or her experience and expertise.

In addition, the board of directors (or an appropriate committee of the board) must ensure that the depository institution's management 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 or an appropriate committee thereof is completely satisfied as to the creditworthiness 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," NCUA's Interpretive Ruling and Policy Statement No. 85-2). FCUs, when entering into a repurchase agreement with a 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 providing oversight over a depository institution's relationships with securities the board of directors may wish to consider adopting a policy concerning conflicts of interest when employees who are directly involved in purchasing and selling securities for the depository institution are also engaging in personal securities transactions with these same securities firms.

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.) An FCUs directors, officials, committee members, senior Management employees, and employees directly involved in investments or deposits, and the immediate family members of such individuals, may not receive pecuniary consideration in connection with the making of an investment or deposit by the FCU (see part 703 of the NCUA Rules and Regulations).

## Section II: Securities Portfolio Policy and Strategies and Unsuitable Investment Practices

### Policy and Strategies

A portfolio policy is a written description of authorized securities investment, trading and held-for-sale activities, and the goals and objectives the institution expects to achieve through such activities. Strategies are written descriptions of the way management intends to achieve these goals and objectives and should address management's plans for each type of security (e.g., U.S. Treasuries, mortgage-backed securities, etc.) that will be used to carry out the portfolio policy. 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 and adequate liquidity. 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 institutions will not enter into any trading or held-for-sale activities.

Securities activities must be conducted in a safe and sound manner. Each depository institution's board of directors should review and approve the overall portfolio policy and management's documented strategies annually, or more frequently if appropriate, and these approvals must be adequately documents. Furthermore, the board of directors of an appropriate committee thereof should review the institution's securities activities and holdings no less than quarterly. The board of directors or an appropriate committee thereof should also oversee the establishment of appropriate systems and internal controls that are designed to

ensure that securities activities and holdings are consistent with the strategies of the institution and that the implementation of the strategies remains consistent with the portfolio policy's objectives.

When developing its portfolio policy and strategies, an institution should take into account such factors as asset/liability position, asset concentrations, interest rate risk, liquidity, credit risk, market volatility, and management's capabilities and desired rate of return. If the board of directors of a depository institution fails to adopt policies and strategies related to securities or if an institution fails to adhere to the policies and strategies approved by its board of directors, examiners may determine that some or all securities 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 reported at market value.

### Proper Reporting of Securities Activities

Securities must be reported in accordance with generally accepted accounting principles (GAAP) /2 consistent with the institution's intent to trade, to hold for sale or to hold for investment.

/2 In those cases where a difference in the interpretation of GAAP arises between an institution and its primary federal supervisory agency, the supervisory agency will require the institution to prepare its supervisory reports in accordance with the agency's interpretation.

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 to accomplish 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 long-term investment purposes. Transactions entered into in anticipation of taking gains on 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 and adequate liquidity. 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 institution'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. Prices used in periodic reevaluations should be obtained from sources that are independent of the securities dealer doing business with the depository institution. When prices are internally estimated by the portfolio manager (when reliable external price quotations are not available), they should be reviewed by persons independent of portfolio management function.

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 determines whether securities reported as being held as investment portfolio assets are, in reality, held for trading or for sale. Examiners will particularly 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 on investment portfolio securities will generally be viewed as an acceptable investment practice. Such activities usually would not result in the redesignation 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 investment portfolio securities holdings is consistent with management's intent for such holdings. Some of the factors relating to investment portfolio securities 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, the length of time securities are held after an unrealized gain is evident, and the remaining life of the security at the time of sale; and
- (6) The reasons for the depository institution's 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 investment portfolio securities include:

- (1) The sources and availability of funding;

(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 value accounting to portions of the loan portfolio has not been an issue except in those depository institutions that have regularly originated or purchased loans for purposes of subsequent sale. Nevertheless, as with debt securities, reporting loans at the lower of cost or market value is required when the institution does not have both the intent and ability to hold these loans for long-term 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 subsequently selling them at par once the yield approximates market is another factor that will be considered when evaluating management's intent.

#### Unsuitable Investment Practices

The following activities raise [Illegible] supervisory concerns. The first [Illegible] 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. Practices seven and eight involve an institution's transfer of control over individual assets, segment of the portfolio, or the entire portfolio persons or companies unaffiliated with the institution. In such situations, the depository institution clearly no longer has the ability to hold the affected securities for investment purposes and such securities should be reported as held for sale. The ninth practice is wholly unacceptable under all circumstances.

