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Disclosure of certain information by financial institutions about debt securities held as assets : November 30, 1990 : amendment to AICPA audit and accounting guides Audits of banks, Audits of credit unions, Audits of finance companies (including independent and captive financing activities of other companies), Audits of property and liability insurance companies, Savings and loan associations, and Audits of stock life insurance companies; Statement of position 90-11;

American Institute of Certified Public Accountants. Accounting Standards Executive Committee

Statement of Position 90-11

Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets

November 30, 1990

Amendment to
AICPA Audit and Accounting Guides
Audits of Banks,
Audits of Credit Unions,
Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies),
Audits of Property and Liability Insurance Companies,
Savings and Loan Associations, and
Audits of Stock Life Insurance Companies

Issued by the
Accounting Standards Executive Committee

American Institute of
Certified Public Accountants

AICPA

NOTE

Statements of position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statements of position do not establish standards enforceable under rule 203 of the AICPA Code of Professional Conduct. However, paragraph 7 of Statement on Auditing Standards (SAS) No. 5, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report*, as amended by SAS No. 43, *Omnibus Statement on Auditing Standards*, and SAS No. 52, *Omnibus Statement on Auditing Standards—1987*, includes AICPA statements of position among the sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by rule 203. If an established accounting principle from one or more of these sources is relevant to the circumstances, the AICPA member should be prepared to justify a conclusion that another treatment is generally accepted.

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Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets

Scope

1. This statement of position provides guidance for disclosure by financial institutions of certain information about debt securities held as assets. It applies to financial institutions whose policy is to carry such securities either at historical cost or at the lower of cost or market value. Such financial institutions include banks, savings and loan associations, savings banks, credit unions, finance companies, and insurance companies. Entities other than financial institutions that include financial institution subsidiaries in their consolidated financial statements should provide the disclosures required by this statement for debt securities held as assets by such subsidiaries.

2. As used in this statement, *debt securities* include—

- Bills, notes, and bonds issued by—
  - *a.* The federal, state, and local governments in the United States and agencies and authorities of those governments.
  - *b.* Foreign governments and agencies of those foreign governments.
- Bonds and commercial paper issued by business enterprises and not-for-profit organizations, including collateralized bond obligations and interest-only and principal-only strips of such bonds and commercial paper.
- Mortgage-backed and other securitized debt instruments, including collateralized mortgage obligations[1] and principal-only and interest-only strips of such instruments.

Debt securities also include preferred stock that, by its terms, either must be redeemed by the issuing enterprise or is redeemable at the

[1]For purposes of this statement, collateralized mortgage obligations also include instruments issued in equity form that are required to be accounted for as nonequity instruments under the consensus on Emerging Issues Task Force Issue 89-4.

option of the investor, because, for the purposes of this statement, such preferred stock has the essential characteristics of debt. Other unsecuritized commercial and personal loans; notes and bonds of foreign governments classified as loans; and unsecuritized leases, credit card receivables, real estate loans, construction loans, and automobile loans are not included in the scope of this statement.

3. This statement amends the following AICPA industry audit and accounting guides:

- *Audits of Banks*
- *Audits of Credit Unions*
- *Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies)*
- *Audits of Property and Liability Insurance Companies*
- *Savings and Loan Associations*
- *Audits of Stock Life Insurance Companies*

Background

4. On May 25, 1990, the Accounting Standards Executive Committee (AcSEC) issued an exposure draft of a proposed statement of position, *Reporting by Financial Institutions of Debt Securities Held as Assets.* That exposure draft was issued in response to concerns that the guidance on reporting debt securities held as assets in the AICPA audit and accounting guides for the various financial industries is uniform for particular industries but is inconsistent from industry to industry. Further, changes in the economic environment, deregulation of interest rates, the increased sophistication of interest rate and other risk management techniques, and the availability of new financial instruments used to reduce or hedge interest rate risk have resulted in increased purchases and sales of debt securities classified as investments, which have contributed to diversity in the application of that guidance.

5. Regulators of financial institutions have expressed concern about certain activities concerning securities classified as investments. Such activities are described in the April 14, 1988, Banking Circular, *Selection of Securities Dealers and Unsuitable Investment Practices*, which is reproduced in appendix B.

6. The exposure draft recommended guidance on reporting debt securities held as investment assets that attempted to make more workable the assessment of the ability and intent to hold such securities that is required under current literature. However, comment letters on the exposure draft raised significant questions about the subjectivity of the guidance, and AcSEC concluded that the proposal needed to be studied further.

