FEDERAL RESERVE BANK OF DALLAS

DALLAS, TEXAS 75222

Circular No. 80-179
September 23, 1980

POLICY STATEMENT

(Bank Holding Company Participation in Forward Placement or Delayed Delivery Contracts and Interest Rate Futures Contracts)

TO ALL MEMBER BANKS,
BANK HOLDING COMPANIES,
AND OTHERS CONCERNED IN THE
ELEVENTH FEDERAL RESERVE DISTRICT:

The Board of Governors of the Federal Reserve System has approved a policy statement relating to bank holding companies' participation in forward placement or delayed delivery contracts and interest rate futures contracts. The policy statement, presented in the form of a letter to bank holding compaines, is enclosed.

The three Federal bank regulatory agencies jointly issued revised policy statements earlier this year, which set forth precautionary rules and specific guidelines for commercial banks that may consider it desirable to enter into futures, forward or standby contracts on U.S. Goverment and agency securities. The press release announcing those revisions is also enclosed.

Any questions concerning the enclosed documents should be directed to the Attorneys' Section of our Holding Company Supervision Department, Ext. 6182. Additional copies of this circular will be furnished upon request to the Bank and Public Information Department, Ext. 6266.

Sincerely yours,

Robert H. Boykin

First Vice President

Enclosures

Banks and others are encouraged to use the following incoming WATS numbers in contacting this Bank: 1-800-442-7140 (intrastate) and 1-800-527-9200 (interstate). For calls placed locally, please use 651 plus the extension referred to above.

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LETTER TO BANK HOLDING COMPANIES

The three Federal bank regulatory agencies jointly issued revised policy statements on March 14, 1980 which set forth precautionary rules and specific guidelines for banks that may consider it desirable to enter into futures, forward and standby contracts on U. S. Government and agency securities ("financial contracts"). A copy of the press release announcing these revisions is enclosed for your convenient reference. In recent months, questions have arisen concerning the application of the joint bank policy statements to bank holding companies that might consider engaging in similar practices.

In supervising the activities of bank holding companies, the Board has adopted and continues to follow the principle that bank holding companies should serve as a source of strength for their subsidiary banks. Accordingly, the Board believes that any positions that bank holding companies or their nonbank subsidiaries take in financial contracts should reduce risk exposure, that is, not be speculative.

If the parent organization or nonbank subsidiary is taking or intends to take positions in financial contracts, that company's board of directors should approve prudent written policies and establish appropriate limitations to insure that financial contract activities are performed in a safe and sound manner with levels of activity reasonably related to the organization's business needs and capacity to fulfill obligations. In addition, internal controls and internal audit programs to monitor such activity should be established. The board of directors, a duly authorized committee thereof or the internal auditors should review periodically (or at least monthly) all financial contract positions to insure conformance with such policy and limits. In order to determine the company's exposure, all open positions should be reviewed and market values determined at least monthly, or more often, depending on volume and magnitude of positions.

In formulating its policies and procedures, the parent holding company may consider the interest rate exposure of its nonbank subsidiaries, but not that of its bank subsidiaries. As a matter of policy, the Board believes that any financial contracts executed to reduce the interest rate exposure of a bank affiliate of a holding company should be reflected on the books and records of the bank affiliate (to the extent required by the bank policy statements), rather than on the books and records of the parent company. If a bank has had an interest rate exposure that management believes requires hedging with financial contracts, the bank should be the direct beneficiary of any effort to reduce that exposure. The Board also believes that final responsibility for financial contract transactions for the account of each affiliated bank should reside with the management of that bank.

As you may know, the joint bank policy statements referred to above include accounting guidelines for banks that engage in financial contract activities. Since a special task force of the American Institute of Certified Public Accountants is presently considering accounting standards for contract activities, no specific accounting requirements for financial contracts entered into by parent bank holding companies and nonbank subsidiaries are being mandated at this time. The Board expects to review further developments in this area.

The Board intends to monitor closely bank holding company transactions in financial contracts to ensure that any such activity is consistent with maintaining a safe and sound banking system. In any cases where bank holding companies are found to be engaging in speculative practices, the Board is prepared to institute appropriate action under the Financial Institutions Supervisory Act of 1966, as amended.

Enclosure

Joint News Release

Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board

For immediate release March 14, 1980

The three Federal bank regulatory agencies today announced a number of revisions in their guidelines for banks that engage in futures, forward and standby contracts on U.S. government and agency securities.

