

Investment Securities Program

EXAMINATION OBJECTIVES

To determine the adequacy of the savings association's policies, procedures, and internal controls regarding its investments.

To determine if the savings association's investment policy, interest rate risk policy, funds management policy, and business plan adequately describe the type and level of authorized investments.

To determine if the savings association documents and describes the rationale for all investments.

To determine if the savings association adequately analyzes its investments prior to purchase.

To determine if these investments are appropriate based on the savings association's current portfolio, interest rate risk structure, and regulatory capital position.

To determine the prudence of risk management strategies through evaluation of practices and procedures.

To determine if the savings association's officers and employees are operating in conformance with the established policies and whether these individuals have the necessary expertise to execute the authorized strategies.

To determine the overall quality of the savings association's investments and assess the effect of the portfolio quality on the overall soundness of the savings association.

To determine if the savings association is in compliance with the regulations and whether the savings association records transactions according to generally accepted accounting principles (GAAP).

To determine the scope and adequacy of the internal and external audit functions considering the type and complexity of the savings association's investments.

To determine if the savings association incurred any significant prepayment risk from its investment in mortgage-backed securities (MBSs) or mortgage-derivative products (MDPs).

To determine if the savings association actively monitors its investments.

To determine if the savings association, at least quarterly, obtains or performs analysis of each complex security purchased with board of director approved techniques demonstrating that the security reduces overall interest rate risk.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Investment Securities Program

WKP. REF.

To determine if the savings association engages in speculative trading.

To evaluate investment and trading activities to determine if the volume and number of transactions have any broad and potentially adverse effect on the savings association's financial health.

To summarize findings and initiate corrective actions when there are deficiencies.

EXAMINATION PROCEDURES

LEVEL I

WKP. REF.

1. Review scoping materials applicable to this program. If another examiner performed the review of scoping materials, obtain a written or oral summary of the review(s) of items concerning this program.

2. Determine if the savings association corrected any transactions or policies and procedures subject to any of the following:

- Previous examination report comments and previous examination exceptions.
 - Independent audit exceptions.
-

3. Review the current written investment policy and business plan.

4. Review all procedures related to investment activities.

5. Ascertain whether the board adopted any policy revisions since the previous examination.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Investment Securities Program

WKP. REF.

6. Judge the adequacy of the guidance in the written investment policy.

7. Evaluate the objectives of the savings association's investment activities as stated in the investment policy and business plan. Discuss any apparent conflicting objectives with management.

8. Evaluate whether management has the expertise necessary to carry out the objectives of the policy. Identify any backup expertise available to management.

9. Review management's reports to the board for accuracy and completeness.

10. Review board meeting minutes to determine the following:

- Did the board approve the broad objectives, strategies, and major policies for investment activities?
- Do the investment strategies contain an adequate amount of detail?
- Did the board establish appropriate dollar and percentage limits on investment securities?
- Do the reports to the board accurately and adequately detail the returns from the investment activity?

11. Review the securities transactions in the context of the savings association's funds management structure and current interest rate risk profile, profitability, capital, and liquidity positions. Discuss findings with examiners working on liquidity, funds management, earnings, operations, interest rate risk, and capital.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Investment Securities Program

WKP. REF.

12. Evaluate whether the savings association classifies transactions appropriately in the portfolio as held-to-maturity, available-for-sale (AFS), or trading.
-
13. Assess policies and procedures for reviewing investment securities for asset classification purposes or coordinate with the examiner reviewing classifications.
-
14. Identify methods used to estimate prepayments for investment securities.
- Determine if prepayment assumptions differ markedly from those of securities with similar underlying collateral.
 - Determine the yield and estimated maturity of the investment portfolio.
-
15. Examine the documentation of the analysis of investment securities.
-
16. Considering a review of the information gathered through procedures, observations, and discussions with management and other personnel, determine the following:
- The adequacy of internal controls.
 - Proper authorization of all trades.
 - Compliance with regulations and conformance with GAAP.
 - Management's level of expertise and conformance by management with the savings association's policies and procedures.
 - The adequacy of the management report and information system used to provide management and the directors with accurate decision-making information and the ability to monitor compliance with established guidelines.
-

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Investment Securities Program

WKP. REF.

17. Summarize findings, obtain management responses, and update programs and the continuing examination file (CEF), if applicable, with any information that will facilitate future examinations. File exception sheets in the general file.

18. Determine that investment securities meet applicable regulatory and policy requirements, including:

- 12 CFR 560.40, Commercial Paper and Corporate Debt Securities.
 - 12 CFR 560.32, Pass-Through Securities.
 - TB 13a, Management of Interest Rate Risk, Investment Securities, and Derivatives Securities.
-

19. Determine that investment securities are suitable to the institution's operational and strategic goals and that the securities are safe and sound.

20. Determine that the institution performed thorough underwriting analyses prior to purchase.

21. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Investment Securities Program

WKP. REF.