7. The exposure draft proposed disclosures about debt securities held as assets, and many commentators recommended expanded disclosures as an interim solution. This statement is intended to be such an interim solution.

Conclusions

8. Financial institutions should include in the notes to their financial statements an explanation of their accounting policies for debt securities held, including the basis for classification into balance sheet captions, such as investment or trading.

9. Financial institutions should also disclose in the notes to their financial statements the following information concerning debt securities carried at either historical cost or the lower of cost or market value[2]:

- For each balance sheet presented, the amortized cost[3], estimated market values, gross unrealized gains, and gross unrealized losses for each pertinent category. Examples of such categories are the following:
  - —Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies
  - —Debt securities issued by states of the U.S. and political subdivisions of the states
  - —Debt securities issued by foreign governments and not classified as loans

[2]If a financial institution carries some debt securities at amortized cost and others at the lower of cost or market value and it reports them in separate balance sheet captions, these disclosures should be presented for each caption.

[3]Amortized cost is the face amount of the debt security increased or decreased by unamortized premium, discount, finance charges, or acquisition fees and costs and may also reflect a previous direct write-down of the debt security. Total amortized cost presented in this disclosure should be reconciled to the amounts presented in the balance sheet, if different.

- —Corporate securities
- —Mortgage-backed securities
- —Other debt securities

- For the most recent balance sheet, the amortized cost and estimated market values of debt securities due—
  - *a*. In one year or less
  - *b*. After one year through five years
  - *c*. After five years through ten years
  - *d*. After ten years[4]
- For each period for which results of operations are presented, the proceeds from sales[5] of such debt securities and gross realized gains and gross realized losses on such sales

Effective Date and Transition

10. This statement is effective for financial statements for fiscal years ending after December 15, 1990. This statement need not be applied to financial statements for fiscal years ending before its effective date that, for comparative purposes, are being provided with financial statements for fiscal years ending after its effective date.

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[4]Securities not due at a single maturity date, such as mortgage-backed securities, may be included in a separate category. If such securities are not included in a separate category, the method used for inclusion in the maturity table should be disclosed.

[5]As debt securities approach maturity, their market prices tend to approach their maturity amounts less interest and a factor for credit risk, and market risk diminishes as a factor in their pricing. For purposes of this statement, securities that are sold at maturity or near enough to maturity that market risk is substantially eliminated as a pricing factor may be excluded from this disclosure.

APPENDIX A

Illustrative Financial Statement Disclosure

Investment Securities

The amortized cost and estimated market values of investments in debt securities are as follows[a]:

	Amortized Cost[b]	*Gross Unrealized Gains*	*Gross Unrealized Losses*	*Estimated Market Value*
US Treasury securities and obligations of US government corporations and agencies	$XXXXX	$XXX	$(XXX)	$XXXXX
Obligations of states and political subdivisions	XXXXX	XXX	(XXX)	XXXXX
Debt securities issued by foreign governments	XXXXX	XXX	(XXX)	XXXXX
Corporate securities	XXXXX	XXX	(XXX)	XXXXX
Mortgage-backed securities	XXXXX	XXX	(XXX)	XXXXX
Other debt securities	XXXXX	XXX	(XXX)	XXXXX
Totals	$XXXXX	$XXX	$(XXX)	$XXXXX

The amortized cost and estimated market value of debt securities at December 31, 19XX, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

[a]This information should be provided for each balance sheet presented that is dated after December 15, 1990.

[b]See footnote 3 on page 5.

	Amortized Cost	*Estimated Market Value*
Due in one year or less	$ XXX	$ XXX
Due after one year through five years	XXX	XXX
Due after five years through ten years	XXX	XXX
Due after ten years	XXX	XXX
	XXXX	XXXX
Mortgage-backed securities	XXX	XXX
	$XXXXX	$XXXXX

Proceeds from sales of investments in debt securities during 19XX were $______. Gross gains of $______ and gross losses of $______ were realized on those sales[c].

[c]This information should be provided for each period for which results of operations are presented for periods ending after December 15, 1990.

APPENDIX B

BANKING CIRCULAR—SELECTION OF SECURITIES DEALERS AND UNSUITABLE INVESTMENT PRACTICES*

PURPOSE

This issuance is to provide you with recommended procedures to be employed by all national banks when selecting securities dealers and to advise you of certain securities activities that the depository institution regulators view as unsuitable in an investment portfolio. The Federal Financial Institution Examination Council (FFIEC) recently endorsed the same policy statement. Adoption of the FFIEC policy is intended to achieve uniform and effective supervision by depository institution investment portfolio managers. The following is the text of the policy statement.

