Investment Securities

Savings associations must conduct their investment activities prudently and within the bounds of a clear and well-reasoned investment policy. Associations should have diversified portfolios that achieve an appropriate balance between risk and return. In addition, associations should establish appropriate risk management systems and controls to monitor and control investment portfolio activity and performance.

This section outlines the following areas:

- Role of the investment portfolio
- Permissible investments
- The investment process
- Investment risks
- TB 13a requirements and guidance
- Use of investment consultants
- Reporting and accounting for securities
- Collateralized Mortgage Obligation (CMO) issuances

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In addition, this section has three appendices that cover the following areas:

Appendix A – Total Return Analysis

Appendix B – Money Market, Fixed-Income Market, and Equity Market Securities

Appendix C – Mortgage-Related Securities

ROLE OF THE INVESTMENT PORTFOLIO

A savings association's investment portfolio serves as a source of income and liquidity, as well as a tool for asset/liability management. At many associations, the primary influences of loan demand and liquidity needs determine the percentage of assets allocated to the investment portfolio. When loan demand is weak, the association deploys excess cash inflows in the investment account, and when loan demand is strong, the association draws down the investment account.

Since savings associations can change the composition of an investment portfolio with relative ease, many savings associations also use the investment portfolio to adjust their overall interest rate risk exposure. Similarly, some associations use the investment portfolio to manage diversification, asset quality, and risk-based capital levels.

PERMISSIBLE INVESTMENTS

Section 5 of the Home Owners' Loan Act (HOLA) outlines permissible investments for federal savings associations. Applicable OTS regulations include those in Part 560, Lending and Investment.

Subject to certain restrictions and limitations, the following types of investments are permissible investments for savings associations:

- Bankers' bank stock
- Business development credit corporations
- Commercial paper
- Corporate debt securities
- Community development equity investments
- Deposits in insured depository institutions
- U.S. Treasury securities
- Securities and instruments issued by U.S. Government-sponsored enterprises
- Foreign assistance investments
- HUD-insured or guaranteed investments
- Liquidity investments
- Mortgage-backed securities
- National Housing Partnerships Corporation and related partnerships and joint ventures
- Open-end management investment companies registered with the SEC

- Small business investment companies
- Small business-related securities
- State and local government obligations
- State and local housing
- State housing corporations.

See Appendices B, Money Market, Fixed-Income Market, and Equity Market Securities; and C, Mortgage-Related Securities, for information on specific types of investments.

THE INVESTMENT PROCESS

A sound investment program results from clear policies and objectives, and a sound investment process. The savings association should begin the investment process by determining its objectives for return requirements and risk tolerance. Management should have a clear understanding of how much return they expect the investment portfolio to generate and how much risk they can tolerate. Management should determine risk and return objectives in the context of the various investment constraints faced by the savings association, including those that restrict the list of permissible investments. The association's investment objectives and constraints provide the foundation for developing sound investment policies.

Investment Objectives

The savings association should clearly state portfolio objectives. The objectives should focus on the trade-off between risk and return. In formulating risk and return objectives, a savings association should consider the following constraints:

- Liquidity
- Interest rate risk
- Investment horizon
- Taxes
- Laws and regulations
- Other needs.

The investment objectives should be internally consistent and supportive of other efforts such as the interest rate risk policy, funds management, capital plan, and profit plan. The investment policy should fit into the association's overall direction as described in the business plan.

INVESTMENT RISKS

Investment Risk Versus Portfolio Risk

While management should understand the risks associated with individual securities, the decision of whether to buy a security should not rest on the risk of a security alone. Management should evaluate how the addition of the security to the portfolio affects the overall risk and return of the portfolio. The addition of a risky security to a portfolio can either raise or lower portfolio risk depending on the characteristics of the security and the portfolio.

Management should have a clear understanding of how changes in the composition of the investment portfolio affect the risk of the investment portfolio and the overall risk of the savings association. In a sense, the investment portfolio is a portfolio within a larger portfolio that includes all the assets, liabilities, and off-balance sheet contracts of the savings association. The overall risk of the savings association should be the primary consideration of management.

