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VIA FACSIMILE & FEDERAL EXPRESS

November 17, 1997

Mr. Joe M. Cleaver
Executive Secretary
Federal Financial Institutions Examination Council
2100 Pennsylvania Avenue, N.W.
Suite 200
Washington, DC 20037

Re: Proposed Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities

Dear Mr. Cleaver:

The Bond Market Association ("the Association")[1] is pleased to submit its comments in response to the above-referenced proposed Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities[2] (the "1997 Statement" or the "proposals") issued by the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA), (collectively, the "agencies"), the under the auspices of the Federal Financial Institutions Examination Council (FFIEC).

Depository institutions are important participants in the fixed income markets, and their investment activities are essential to the liquidity and efficient functioning of those markets. Broad latitude to invest in a variety of fixed income instruments provides regulated institutions with a wide range of alternatives that can help them achieve important portfolio goals, including increased yield and return on investment, diversification, asset-liability management, risk management and similar objectives. We therefore believe it crucial for the FFIEC and its component agencies to accommodate and facilitate these activities, and not unduly inhibit or distort institutions' involvement in various sectors of the fixed income market. The Association provided technical market expertise and participated extensively during the FFIEC's development of its original Supervisory Policy Statement on Securities Activities, published on February 3, 1992 (the "1992 Statement"). [3] We continue to take an active interest in the FFIEC's supervision and oversight of financial institutions' investment securities and derivatives activities, and are grateful for the opportunity to provide our input in this process.

The Association's comment letter is divided into two sections. The first section provides our general comments on the agencies' proposed approach to supervision and oversight of investment securities and related activities. The second section provides several specific comments and suggestions on particular aspects of the 1997 Statement. Consistent with the Association's organizational mission, these comments focus on investment securities (as opposed to derivatives) activities of regulated institutions.

I. GENERAL COMMENTS

The Bond Market Association strongly supports the 1997 proposals for their updated and more institution-based approach to the supervision and oversight of investment securities activities. The Association believes that these proposals, if adopted, would implement a supervisory policy and regulatory framework that is sufficiently flexible to accommodate important differences among financial institutions' diverse investment capabilities, portfolio needs and goals. Such flexibility is critically important in enabling institutions to carry out their investment and risk management responsibilities in an efficient manner, and allowing them to remain competitive and responsive to the needs of the public.

The Association particularly commends the agencies and the FFIEC for their decision to reconsider, and propose to rescind, the formulaic, security-level investment tests of the 1992 Statement and to develop the more comprehensive, flexible, portfolio-based supervisory approach embodied in the 1997 Statement. The Association strongly supports the regulatory philosophy underlying this proposal. Specifically, the Association agrees with the agencies' conclusion that it is neither appropriate nor effective to attempt to manage or control financial market risks by imposing arbitrary, quantitative restrictions on institutions' ability to purchase or invest in specific categories of financial instruments. We further agree that the most effective approach to supervising the investment and risk management process is one in which individual institutions are required to demonstrate their ability to identify, measure, monitor and control the risk of investment activities on a comprehensive, portfolio-wide and institution-wide basis.

The Bond Market Association concurs with the FFIEC that the 1992 Statement - particularly the "high risk" tests for residential "mortgage derivative products," or "MDPs" - may have caused unintended distortions in depository institutions' investment decision making processes. We agree that the 1992 Statement created uneconomic incentives for depository institutions to acquire, or to refrain from acquiring, certain types of securities, depending solely upon their treatment under these tests. We believe that the current proposals will help to eliminate these investment distortions.

The Association also agrees that many positive changes have occurred in the financial markets since the issuance of the 1992 Statement, including revisions to generally accepted accounting principles and developments in the securities and derivatives markets. In 1992 it may have been the case that some institutions did not sufficiently understand the risks inherent in MDPs, such that the high risk tests helped to prevent losses that might otherwise have occurred. However, the investment activities of many other well-managed institutions were unduly constrained by the application of these tests.