BACKGROUND

The depository institution regulators have become aware of speculative activity which has taken place in a number of depository institutions' investment portfolios. Certain of these institutions have failed because of the speculative activities, and other institutions have been weakened significantly as their earnings and capital have been impaired and the liquidity of their securities has been eroded by the depreciation in their market value.

Speculative activity often occurs when a depository institution's investment portfolio manager follows the advice of securities dealers who, in order to generate commission income, encourage speculative practices that are unsuitable for the investment portfolio.

RECOMMENDATIONS CONCERNING THE SELECTION OF A SECURITIES DEALER

It is common for the investment portfolio managers of many depository institutions to rely on the expertise and advice of a securities sales representative for: recommendations of proposed investments; investment strategies; and the timing and pricing of securities transactions. Accordingly, it is important for the management of depository institutions to know the securities firms and the personnel with whom they deal. An investment portfolio manager should not engage in securities transactions with any

*This banking circular was distributed by the comptroller of the currency on April 14, 1988, to chief executive officers of all national banks, deputy comptrollers, and all examining personnel.

securities dealer that is unwilling to provide complete and timely disclosure of its financial condition. Management must review the dealer's financial statements and make a judgment about the ability of the dealer to honor its commitments. An inquiry into the general reputation of the dealer also is necessary.

The board of directors and/or an appropriate board committee should review and approve a list of securities firms with whom the depository's management is authorized to do business. The following securities dealer selection standards are recommended, but are not all inclusive. The dealer selection process should include:

- A consideration of the ability of the securities dealer and its subsidiaries or affiliates to fulfill commitments as evidenced by capital strength and operating results disclosed in current financial data, annual reports, credit reports, etc.;
- an inquiry into the dealer's general reputation for financial stability and fair and honest dealings with customers, including an inquiry of past or current financial institution customers of the securities dealer;
- an inquiry of appropriate State or Federal securities regulators and securities industry self-regulatory organizations, such as the National Association of Securities Dealers, concerning any formal enforcement actions against the dealer or its affiliates or associated personnel;
- an inquiry, as appropriate, into the background of the sales representative to determine his or her experience and expertise;
- a determination whether the depository institution has appropriate procedures to establish possession or control of securities purchased. Purchased securities and repurchase agreement collateral should only be kept in safekeeping with selling dealers when (1) the board is completely satisfied as to the creditworthiness of the securities dealer and (2) the aggregate value of securities held in safekeeping in this manner is within credit limitations that have been approved by the board of directors, or a committee of the board, for unsecured transactions (see FFIEC Policy Statement adopted October 1985). Federal credit unions, when entering into a repurchase agreement with a broker/dealer, are not permitted to maintain the collateral with the broker/dealer, reference part 703 of the National Credit Union Administration rules and regulations.

As part of the process of managing a depository institution's relationships with securities dealers the board of directors may wish to consider including in the financial institution's code of ethics or code of conduct a prohibition by those employees, who are directly involved in purchasing and selling securities for the depository institution, from engaging in personal securities transactions with the same securities firm that the depository institution uses for its transactions without specific board approval and periodic review. The board also may wish to adopt a policy applicable to directors, officers or employees concerning the receipt of gifts, gratuities or travel expenses from approved dealer firms and their personnel (also see in this connection the Bank Bribery Law, 18 USC 215 and interpretive releases).

OBJECTIONABLE INVESTMENT PRACTICES

Depository institution directors are responsible for prudent administration of investments in securities. An investment portfolio traditionally has been maintained by a depository institution to provide earnings, liquidity and a means of diversifying risks. When investment transactions are entered into in anticipation of taking gains on short-term price movements, the transactions are no longer characteristic of investment activities and should be conducted in a securities trading account. Securities trading of the types described in section I of the attached appendix will be viewed as unsuitable activities when they are conducted in a depository institution's investment account. Securities trading should take place only in a closely supervised trading account and be undertaken only by institutions that have strong capital and current earnings positions. Acquisitions of the various forms of zero coupon, stripped obligations and asset-backed securities residuals discussed in section II of the attached appendix will receive increased regulatory attention and, depending upon the circumstances, may be considered unsuitable for a depository institution.

State chartered financial institutions are cautioned that certain of the investment practices listed in the appendix may violate state law. If any such practices are contemplated, the appropriate state supervisor should be consulted regarding permissibility under state law.

