MONEY MARKET, FIXED-INCOME MARKET, AND EQUITY MARKET SECURITIES

There are investment opportunities in each of the three major areas that make up the money and capital markets:

- Money market
- Fixed-income market
- Equity market.

Money Market

The money market is the arena where financial institutions and other businesses adjust their liquidity positions. This primarily consists of debt instruments with a remaining maturity of one year or less. Money market securities generally have a high degree of liquidity and low risk to principal. The money market operates through dealers, money center banks, and the Open Market Trading Desk of the New York Federal Reserve Bank.

Federal Funds

Federal funds are balances at the Federal Reserve that financial institutions lend to one another and are not subject to reserve requirements. The purchasing institution uses these funds to meet reserve requirements or for a special arbitrage funding arrangement. Federal funds sold are subject to default risk, as with any unsecured loan. The shorter the term of the transaction, the less default risk is a primary concern. The majority of federal funds transactions are for overnight or over weekends. Term federal funds, however, are not uncommon. They transact at a fixed rate for a period longer than one day, typically 30, 60, or 90 days. Term federal funds are subject to loans-to-one-borrower and other lending limitations.

Negotiable Certificates of Deposit

These certificates are usually issued by money center or large regional banks in denominations of $1M or more and the issuing institution may issue them at face value with a stated rate of interest, or at a discount similar to U.S. Treasury bills. These certificates are widely traded and offer substantial *liquidity*.

Eurodollar Time Deposits

Eurodollar time deposits are certificates of deposit issued by banks in Europe, with interest and principal paid in dollars. Such certificates of deposit usually have minimum denominations of $100,000 and short-term maturities of less than two years. Usually they have interest rates pegged to LIBOR.

Certificates of Deposit

Certificates of deposit are time deposits in banks or savings associations with maturities longer than 30 days. Most certificates of deposit have an original maturity of one to three months. Variable-rate

certificates of deposit are also available, typically either six-month with a 30-day roll or one year with a three-month roll. In general, certificates of deposit have a slightly higher return, are slightly riskier, and are slightly less liquid than Treasury bills. A prudent investment manager should limit holdings in any depository institution to amounts covered by federal deposit insurance.

Repurchase Agreements

In a repurchase transaction, an institution loans funds and, in effect, buys securities from a counterparty. They also commit to resell the same securities back to the counterparty, at a later date at a specified price. In a reverse repurchase transaction an institution receives funds from and sells securities to a counterparty. They also promise to repurchase the same securities at a specified price and date. Repurchase agreements are short-term in nature; therefore, the transaction takes place in the money market.

Treasury Bills

U.S. Treasury bills are U.S. Government securities with three-month, six-month, and one-year maturities. The government issues them in minimum denominations of $10,000 and multiples of $5,000 thereafter. The government issues treasury bills at a discount from face value. They are exempt from state and local taxation, and are backed by the full faith and credit of the U.S. Government.

Municipal Notes

Short-term municipal bond with a maturity of one year or less.

Municipal Bonds

Municipal bonds based on the general taxing authority of the issuer or general obligation bonds have certain factors that may adversely affect the creditworthiness of these types of bonds. These factors include the following:

- Declining property values and an increasing number of delinquent taxpayers.
- Increasing tax burden relative to other regions.
- Increasing property tax rate in conjunction with declining population.
- Actual general fund revenues consistently falling below budgeted amounts.
- Budget expenditures increasing annually in excess of inflation rate.
- General obligation debt increasing while property values remain static.
- Declining economy as measured by increased unemployment and declining population.
- Investment activities that involve excessive leveraging to achieve enhanced yields.

Floating-rate notes usually have a maturity of five to seven years, and interest payments periodically adjust, often every six months. A money market index, usually Treasury bills or Eurodollar rates determine the interest rate. State, municipal, and other political subdivisions, including independent school districts, issue municipal bonds that are usually dependent upon the general taxing authority of the locality or on specific revenue generating projects for repayment. Interest income generated by state and municipal obligations is not subject to federal income taxes and is usually exempt from taxation by the issuing state and local authorities. Other state and municipal obligations include Bond Anticipation Notes (BANs), Tax Anticipation Notes (TANs), and Revenue Anticipation Notes (RANs). These notes are short-term obligations to finance current expenditures pending receipt of proceeds from expected bond offerings or revenues.