Moreover, as a general matter, we believe that financial institutions since that time have become much more aware, knowledgeable and sophisticated in their approaches to investing and risk management. Since the agencies' implementation of 1992 Statement, depository institutions and other institutional investors have established a greater degree of familiarity with the benefits - and corresponding risks - of MDPs, structured notes, and other products that may entail significant market risk or potential price volatility. Part of this may be attributed to the painful lessons of the 1993-1994 market environment, in which rapid increases in short-term interest rates produced losses and dislocations throughout the fixed income markets. In any case, we believe that attention to market risk - in addition to the traditional focus on credit risk - has become a well-ingrained component of an effective and comprehensive risk management program.

The provision of broader and more flexible investment opportunities offers a number of benefits. Specifically, institutions may be exposed to less concentration risk, and will have broader latitude to construct investment portfolios that can help them manage their return, maturity, duration and other investment goals. Increased investment options can also contribute to improved funding costs, as the economic benefits that flow from access to a wider selection of securities products may permit institutions to offer more competitive interest rates on their loan products, ultimately benefiting mortgage and other borrowers.

However, given the complex and dynamic character of the financial markets, increased investment authority and flexibility requires a corresponding increase in responsibility and expertise on the part of institutions. The Association believes that an important and highly desirable result of the proposals will be to encourage depository institutions to develop, implement and improve their internal investment oversight and risk management systems, and to incent institutions to take a more active and responsible posture toward portfolio management. The Association generally supports the proposals' allocation of investment and risk management responsibility between institutions' boards of directors, who are responsible for establishing general policy, and senior management, who are responsible for the implementation of this policy on a day-to-day basis. The specific approach that a depository institution applies to fulfill these responsibilities should be commensurate with the size, scope and complexity of its activities and holdings. Regardless of its size or scope, however, we agree that an acquiring institution is ultimately responsible for ensuring that appropriate personnel adequately understand and manage the risks of all transactions into which it enters. The Association accordingly endorses the proposals' observation that institutions that do not have adequate resources or expertise to manage their own investment activities and risks should seek and obtain outside professional advice.

The Bond Market Association understands that, through their participation in developing and proposing the 1997 Statement, each of the agencies has tacitly endorsed the FFIEC's policy emphasis on a more comprehensive, portfolio-based approach to supervising the investment and risk management process. As noted above, we fully support this shift in regulatory philosophy, and favor swift adoption of the proposals. However, we encourage the agencies to take several further actions to implement and reinforce the policies underlying the 1997 Statement. We believe that our suggestions will help to achieve the intended benefits of the 1997 Statement, and to provide clear and unambiguous guidance to regulated institutions concerning appropriate methods of complying with its requirements. In particular:

(1) The Association strongly encourages the agencies to implement the policies underlying 1997 Statement guidance in actual practice. We are concerned that, notwithstanding the 1997 Statement's stated shift in oversight policy, individual agencies and examiners may nonetheless continue to require depository institutions to meet the same or similar investment tests, documentation or evidentiary compliance requirements, and/or other standards that are currently in place under the 1992 Statement.

(2) The Association urges each of the agencies to adopt promptly such revisions to their current individual regulations, policies and practices as are necessary to conform any existing, conflicting regulatory guidance with the 1997 Statement. Each of the above concerns, and several other specific comments, are discussed in more detail in the following section of this letter.

II. SPECIFIC COMMENTS

A. Application of the 1997 Statement

As discussed above, The Bond Market Association fully supports the notion that regulated financial institutions should have a clear understanding of the specific characteristics of the investments they are purchasing, so that they may understand, manage and respond appropriately to adverse changes to their earnings or the economic value (of an individual instrument, a portfolio or the entire institution) resulting from movements in interest rates and securities prices, or other market events or conditions. As part of a prudent management approach, the Association considers the FFIEC's proposed establishment of institution-wide investment and risk management policies, procedures and limits to be essential. An important component of this approach includes having in place systems for identifying, measuring, and reporting on various types of risk.