Appendix to FFIEC Supervisory Policy Statement on the Selection of Securities Dealers and Unsuitable Investment Practices

I. TRADING IN THE INVESTMENT PORTFOLIO

Trading in the investment portfolio is characterized by a high volume of purchase and sale activity, which when considered in light of a short holding period for securities, clearly demonstrates management's intent to profit from short-term price movements. In this situation, a failure to follow accounting and reporting standards applicable to trading accounts may result in a misstatement of the depository institution's income and a filing of false regulatory reports and other published financial data. It is an unsafe and unsound practice to record and report holdings of securities that result from trading transactions using accounting standards which are intended for investment portfolio transactions; therefore, the discipline associated with accounting standards applicable to trading accounts is necessary. Securities held in trading accounts should be marked to market, or the lower of cost or market, periodically with unrealized gains or losses recognized in current income. Prices used in periodic revaluations should be obtained from sources that are independent of the securities dealer doing business with the depository.

The following practices are considered to be unsuitable when they occur in a depository institution's investment portfolio.

A. "Gains Trading". "Gains trading" is a securities trading activity conducted in an investment portfolio, often termed "active portfolio management." "Gains trading" is characterized by the purchase of a security as an investment and the subsequent sale of that same security at a profit within several days or weeks. Those securities initially purchased with the intent to resell are retained as investment portfolio assets if they cannot be sold at a profit. These "losers" are retained in the investment portfolio because investment portfolio holdings are accounted for at cost, and losses are not recognized unless the security is sold. "Gains trading" often results in a portfolio of securities with extended maturities, lower credit quality, high market depreciation and limited practical liquidity.

In many cases, "gains trading" has involved the trading of "when-issued" securities and "pair-offs" or "corporate settlements" because the extended settlement period associated with these practices allows speculators the opportunity for substantial price changes to occur before payment for the securities is due.

B. "When-Issued" Securities Trading. "When-issued" securities trading is the buying and selling of securities in the interim between the announcement of an offering and the issuance and payment date of these securities. A purchaser of a "when-issued" security acquires all the risks and rewards of owning a security and may sell the "when-issued" security at a profit before taking delivery and paying for it. Frequent purchases and sales of securities during the "when-issued" period generally are indications of trading activity and should not be conducted in a bank's investment portfolio.

C. "Pair-Offs". A "pair-off" is a security purchase transaction which is closed out or sold at, or prior to, settlement date. As an example, an investment portfolio manager will commit to purchase a security; then, prior to the predetermined settlement date, the portfolio manager will "pair-off" the purchase with a sale of the same security prior to, or on, the original settlement date. Profits or losses on the transaction are settled by one party to the transaction remitting to the counter party the difference between the purchase and sale price. Like "when-issued" trading, "pair-offs" permit speculation on securities price movements without paying for the securities.

D. Corporate Settlement on U.S. Government and Federal Agency Securities Purchases. Regular-way settlement for transactions in U.S. Government and Federal agency securities is one business day after the trade date. Regular-way settlement for corporate securities is five business days after the trade date. The use of a corporate settlement method (5 business days) for U.S. Government securities purchases appears to be offered by dealers in order to facilitate speculation on the part of the purchaser.

E. Repositioning Repurchase Agreements. Dealers who encourage speculation through the use of "pair-off," "when-issued" and "corporate settlement" transactions often provide the financing at settlement of purchased securities which cannot be sold at a profit. The buyer purchasing the security pays the dealer a small "margin" that is equivalent roughly to the actual loss in the security. The dealer then agrees to fund the purchase by buying the security back from the purchaser under a resale agreement. Apart from imprudently funding a longer-term, fixed-rate asset with short-term, variable-rate source funds, the purchaser acquires all the risks of ownership of a large amount of depreciated securities for a very small margin payment. Purchasing securities in these circumstances is inherently speculative and is a wholly unsuitable investment practice for depository institutions.

F. Short Sales. A short sale is the sale of a security that is not owned. The purpose of a short sale generally is to speculate on the fall in the price of the security. Short sales are speculative transactions that should be conducted in a trading account, and when conducted in the investment portfolio, they are considered to be unsuitable.

Short sales are not permissible activities for Federal credit unions.

