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Department of Regulatory Agencies

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TO: Division of Banking Staff

FROM: Barbara M. A. Walker, State Bank Commissioner

DATE: March 31, 1992

RE: Securities Portfolio Policy and Strategies and Unsuitable Investment Practices

The following Operating Memo parallels the policy statement developed by the Federal Financial Institutions Examination Council and adopted by the Federal Deposit Insurance Corporation, The Board of Governors of the Federal Reserve System, and the Office of the Comptroller of the Currency, effective February 10, 1992.

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 institution 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 documented. Furthermore, the board of directors or 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 or any concentration which by one occurrence could impair the safety and soundness of the institution, 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) consistent with the institution's intent to trade, to hold for sale or to hold for investment. In those cases where a difference in the interpretation of GAAP arises between an institution and the Division of Banking, the Division will require the institution to prepare its supervisory reports in accordance with the Division'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 revaluations 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 the 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, 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 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. Practices seven and eight 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 securities for investment purposes and such securities should be reported as held for sale. The ninth practice is wholly unacceptable under all circumstances.

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 contracts), 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 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.

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 products is five business days after 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 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 hold the speculative position until it 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. The activity is inherently speculative and is 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 gain or loss recognized.

7. 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 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 all 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 institution's 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 transactions.

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 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. 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 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 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 funding.

Institutions should only initiate a covered call program for securities when the board of directors or its 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 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 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.

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.

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