All investments, even U.S. Treasury securities, carry some elements of risk. The primary risks associated with investments are:

- Market risk (including interest rate risk)
- Credit risk
- Prepayment risk
- Liquidity risk
- Operational risk.

Market Risk

We define market risk as the potential that the market price of a security will fall due to changes in interest rates, exchange rates, commodity prices, or other market or political conditions.

A primary market risk faced by investors in fixed income securities is interest rate risk. Simply put, interest rate risk is the risk that the price of a security will change when interest rates rise or fall. Almost all fixed income securities decline in price when interest rates rise.

A savings association can control the degree of interest rate risk in its investment portfolio by managing the weighted average maturity of the securities in its portfolio. In general, the longer the weighted average maturity of a portfolio, the greater the interest rate risk. Similarly, a savings association can also control interest rate risk exposure by managing the duration of the portfolio. Duration is a more precise measure of the interest rate sensitivity of a security or a portfolio of securities than weighted average maturity. Duration is a measure of the average time required to receive all the cash flows (interest and principal) from a security or a portfolio of securities. The higher a portfolio's duration, the greater the losses when interest rates rise. In general, bonds with longer maturities and higher durations carry more risk. For more information on interest rate risk, see Section 650.

Credit Risk

Credit risk is the risk that an issuer may default (fail to pay) on principal or interest payments. Savings associations can manage the credit risk of an investment portfolio by using the following techniques:

- Portfolio diversification – investing in a variety of securities with differing credit risks.
- Investment selection – managing the quality of securities in the portfolio.

Savings associations can assess the overall quality of individual bonds by analyzing the financial condition of the issuer and other related factors. Such factors include the quality of management, competitive conditions in the industry, economic conditions, and so forth.

Many investors rely on credit rating agencies to measure the quality of corporate and municipal bonds. The most widely used bond rating agencies are Standard & Poor's Ratings Services and Moody's Investors Service.

Savings associations may only invest in investment grade bonds. Investment grade bonds are those in one of the four highest rating categories by a nationally recognized investment rating service such as Standard & Poor's and Moody's. Savings associations, by statute, may not invest in non-investment grade bonds. The table below shows investment-grade and non-investment-grade ratings of these agencies.

Bond-Quality Ratings

Moody's	Standard & Poor's
Investment Grade: Aaa – Highest Quality Aa A Baa	Investment Grade: AAA – Highest Quality AA A BBB
Non-Investment Grade ("Junk Bonds") Ba and below	Non-Investment Grade ("Junk Bonds") BB and below

Savings associations that invest in corporate bonds should obtain current bond ratings before purchase and should review the ratings of their holdings on a regular basis. For more detailed information on bond ratings, see Appendix B, Money Market, Fixed-Income Market, and Equity Market Securities.

For both rated and non-rated issues, associations should develop a system of periodic credit review. Refer to Examination Handbook Section 260, Classification of Assets, for classification of non-investment-grade corporate debt securities.

Prepayment Risk

Prepayment risk is the risk that an issuer may repay all or part of the principal on a bond prior to maturity. Prepayment risk is a particular concern with mortgage-backed securities (MBS). Issuers back MBS by mortgages that borrowers can prepay or refinance. When this occurs, the principal of the MBS is reduced and the issuer returns the cash flows from prepayments to the holders of the MBS. The risk is that the bonds will repay at an inopportune time, such as when interest rates are falling. Periods of falling interest rates usually generate widespread prepayments. If the investor wants to reinvest the proceeds from the prepayments, the prevailing yields on newly issued bonds are generally lower than the investor previously earned on the bond that prepaid.

Liquidity Risk

Liquidity risk is the risk that a security will be difficult to sell at a reasonable price within a reasonable time. On occasion, the liquidity of entire securities markets can seize up due to financial crisis or panic. Certain types of securities, however, such as those of small firms and securities with unusual features, are inherently illiquid.

By law, savings associations may not invest in corporate securities that they cannot sell with reasonable promptness at a price that corresponds reasonably to the fair value of the security. See 12 CFR §541.7.