II. STRIPPED MORTGAGE-BACKED SECURITIES, RESIDUALS, AND ZERO COUPON BONDS

There are advantages and disadvantages in owning these products. A depository institution must consider the liquidity, marketability, pledgeability, and price volatility of each of these products prior to investing in them. It may be unsuitable for a depository institution to commit significant amounts of funds to long-term stripped mortgage-backed securities, residuals and zero coupon bonds which fluctuate greatly in price.

A. Stripped Mortgage-Backed Securities (SMBS) consist of two classes of securities with each class receiving a different portion of the monthly interest and principal cash flows from the underlying mortgage-backed securities. In its purest form, an SMBS is converted into an interest-only (IO) strip, where the investor receives 100% of the interest cash flows, and a principal-only (PO) strip, where the investor receives 100% of the principal cash flows.

All IOs and POs have highly volatile price characteristics based, in part, on the prepayment of the underlying mortgages and consequently on the maturity of the stripped security. Generally, POs will increase in value when interest rates decline while IOs increase in value when interest rates rise. Accordingly, the purchase of an IO strip may serve, theoretically, to offset the interest rate risk associated with mortgages and similar instruments held by a depository institution. Similarly, a PO may be useful as an offset to the effect of interest rate movements on the value of mortgage servicing. However, when purchasing an IO or PO the investor is speculating on the movements of future interest rates and how these movements will affect the prepayment of the underlying collateral. Furthermore, those SMBS that do not have the guarantee of a government agency or a government-sponsored agency as to the payment of principal and interest have an added element of credit risk.

As a general rule, SMBS cannot be considered as suitable investments for the vast majority of depository institutions. SMBS, however, may be appropriate holdings for depository institutions that have highly sophisticated and well-managed securities portfolios, mortgage portfolios or mortgage banking functions. In such depository institutions, however, the acquisition of SMBS should be undertaken only in conformance with carefully developed and documented plans prescribing specific positioning limits and control arrangements for enforcing these limits. These plans should be approved by the institution's board of directors and vigorously enforced.

In those depository institutions that prepare their published financial statements in accordance with Generally Accepted Accounting Principles, SMBS holdings must be accounted for in accordance with Financial Accounting Standards Board Statement #91 (FAS #91) which requires that the carrying amount be adjusted when actual prepayment experience differs from prepayment estimates. Other institutions may account for their SMBS holdings under FAS #91 or alternatively at market value or the lower of cost or market value.

Several states have adopted, or are considering, regulations that prohibit state chartered banks from purchasing IO strips. Accordingly, state chartered institutions should consult with their state regulator concerning the permissibility of purchasing SMBS.

B. Asset-Backed Securities (ABS) Residuals. Residuals are the excess cashflows from an ABS transaction after the payments due to the bondholders and the trust administrative expenses have been satisfied. This cashflow is extremely sensitive to prepayments, and thus has a high degree of interest rate risk.

Generally, the value of residual interests in ABS rises when interest rates rise. Theoretically a residual can be used as a risk management tool to offset declines in the value of fixed-rate mortgage or ABS portfolios. However, it should be understood by all residual interest purchasers that the "yield" on these instruments is inversely related to their effectiveness as a risk management vehicle. In other words, the highest yielding ABS residuals have limited risk management value usually due to a complicated ABS structure and/or unusual collateral characteristics that make modeling and understanding the economic cashflows very difficult.

Alternatively, those residuals priced for modest yields generally have positive risk management characteristics.

In conclusion, it is important to understand that a residual cashflow is highly dependent upon the prepayments received. Caution should be exercised when purchasing a residual interest, especially higher "yielding" interests, because the risk associated over the life of the ABS may warrant an even higher return in order to adequately compensate the investor for the interest rate risk assumed. Purchases of these equity interests should be supported by in-house evaluations of possible rate of return ranges in combination with varying prepayment assumptions.

Residual interests in ABS are not permissible acquisitions for Federal credit unions. Holdings of ABS residuals by other institutions should be accounted for in the manner discussed under stripped mortgage-backed securities and should be reported as "Other Assets" on regulatory reports.

C. Other Zero Coupon or Stripped Products. The interest and/or principal portions of U.S. Government obligations are sometimes sold to depository institutions in the form of stripped coupons, stripped bonds (principal), STRIPS, or propriety products, such as CATs or TIGRs. Also, Original Issue Discount Bonds (OIDs) have been issued by a number of municipal entities. Longer maturities of these instruments can exhibit extreme price volatility and, accordingly, disproportionately large long-maturity holdings (in relation to the total portfolio) of zero coupon securities appear to be unsuitable for investment holdings for depository institutions.

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