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 a profit after a short-term holding period. Securities that cannot be sold 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, [Illegible] 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 movement. 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 contracts), or "corporate" or "extended settlements" because these [Illegible] practices afford an opportunity for substantial price changes to occur before payment for the securities is [Illegible]

## 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. FCUs unions engaging in "when-issued" trading must follow NCUA's regulation on cash forward agreements (see part 703 of the NCUA Rules and Regulations).

## 3. "Pair-Offs"

A "pair-off" is a security purchase transaction that is closed-out or sold at, or prior to, settlement date or expiration date. "Pair-offs" may also involve optional or mandatory off-balance sheet contracts (e.g., swaps, options on swaps, forward commitments, and options on forward commitments).

In a "pair-off," 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 counter-party 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-off transactions using cash forward agreements are impermissible for FCUs. Under part 703 of NCUA's Rules and Regulations, cash forward agreements (settlement occurring within 30-120 days) must be settled on a cash basis. Also, FCUs are not authorized to engage in interest rate swaps or to purchase caps, collars, floors, or similar instruments (see part 703 of the NCUA Rules and Regulations).

## 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. In addition, regular-way settlement for

transactions in mortgage-backed and mortgage derivative products varies and can be up to 45 to 60 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 appears 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 a settlement period in excess of the regular-way settlement period appropriate for an instrument and, in any event beyond 60 days, in order to facilitate speculation is considered a trading activity.

#### 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 trading," and "corporate or extended settlement" transactions for securities which cannot be sold at a profit. The repositioning repurchase agreement is a service provided by the dealer so the buyer can be sold at a gain. 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 a repositioning repurchase agreement that is used to fund the speculative 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.

#### 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 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 a gain or loss recognized. Short sales that do not involve the delivery of the security sold short by borrowing it from the investment portfolio are impermissible activities for FCUs (see part 703 of the NCUA Rules and Regulations).

#### 7. Delegation of Discretionary Investment Authority

Some depository institutions have delegated the purchase and sale authority for authority for all or a portion of their investment securities portfolio to a non-affiliated firm or to an individual who is not an employee of the institution or one of its affiliates. 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 a non-affiliated firm or to one or more 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 an holdings for which such authority has been delegated must be reported as held for sale.

The centralized management of investment portfolios of affiliated depository institutions by the parent holding company or another affiliate is not ordinarily considered to be the delegation of investment authority.

Investment authority will also not be considered delegated to unaffiliated parties when a depository institutions portfolio manager is required to authorize a recommended purchase or sale transaction prior to its execution and the portfolio manager, in practice, reviews such recommendations and does, in fact, authorize such actions.

## 8. 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 <sup>1</sup>/<sub>3</sub> 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.

<sup>1</sup>/<sub>3</sub> 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.

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 an 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, the gain on a security covered by a written call is 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 similarly 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 its assets and its liabilities.

Institutions should only initiate a covered call for securities when the board of directors or an appropriate board committee has specifically approved a policy permitting this activity. This policy must set forth specific procedures for controlling covered call strategies including recordkeeping, reporting and review of activity, as well as providing for appropriate management information systems to report the results. Since the purchaser of the call inquires the ability to call the security away from the institution that writes the option, the ability of that institution to continue to

hold the security rests with an outside party. Securities held for investment against which call options have been written should therefore be redesignated as held for sale and reported at the lower of cost or market value.

However, if an option contract requires the writer to settle in cash rather than by delivering an investment portfolio security, the institution writing the option maintains the ability to hold the security and, thus, the security may be reported as an investment. In this case, the option must still be reported at the lower of cost or market value.

Covered call writing (referred to as "purchasing or selling a standby commitment" in part 703 of the NCUA Rules and Regulations) is an impermissible activity for FCUs (see part 703 of the NCUA Rules and Regulations).

#### 9. "Adjusted Trading"

"Adjusted trading" is a practice involving the sale of a security to a broker or dealer 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 or dealer 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 U.S.C. 1001-False Statements or Entries and 1005-False Entries. For FCUs, such transactions are also prohibited under part 703 of the NCUA Rules and Regulations.

#### Section III: Mortgage Derivative Products, Other Asset Backed Products, and Zero-Coupon Bonds /4

/4 FCUs must comply with the rules and regulations governing mortgage-derivative products and zero coupon bonds in part 703 of the NCUA Rules and Regulations rather than those set forth in section III of this policy statement. Where the rules set forth in section III of this policy statement are more restrictive than those in part 703, FCUs may choose to consult section III for further guidance. FCUs are not permitted to purchase Asset-Backed Securities (ABSs) where the security is supported by installment loans or leases or by revolving lines of credit.

