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April 14, 1999

The Honorable Tom Bliley
Chairman, Committee on Commerce
House of Representatives

Subject: Accounting Standards: Treatment of Asset-Backed Securities

Dear Mr. Chairman:

This letter responds to your request for information on whether the greater discretion allowed to banks as opposed to securities broker/dealers under accounting standards and practices may have resulted in less transparency in the value of asset-backed securities held by banks.[1] Your concern stemmed from the fact that banks, unlike broker/dealers, are allowed to carry some securities at amortized cost, which is less transparent than carrying them at fair value.[2] As a result, if there were a decline in the fair value of securities carried at amortized cost, investors would not see it reflected in the related financial statement balances. Your letter also suggested that a movement of these securities into banks may have contributed to a loss of liquidity in the marketplace this past fall. Because the largest portion of asset-backed securities are securities whose underlying assets are residential mortgages, called mortgage-backed securities (MBS), we agreed with your office to focus on MBS.[3] Specifically, we agreed to provide information on (1) the accounting treatment applied to securities (including MBS) held by banks and broker/dealers and (2) the accounting for securities holdings by the six largest bank holding companies and whether such holdings might have affected the transparency of financial statements.

To meet these objectives, we reviewed the accounting standards and practices for reporting securities held by banks and broker/dealers. In addition, we examined data in the December 31, 1997, and September 30, 1998, annual and quarterly investor reports filed by the six largest bank holding companies in order to assess whether banks' accounting for securities might have resulted in less transparency to investors. These bank holding company (BHC) reports provided consolidated data for the holding company and all of its subsidiaries, both banks and nonbanks, and showed the accounting treatment of securities held. As of September 30,

[1]Asset-backed securities are bonds or debt securities backed by the cash flow from pools of underlying assets, such as mortgages, car loans, or credit card receivables.

[2]Amortized cost is the face value of the securities plus the unamortized premium or less the unamortized discount. Fair value is defined as the amount at which an item could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. Because fair value generally represents a more current value than amortized cost, reporting securities at fair value is more transparent to securities investors.

[3]As of September 30, 1998, there was a total amount of $3,156 billion of asset-backed securities outstanding in the United States; MBS accounted for 81 percent of this amount.

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1998, the 6 largest BHCs accounted for 49 percent of the total assets of the top 50 BHCs in the United States. They accounted for an even larger share—61 percent—of the top 50 BHCs' trading and investment accounts.[4] We also examined data that showed the 50 largest concentrations of MBS held in BHCs and the banks' accounting treatment of mortgage pass-through securities.[5] In addition, we interviewed officials at the Federal Reserve Board to obtain their views on what the large BHCs had done in their securities activities in 1998.

We obtained oral comments on a draft of this letter from Federal Reserve officials, and their comments are discussed at the end of this letter. We did our work in February and March 1999, in accordance with generally accepted government auditing standards.

Results in Brief

Accounting standards allow banks and most other companies to report their securities holdings at either fair value or at amortized cost, depending on the nature of the securities and the purpose for which the securities are held. Because fair value reporting generally represents a more current value of reported assets than amortized costs do, assets reported at fair value offer readers of financial statements greater transparency. A review of the securities holdings at the six largest bank holding companies showed that they were reporting the bulk of their securities holdings at fair value. Further, between December 1997 and September 1998, these companies' combined holdings of securities reported at amortized cost had declined, and the securities holdings reported at fair value had substantially increased. As a result, the transparency of their securities holdings improved during this period.

At the Federal Reserve, officials had reviewed developments in the financial markets through the fourth quarter of 1998 and data on individual entities' securities transactions through the third quarter of 1998. They said their review revealed two instances in which account balances changed in a way that might indicate intracompany securities transactions, but they pointed out that the changes could also be attributable to other causes. They also observed that the reduced liquidity in certain markets in late 1998 was part of a more general phenomenon in which market participants had become very risk averse at that time.

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[4]Securities that banks have bought for short-term resale at a profit are placed in the trading account; other securities are placed in the bank's own investment portfolio, which is commonly called the investment account.