Operational Risk

Operational risk is the risk that deficiencies or failures in personnel, technology, or systems will result in unexpected losses.

Settlement Risk

Settlement is an arrangement between parties for payment or receipt of cash or securities. Settlement risk is the possibility that a counterparty will fail to honor its obligation to deliver cash or securities at settlement, and is a key operational risk in managing investment portfolios.

The careful selection of brokers and dealers can mitigate settlement risk. The selection process should include a review of each firm's financial statements and an evaluation of its ability to honor its commitments.

An inquiry into the general reputation of the dealer is also appropriate. This includes review of information from state or federal securities regulators and industry self-regulatory organizations. For example, the National Association of Securities Dealers provides public information concerning any formal enforcement actions against the dealers, their affiliates, and associated personnel.

TB 13A REQUIREMENTS

You should ensure that the savings association conducts its investment activities in accordance with Thrift Bulletin 13a. Part III of TB 13a identifies, in broad terms, the types of analysis a savings association should undertake before making securities investments. A savings association should exercise diligence in assessing the risks and returns associated with investment securities, including expected total return. For a discussion of total return, see Appendix A, Total Return Analysis. As a matter of sound practice, before taking an investment position, an institution should:

- Ensure that the investment is legally permissible. Review the terms and conditions of the investment. Ensure that the investment is allowable under the institution's investment policies and is consistent with the institution's objectives and liquidity needs. Exercise diligence in assessing the market value, liquidity, and credit risk of the investment.
- Conduct a pre-purchase portfolio sensitivity analysis for any significant investment (see TB 13a for details).
- Conduct a pre-purchase price sensitivity analysis of any complex security before taking a position (see TB 13a for details).

TB 13a states that, "Investments in complex securities and the use of financial derivatives by associations that do not have adequate risk measurement, monitoring, and control systems may be viewed as an unsafe and unsound practice."

Risk Reduction

In general, savings associations should limit investments in complex securities with high price sensitivity (see TB 13a) to transactions and strategies that lower interest rate risk. Any savings association that invests in such securities for a purpose other than that of reducing portfolio risk should do so in accordance with safe and sound practices.

Sound Practices for Market Risk Management

You should assess the overall quality and effectiveness of the savings association's risk management process as it relates to investment activities. In making this assessment, you should review TB 13a, Appendix B, *Sound Practices for Market Risk Management*. This section summarizes the key elements of that Appendix.

Board and Senior Management Oversight

The board and senior management should understand their oversight responsibilities regarding the management of investment activities. Board oversight need not involve the entire board, but may be carried out by an appropriate subcommittee of the board. In particular, the board, or an appropriate subcommittee of board members, should take the following steps:

- Approve broad objectives and strategies and major policies governing investment activities.
- Provide clear guidance to management regarding the board's tolerance for risk.
- Ensure that senior management takes steps to measure, monitor, and control risk.
- Review periodically information that is sufficient in timeliness and detail to allow the board to understand and assess the institution's investment activities.
- Assess periodically compliance with board-approved policies, procedures, and risk limits.
- Review policies, procedures, and risk limits at least annually.

Senior management should ensure the effective management of the institution's operations, establish and maintain appropriate risk management policies and procedures, and ensure that resources are available to conduct the institution's activities in a safe and sound manner. In particular, senior management should take the following steps:

- Ensure that effective risk management systems are in place and properly maintained.
- Establish and maintain clear lines of authority and responsibility for managing investment activities.
- Ensure that competent staff with technical knowledge and experience consistent with the nature and scope of their activities conducts the institution's operations and activities.
- Provide the board of directors with periodic reports and briefings on the institution's investment activities and risk exposures.
- Review periodically the institution's investment risk management systems, including related policies, procedures, and risk limits.

Adequate Policies and Procedures

Savings associations should have written policies and procedures governing investment activities. Such policies and procedures should be consistent with the institution's strategies, financial condition, risk-management systems, and tolerance for risk. An institution's policies and procedures (or documentation issued pursuant to such policies) should do the following:

- Identify the staff authorized to conduct investment and derivatives activities, their lines of authority, and their responsibilities.
- Identify the types of authorized investments and investment instruments.