Section 560.42 permits savings associations to invest in obligations of state or political subdivisions. The obligations must meet the following requirements:

- Rated in one of the four highest grades.
- Issued by a public housing agency.
- Backed by the full faith and credit of the United States.

The regulation limits investments in state or political subdivisions ten percent of capital for any one issuer, excluding general obligations of any one issuer. A savings association may invest, in the aggregate, up to one percent of its assets outside of the rating requirements and guarantee provisions within the state or political subdivision where the savings association's home or branch office is located.

Revenue Bonds

Revenue bonds are dependent upon the income generated by specific projects established by government authority. A type of revenue bond often held by savings associations are public housing authority revenue bonds. Although they have corporate debt characteristics, the FDIC does not consider such public entity issues to be corporate debt securities and are not subject to the FDIC divestiture requirements. The credit quality of these issues varies greatly and is dependent upon the revenue source, any guarantees, sinking funds, and market value of collateral, if any.

Because the taxing authority does not support revenue bonds, unless rated, you should classify them the same as other commercial credits. Other factors that negatively affect their creditworthiness include:

- Decreasing coverage of debt service by net revenues.
- Regular use of debt reserves and other reserves by the issuer.
- Growing financial dependence of the issuer on unpredictable federal and state aid appropriations for meeting operating budget expenses.
- Unanticipated cost overruns and schedule delays on capital construction projects.

- Frequent or significant user rates increases.
- Deferred capital plant maintenance and improvement.
- Shrinking customer base.
- New and unanticipated competition.

Commercial Paper

Top-rated corporations issue commercial paper with 2- to 270-day maturities. Commercial paper is unsecured, usually discounted and possibly backed by bank lines of credit. Standard and Poor's rates commercial paper ranging from A, the highest quality, to D, the lowest quality. Moody's uses designations of Prime-1 to Prime-3, and Not Prime (issuers that do not fall within any of the Prime rating categories).

Banker's Acceptances

Banker's acceptances arise mostly out of foreign trade transactions and are similar to commercial paper in form. They are noninterest-bearing notes sold at a discount and redeemed by the accepting bank at maturity for full face value. Banker's acceptances are short-term instruments with maturities of nine months or less. Most banker's acceptances are for very large amounts, although some are available for as low as $5,000. Liquidity risk varies considerably based on the size of the security. There is no secondary market for the very low denomination instruments. Banker's acceptances have very low credit risk since the accepting bank and the ultimate borrower both guarantee payment.

Federal Agency Discount Notes and Coupon Securities

Although they are only a small portion of the money market, federal agency securities are second highest in credit quality. The purposes, maturities, and types of agency securities issued vary widely. Typically the government backs these issues with collateral such as cash, U.S. Government securities, and debt obligations the issuing agency acquires through its lending activities. The more common types of federal agency securities include obligations of the following agencies:

- Federal Home Loan Banks (FHLBs)
- Farm Credit System (FCS)
- Federal National Mortgage Association (Fannie Mae)
- Federal Home Loan Mortgage Corporation (Freddie Mac)
- Government National Mortgage Association (GNMA)
- Student Loan Marketing Association (SLMA).

Obligations of the U.S. Government and federal agencies are safe and liquid. Federal agency securities (except for GNMAs) generally do not bear the full faith and credit of the U.S. Government. They do bear the full faith and credit of the U.S. Government agency or government sponsored enterprise that sponsors them.

Structured Notes

Federal agency notes include structured notes that are securities with derivative-like characteristics. Structured notes are fixed-income securities with embedded options where the bond's coupon, average life, or redemption value are dependent on a reference rate, an index, or formula. Fannie Mae, Freddie Mac, and the FHLBs are the primary issuers of structured notes. OTS considers structured notes a complex security and they require a price sensitivity analysis. See TB 13a-2 for more information.

Structured notes take various forms. The term structured notes includes the following securities:

- Dual-indexed floaters
- De-leveraged floaters
- Inverse floaters
- Leveraged inverse floaters
- Ratchet floaters
- Range floaters
- Leveraged cap floaters
- Stepped cap/floor floaters
- Capped callable floaters
- Stepped spread floaters
- Multi-step bonds
- Indexed amortization notes.

The major type of structured note owned by financial institutions are step-up bonds. These bonds have successively higher coupons over their life and the issuer may call them. Institutions should carefully evaluate the purchase of a step-up bond. See the explanation of the call feature of step up bonds immediately below in the description of corporate bonds.

