

FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. 8905]
August 27, 1980

Participation by Bank Holding Companies
in Futures Contracts for Government Securities

To All Bank Holding Companies
in the Second Federal Reserve District:

The three Federal bank regulatory agencies jointly issued revised policy statements in March 1980 that set forth precautionary rules and specific guidelines for banks that may consider it desirable to enter into futures, forward, or standby contracts on U. S. Government and agency securities ("financial contracts"). (A copy of the policy statement is enclosed for the convenience of bank holding companies.) 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 of Governors of the Federal Reserve System 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 (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.

(OVER)

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 Federal Reserve 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.

Questions regarding this policy may be directed to our Bank Examinations Department (Tel. No. 212-791-5887).

ANTHONY M. SOLOMON,
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 (Revised).

SUMMARY: The Board of Governors has revised a previously published policy statement (44 Fed. Reg. 68033, November 28, 1979) which 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 apply to outstanding contracts as of January 1, 1980 as well as those entered into subsequent to that date. However, the accounting procedures contained in numbered paragraph 5 of the policy statement apply only to those futures and forward contracts entered into, renewed or extended after January 1, 1980.

- 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.

In response to comments received, the previously published policy statement has been revised (1) to give banks the option to carry futures and forward positions on a market or lower of cost or market basis, (2) to exempt futures and forward contract activities associated with bona fide hedging of a mortgage banking operation from the otherwise prescribed accounting treatment with respect to such contracts, and (3) to exempt those futures and forward contracts executed prior to January 1, 1980 from the accounting procedures contained herein. Other technical amendments, including a relaxation of the requirement that a bank's board of directors review contract positions at least monthly, have also been made.

DATE: The original policy statement became effective January 1, 1980. The revised policy statement is effective immediately.

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.

SUPPLEMENTARY INFORMATION: In November 1979 the Board of Governors adopted, effective January 1, 1980, a policy statement concerning forward placement or delayed delivery contracts and interest rate futures contracts. At the time of publication, public comment on the policy statement was invited and approximately 55 letters of comment were received. The majority of comments concerned the accounting provisions contained in the policy statement. Other less controversial issues were also raised.

Several of the comments questioned the appropriateness of the bank regulatory agencies establishing accounting procedures and suggested that the determination of such procedures should be left to the accounting industry. A letter from the American Institute of Certified Public Accountants stated that it had recently convened a task force to examine the issue of accounting for futures and forward contracts and after the task force completes its deliberations it will submit its advisory conclusions to the Financial Accounting Standards Board for its conclusions and resolution. The letters of comment reveal, however, that there is at present no accepted industry practice and, indeed, there is a difference of opinion in the accounting profession as to what accounting standards should be adopted. As noted previously, the guidelines prescribed in the policy statement are necessary, in the Board's judgment, to prevent unsafe and unsound banking practices. Accordingly, although the Board stands ready to confer with representatives of the accounting profession and to modify, or even eliminate, the prescribed accounting procedures upon adoption of acceptable accounting standards by the accounting industry, the Board believes that the prescription of accounting standards at this time is within its statutory responsibility to prevent unsafe and unsound banking practices.

A number of commenters noted that the requirement to carry futures contracts at market conflicted with the requirement to enter securities acquired pursuant to futures contracts on the bank's books on the basis of the lower of contract price or market price on settlement date. The revised policy statement specifies that securities acquired pursuant to contracts be recorded on a basis consistent with that applied to contracts. In addition, some commenters stated that it is unfair to make banks recognize forward contract losses but preclude them from recognizing gains. The revised policy statement gives banks the option of carrying forward contracts, as well as futures contracts, at market providing that trading account contracts be carried in a manner consistent with other positions in a trading account.

The revised policy statement also gives banks the option to carry futures positions at the lower of cost or market. This option will permit banks to defer gains resulting from a futures activity but will preclude them from delaying recognition of losses on such activity.

Other comments suggested that the prescribed accounting treatment would be inconsistent with accounting standards that have been prescribed with respect to mortgage banking activities (AICPA Position No. 74-12) and that the new procedures are neither necessary nor appropriate where a bank has a mortgage banking department or conducts mortgage banking activity. Since there were already accounting industry standards for this activity, which the Board believes are appropriate, the revised policy statement excludes futures and forward contract activities associated with bona fide hedging of mortgage banking operations from the accounting standards prescribed in the policy statement.

A number of commenters faulted the effective date of the accounting procedures contained in the policy statement. They argued that it is inequitable to change the accounting procedures during the period a contract is held, especially since the decision to enter into a contract was made without knowledge of the subsequent accounting guidelines. Upon reconsideration, the Board has agreed that the accounting procedures contained in numbered paragraph 5 of the policy statement are not required to be applied to futures and forward contracts entered into prior to January 1, 1980. Accordingly, these accounting procedures apply only to futures and forward contracts entered into, renewed or extended after January 1, 1980. No change has been made concerning the effective date of the policy statement with respect to standby contracts.

Finally, many commenters noted that the requirement in the original policy statement that the bank's board of directors review contract positions at least monthly to ascertain conformance with limits previously established by the Board is unduly burdensome and, in some cases, impractical. Accordingly, the revised policy statement provides that the position review may be carried out by the board, a duly authorized committee of the board or the bank's internal auditors.

Acting pursuant to its 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, the Board of Governors has amended its previously published policy statement which, as revised, is hereinafter set forth in its entirety.

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 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 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 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.^{4/} 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.^{5/} Standby contracts should be valued on the basis

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

of the lower of cost or market.^{6/} Market basis for forward and standby contracts should be based on the 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.

^{6/} 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.

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, 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.

By order of the Board of Governors of the Federal Reserve System, March 12, 1980.

Theodore E. Allison
Secretary of the Board