- Specify the required type and scope of pre-purchase analysis for various types or classes of investment securities.
- Define, where appropriate, position limits and other constraints on each type of authorized investment, including constraints on the purpose(s) for which such instruments may be used.
- Identify dealers, brokers, and counterparties that the board or a board-designated committee authorizes the institution to conduct business with and identify credit exposure limits for each authorized entity.
- Ensure that contracts are legally enforceable and documented correctly.
- Establish a code of ethics and standards of professional conduct applicable to personnel involved in investment and derivatives activities.
- Define procedures and approvals necessary for exceptions to policies, limits, and authorizations.

Monitoring and Reporting

Savings associations should have accurate, informative, and timely management information systems, both to inform management and to support compliance with investment policy. The board of directors and senior management should receive reports for monitoring investment risk on a timely basis.

The board of directors and senior management should monitor investment activities on a regular basis. The types of reports prepared for the board and various levels of management will vary depending on the size and complexity of the saving's associations operations.

Record Keeping

Savings associations must maintain accurate and complete records of all securities transactions according to 12 CFR § 562.1. In particular, savings associations should retain any analyses (including pre- and post-purchase analyses) relating to investment transactions. A savings association should make these records available to you upon request.

Internal Controls

Savings associations should have adequate internal controls over investment activities. A fundamental component of the internal control system involves regular independent reviews and evaluations of the effectiveness of the system.

Internal controls should promote effective and efficient operations, reliable financial and regulatory reporting, and compliance with relevant laws, regulations, and institutional policies. An effective system of internal control should include the following elements:

- Effective policies, procedures, and risk limits.
- An adequate process for measuring and evaluating risk.
- Adequate risk monitoring and reporting systems.
- A strong control environment.
- Continual review of adherence to established policies and procedures.

Savings associations should review their system of internal controls at least annually. Individuals independent of the function being reviewed should conduct the review. Reviewers should report results directly to the board. You should consider the following factors when reviewing an institution's internal controls:

- Does the association maintain risk exposures at prudent levels?
- Does the association employ the risk measures that are appropriate to the nature of the portfolio?
- Does the association have board and senior management actively involved in the risk management process?
- Does the association document policies, controls, and procedures adequately?
- Do association personnel follow the established policies and procedures?
- Does the association adequately document the assumptions of the risk measurement system?
- Does the association accurately process data?
- Is the risk management staff adequate?
- Has the association changed risk limits since the last review?
- Have there been any significant changes to the institution's system of internal controls since the last review?
- Are internal controls adequate?

Analysis and Stress Testing

Management should thoroughly analyze the various risks associated with investment securities before making an investment. (See TB 13a, Part III.) In addition, management should periodically review the portfolio.

Before taking a position in any complex securities, management should analyze how the future direction of interest rates and other changes in market conditions could affect the instrument's cash flows and market value. In particular, management should understand the following elements of the complex security:

- The structure of the instrument.
- The best case and worst-case interest rate scenarios for the instrument.
- How the existence of any embedded options or adjustment formulas might affect the instrument's performance under different interest rate scenarios.
- The conditions, if any, under which the instrument's cash flows might be zero or negative.
- The extent to which price quotes for the instrument are available.
- The instrument's universe of potential buyers.
- The potential loss on the instrument (that is, the potential discount from its fair value) if sold prior to maturity.

That the issuer, together with any guarantors, has the financial capacity, and willingness to meet the repayment terms of the investment.

That analysis of the legal structure of the investment affirms the institution's authority to make such investment.

How the investment is expected to perform under various loss and interest rate scenarios, the impact on the overall risk profile of the institution and how all covenants of any trust agreement apply to the senior tranches.

The effect of the payment priority should the security be divided into separate tranches with unequal payments.

That a review and analysis of the collateral managers includes historical performance to document investment prudence.