[5]Mortgage-backed securities consist of mortgage pass-through securities and collateralized mortgage obligations (CMOs). Mortgage pass-through securities entitle investors to share on a pro rata basis in all principal and interest payments received from a mortgage pool. CMOs divide the principal and interest payments from the underlying pool into classes with different risk characteristics and issue securities for each class. In September 1998, all commercial banks in the United States held $277 billion of pass-through mortgage securities compared to $156 billion of CMOs.

Accounting Standards and Practices for Securities Held by Bank Holding Companies

The following accounting standards and practices apply to holdings of securities (including MBS) by bank holding companies and their subsidiaries.

- Broker/dealer subsidiaries (called Section 20 subsidiaries)[6] are to utilize specialized accounting practices in which substantially all securities held are to be reported on the balance sheet at fair value, with unrealized gains and losses reflected in net income.
- Securities held in the bank subsidiaries of a bank holding company are subject to the accounting standards set forth in Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities (FAS 115).
  - Similar to the accounting treatment for broker/dealers, securities that are held for trading purposes are to be reported in the trading account line of the balance sheet at fair value, with unrealized gains and losses reflected in net income.
  - Securities that are held for longer term purposes are to be reported in the investment account and designated either as "held-to-maturity" or "available-for-sale." Securities may be designated as held-to-maturity only if the entity has the intent and ability to hold them to maturity, in which case they are to be reported in the balance sheet at amortized cost, with disclosures in the notes regarding fair market value and unrealized gains and losses. Securities designated as "available-for-sale" are to be reported in the balance sheet at fair value. Unrealized gains and losses are not to be reported in earnings but reported in the notes to the financial statements and reflected in equity as an adjustment to net income.
  - A security may not be classified as "held-to-maturity" if that security can be contractually prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. MBS that meet this criterion must be classified as "available-for-sale" or trading and are to be reported on the balance sheet at fair value.

Accounting for Securities Holdings by the Six Largest Bank Holding Companies

We analyzed the quarterly reports to investors (known as Form10-Qs)[7] and the annual reports of the six largest bank holding companies, focusing on the areas where securities are reported—namely the trading and investment accounts. The data indicated that as of September 1998 the bulk—98.2 percent—of their holdings in these accounts were recorded at

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[6]Banking organizations that are members of the Federal Reserve System are permitted to conduct broker/dealer business only if they are authorized by the Federal Reserve Board to have a Section 20 subsidiary, which is a nonbank subsidiary of a bank holding company. This name refers to Section 20 of the Glass-Steagall Act (12 U.S.C. sec 377). A Section 20 subsidiary can function as an investment bank by underwriting (publicly distributing new issues of securities) and as a broker/dealer by buying and selling securities for its own account or for others.

[7]Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

fair value. (See table I.1.) These data encompass not only MBS but also all other types of securities, as well as derivatives held for trading.[8]

Because bank holding companies are to carry all assets in the trading account at fair value, we focused on the investment account portfolios of these six BHCs. The Form 10-Q reports for these companies indicated that 95.7 percent of their investment account securities were reported at fair value in September 1998, up from 93.8 percent in December 1997. The lowest percentage reported at fair value among the six companies in September 1998 was 94.2 percent. For the six BHCs, their combined holdings of securities reported at amortized cost declined $2.4 billion between December 1997 and September 1998, notwithstanding a $33.8 billion increase in the total holdings of securities in their investment accounts. Thus, even if there were any intracompany shifts of securities, by the end of the period the transparency of their securities holdings was probably greater than at the beginning of the period.

Banks' Holdings of MBS

On September 30, 1998, banks held $433.6 billion of MBS, compared to the nationwide total amount of $2,458 billion of outstanding MBS. Within banks' holdings of MBS, 64 percent were pass-through securities. Table I.2 presents the accounting treatment of the 50 largest portfolios of pass-through MBS held at banks. (The data in table I.2 do not show the holdings of the largest 50 banks; instead, they show the largest 50 portfolios, regardless of the size of the company.) In these 50 portfolios, 91 percent of the dollar volume was available for sale, i.e., carried at fair value; and 9 percent was carried at amortized cost. For all banks in the United States, the figures were 88 percent at fair value and 12 percent at amortized cost. Thus, for this one important part of the securities portfolio, transparency did not appear to be a significant issue at the end of September 1998.

