

Decision of the
Supervision Appeals Review Committee

In the Matter of * * *

Case No. 2023-04

Summary

After consideration of the timely filed written submissions of the parties and the record of this case, and following the deliberative meeting of this Committee, the Committee upholds the decision of the Director of the Division of Risk Management Supervision (“RMS”).

Procedural History

In this appeal, * * * Bank, [city, state] (the “Bank”) appeals the [month day], 2023 determination by the Deputy Regional Director of the Federal Deposit Insurance Corporation’s (the “FDIC’s”) * * * Regional Office that the Bank tainted its held-to-maturity (“HTM”) debt securities portfolio (the “Accounting Determination”) when it transferred \$261.6 million of debt securities from HTM to available-for-sale (“AFS”) on March 28, 2022 (the “Securities Transaction”).¹

On August 17, 2023, the Bank filed a request for review of the Accounting Determination with the Director of RMS. In a letter dated October 2, 2023, the Director concurred in the Accounting Determination.

The Bank timely filed an appeal of the Division Director’s concurrence with the Accounting Determination with this Committee. The Committee met to hear oral presentation from the parties and consider the appeal on February 27, 2024.

In accordance with the FDIC’s Guidelines for Appeals of Material Supervisory Determinations (the “Guidelines”),² the Committee reviewed the appeal for consistency with the policies, practices, and mission of the FDIC, and the reasonableness of, and the support offered for, the positions of the parties. Under the Guidelines, the burden of proof rests with the Bank.

¹ On March 31, 2022, the Bank sold \$108.5 million of the securities that had been transferred from HTM to AFS, and in April 2022 sold another \$148.9 million.

² 87 FR 77112 (Dec. 16, 2022) (available at <https://www.fdic.gov/resources/regulations/appeals-of-material-supervisory-determination>).

Accounting Standards

Section 37 of the Federal Deposit Insurance Act requires that “the accounting principles applicable to reports or statements required to be filed with Federal banking agencies by all insured depository institutions shall be uniform and consistent with generally accepted accounting principles.”³ Regulatory reporting instructions applicable to the Consolidated Reports of Condition and Income (“Call Report”) provide that the regulatory reporting requirements related to recognition and measurement shall conform to U.S. generally accepted accounting principles as set forth in the Financial Accounting Standards Board’s (“FASB”) Accounting Standards Codification (“ASC”).⁴ The parties agree that ASC Topic 320 Investments—Debt Securities applies to the Securities Transaction, but disagree on the appropriate application of certain provisions related to the transfer or sale of debt securities classified as HTM.

The ASC provides that, in general, the transfer of a debt security from the HTM portfolio to either the AFS or trading portfolios results in the tainting of the remaining HTM portfolio *unless* the transfer falls within one of the safe harbors specified in the ASC.⁵ If the HTM portfolio is tainted, the ASC requires the holder of affected debt securities to mark the securities to their fair value rather than accounting for them at their amortized cost.

Of relevance are the following three provisions of the ASC. ASC 320-10-25-9 provides that a transfer or sale of HTM securities does not taint the HTM portfolio if the sale is caused by an event that is isolated, is nonrecurring, is unusual for the reporting entity, and could not have been reasonably anticipated. ASC 320-10-25-10 provides that, “[o]ther than extremely remote disaster scenarios (such as a run on a bank or an insurance entity), very few events would meet all four of” the conditions listed in ASC 320-10-25-9. ASC 320-10-25-11 further clarifies that, “[e]xtremely remote disaster scenarios shall not be anticipated by an entity in deciding” whether the conditions for the exception are satisfied.

The Bank’s Position

The Bank asserts that its HTM portfolio has not been tainted because the safe harbor conditions set forth in ASC 320-10-25-9 were satisfied. The Bank specifically asserts that it was experiencing a bank run⁶ and cites as support the following factors: (1) a dramatic decline in the personal savings rate to below its long-term average; (2) a large percentage of the Bank’s CD

³ 12 U.S.C. § 1831n(a)(2)(A).

⁴ Federal Financial Institutions Examination Council: Consolidated Reports of Condition and Income for the FFIEC 031 and 041 Report Forms: General Instructions, pp. 14-15 (Mar. 2022), *available at* <https://www.fdic.gov/resources/bankers/call-reports/crinst-031-041/2022/2022-03-generalinstructions.pdf>

⁵ ASC 320-10-35-8.

⁶ As noted above, ASC 320-10-25-10 states: “[o]ther than extremely remote disaster scenarios (such as a *run on a bank* or an insurance entity), very few events would meet all four of [the] conditions [in ASC 320-10-25-9]” (emphasis added).

portfolio maturing within 3 or 12 months; (3) several of the Bank's largest depositors considering withdrawals of deposits due to concerns over having large uninsured deposits * * * in the prevailing rate environment; and (4) concerns that pending regulatory issues could adversely affect the local community's perception of the Bank's condition.