The changes announced today were to guidelines adopted last November. The Federal Deposit Insurance Corporation and the Federal Reserve Board incorporated the guidelines in a policy statement. The Comptroller of the Currency's guidelines were contained in an operating circular.

In one change, adopted by the FDIC and the Federal Reserve, futures and forward contracts executed by State chartered banks before January 1, 1980 were exempted from the accounting procedures specified in the guidelines. The Comptroller of the Currency retained the January 1 effective date for all contracts entered into by national banks, as the Comptroller has had similar accounting provisions in effect since 1977.

Other principal changes in the guidelines adopted in the light of substantial comment received since the guidelines were published last November, include the following:

1. Banks may exercise the option of carrying futures and forward positions on a market or on a lower of cost or market basis.

2. Futures and forward contract activities associated with bona fide hedging of a mortgage banking operation are exempted from the otherwise prescribed accounting treatment for such contracts.

3. A number of other technical changes have been made, including relaxation of the requirement that a bank's board of directors review contracts at least monthly.

The agencies adopted the guidelines following a Treasury/Federal Reserve Study indicating that banks can effectively use financial futures

contracts to hedge their risk of losses due to changes in interest rates, but noting that improper use of interest rate futures contracts increases, rather than decreases, the risk of loss due to changes in interest rates.

In addition to their guidelines, the agencies provided the following precautionary rules to banks they supervise:

1. Banks that engage in futures, forward or standby contract transactions should do so only in accordance with safe and sound banking practices.

2. Such transactions should be of a size reasonably related to the bank's business needs and to its capacity to fulfill obligations incurred.

3. The positions banks take in futures, forward and standby contracts should be such as to reduce the bank's exposure to loss through interest rate changes.

4. Policy objectives should be formulated in the light of the bank's entire mix of assets and liabilities.

5. Standby contracts calling for settlement in excess of 150 days should not be issued by banks except in special circumstances and ordinarily such long term standby contracts would be viewed by the agencies as being inappropriate.

The 10-point guidelines that should be followed by banks authorized to participate in these markets include directives on the role of bank boards of directors, record keeping, monitoring of such activities, valuation of contracts, treatment of fee income in connection with a standby contract, disclosures of activity by a bank in futures, forward and standby contracts, monitoring of credit risk exposure and internal controls at banks.

The text of the guidelines is attached.

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Guidelines for Banks that Engage in Futures, Forward and Standby Contract Activities

Banks that engage in futures,[1/] forward[2/] and standby[3/] contract activities should only do so in accordance with safe and sound banking practices with levels of activity reasonably related to the bank's business needs and capacity to fulfill its obligations under these contracts. In managing their assets and liabilities, banks should evaluate the interest rate risk exposure resulting from their overall activities to insure that the positions they take in futures, forward and standby contract markets will reduce their risk exposure; and policy objectives should be formulated in light of the bank's entire asset and liability mix. The following are minimal guidelines to be followed by banks authorized to participate in these markets.

1. Prior to engaging in these transactions, a bank should obtain an opinion of counsel or its State banking authority concerning the legality of its activities under State law.[4/]

1/ Futures Contracts: These are standardized contracts traded on organized exchanges to purchase or sell a specified security on a future date at a specified price. Futures contracts on GNMA mortgage-backed securities and Treasury bills were the first interest rate futures contracts. Several other interest rate futures contracts have been developed, and it is anticipated that new and similar interest rate futures contracts will continue to be proposed and adopted for trading on various exchanges.

2/ Forward Contracts: These are over-the-counter contracts for forward placement or delayed delivery of securities in which one party agrees to purchase and another to sell a specified security at a specified price for future delivery. Contracts specifying settlement in excess of 30 days following trade date shall be deemed to be forward contracts. Forward contracts are not traded on organized exchanges, generally have not required margin payments, and can only be terminated by agreement of both parties to the transaction.

3/ Standby Contracts: These are optional delivery forward contracts on U.S. government and agency securities arranged between securities dealers and customers and do not currently involve trading on organized exchanges. The buyer of a standby contract (put option) acquires, upon paying a fee, the right to sell securities to the other party at a stated price at a future time. The seller of a standby (the issuer) receives the fee, and must stand ready to buy the securities at the other party's option.