Federal Reserve Board Officials' Observations on Bank Holding Companies' Activities

Officials at the Federal Reserve Board provided us with their observations on BHCs' activities concerning trading and investment accounts in 1998. In general, they saw strong growth in banks' securities holdings in both accounts in the fourth quarter of 1998. Within bank holding companies, the officials looked at the overall data for Section 20 subsidiaries through the third quarter of 1998 but did not see anything they viewed as significant. While in two cases sizable changes in securities holdings were noted, they said that these data did not provide a sufficient basis from which to draw conclusions. For one thing, the officials stressed that trading account balances are very volatile and that data are available for only the four call report dates each year. For another, they noted that decreases and increases in such accounts could reflect transactions with third parties, rather than intracompany transactions. The

[8]Derivatives are financial products that enable risk to be shifted from one party to another; their value is based on an underlying reference rate, index, or asset, such as stocks, bonds, commodities, interest rates, foreign currency exchange rates, and various market indexes.

officials said that discovery of the specific causes for changes in the trading and investment account totals would require close bank-by-bank examination.

Regarding the reported loss of liquidity in MBS markets, the Federal Reserve officials attributed this to the fact that dealers had become very risk averse. They said this was a general phenomenon, present in different types of dealers and in various financial instruments.

Agency Comments

We requested comments on a draft of this letter from the Federal Reserve. On April 1, 1999, we received oral comments from the Deputy Associate Director, Division of Banking Supervision and Regulation. He generally agreed with the contents of our letter and made technical comments, which we incorporated as appropriate.

We will send copies of this letter to Representative John Dingell, Ranking Minority Member, House Committee on Commerce; Alan Greenspan, Chairman of the Board of Governors at the Federal Reserve System; Arthur Levitt, Chairman, Securities and Exchange Commission; John D. Hawke, Jr., Comptroller of the Currency, Office of the Comptroller of the Currency; and other interested parties. We will also make copies available to others on request.

We hope that this information is useful; if more information is desired, we will be glad to assist. If you have any questions, please call me or John Treanor at (202) 512-8678.

Sincerely yours,

Thomas J. McCool

Thomas J. McCool
Director, Financial Institutions
and Markets Issues

Enclosure

Selected Financial Data on Banks' Holdings of Securities

Table I.1: Assets in the Trading and Investment Accounts of the Six Largest Bank Holding Companies

Dollars in millions

Accounts	December 1997	September 1998	Increase (decrease)
A. Trading account[a]	$337,888	$352,723	$14,835
B. Investment account	209,515	243,342	33,827
of which:			
B.1. Reported in balance sheet at amortized cost	12,894	10,475	(2,419)
B.2. Reported in balance sheet at fair value	196,621	232,867	36,246
Share of investment account held at fair value	93.8%	95.7%	
C. Total assets in the two accounts (A plus B)	547,403	596,065	48,662
of which:			
C.1. Reported at amortized cost (B.1)	12,894	10,475	(2,419)
C.2. Reported at fair value (A plus B.2)	534,509	585,590	51,081
Share of total held at fair value	97.6%	98.2%	

Note: Ranked by assets as of September 1998, the six largest bank holding companies were BankAmerica Corporation; Chase Manhattan Corporation; Citicorp; J.P. Morgan & Co., Incorporated; First Union Corporation; and Bankers Trust Corporation.

[a] The trading account includes both securities and the positive value of derivatives held for trading purposes.

Sources: GAO analysis of the companies' quarterly reports on Form 10-Q and annual reports.

