

**FEDERAL RESERVE BANK
OF NEW YORK**

AT10702.C
May 12, 1994

**Interim Revision to the Supervisory Policy Statement
on Securities Activities**

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

The following statement was issued by the Federal Financial Institutions Examination Council:

The Federal Financial Institutions Examination Council (FFIEC) announced that it is issuing an interim revision to its December 1991 "Supervisory Policy Statement on Securities Activities." The interim revision is designed to address questions raised by new accounting rules and their application to mortgage derivative products such as collateralized mortgage obligations (CMOs).

The 1991 policy statement contains guidance on the accounting and reporting for securities and on the suitability of acquiring and holding mortgage derivative securities. The accounting and reporting guidance in the policy statement was based on generally accepted accounting principles (GAAP) in effect at that time. However, Financial Accounting Standards Board (FASB) Statement No. 115, "Accounting for Certain Investments in Debt and Equity Securities," was issued in May 1993 and establishes new GAAP for certain securities. Depository institutions must adopt FASB Statement No. 115 for regulatory reporting purposes for fiscal years beginning after December 15, 1993. Early adoption is permitted in accordance with this new accounting standard.

Because FASB Statement No. 115 was issued after the policy statement, questions have been raised regarding the reporting of mortgage derivative products in accordance with this new accounting standard in light of the policy statement's guidance on the acquisition and holding of these securities. The staffs of the FFIEC's member agencies have developed an interim revision to the policy statement's subsection entitled "Supervisory Policy for Mortgage Derivative Products." This interim revision will be incorporated into a revision of the entire supervisory policy statement the staffs are undertaking that includes revising the accounting discussions in the policy statement for FASB Statement No. 115.

The interim revision to the policy statement:

- Removes the regulatory reporting requirement that nonhigh-risk mortgage securities that later become high-risk must be redesignated as held for sale or trading;

- Instructs examiners to consider any unrecognized net depreciation in held-to-maturity high-risk mortgage securities when they evaluate the adequacy of an institution's capital;
- Reiterates that mortgage derivative products that are high-risk when acquired shall not be reported in regulatory reports as held-to-maturity securities at amortized cost;
- Explains that, for banks and thrifts, examiners may seek divestiture of high-risk mortgage securities that do not reduce interest rate risk when they determine that continued ownership of these securities represents an undue safety and soundness risk to the institution and identifies certain factors that provide evidence of this risk; and
- States that credit unions can hold high-risk mortgage securities only under very limited circumstances and should refer to Part 703 of the National Credit Union rules and regulations.

Institutions should follow the guidance in the interim revision as they prepare their first quarter 1994 and subsequent regulatory reports pending completion of the revised supervisory policy statement.

Printed on the following pages is the text of the Interim Revision to the Supervisory Policy Statement on Securities Activities, effective April 15, 1994. The previous Statement was sent to member banks in this District with our Circular No. 10517, dated February 15, 1992.

Questions regarding this matter may be directed to Donald E. Schmid, Manager, Domestic Banking Department (Tel. No. 212-720-6611).

CHESTER B. FELDBERG,
Executive Vice President.



INTERIM REVISION TO THE SUPERVISORY POLICY STATEMENT ON SECURITIES ACTIVITIES

April 15, 1994

In December 1991, the Federal Financial Institutions Examination Council approved a "Supervisory Policy Statement on Securities Activities" and recommended its adoption to the Examination Council's member agencies. The agencies adopted the policy statement, which became effective on February 10, 1992. The three sections of the policy statement address (a) the selection of securities dealers, (b) securities portfolio policy and strategies and unsuitable investment practices, and (c) mortgage derivative products, other asset-backed products, and zero-coupon bonds.

One of the principal provisions of the supervisory policy is that securities must be reported in accordance with generally accepted accounting principles (GAAP). The discussion of accounting and reporting matters throughout the December 1991 policy statement was written in terms of GAAP as it was then in effect. Under GAAP at that time, securities were categorized as held for investment, for trading, or for sale. However, in May 1993, the Financial Accounting Standards Board (FASB) issued Statement No. 115, "Accounting for Certain Investments in Debt and Equity Securities," which is effective for fiscal years beginning after December 15, 1993, with earlier application permitted in certain circumstances. This new accounting standard establishes three categories of securities: held-to-maturity, trading, and available-for-sale.