Evaluation of New Products, Activities, and Financial Instruments

New investment products and activities can entail significant risk. Senior management should evaluate the risks inherent in new products and activities to ensure that they are subject to adequate review procedures and controls. The board, or an appropriate committee, should approve major new initiatives involving new products and activities.

Before authorizing a new initiative, the review committee should review the following items:

- A description of the relevant product, activity, or instrument.
- An analysis of the appropriateness of the proposed initiative in relation to the institution's overall financial condition and capital levels.
- Descriptions of the procedures to measure, monitor, and control the risks of the proposed product, activity, or instrument.

Management should ensure that adequate risk management procedures are in place before undertaking any significant new initiatives.

USE OF INVESTMENT CONSULTANTS

Some savings associations use consultants in the investment process. The association should limit the role of consultants and brokers to advising management and executing transactions approved by management. The savings association should not delegate investment decision-making authority to third parties, including brokers or consultants. Ceding decision-making power to a consultant or broker represents an unsafe and unsound practice.

Any savings association that engages a consultant must have a formal written contract that covers the following elements:

- The types of assets that the consultant or broker can buy and sell on a pre-approved basis.
- The requirement for authorization from the board or senior management for any transactions not pre-approved in the contract.
- The documentation and rationale for each trade made for the savings association.
- The requirement of the consultant or broker to maintain records and submit evidence that they obtain prices from several brokers for all transactions, particularly if the consultant is a broker.
- Compensation programs that do not encourage churning (excessive trading activity) of portfolios or short-term strategies that are not in the savings association's best interest.
- The right of the savings association or its agent to audit the records of transactions executed for the savings association.
- The authority of OTS to examine the records of the consultant or broker that pertain to the transactions for the savings association.

If a savings association uses consultants, it should establish internal policies, controls, and procedures that include the following criteria:

- Establish limitations on the assets managed by consultants with consideration to the types and level of risk of the assets authorized for purchase.

- Monitor compliance with the limitations established by the board.

- Require senior management personnel or an independent agent to periodically audit the consultant or broker to ensure that the firm is buying and selling securities at the most favorable price for the savings association.

- Guarantee that the savings association always has a perfected security interest on securities bought for its account.

The savings association should measure the performance of the consultant against a relevant benchmark (for example, a standard bond index). In measuring the performance (total return) of the consultant against a benchmark, the association should factor in fees and expenses charged by the consultant. Savings associations should note that consultants and contractors may be subject to OTS enforcement actions as provided for by Section 8 of the FDIA, as amended by FIRREA.

Senior management personnel should supervise the activities of the consultant to ensure conformity to the savings association's investment, liquidity, and interest rate risk management plan. Management must keep the board of directors informed of the performance of the consultant, through periodic reports.

Reporting and Accounting for Securities

Part 562 of the OTS regulations, require savings associations to record and report their financial condition according to GAAP. This responsibility includes the obligation to properly account for the savings association's securities under GAAP.

Savings associations must categorize each security as trading, available-for-sale (AFS), or held-to-maturity consistent with FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, as amended. A savings association should determine whether securities are for its trading accounts, AFS, or held-to-maturity at the time it purchases or originates the securities. The savings association should not record securities in a suspense account until it determines the appropriate category. Management should periodically reassess its security categorization decisions to ensure they remain appropriate.

Trading Assets

Savings associations should classify as trading assets securities that the association intends to hold principally for the purpose of selling them in the near term. Trading activity includes active and frequent buying and selling of securities for the purpose of generating profits on short-term fluctuations in price. Savings associations must report securities held for trading purposes at fair value; and recognize unrealized gains and losses in current earnings and regulatory capital.

Held-to-Maturity

Held-to-maturity securities are debt securities that the savings association has the positive intent and ability to hold to maturity. Savings associations generally report held-to-maturity securities at amortized cost.

Available-for-Sale

Savings associations must report securities not categorized as trading or held-to-maturity as available-for-sale. Savings associations must report AFS securities at fair value on the balance sheet. Savings associations must exclude unrealized gains and losses from earnings and report them in a separate component of equity capital.