However, the Association is concerned that the proposals' encouragement of prepurchase analysis, especially in the case of complex or potentially volatile instruments, may unintentionally perpetuate a micro-managerial, security-level approach for assessing the appropriateness of individual investments. Specifically, we are concerned that the proposal's suggestion that a prepurchase analysis for such instruments "should show the impact of an immediate parallel shift in the yield curve of plus and minus 100, 200 and 300 basis points,"4 may impose a de facto quantitative pass/fail test that is substantially similar to that employed by the 1992 Statement. Certain investments may appear as high risk if purchased alone, but are not risky in combination with other assets, as part of a larger portfolio. Moreover, there are legitimate and prudent uses within an investment portfolio for many securities that may exhibit significant interest rate sensitivity or price volatility when considered individually. Accordingly, any final version of the 1997 Statement should emphasize that neither pre-acquisition stress testing generally, nor any particular stress testing methodology, is necessarily required for every individual investment (even those that may be "complex or potentially volatile"), and that the management of market risk may appropriately be conducted at the institutional or portfolio level.

More broadly, the Association believes that if the FFIEC intends to implement a more comprehensive, management-directed investment and risk management oversight policy, then the agencies' supervisory and examination practices should be sufficiently flexible to accommodate institutions that have developed, implemented and can demonstrate an effective program for monitoring, analyzing and reacting to the impact of prospective changes to the composition of their investment portfolios under a variety of market conditions. No single approach nor set of compliance requirements should be established, either formally or informally.

Similarly, the Association supports the FFIEC's proposal that management may demonstrate compliance with the 1997 Statement by "establish[ing] practices and maintain[ing] documentation appropriate to the institution's individual circumstances."5 The Association thus supports the FFIEC's statement that the proposals describe a general framework of prudent management practices and are not intended to be a "checklist." This is an important concept. It must be consistently applied in practice in order to achieve the proposal's desired flexibility as it is applied to a wide range of institutions, each with different investment needs and operations.

The Association's basic concern is that conflicts may arise between this stated approach, and the types of specific methods, procedures, evidence, records and other documentation that agencies and their examination staffs may routinely seek or require from individual institutions. As long as the agencies are proposing new supervisory policies and practices that will vary in their specific application by different types of institutions, it is important that they remain flexible in terms of the approaches and documentation that are required in order to achieve compliance.

B. Conformance of Conflicting Agency Regulatory Policies and Guidance

Another significant Association concern is that, notwithstanding its revised approach, the 1997 Statement "does not supersede any other requirements of the respective agencies' statutory rules, regulations, policies, or supervisory guidance."6 In at least several instances, existing agency regulations and guidance conflict with the spirit, if not the letter, of the proposed 1997 Statement. The Association strongly believes that unless these conflicting agency rules, regulations, and policies are promptly and consistently revised, the goals and benefits of the 1997 Statement will not be fully realized.

For example, existing investment tests, if not superseded by revised regulatory and examination policies, will continue to have an undesirable distorting effect on institutions' investment decisionmaking. NCUA regulatory guidance under 12 C.F.R. Parts 703 and 704 currently requires that corporate and natural person credit unions conduct CMO/REMIC investment tests. These NCUA regulations prohibit investment in any CMO or REMIC that does not pass the FFIEC's tests for average life, average life sensitivity, price sensitivity and other investment level standards, as set forth in the 1992

Statement. We believe that the NCUA, as a constituent member of the FFIEC, should conform its independent supervisory guidance governing the investment activities of credit unions with the proposals contained in the 1997 Statement. It strikes us as confusing and inconsistent for the NCUA on one hand to endorse the agencies' proposed 1997 Statement, which would specifically rescind the high risk MDP tests while, on the other hand, simultaneously retaining separate requirements for credit unions to conduct these tests. Specifically, the Association would suggest that the NCUA act promptly to conform conflicting guidance in its new 1997 regulations7 with that of the 1997 Statement before its regulations become effective on January 1, 1998.