Selected Financial Data on Banks' Holdings of Securities

Table I.2: Top 50 Portfolios of Pass-Through MBS at Banks as of September 30, 1998

Dollars in millions

Bank holding companies	Total	Held to maturity[a]	Available for sale[b]	Portion available for sale (percent)
Chase Manhattan Corporation	$35,017	$987.4	$34,029.3	97%
BankAmerica Corporation	31,173	1,573.6	29,599.5	95
First Union Corporation	23,459	835.7	22,623.6	96
Norwest Corporation	16,005	0.0	16,005.4	100
Republic New York	12,550	6,714.4	5,835.2	46
ABN Amro Americas	7,909	99.8	7,809.0	99
Fleet Financial Group	7,525	0.0	7,525.2	100
Banc One Corporation	6,720	62.8	6,657.5	99
Fifth Third Bancorp	6,001	0.0	6,000.5	100
Mellon Bank Corporation	5,061	1,605.2	3,455.4	68
Wachovia Corporation	3,359	525.7	2,832.8	84
BankBoston Corporation	3,296	137.8	3,157.7	96
National City Corporation	2,851	0.0	2,850.5	100
U.S. Bancorp	2,622	0.0	2,622.1	100
Wells Fargo & Co.	2,530	0.0	2,530.3	100
KeyCorp	2,478	0.0	2,478.0	100
Crestar Financial Corporation	2,410	20.1	2,390.1	99
Comerica Incorporated	2,259	0.0	2,259.0	100
Bank of Montreal	2,004	0.0	2,003.8	100
Commerce Bancorp	1,975	977.3	997.6	51
AmSouth Bancorp	1,899	975.1	923.9	49
Bankers Trust Corporation	1,860	0.0	1,859.5	100
Allied Irish Banks Ltd.	1,734	0.0	1,734.0	100
BB&T Corporation	1,677	0.0	1,676.7	100
TCF Financial Corporation	1,664	0.0	1,664.1	100
CNB Bancshares Incorporated	1,541	58.4	1,482.6	96
North Fork Bancorp	1,467	638.8	827.6	56
SunTrust Banks Inc.	1,416	0.0	1,416.0	100
Cullen/Frost Bankers Incorporated	1,413	115.2	1,298.2	92
SouthTrust Corporation	1,401	351.0	1,050.5	75
Summit Bancorp	1,303	986.9	316.5	24
Star Banc Corporation	1,302	0.0	1,302.1	100
Regions Financial Corporation	1,287	50.1	1,236.6	96
Mercantile Bancorp	1,224	73.3	1,151.1	94
Community First Bankshares	1,215	0.0	1,214.5	100
HSBC Holdings, Plc	1,195	0.0	1,195.0	100
Pacific Century Financial Corporation	1,192	456.4	735.5	62
Huntington Bancshares Incorporated	1,082	0.0	1,082.1	100
Royal Bank of Scotland	1,080	0.0	1,080.0	100
Firstar Corporation	1,049	906.3	142.6	14
Marshall & Ilsley Corporation	1,044	0.0	1,044.2	100
US Bancorp Incorporated	775	289.1	485.8	63
Union Planters Corporation	769	0.0	768.6	100
M & T Bancorporation	732	0.0	732.3	100
Hibernia Corporation	732	0.0	731.9	100

Selected Financial Data on Banks' Holdings of Securities

Dollars in millions

Bank holding companies	Total	Held to maturity[a]	Available for sale[b]	Portion available for sale (percent)
Centura Banks Incorporated	726	0.0	726.3	100
First Security Corporation	705	0.0	705.2	100
Fulton Financial Corporation	660	133.7	526.5	80
UST Corporation	612	0.0	611.7	100
Valley National Bancorporation	587	64.3	522.7	89
Totals for the top 50	$212,545	$18,638	$193,907	91%
Totals for all commercial banks	$277,192	$32,506	$244,686	88%

Note 1: Pass-through MBS are mortgage-backed securities in the form of pass-through securities, which entitle investors to share on a pro rata basis in all principal and interest payments received from a mortgage pool.

Note 2: This list is the 50 largest portfolios of pass-through MBS, not the 50 largest bank holding companies (BHC) by asset size. Totals may not add because of rounding.

[a]Held to maturity securities are recorded on the balance sheet at amortized cost.

[b]Available for sale securities are recorded on the balance sheet at fair value.

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