4/ The Comptroller's Office has defined these contracts to be incidental to banking provided their use corresponds to the definitions outlined in the Comptroller's Banking Circular.

2. The board of directors should consider any plan to engage in these activities and should endorse specific written policies in authorizing these activities. Policy objectives must be specific enough to outline permissible contract strategies and their relationship to other banking activities, and record keeping systems must be sufficiently detailed to permit internal auditors and examiners to determine whether operating personnel have acted in accordance with authorized objectives. Bank personnel are expected to be able to describe and document in detail how the positions they have taken in futures, forward and standby contracts contribute to the attainment of the bank's stated objectives.

3. The board of directors should establish limitations applicable to futures, forward and standby contract positions; and the board of directors, a duly authorized committee thereof, or the bank's internal auditors should review periodically (at least monthly) contract positions to ascertain conformance with such limits.

4. The bank should maintain general ledger memorandum accounts or commitment registers to adequately identify and control all commitments to make or take delivery of securities. Such registers and supporting journals should at a minimum include:

(a) the type and amount of each contract,
(b) the maturity date of each contract,
(c) the current market price and cost of each contract, and
(d) the amount of money held in margin accounts.

5. With the exception of contracts described in item 6, all open positions should be reviewed and market values determined at least monthly (or more often, depending on volume and magnitude of positions), regardless of whether the bank is required to deposit margin in connection with a given contract.5/ All futures and forward contracts should be valued on the basis of either market or the lower of cost or market, at the option of the bank.6/ Standby contracts should be valued on the basis of the lower of cost or market.7/ Market basis for forward and standby contracts should be based on the

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5/ Underlying security commitments relating to open futures and forward contracts should not be reported on the balance sheet. Margin deposits and any unrealized losses (and in certain instances, unrealized gains) are usually the only entries to be recorded on the books. See "General Instructions" to the Reports of Condition and Income for additional details.

6/ Futures and forward contracts executed for trading account purposes should be valued on a basis consistent with other trading positions.

7/ Losses on standby contracts need be computed only in the case of the party committed to purchase under the contract, and only where the market value of the security is below the contract price adjusted for deferred fee income.

market value of the underlying security, except where publicly quoted forward contract price quotations are available. All losses resulting from monthly contract value determination should be recognized as a current expense item; those banks that value contracts on a market basis would recognize gains as a current income item. In the event the above described futures and forward contracts result in the acquisition of securities, such securities should be recorded on a basis consistent with that applied to the contracts (either market or lower of cost or market). Acquisition of securities arising from standby contracts should be recorded on the basis of lower of adjusted cost (see Item 7(c)) or market.

6. Futures or forward contracts associated with bona fide hedging of mortgage banking operations, i.e., the origination and purchase of mortgage loans for resale to investors or the issuance of mortgage-backed securities, may be accounted for in accordance with generally accepted accounting principles applicable to such activity.

7. Fee income received by a bank in connection with a standby contract should be deferred at initiation of the contract and accounted for as follows:

a. upon expiration of an unexercised contract the deferred amount should be reported as income;

b. upon a negotiated settlement of the contract prior to maturity, the deferred amount should be accounted for as an adjustment to the expense of such settlement, and the net amount should be transferred to the income account; or

c. upon exercise of the contract, the deferred amount should be accounted for as an adjustment to the basis of the acquired securities. Such adjusted cost basis should be compared to market value of securities acquired. See item 5.

8. Bank financial reports should disclose in an explanatory note any futures, forward and standby contract activity that materially affects the bank's financial condition.

9. To insure that banks minimize credit risk associated with forward and standby contract activity, banks should implement a system for monitoring credit risk exposure associated with various customers and dealers with whom operating personnel are authorized to transact business.

10. To assure adherence to bank policy and prevent unauthorized trading and other abuses, banks should establish other internal controls including periodic reports to management, segregation of duties, and internal audit programs.

The issuance of long-term standby contracts, i.e., those for 150 days or more, which give the other party to the contract the option to deliver securities to the bank will ordinarily be viewed as an inappropriate practice. In almost all instances where standby contracts specified settlement in excess of 150 days, supervisory authorities have found that such contracts were related not to the investment or business needs of the institution, but primarily to the earning of fee income or to speculating on future interest rate movements. Accordingly, banks should not issue standby contracts specifying delivery in excess of 150 days, unless special circumstances warrant.