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Handbook: Thrift Activities **Section: 220**
Subject: Investment Securities **TB 41**

December 29, 1989

Interim Guidelines for Securities Portfolio Policies and Strategies

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Summary: This Bulletin requires an institution to document prudent portfolio policies and strategies for loans and debt securities held as assets. The Bulletin reiterates the requirement that securities must be recorded and reported in accordance with generally accepted accounting principles (GAAP).

For Further Information Contact: The OTS District in which you are located or the OTS Chief Accountant's Section, Washington, D.C.

Thrift Bulletin 41

General.

This Thrift Bulletin requires an institution to document prudent portfolio policies and strategies for loans and debt securities held as assets (herein after referred to as portfolio policy or strategies).1 It holds the institution's board of directors responsible for establishing and approving the portfolio policy. The Thrift Bulletin reiterates the requirement that securities must be recorded and reported in accordance with generally accepted accounting principles (GAAP) and in accordance with the institution's intent to trade, to hold for sale and to hold for investment, and proscribes the use of amortized cost for certain transactions.

The portfolio strategies should address the plans for each type of security that will be used to carry out the portfolio policy. The institution's strategies should anticipate rising and falling interest rates and other conditions that are prudent to anticipate based on past history and current events.

When an institution experiences unanticipated conditions management generally should re-evaluate its financial position and evaluate its need to re-position itself (assets and liabilities) for the significant changes encountered.

Safety and soundness.

Securities activities must be conducted in a safe and sound manner. The institution's board of directors should understand and approve the portfolio policy and review the strategies and securities activities. Securities activities should be carried out consistent with the portfolio policy and strategies. The institution's board of directors or an investment 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.

Portfolio policy and strategies.

(1) Documentation of policy and strategies.

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.

(2) Content of policies and strategies.

A policy statement is a description of the goals and objectives the institution expects to achieve through its securities activities. A strategy is a description of the way management intends to achieve these goals and objectives. The portfolio policy and strategies must identify anticipated trading, hold for sale and investment securities activities. The portfolio policy and strategies should consider capital adequacy, credit risk, interest rate risk, market volatility, rate of return, asset/liability position, liquidity, and management capabilities of an institution.

(3) Board of directors' approval and review.

The portfolio 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 investment 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.

Recording and reporting of securities.

Institutions are required by OTS regulations to record and report their financial condition in accordance with generally accepted accounting principles ("GAAP"), 12 C.F.R. Section 563.233. This responsibility includes the obligation to properly account for the institution's securities under GAAP, consistent with the institution's intent to trade, hold for sale or hold for investment such securities.

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Recording and reporting of securities that are held for trading or for sale as if they were held for the institution's investment portfolio also constitutes an unsafe and unsound practice. In particular, securities held in trading accounts must be marked to market, and those held for sale must be marked to the lower of cost or market, on at least a quarterly basis, with unrealized gains or losses recognized in current income. The use of amortized cost for material securities activities of the type described in Appendix A, such as "gains trading" and "pair off" transactions, is not only inconsistent with GAAP, but is an abusive accounting practice that represents an unsafe and unsound practice.

Other circumstances also may indicate improper recording and reporting of securities, and also will be considered an unsafe and unsound practice. The factors that the OTS will consider in this regard in evaluating an institution's intent to trade, hold for sale or investment are set forth in subparagraph (1), below.

The OTS will aggressively pursue institutions that record and report securities that are held for trading or for sale as if they were held for the institution's investment portfolio, both on the basis that such practices constitute an unsafe and unsound practice and on the basis that such reporting is contrary to GAAP and, accordingly, in violation of OTS regulations.

(1) Intent - Sales, Originations and Purchases.

Management must evaluate on at least a quarterly basis whether the recording and reporting of securities activities is consistent with management's intent and actions. The factors management should consider include, but are not limited to the following:

(A) Whether the reason for the sale is consistent with the portfolio strategy;

(B) The number of sales transactions at gains and at losses during the reporting period;

(C) The relative volume of gross gains and gross losses on sales of securities as percentages of income before tax and equity;

(D) The net gain or loss from sales of securities as a percentage of income before tax and equity, (for example, net gains from the investment portfolio that are [illegible]% of income before tax could indicate gains trading);

(E) The dollar amount of securities sold compared with outstanding balances throughout the reporting period;

(F) The frequency of turnover, including consideration of the average number of days securities are owned prior to sale;

(G) A pattern indicating that sales of securities transpire largely when gains are available ("gains trading") and unrealized losses are retained in the portfolio;

(H) The nature of the securities (e.g., type, term, duration, yield) originated or purchased;

(I) Trends indicating that market value is consistently below cost at the time of origination or settlement; and

(J) The method by which securities are financed. The consistent funding of securities with short-term liabilities may indicate that management does not intend to hold for investment.