OTS does not consider standard, non-leveraged, floating rate securities (where the interest rate is not based on a multiple of the index) to be structured notes.

Shares in Money Market Funds

The combined money of many entities that is jointly invested in high yield financial instruments including U.S. government securities, certificates of deposits, and commercial paper. A money market fund is a mutual fund that makes its profit by buying and selling various forms of money rather than buying and selling shares of ownership in corporations.

Fixed-Income Investments

The bond (or debt) market represents debt instruments with maturities of longer than one year and includes longer-term U.S. Government and federal agency bonds and notes, corporate debt securities, and municipal bonds.

Bond Ratings

Bond ratings are good threshold indicators of the probability of default, but savings associations should conduct a thorough credit analysis of the security issuer before buying a security. Savings associations should also monitor the security after the purchase. The issuer should have the capacity to meet principal and interest payments as they become due. Failure to do so results in a default. Credit analysis should, at a minimum, encompass a review of the issuing entity's financial statement, level of capitalization, management, earnings, business reputation, and other relevant factors. Other relevant factors may include: adequacy of sinking funds, collateralization, refinancing needs, and callability.

Besides performing the very basic credit analysis, each type of bond or industry has a unique set of factors. The institution should also review these factors when performing a credit review.

Rated Securities

We identify Moody's ratings first, and Standard & Poor's ratings in parentheses.

Investment Grade

- Aaa (AAA): Bonds judged to be of the best quality that carry the smallest degree of risk. The capacity to pay interest and repay principal is extremely strong.

- Aa (AA): Bonds judged to be of high quality by all standards. These securities have a very strong capacity to pay interest and repay principal. They differ from the higher-rated issues only in a small degree.

- A (A): Bonds of upper-medium-grade obligation with many favorable investment attributes. These securities have a strong capacity to pay interest and principal. However, they are somewhat more susceptible to the adverse effects of changes in circumstance and economic conditions than debt in higher-rated categories.

- Baa (BBB): Bonds considered to be of medium-grade obligation. They are not highly protected nor poorly secured. These securities have an adequate capacity to pay interest and repay principal. Normally, debt in this category exhibits adequate protection limits. However, adverse

economic conditions or changing circumstances are more likely to lead to a weakened capacity to pay interest and repay principal than in higher-rated categories.

Below Investment Grade

- Ba (BB): Bonds judged to have speculative elements. Often the protection of interest and principal payments may be moderate and thereby not well safeguarded.

- B (B): These bonds generally lack the characteristics of a desirable investment. Assurance of principal and interest payments or maintenance of other contract terms over a long period may be suspect.

- Caa, Ca, C (D): These bonds are of poor standing. Such issues may be in default or have other shortcomings.

The rating agencies (Moody's or Standard & Poor's) may append a designation of Provisional (Moody's) or Conditional (Standard & Poor's) to a rating. For example, the provisional or conditional description is when the issuer does not specify an offering date.

Subquality debt is, on balance, predominantly speculative regarding capacity to pay interest and repay principal according to the terms of the obligation. Large uncertainties on major risk exposures to adverse conditions outweigh any quality and protective characteristics. Debt rated D is in payment default. Rating companies use the D rating category when issuers do not make interest or principal payments on the date due. They assign the D rating even if the applicable grace period has not expired, unless the rating agency believes that the issuer will make such payments during the grace period.

Institutions should obtain current bond ratings or credit analysis before any purchase. Associations invested in corporate bonds should regularly review the current ratings of their holdings for any adverse changes, and management should report the result of these credit reviews to the board of directors.

Non-Rated Securities

For non-rated securities, institutions should establish guidelines to ensure that the securities meet legal requirements and that the institution fully understands the risk involved. Institutions should establish limits on individual counterparty exposures. Policies should also provide credit risk and concentration limits. Such limits may define concentrations relating to a single or related issuer or counterparty, a geographical area, or obligations with similar characteristics.

U.S. Treasury Securities

Treasury Notes

A U.S. government long-term security, sold to the public and having a maturity of one to ten years.

Treasury Bonds

A U.S. government long-term security, sold to the public and having a maturity longer than ten years.