Under FASB Statement No. 115, held-to-maturity securities are reported at amortized cost. Trading securities are reported at fair value (i.e., generally, market value), with unrealized changes in value (appreciation and depreciation) reported in an institution's income statement as part of its earnings. Available-for-sale securities are also reported at fair value, but any unrealized appreciation or depreciation, net of tax effects, is reported as a separate component of equity capital.

The staffs of the Examination Council's member agencies are undertaking a revision of the entire supervisory policy statement that would conform the accounting terminology and related discussions throughout the policy to FASB Statement No. 115. Until this effort has been completed and a revised supervisory policy takes effect, references in the existing policy statement to securities held for investment, for trading, and for sale and the accounting treatment for each category should generally be interpreted to mean held-to-maturity, trading, and available-for-sale securities, respectively, as those terms and their related accounting treatment are described in FASB Statement No. 115.

Because FASB Statement No. 115 was issued after the agencies had adopted the supervisory policy, certain provisions of the policy statement's "Section III: Mortgage Derivative Products, Other Asset-Backed Products, and Zero-Coupon Bonds" may conflict with the requirements of this new accounting standard. This has led to questions concerning the proper reporting of mortgage derivative products in light of the supervisory guidance currently contained in Section III. The Examination Council has reviewed those portions of Section III that are of immediate concern and has considered the safety and soundness objectives of the section, including the distinction between "high-risk" and "nonhigh-risk" mortgage securities and the guidance provided on the reporting treatment for these securities.

Accordingly, the staffs of the agencies have developed for the Examination Council an interim revision to the Section III subsection entitled "Supervisory Policy for Mortgage Derivative Products" which will be incorporated into the revision of the entire supervisory policy statement. That Section III subsection addresses both "Nonhigh-risk Mortgage Securities" and "High-risk Mortgage Securities." Institutions should follow the interim revised guidance set forth herein pending completion of the revised supervisory policy statement.

The discussion of "Nonhigh-risk Mortgage Securities" in Section III indicates that a mortgage derivative product that was not a high-risk mortgage security when it was purchased may later fall into the high-risk category. The interim revision instructs examiners to consider any unrecognized net depreciation in held-to-maturity high-risk securities when they evaluate the adequacy of an institution's capital and removes a provision stating that nonhigh-risk mortgage securities that later become high-risk must be redesignated as held for sale or trading assets.

The supervisory guidance on "High-risk Mortgage Securities" in Section III states that an institution may only acquire a high-risk mortgage security to reduce its overall interest rate risk (or, in certain cases, for trading purposes). An institution that acquires high-risk mortgage securities to reduce its interest rate risk needs to frequently assess its interest rate position and the performance of these securities. Since interest rate positions constantly change, an institution may determine that these high-risk mortgage securities no longer reduce interest rate risk. Therefore, in accordance with the existing policy statement, mortgage derivative products that are high-risk when acquired shall not be reported as held-to-maturity securities at amortized cost.

In addition, the policy statement's discussion of "High-risk Mortgage Securities" currently indicates that, in appropriate circumstances, examiners may seek the orderly divestiture of high-risk mortgage securities that do not reduce interest rate risk. The interim revision explains

that, for banks and thrifts, appropriate circumstances are those in which examiners determine that continued ownership of high-risk mortgage securities represents an undue safety and soundness risk to the institution. This risk can arise from the size of a bank's or thrift's holdings of high-risk mortgage securities in relation to its capital and earnings, management's inability to demonstrate an understanding of the nature of the risks inherent in the securities, the absence of internal monitoring systems and other internal controls to appropriately measure the market and cash flow risks of these securities, management's inability to prudently manage its overall interest rate risk, or similar factors. Credit unions can hold high-risk mortgage securities only under very limited circumstances and should refer to Part 703 of the National Credit Union Administration rules and regulations.

Upon completion of the revision of the entire supervisory policy statement by the staffs of the agencies, the revised policy will be presented to the Examination Council for its approval. The Examination Council would then recommend to its member agencies that they adopt the revised policy.