#### Summary

Mortgage derivative products include Collateralized Mortgage Obligations ("CMOs"), Real Estate Mortgage Investment Conduits ("REMICs"), CMO and REMIC residuals, and Stripped Mortgage-Backed Securities ("SMBs"). 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.

Some mortgage derivative products exhibit considerably more price volatility than mortgages or ordinary mortgage pass-through securities and can expose investors to significant risk of loss if not managed in a safe and sound manner. This price volatility is caused in part by the uncertain cash flows that result from changes in

the prepayment rates of the under [Illegible] mortgages.

In addition, because these products are complex, a high degree of technical expertise is required to understand that their prices and cash flows may behave in various interest rate and prepayment environments. Moreover, because the secondary market for some 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 possess average life or [Illegible] volatility in excess for a benchmark fixed rate 30-year mortgage-backed pass-through security are "high-risk mortgage securities" and are not suitable investments. All high-risk mortgage securities, as defined in detail below, acquired by a depository institution after the effective date of the policy statement must be carried in the institution's trading account or as assets held for sale. On the other hand, mortgage derivative products [Illegible] meet the definition of a high-risk mortgage security at the time of purchase should be reported as investments, held-for-sale assets, or trading assets, as appropriate. Institutions must ascertain no less frequently than annually that such products remain outside the high risk category.

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. /5 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 analyze, monitor, and prudently adjust its holdings of high-risk mortgage securities in an environment of changing price and maturity expectations.

/5 Notwithstanding the provisions of this supervisory policy requiring the use of high-risk mortgage securities to reduce interest rate risk, the 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. [Illegible] 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 conduct an analysis to ensure that the position will reduce 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 mortgage 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. Purchases of high-risk mortgage securities prior to the effective date of this policy statement generally will be

reviewed in accordance with previously-existing supervisory policies.

Securities and other products, whether carried on or off the balance sheet (such as CMO swaps, but excluding service assets), having risk characteristics similar to high-risk mortgage securities will 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 some or all of these 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. 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 and interest rate risk reduction tools from a price sensitivity perspective 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, hereinafter 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 to guaranteed by the Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA), or Federal Home Loan Mortgage Corporation (FHLMC) and held in trust for CMO investors. IN contrast to MBSs where cash flows are received pro rata by all security holders, the cash flows from the mortgages underlying a CMO are segmented and paid in accordance with a predetermined priority to investors holding various CMO tranches. By allocating the principal and interest 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 prepayment characteristics. Notwithstanding the importance of the CMO structure to an evaluation of the timing and amount of cash flows, it is essential to understand the coupon rates on the mortgages underlying the CMO to assess the prepayment sensitivity of the CMO tranches.

C. Residuals, in the traditional sense, are claims on any excess cash flows form 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. 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 of these 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.

In addition, the 1986 legislation creating the REMIC structure requires that one class of each REMIC issue be designated the residual interest for tax purposes. Some of these REMIC residuals are not residuals in the traditional sense.

However, these REMIC residuals also are subject to this policy statement.

#### Definition of "High-Risk Mortgage Security"

In general, any mortgage derivative product that exhibits greater price volatility than a benchmark 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 any of the following tests. /6 In general a mortgage derivative product that does not meet any of the three tests below will be considered to be a "nonhigh-risk" mortgage security." [Editor's note - could not find opening quotation mark in text.]

/6 When the characteristics of a mortgage derivative product are such that the first two tests cannot be applied (such as with IOs), the mortgage derivative product remains subject to the third test.

##### (1) Average Life Test

The mortgage derivative product has an weighted average life greater than 10.0 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 6.0 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 17 percent, due to an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points. /7

/7 When performing the price sensitivity test, the same prepayment assumptions and same cash flows that were used to estimate average life sensitivity must be used. The only additional assumption is the discount rate assumption.

First, assume that the discount rate for the security equals the yield on a comparable average life U.S. Treasury security plus a constant spread. Then, calculate the spread over Treasury rates from the bid side of the market for the mortgage derivative product. Finally, assume the spread remains constant when the Treasury curve shifts up or down 300 basis points. Discounting the aforementioned cash flows by their respective discount rates estimates a price in the plus and minus 300 basis points environment.

The initial price will be determined by the offer side of the market and used as the base price from which the 17 percent price sensitivity test will be measured.

In applying any of the above test, all of the underlying assumptions (including prepayment assumptions) for the underlying collateral must be reasonable. All of the assumptions underlying the analysis must be available for examiner review. 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 these median prepayment assumptions in determining if a particular mortgage derivative product is high risk.