Section 260, Classification of Assets, states that savings associations holding noninvestment grade securities with maturities of July 1, 1994, or later must classify these securities as held for sale since they do not have the ability to hold them to maturity.

Changes in Categorization

If a savings association judges a decline in fair value of a held-to-maturity or AFS security to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and include the amount of the write-down in earnings. For example, if it is probable that a savings association will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment has occurred.

Sales from the held-to-maturity portfolio could call the intent to hold to maturity into question and result in tainting the remaining portfolio. The savings association may need to redesignate the portfolio as AFS and be subject to mark-to-market adjustments. As a result, savings associations normally limit portfolio restructuring activities to AFS portfolios.

Proper Categorization of Securities

The proper categorization of securities ensures that savings associations promptly recognize trading gains and losses in earnings and regulatory capital.

Trading Activity

While designating certain assets for trading can be consistent with prudent investment securities management, you may consider certain practices speculative or otherwise abusive. OTS and the other banking agencies consider the following practices to be trading activities.

Gains Trading

Gains trading is the purchase of a security and the subsequent sale of the same security at a profit after a short holding period. Savings associations typically retain securities acquired for this purpose that the association cannot sell at a profit in the AFS or held-to-maturity portfolio. Savings associations may use gains trading to defer recognition of losses because unrealized losses on AFS and held-to-maturity debt securities do not directly affect regulatory capital. Generally, savings associations do not report unrealized losses in income until the security is sold. A pattern of selling above-market securities at a gain while retaining below-market securities overstates the institution's financial health.

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 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. Because savings associations intend such transactions to generate profits from short-term price movements, savings associations should categorize such transactions as trading.

Pair-offs

Pair-offs are security purchase transactions that are closed-out or sold at, or prior to, settlement date. In a pair-off, a savings association commits to purchase a security. Then, prior to the predetermined settlement date, the savings association will pair-off the purchase with a sale of the same security. Pair-offs are settled net when one party to the transaction remits the difference between the purchase and sale price to the counter party. Pair-offs may also involve the same sequence of events using swaps, options on swaps, forward commitments, options on forward commitments, or other off-balance sheet derivative contracts.

Extended Settlements

In the U.S., regular-way settlement for federal government and federal agency securities (except mortgage-backed securities and derivative contracts) is one business day after the trade date. Regular-way settlement for corporate and municipal securities is three business days after the trade date. For mortgage-backed securities, it can be up to 60 days or more after the trade date. Securities dealers may offer the use of extended settlements to facilitate speculation on the part of the purchaser, often in connection with pair-off transactions. Savings associations should report as trading assets securities acquired through the use of a settlement period in excess of the regular-way settlement periods to facilitate speculation.

Repositioning Repurchase Agreements

A repositioning repurchase agreement is a funding technique offered by a dealer in an attempt to enable a savings association to avoid recognition of a loss.

A repositioning repurchase agreement occurs when a savings association enters into a when-issued trade or a pair-off (which may include an extended settlement) that the savings association cannot close out at a profit on the payment or settlement date. The dealer provides financing in an effort to fund its speculative position until the security can be sold at a gain. The savings association purchasing the security typically 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, typically by buying it back from the purchaser under a resale agreement. The savings association should report as trading assets any securities acquired through a dealer financing technique such as a repositioning repurchase agreement that the association uses to fund the speculative purchase of securities.

Short Sales

A short sale is the sale of a security that the savings association does not own. The purpose of a short sale generally is to speculate on a fall in the price of a security.

Adjusted Trading

Adjusted trading is not acceptable under any circumstances. Adjusted trading involves the sale of a security to a broker dealer at a price above the prevailing market value. Simultaneously, the savings association purchases and books a different security, frequently a lower-rated or lower quality issue or one with a longer maturity, at a price above its market value. Thus, the savings association reimburses the dealer for losses on the purchase from the savings association and ensures the dealer a profit. Such transactions inappropriately defer the recognition of losses on the security sold and establish an excessive cost basis for the newly acquired security. Consequently, the banking agencies prohibit such transactions. In addition, these transactions may be in violation of 18 USC §§ 1001, False Statements or Entries, and 1005, False Entries.

