

FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. 8687]
November 23, 1979

POLICY ON FUTURES CONTRACTS FOR GOVERNMENT SECURITIES

Effective January 1, 1980; Comment Invited by December 15, 1979

*To All State Member Banks, and Others Concerned,
in the Second Federal Reserve District:*

A policy statement setting forth rules and guidelines for commercial banks that engage in futures, forward, and standby contracts for U.S. Government and Agency securities has been issued by the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation. The following is quoted from the joint announcement of these bank regulatory agencies:

The agencies said the policy statement will become effective January 1, 1980 for contracts outstanding at that time and for those entered into subsequently.

However, the agencies also invited comment on the policy statement, through December 15, 1979.

The agencies noted this background to the general guidance they gave to commercial banks engaging in interest rate futures, forward and standby contracts on United States government and agency securities:

A recent Treasury/Federal Reserve study indicated that banks can effectively use financial futures contracts to hedge their risk of losses due to changes in interest rates, but noted that improper use of interest rate futures contracts increases, rather than decreases, the risk of loss due to changes in interest rates.

The study also:

- Cited the experience of participants in financial futures markets who have been approached by salespersons who suggested speculative rather than hedging transactions.
- Indicated that some banks and other financial institutions have issued standby obligations for delivery of securities at predetermined prices in contracts that were so large they exposed the institutions to losses that could, and in some cases did, affect their financial condition.

The agencies' policy statement provided the following precautionary rules:

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 affecting securities in the bank's investment portfolio.
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 policy statement also provides a 10-point set of guidelines that should be followed by banks authorized to participate in these markets. The guidelines—which may be found in the attached agencies' policy statement—included directives on the role of bank boards of directors, record keeping, monitoring of such activities, valua-

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tion of contracts, treatment of fee income in connection with 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 agencies said they will closely monitor bank transactions in financial futures, forward and standby contracts and that, depending on what this monitoring discloses, they might find it necessary to establish position limits or take other supervisory precautions against unsafe or unsound practices.

The agencies said that they may issue a similar policy statement for bank trust departments and trust companies at a later time.

Enclosed—for State member banks in this District—is the text of the policy statement. It will be published in the *Federal Register*, and copies will be furnished upon request directed to our Bank Examinations Department (Tel. No. 212-791-5887).

THOMAS M. TIMLEN,
First Vice President.

FEDERAL RESERVE SYSTEM

Policy Statement Concerning
Forward Placement or Delayed Delivery
Contracts and Interest Rate Futures Contracts

[Docket No. R-0261]

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Policy Statement.

SUMMARY: This policy statement contains policies and procedures that the Board of Governors believes should be instituted by State member banks that engage in interest rate futures contracts,^{1/} forward contracts^{2/} or standby contracts,^{3/} on U. S. government and agency securities to insure that such activities are conducted in accordance with safe and sound banking practices. The policies and procedures will apply to outstanding contracts as well as those entered into after January 1, 1980. Similar policy statements are being adopted by the Comptroller of the Currency and the Federal Deposit Insurance Corporation.

DATE: The policy statement is effective January 1, 1980.
Comments, however, will be received until December 15, 1979.

- 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.

FOR FURTHER INFORMATION CONTACT: Robert S. Plotkin, Assistant Director, or Michael J. Schoenfeld, Senior Securities Regulation Analyst (202/452-2782), Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, Washington, D. C. 20551.

ADDRESS: Comments should be addressed to Theodore E. Allison, Secretary of the Board, Board of Governors of the Federal Reserve System, Washington, D. C. 20551. Comments should contain Docket No. R-0261.

SUPPLEMENTARY INFORMATION: This policy statement is issued pursuant to the Board's supervisory authority over State member banks contained in section 9 (12 U.S.C. §321 et seq.) and section 11 (12 U.S.C. §248) of the Federal Reserve Act and the Financial Institutions Supervisory Act of 1966 (12 U.S.C. 1818 (b)) and related provisions of law.

Statement of Policy Concerning
Forward Contracts and Futures Contracts

The following is a Board policy statement relating to State member bank participation in the futures and forward contract markets to purchase and sell U. S. government and agency securities. Information contained below is applicable specifically to commercial banking activities. An additional statement of policy applicable to trust department activities of State member banks may be issued at a later time.

The staff of the Treasury Department and the Board of Governors of the Federal Reserve System recently completed a study of the markets for Treasury futures. In part, the study notes that there is evidence that financial futures can be used by banks effectively to hedge portions of their portfolios against interest rate risk. However, the study also cautions that improper use of interest rate futures contracts will increase interest rate risk - rather than decrease such risk. In addition, various participants have advised that certain salespersons are attempting to suggest inappropriate futures transactions for banks, such as taking futures positions to speculate on future interest rate movements. Furthermore, some banks and other financial institutions have recently issued standby contracts (giving the contra party the option to deliver securities to the bank at a predetermined price) that were extremely large given their ability to absorb interest rate risk. In so doing, these institutions have been exposed to potentially large losses that could (and sometimes did) significantly affect their financial condition.

Banks that engage in futures, forward and standby 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 investment portfolio, 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. Pairing a transaction

in the spot market with an offsetting position in either futures, forward or standby contracts can be an effective way to reduce interest rate risk. However, 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 under State law 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.

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 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. 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.^{4/} All futures contracts should be marked to market at least monthly. Any loss related to open forward and standby^{5/} contracts should be recognized on the basis of the lower of cost or market value of the underlying security as determined at month-end.^{6/} At the State member bank's option open forward contracts maintained in trading accounts may be carried at market.

6. Completed futures, forward or standby contracts giving rise to acquisition of securities will require such security transactions to be recorded on the basis of the lower of contract price or market price on settlement date. If the market value of the securities is lower than the contract price, the difference should be recorded as an immediate charge against income.

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

^{4/} 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 as noted below, 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.

^{5/} 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.

^{6/} Should margin on forward contracts be required, and assuming the margin accounts would work in the same manner as exchange margins, bank forward contracts should be carried at market to reflect the margin transactions.

an adjustment to the basis of the acquired securities. Such adjusted cost basis should be compared to market value of securities acquired. See item 6.

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. Banks should establish other internal controls including periodic reports to management and internal audit programs to assure adherence to bank policy, and to prevent unauthorized trading and other abuses.

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, the Board concludes that State member banks should not issue standby contracts specifying delivery in excess of 150 days, unless special circumstances warrant.

The Board intends to monitor closely State member bank transactions in futures, forward and standby contracts to ensure that any such activity is conducted in accordance with safe and sound banking practices. In light of that continuing review, it may be found desirable to establish position limits applicable to State member banks. Supervisory action in individual cases under the Financial Institutions Supervisory Act (12 U.S.C. 1818 (b)) may also be instituted if necessary.

This policy statement will become effective January 1, 1980 and will apply to all outstanding contracts as well as those entered into by State member banks after January 1. The Board, however, will receive comments on this policy statement. Interested parties may submit comments and information on this statement in writing to Theodore E. Allison, Secretary of the Board of Governors of the Federal Reserve System, Washington, D. C. 20551, to be received by December 15, 1979. All material submitted should include the Docket Number R-0261.

Such material will be made available for inspection and copying upon request except as provided in section 261.6(a) of the Board's Rules Regarding Availability of Information (12 CFR 261.6(a)).

By order of the Board of Governors of the Federal Reserve System, November 15, 1979.

(signed) Theodore E. Allison

Theodore E. Allison
Secretary of the Board

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