Another example of conflicting regulatory guidance involves a recent joint Notice and Request for Comment8 by the FDIC, FRB and OCC that would revise all federally insured banks' Consolidated Reports of Condition and Income (Call Reports), specifically as they pertain to "investment securities with high price volatility." The bank agencies' proposed Call Report changes would revise the information collected on "high risk" mortgage securities and structured notes to reflect information based on "significant price volatility" under specific interest rate or major factor scenarios, e.g., an estimated change in value of 20 percent or more due to an immediate yield curve shift of plus or minus 300 basis points."9 Specific definitions and tests to estimate "significant price volatility" have not yet been developed.

These October 2nd proposals appear to be wholly inconsistent, and would directly conflict with, the overarching concept and spirit of the 1997 Statement; namely, that investment risk management of reporting institutions should be a function of an institution's entire portfolio, not its individual assets. This proposed Call Report scheme may encourage banks to reduce their investments in certain securities that must be reported as possessing "significant" price volatility. Although nominally this guidance would apply only in the reporting (rather than investment) context, it would nevertheless be logical to conclude that banking institutions may be dissuaded from purchasing those types of securities that require special "high risk" reporting, even when such investments may be appropriate and beneficial from an overall risk management perspective. As long as a reporting regime can be developed that provides an accurate overall picture of an institution's portfolio, and the degree to which it is exposed to various credit, interest rate, market and other risks, then we believe it unnecessary for the agencies to develop a specific reporting requirement focused on "high risk" mortgage securities and structured debt instruments. Accordingly, the Association recommends that the NCUA and the other agencies promptly revise their separate investment, reporting and related regulations as may be necessary to conform with the standards proposed in the 1997 statement.

C. Credit Risk

The 1997 Statement advises institutions to consider settlement and pre-settlement risk in managing credit issues. It emphasizes the need to develop specific criteria for selecting dealers, investment bankers and brokers as a means of effectively managing these risks. The Association concurs that it is extremely important for institutions to develop and apply policies for assessing a counterparty's credit standing, performance capabilities, general reputation, and other attributes prior to entering into a specific transaction or a broader business relationship.

However, it may be unnecessary in all cases for the board of directors of an institution - particularly larger institutions that conduct business with many different counterparties - to review and specifically authorize every dealer, investment banker and broker with which an institution transacts business. These ongoing responsibilities may be effectively delegated by the board of directors to senior management. The Association therefore believes it would be helpful for the agencies to clarify that institutions may meet their credit oversight obligations under the 1997 Statement as long as the board of directors determines that the institution has in place appropriate and effective policies and procedures to review, approve and monitor individual counterparties. The application of these responsibilities may be delegated to senior management of the organization. Finally, the proposals indicate that the board, or a committee thereof, should set limits on the amounts and types of transactions authorized for each securities firms with whom the institution deals. The Association believes that the establishment of any such limits would be unnecessary and redundant, especially since the proposals independently require individual counterparty credit limit exposures to be established.

* * *

Again, The Bond Market Association appreciates the opportunity to comment on the 1997 Statement. Should you have any questions or desire clarification of any of the foregoing, please contact George Miller, Vice President and Deputy General Counsel of The Bond Market Association, at 212.440.9403.

Sincerely,

/s/
Lawrence E. Thomas, Chairman
Mortgage and Asset-Backed Securities Division
of The Bond Market Association

cc: Members of the Mortgage and Asset-Backed Securities Executive Committee of
The Bond Market Association
Selected Staff of The Bond Market Association

1 The Bond Market Association (formerly the Public Securities Association, or "PSA") represents securities firms and banks that underwrite, distribute and trade a wide range of debt securities, both domestically and internationally. Additional information about the Association is available from our Internet website at www.bondmarkets.com.

2 62 Federal Register 51862 (October 3, 1997), hereinafter referred to as the "Release."

3 See PSA letters to FFIEC dated December 5, 1990, March 5, 1991 and September 9, 1991.

4 Release at 51865.

5 Release at 51863.

6 Release at 51862.

7 62 Federal Register 12929 and 32989.

8 "Proposed Agency Information Collection Activities; Comment Request" 62 Federal Register 51715 (October 2, 1997).

9 FFIEC Call Report Schedule RC-B, Memoranda Items M8 (a), M8 (b), M9 (a) and M9 (b).