LEVEL II

1. Obtain a listing of all investment securities held. The list should contain, at a minimum, the following information:
 - Description of the security.
 - Classification as held-to-maturity, AFS, or trading.
 - Committee on Uniform Securities Identification Procedures (CUSIP) number.
 - Purchase price or cost.
 - Date of purchase.
 - Par value and principal amount purchased.
 - Current book value including any unaccreted discounts or unamortized premiums.
 - Maturity date and call provisions, if any.
 - Current market value.

2. Ascertain whether management shifted its risk posture. Also determine if the association is taking on riskier investments.
 - Obtain a list of securities purchased, sold, and matured between examinations.
 - Categorize the securities by type, for example, U.S. Government, agency, state and municipal obligations, corporate debt.
 - Review the analysis of municipal and corporate issues by rating classification. For non-U.S. Government securities, obtain most recent bond ratings by an independent bond rating service.
 - Determine the total in each rating class and total of unrated issues.
 - Determine the total of unrated investment securities issued by obligors located outside the savings association's trade area.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Investment Securities Program

WKP. REF.

3. Identify any changes in the portfolio composition from the previous examination by type and rating.
-

4. Ascertain whether any concentration of credit exists by type, area, or in any one entity.
-

5. Ascertain whether market value depreciation is significant in comparison with capital and total investment portfolio.
-

6. Evaluate the overall effectiveness of investment activities and the portfolio's contribution to the income stream.

- Analyze yields and spreads of the investment portfolio. Ascertain whether investment strategies are effective in maintaining targeted yields and spreads.
 - Review net trading gains/losses, taking into consideration broker/dealer commissions.
-

7. Compare the coupon rates and yields of recently acquired investments with similar instruments. Discuss with management the appearance of any differences where coupon rates or yields may be significantly higher or lower.
-

8. Evaluate the savings association's transactions to determine if securities are held to maturity, AFS, or for trading. Ascertain if the savings association records trading and AFS portfolios at fair value.
-

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Investment Securities Program

WKP. REF.

9. Determine if the association's trading activity is speculative or abusive. Also determine if the association makes adjusted trades.
-
10. Review any transfers or swaps of securities from the trading or AFS portfolios to the held-to-maturity portfolio.
-
11. Evaluate the adequacy of credit analysis procedures. Review the savings association's credit analysis of the following:
- The obligor on securities purchased under agreement to resell, when the readily marketable value of the security is not sufficient to satisfy the obligation or when collateral custody procedures are inadequate to ensure the association's unassailable right to the collateral.
 - All money market instruments acquired since the previous examination.
-
12. Determine if management identifies credit and default risk; and all defaulted issues.
-
13. Ascertain any changes in the credit rating after the savings association purchased the security.
-
14. Review the savings association's classification of securities in accordance with asset classification regulations. Indicators of the extent of credit deterioration include credit rating downgrades or market value depreciation (excluding that caused by interest-rate shifts). The savings association should classify the market value depreciation of defaulted issues as Loss.
-

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Investment Securities Program

WKP. REF.

15. Review the use of outside investment consultants:
- Determine the extent of the capacity in which the consultant serves.
 - Review the consultant's contract.
 - Determine the consultant's background and expertise.
 - Determine the consultant's investment powers and authority.
 - Evaluate the supervision, level of control over, and degree of dependence upon outside consultants.
-
16. Review safekeeping of records to determine location of securities held by third parties. Determine if management has procedures to verify that securities are being held in safekeeping.
-
17. If the savings association's stock trades publicly, review the applicable reports filed with the Securities and Exchange Commission, including the 10K (Annual) and 10Q (Quarterly) for any mention of investments. Determine the accuracy of these references and report any discrepancies to OTS Washington pursuant to procedures in [Section 110, Capital Stock and Ownership](#).
-
18. Determine if the savings association's investment in MBSs or MDPs exacerbated or caused any deficiencies noted in areas such as:
- The purchase of excessive quantities of low-coupon rate or discount securities that would increase interest rate risk.
 - Reliance on nonrecurring gains from the sale of MBSs or MDPs to sustain profitability.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Investment Securities Program

WKP. REF.

- Inadequate capital to sustain adverse fluctuations in the returns from stripped mortgage-backed securities (SMBSs) or the residual interest in multiple-class securities.
-
19. Obtain a detailed listing of the mortgage securities as of the examination date. Determine the following:
- The type, coupon rate, and maturity of the securities in the portfolio.
 - The dollar amount of these investments as a percentage of total assets.
 - If there was a significant increase in the portfolio, identify the funding source and the cause of the increase.
-
20. For MDPs, also ascertain the following:
- The particular class of the security purchased and the terms of that class.
 - The characteristics of the collateral underlying the MDP, for example, the type of security, weighted average coupon (WAC), and maturity.
 - If the savings association performed an analysis of the MDPs.
-
21. Obtain the contract registers, general and subsidiary ledgers, and trade confirmations from brokers to determine:
- The extent of trading activity by reviewing the amount and composition of the portfolio turnover and existence of margin accounts.
 - If the savings association obtained documented comparative price quotes from brokers/dealers other than the broker/dealer that executed the transaction.
 - If the savings association's contract register and general and subsidiary records correspond to the information detailed on confirmations from brokers.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Investment Securities Program

WKP. REF.