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 agency reserves the right to take such action as it deems appropriate to prevent circumvention of the definition of a high-risk mortgage security and other standards set forth in this policy statement.

Generally, a CMO floating-rate debt class will not be subject to the average life and average life sensitivity test described above if it bears a rate that, at the time of purchase or at a subsequent testing date, is below the contractual cap on the instrument. (An institution may purchase interest rate contracts that effectively uncap the instrument.) 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 the London Interbank Offered Rate (LIBOR). Inverse floating rate debt classes are not included in the definition of a floating rate debt class.

### Supervisory Policy for Mortgage Derivative Products

Prior to purchase, a depository institution must determine whether a mortgage derivative product is high-risk, as defined above. A prospectus supplement or other supporting analysis 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. In any event, a prospectus supplement should be obtained as soon as it becomes available.

### Nonhigh-Risk Mortgage Securities

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.

Institutions must ascertain and document prior to purchase and no less frequently than annually thereafter that nonhigh-risk mortgage securities that are held for investment remain outside the high-risk category. If an institution is unable to make these determinations through internal analysis, it must use information derived from a source that is independent of the party from whom the product is being purchased. Standard industry calculators used in the mortgage-related securities marketplace are acceptable and are considered independent sources. In order to rely on such independent analysis, institutions are responsible for ensuring that the assumptions underlying the analysis and the resulting calculation are reasonable. Such documentation will be subject to examiner review.

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. If this occurs, the mortgage derivative product must be redesignated as held for sale or trading. Once a mortgage derivative product has been designated as high-risk, it may be redesignated as nonhigh-risk only if at the end of two consecutive quarters, it does not meet the definition of a high-risk mortgage security. Upon redesignation as a nonhigh-risk security, it does not need to be tested for another year.

#### High-Risk Mortgage Securities

An institution may only acquire a high-risk mortgage derivative product to reduce its overall interest rate risk. (Institutions meeting the guidance established in footnote 3 may also purchase these securities for trading purposes.) An institution that has acquired high-risk mortgage securities to reduce interest rate risk needs to manage its holdings of these securities because of their substantial prepayment and average life variability. Such management implies that the institution does not have both the intent and [Illegible] to hold high-risk mortgage securities [Illegible] long-term investment purposes. Accordingly, high-risk mortgage securities that are being used to [Illegible] 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.

In appropriate circumstances, examiners may 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.

An institution that owns or plans to acquire high-risk mortgage securities must have a monitoring and reporting system in place to evaluate the expected and actual performance of such securities. The institution must [Illegible] an analysis that shows 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 at least quarterly whether this high-risk mortgage security has actually reduced interest rate risk.

The institution's analyses performed prior to the purchase of high-risk mortgage securities and [Illegible] thereafter must be fully documented. [Illegible] will be subject to examiner review. The 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 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, price quotes cannot be obtained from more than one broker, management should document the reasons for not obtaining such quote.

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 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 special 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 comply with this policy will be viewed as an unsafe and unsound practice.

Purchases of high-risk mortgage securities prior to the effective date of this policy statement generally will be viewed in accordance with previously existing supervisory policies.

Securities and other products, whether carried on or off the balance sheet (such as CMO swaps, but excluding servicing assets), having characteristics similar to those of high-risk mortgages securities will be subject to the same supervisory treatment as high-risk mortgage securities.

## Supervisory Policy for Other Zero-Coupon, Stripped or Original Issue Discount (OID) Products

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 and TIGRs. /8 Also, deep discount OID bonds have been issued by a number of municipal entities.

/8 STRIPS (Separate Trading of Registered Interest and Principal of Securities) is the U.S. Treasury program that permits separate trading and ownership of the interest and principal payments on certain long-term U.S. Treasury note and bond issues that are maintained in the book-entry system operated by the Federal Reserve Banks. CATs (Certificates of Accrual on Treasury Securities) and TIGRs (Treasury Investment Growth Receipts) are proprietary names for a form of coupon stripping that has been developed by securities firms. The securities firm purchases U.S. Treasury securities, delivers them to a trustee, and sells receipts representing the rights to future interest and/or principal payments from the U.S. Treasury securities held by the trustee.

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, remaining maturities exceeding ten years) 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.

### Other Considerations

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.

### Cancellation

Interpretive Ruling and Policy Statement No. 88-1; Policy on Selection of Securities Dealers and Unsuitable Investment Practices, dated June 10, 1988.

By the National Credit Union Administration Board on April 23, 1992

Becky Baker,  
Secretary of the Board.

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