Limits on MBS Trading Activity

Savings associations may buy and sell securities to manage risk or to improve profitability. Active management of an MBS portfolio may presume an ability to anticipate changes in market interest rates. In practice, interest rates are notoriously difficult to predict. Active portfolio management requires outguessing the market consensus sufficiently to cover transaction costs. Historical data suggests that very few investment professionals can outperform a passive fixed income indexing strategy with active portfolio management.

OTS allows savings associations to use an MBS portfolio for trading purposes only in limited cases and subject to certain safeguards. The institution should have the core earnings and capital to absorb potential trading losses. The savings association should also possess the financial expertise and management information systems to monitor and evaluate trading activity effectively.

You should determine the amount of MBS trading activity by reviewing the volume of trades transacted since the previous examination. You should quantify the volume and compare it with the change in portfolio balances since the previous examination. Calculate portfolio turnover ratio by comparing the dollar amount of securities sold, by type, with the balance of the portfolio at the beginning of a period. For example, if the savings association sold $10 million of MBSs all with the same coupon rate during the quarter, compared with the balance of $10 million of this coupon rate at the beginning of the quarter, the turnover ratio would be 100 percent. You can make these comparisons on a monthly or annual basis.

There is no threshold of turnover that automatically indicates that the MBS portfolio is part of a trading portfolio. You should review the composition of the trades and determine the rationale for the transactions.

While designating certain assets for trading can be consistent with prudent portfolio management, you may consider certain practices speculative or otherwise abusive.

Collateralized Mortgage Obligation (CMO) Issuances

Some savings associations issue CMOs. The issuer may retain a subordinate interest in the CMO as a credit enhancement to outside investors. The gain recognized on the sale depends on the relative fair values assigned to the sold and retained tranches. The higher the value assigned to the retained pieces, the lower the cost basis for the securitized assets, and the larger the recognized gain on sale. There is often no liquid market for the retained securities, so their fair values may be difficult to verify. You must analyze the savings association's valuation assumptions to ensure that the savings association bases its gain on sale upon the economics of the transaction rather than merely an inflated value assigned to retained tranches. Particularly important variables include the assumed prepayment rate, loss rate on the underlying mortgages, and required rate of return (discount rate).

Consult Appendix C of this section and Section 560, Deposits/Borrowed Funds, for a more detailed discussion of CMO issuances.

References

United States Code (12 USC)

§ 1464(c)(1)	Loans for Investments Without Percentage of Asset Limitation
§ 1464(c)(2)	Loans or Investments Limited to Stated Percentage of Assets or Capital
§ 1464(c)(4)	Other Loans and Investments

Code of Federal Regulations (12 CFR)

§ 560.40	Commercial Paper and Corporate Debt Securities
§ 560.42	Government Obligations
§ 560.93	Lending Limitations
§ 562.2	Regulatory Reports
§ 563.172	Financial Derivatives
Part 566	Liquidity

Office of Thrift Supervision Bulletins and Memoranda

RB 3b	Policy Statement on Growth for Savings Associations
TB 13a	Management of Interest Rate Risk, Investment Securities, and Derivative Activities
TB 13a-2	Structured Advances

FFIEC Policy Statement

Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities (April 23, 1998)

Financial Accounting Standards Board, Statement of Financial Accounting Standards (SFAS)

No. 91	Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Mortgages with Initial Direct Cost of Leases
No. 107	Disclosures about Fair Value of Financial Instruments
No. 115	Accounting for Certain Investments in Debt and Equity Securities
No. 140	Accounting for Securitizations

Emerging Issues Task Force (EITF)

No. 86-38	Implications of Mortgage Prepayments on Amortization of Servicing Rights

Other References

Committee on Sponsoring Organizations of the Treadway Commission (COSO), Internal Control Issues in Derivatives Usage: An Information Tool for Considering the COSO Internal Control – Integrated Framework for Derivatives Applications.