- The location of all investment securities in safekeeping with other parties or pledged as collateral for any transaction.
-
22. Assess the effect of these transactions on the viability of the savings association. Identify the cause of the problems that could involve inadequate management expertise or lack of adequate research prior to execution of the strategy. Obtain management's intended corrective action.
-
23. Review the adjustable-rate MBSs purchased since the previous examination. Determine the following:
- The index, margin, interest rate caps, and any other adjustment features of the adjustable-rate MBS portfolio.
 - The dollar amount of the adjustable-rate MBSs retained in portfolio with a large portion of the underlying collateral having teaser rates.
 - The interest rate risk of this portfolio by comparing the current interest rate with the lifetime cap and the frequency of interest-rate adjustments.
-
24. Determine if the savings association purchased the residual interest in an MDP. If so, determine the following:
- If the board of directors approved the transaction and if management updates the board regularly on the actual yield.
 - If, prior to purchase, the thrift analyzed the effect on yield and potential value changes under varying prepayment assumptions.
 - The expected return and prepayment assumptions the savings association based this yield upon.
 - The underlying structure of the MDP.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Investment Securities Program

WKP. REF.

- The characteristics of the collateral that underlies the MDP, such as the type of securities (GNMA, Freddie Mac, or Fannie Mae) or whole mortgages, the weighted average remaining maturity (WARM), the coupon rate, and the actual prepayment experience.
 - If the issuer based the security upon real estate mortgage investment conduit (REMIC) authority.
 - If the savings association intended the investment to be a hedging vehicle, and if so, the identity of the matched item and the estimated amount of interest-rate protection provided by the residual.
 - If the savings association classifies a residual interest in securitized assets properly and accounts for them as AFS or trading securities in accordance with SFAS 125 and SFAS 115.
-

25. Determine if the savings association purchased a SMBS or any security with similar characteristics. If so, determine the following:

- If the board of directors approved the investment and if management updates the board regularly on the investments actual yield and market value.
 - If, prior to purchase, the savings association analyzed the expected yield based on various changes in interest and prepayments.
 - If the interest only (IO) or principal only (PO) comprises most of the interest.
 - The expected yield from the investment and the prepayment assumptions used to determine this yield.
 - If the savings association intended to use the SMBS as a hedging vehicle, and if so, the matched item and the estimated amount of interest-rate protection provided by the SMBS.
-

26. Determine if the savings association purchased MBSs backed by commercial real estate. If so, determine the following:

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Investment Securities Program

WKP. REF.

- The type of property.
 - The rating of the security, if any.
 - If management reviewed the prospectus and supplement with particular attention to the risks of the underlying loans and the nature and quality of credit supports.
-

27. Determine if the savings association purchased an interest in a senior/subordinated security. If so, determine the following:

- If the savings association acquired the senior or subordinated interest.
 - The types of mortgages underlying the security.
 - The investment rating.
 - The potential risk of default if the savings association purchased the subordinated interest.
 - If the savings association is properly reporting its interest in the senior/subordinated securities in accordance with the recourse provisions in OTS regulatory capital guidelines.
-

28. Determine whether the savings association securitized assets and retained a residual interest in those securitized assets or subordinated interests. If so, determine the following:

- If the savings association calculates the gain or loss on the sale in accordance with GAAP.
- If the savings association bases the fair value assigned to the retained tranche(s) upon reasonable assumptions concerning prepayments and defaults on the underlying loans.
- Whether the savings association uses a reasonable discount rate that reflects the risk of the securities.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Investment Securities Program

WKP. REF.

- The sensitivity of value of the retained tranches to changes in interest rates, prepayments, defaults, or discount rates.
-

29. Ensure that your review meets the Objectives of this Handbook Section. State your findings and conclusions, and appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.
-

LEVEL III

1. Reconcile the trial balances to general ledger accounts. Cross check investment trial balances with other schedules or records to determine if securities exist.

2. Verify the accuracy of registers by comparing broker advices with trade tickets. Send confirmation to brokers, if necessary.

3. Review pledged securities reports. Identify securities that may be overpledged or cross-collateralized with other securities.

4. Review the maturity distribution schedule and determine if the association is extending or shortening the portfolio's maturity in line with policy objectives.

5. Test for proper accounting for premiums and discounts.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Investment Securities Program

WKP. REF.

- Determine proper accounting for gains and losses.
-

EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	