(2) Ability to hold.

Management must evaluate the institution's ability to hold securities to maturity in determining what accounting classification is appropriate. Documentation should include, but is not limited to analyses of the following:

(i) The source and availability of funding;

(ii) The ability to meet margin calls and overcollateralization requirements;

(iii) The ability of the institution to fund commitments, to purchase or fund loan commitments, or to hold securities in portfolio until maturity after consideration of regulatory limitations (or the non-compliance therewith), e.g., regulatory capital requirements, liquidity, loans-to-one borrower limitations, equity risk limitations, growth limitations, investment authorities.

Effective date.

The Thrift Bulletin is effective January 1, 19[illegible]. Each institution's policies, strategies and accounting practices should be consistent with this bulletin. Institutions that are not in full compliance must act promptly to achieve immediate compliance.

1 The terms "security" and "securities" as used here refer to debt securities, loans, mortgage-backed and other asset-backed securities, and derivative securities.

Appendix A:

"Gains trading" is characterized by the purchase of a security as an investment and the subsequent sale of that same security at a profit after a short-term holding period. Purchase and sale activity in the invest-

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ment portfolio, combined with material net gains, can demonstrate management's intent to profit from short-term price movements. Sometimes securities initially purchased with the intent to hold for sale are retained as investment portfolio assets if they cannot be sold at a profit.

"Gains trading" is also characterized by sales patterns over interest rate cycles that result in a portfolio of securities with extended maturities, lower credit quality, high market depreciation and limited practical liquidity. These "losers" are retained in the investment portfolio because investment portfolio holdings are accounted for at cost, and losses are not recognized unless the security is sold.

Speculative activities such as the trading of "when issued" securities and "pair offs" or "corporate settlements" are gains trading. Such activities could indicate an intent to trade or hold for sale other securities in the investment portfolio acquired under similar circumstances. These types of activities are inherently speculative and are unsuitable investment practices for depository institutions.

(1) "When-issued" securities trading is the buying and selling of securities in the interim between the announcement of an offering and the issuance and payment date of these securities. A purchaser of a "when-issued" security acquires all the risks and rewards of owning a security and may sell the "when-issued" security at a profit before taking delivery and paying for it.

(2) A "pair-off" is a securities purchase transaction that is closed out or sold at, or prior to, settlement date. As an example, an investment portfolio manager will commit to purchase a security then, prior to the predetermined settlement date, the portfolio manager will "pair-off" the purchase with a sale of the same security prior to, or on, the original settlement date. Profits or losses on the transaction are settled by one party to the transaction remitting to the counter party the difference between the purchase and sale price. Like "when issued" trading, "pair-offs" permit speculation on securities price movements without paying for the securities.

(3) Some dealers offer "corporate settlement" on U.S. Government and Federal agency securities. "Regular-way settlement" for transactions in U.S. Government and Federal agency securities is one business day after the trade date. "Corporate settlement" for corporate securities is five business days after the trade date. The use of a corporate settlement method (5 business days) for U.S. Government securities purchases appears to be offered by dealers in order to facilitate speculation on the part of the purchaser and may suggest speculative trading activity if securities are sold during the settlement period.

(4) Some dealers offer "Repositioning Repurchase Agreements" to fund securities commitments that cannot be sold at a gain. Dealers who encourage speculation through the use of "pair-off," "when-issued" and "corporate settlement" transactions often provide the financing at settlement of purchased securities that cannot be sold at a profit. The buyer purchasing the securities pays the dealer a small "margin" that is equivalent roughly to the actual loss in the security. The dealer then agrees to fund the purchase by buying the securities back from the purchaser under a resale agreement. Apart from imprudently funding a longer-term, fixed-rate asset with short-term, variable-rate funds, the purchaser acquires all the risks of ownership of a large amount of depreciated securities for a very small margin payment.

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