Zero-Coupon Treasuries or STRIPS

Zero-coupon bonds, although they can be U.S. Government or agency securities, are most frequently corporate bonds. The market sells zero-coupon bonds at a deep discount from par value. They accumulate and compound interest and pay full face value at maturity. Zero-coupon bonds are highly sensitive to interest rates and tend to exacerbate interest rate risk in the majority of savings associations. As a result, it may be an unsafe and unsound practice for savings associations with excessive exposure to interest rate risk to invest in zero-coupon bonds. Moreover, taxable zero-coupon securities receive unfavorable tax treatment. Even though the savings association receives no cash, thrifts must pay taxes annually on accrued interest.

Corporate Bonds

Corporate bonds can consist of subordinated debentures, collateralized or mortgage bonds, and floating-rate notes. Corporate debt securities face the same risks as loans to a business entity. Section 560.40 restricts investments in corporate obligations that sets forth requirements for minimum credit quality and loan-to-one-borrower limitations. Federal institutions may only invest in investment grade corporate bonds. Investment grade corporate debt securities are those that, at the time of their purchase, were in one of the four highest rating categories by at least one nationally recognized statistical rating organization.

Collateralized Bonds

Corporate bonds come in many varieties with differing features and characteristics such as being secured or unsecured. The real estate mortgage or capital equipment that the bond money purchases usually collateralizes the bond. The bondholder can sell the collateral to satisfy a claim if the bond issuer fails to pay principal and interest when due. The full faith and credit of the issuer, but not any specific collateral backs an unsecured bond or debenture.

Debenture Bonds

A bond that has no specific security set aside or allocated for repayment of the principal. A debenture bond is secured only by the general credit of the issuer.

Callable Bonds

Institutions should carefully evaluate provisions that permit the issuer to modify the maturity of a bond. Many corporate bonds contain call privileges that permit the issuer to redeem the bond, either fully or partially, before the scheduled maturity. Call provisions are generally detrimental to investors since they run the risk of losing a high-coupon bond when rates begin to fall. Call provisions also tend to limit the price appreciation of the bond that might otherwise occur when interest rates decline. The presence of call protection, however, limits the right of the issuer to call the bond to a specified number of years early in the life of the bond.

Sinking Fund Bonds

Sinking fund provisions are a form of maturity modification most often found in industrial bonds but increasingly found in other types of bonds as well. A sinking fund provision can take either of two

forms. In one form, the issuer makes periodic payments to a segregated fund that is sufficient to retire the bonds upon maturity.

The other form mandates the issuer to retire some portion of the debt in a prearranged schedule during its life and before the stated maturity. Sinking funds are beneficial because they assure an orderly retirement of debt and enhance liquidity. Sinking funds can also be disadvantageous to investors. In particular those investors holding one of the early bonds to be called for a sinking fund are disadvantageous to the investor.

Equity Instruments

The equity markets are the primary exchanges for the trading of stocks. The shares of common stock and preferred stock bought and sold in these markets represent actual ownership interest in a corporate entity. The major markets are the New York Stock Exchange, the American Stock Exchange, and the over-the-counter market. Savings associations may not generally invest in or retain equity securities. The Home Owners' Loan Act permits the following investments:

Federal Agency Securities

Savings association may invest in certain equity securities of FHLBs, Freddie Mac, Fannie Mae, SLMA and GNMA.

Banker's Banks

A federal savings association may purchase for its own account shares of stock of a bankers' bank, provided the following conditions are met:

- The institution is insured by the Federal Deposit Insurance Corporation or a holding company that owns or controls such an insured institution, if the stock of such institution or company is owned exclusively by depository institutions or depository institution holding companies.
- Such bank or company and all subsidiaries are engaged exclusively in providing services to or for other depository institutions, their holding companies, and the officers, directors, and employees of such institutions and companies, and in providing correspondent banking services at the request of other depository institutions or their holding companies.
- The total amount of such stock held by the association in any bank or holding company must not exceed at any time ten percent of the association's capital stock and paid in and unimpaired surplus.
- The purchase of such stock must not result in an association's acquiring more than five percent of any class of voting securities of such bank or company.

Trust-Preferred Securities

Savings associations may invest in trust-preferred securities in accordance with the limitations established in 12 CFR § 560.40. Trust preferred securities are non-perpetual cumulative preferred stock

issued by a wholly owned trust subsidiary of a corporation. Revenue from the sale of the trust-preferred securities is exchanged for junior subordinated debentures issued by the parent corporation. These debentures feature coupon payment and term to maturity identical to those of the trust preferred securities. See Thrift Bulletin 73 for a complete discussion of trust secured preferred securities.