The Bank asserts that the four conditions set forth in ASC 320-10-25-9 were satisfied: the threat of large withdrawals coupled with a significant rise in interest rates were isolated; the event was nonrecurring, as the threat of large deposit withdrawals did not materialize and the Bank has since obtained access to additional sources of liquidity; the event was unusual for the reporting entity, as the Bank did not predict such an increased rate of deposit withdrawals; and the Bank could not have anticipated the large deposit inflows driven by the federal response to the COVID pandemic and subsequent unprecedented outflows afterward. Additionally, the Bank notes that its external auditor confirmed the applicability of ASC 320-10-25-9 to the Securities Transaction.

The Bank asserts in its appeal that it continues to have the ability and intent to hold its remaining HTM portfolio to maturity. The Bank does not foresee an event similar to the one giving rise to the need to sell securities because it has since obtained access to additional sources of liquidity that were not available to the Bank at the time of the Securities Transaction.

RMS's Position

RMS asserts that the Securities Transaction does not fall within any of the ASC safe harbors and, as a result of application of the relevant standards, the Bank's HTM portfolio was tainted.

RMS argues that the Bank has not established that it was experiencing a bank run or other extremely remote disaster scenario. RMS notes that the Bank's records prepared contemporaneously with the Securities Transaction do not reference a bank run, nor did notes to the Bank's audited financial statements for the fiscal years ended March 31, 2021 and 2022 or January 2023 correspondence from the Bank's external auditor summarizing the rationale for the Securities Transaction. Further, RMS asserts that the conditions that precipitated the Securities Transaction, i.e., the Bank's balance sheet position and its liquidity management practices, should have been reasonably anticipated and do not constitute an extremely remote disaster scenario.

Accordingly, RMS argues that the Bank is required to mark the securities portfolio to fair value, thereby recognizing losses, and should be required to refile all Call Reports dating back to, and including, the period during which the Securities Transaction occurred.

The Committee's Findings

The question before the Committee is a narrow one: was the Bank's HTM debt securities portfolio tainted as of March 28, 2022, as a consequence of the Securities Transaction. There can be good business reasons to engage in a transaction that has the consequence of tainting an HTM portfolio, despite the accounting consequences, and neither RMS nor the Committee questions as part of this appeal the Bank's decision to engage in the Securities Transaction.

The Bank has relied on the safe harbor in ASC 320-10-25-9. As noted above, ASC 320-10-25-10 provides that, "[o]ther than extremely remote disaster scenarios (such as a run on a bank or an insurance entity), very few events would meet all four of those conditions [in ASC 320-10-25-9]." The Bank has not demonstrated that the circumstances the bank faced in the spring of 2022 constituted an "extremely remote disaster scenario." The FDIC issued FAQs in the spring of 2020, one of which indicated that the sale of an HTM security by an institution affected by the impact of COVID-19 would "not necessarily call into question the bank's intent to hold its remaining HTM securities until maturity,"⁷ but that was two years before the Securities Transaction, and the conditions that motivated the 2020 FAQs had long since subsided.

Further, the Bank has not established that the Bank was responding to a bank run. The lack of contemporaneous evidence that the Bank was responding to a run makes it difficult for the Committee to find that the burden of proof has been met. Nonetheless, the Committee acknowledges the Bank's argument that discouraging a bank from selling securities until a bank run is already underway may be problematic in a world of faster bank runs.

The ASC notes that "very few events" outside of "extremely remote disaster scenarios" such as bank runs satisfy the conditions of ASC 320-10-25-9. This suggests the exception is intended to apply in rare cases. In the spring of 2022, many institutions faced similar conditions to those described by the Bank, and ASC 320-10-25-5 indicates that the transfer or sale of HTM securities in response to "changes to market interest rates" and "need for liquidity" would call into question the HTM classification for other securities.

The Committee acknowledges that the Securities Transaction was undertaken by a new management team, which had replaced a management team that was in place for nearly 50 years, and that the new management team was taking steps to modify the Bank's strategic plan to improve the Bank's condition and prospects. The Committee recognizes that the Bank was in a challenging position in early 2022 and is encouraged that the Bank's current management has taken actions to address longstanding supervisory concerns.

⁷ Federal Deposit Insurance Corporation, Financial Institution Letter (FIL) 18-2020: Frequently Asked Questions for Financial Institutions and Consumers Affected by the Coronavirus (Mar. 19, 2020), *available at* <https://www.fdic.gov/news/financial-institution-letters/2020/fil20018.html>. FIL-18-2020 included a number of undated Frequently Asked Questions (FAQs) for Financial Institutions Affected by the Coronavirus, which were effective as of March 19, 2020 – the original issuance date of the FIL. Additional FAQs, denoted by date of addition, were subsequently added.

The Committee also acknowledges that RMS reached its conclusion 15 months after the Securities Transaction, a long period of time during which the consequences of tainting the HTM portfolio increased significantly due to rapidly rising interest rates. The Committee appreciates RMS's desire to engage with the Bank and consider all the information available, but that should have been achievable in a shorter timeframe, as discussed at the February 27, 2024 Committee meeting. Nonetheless, that delay does not provide grounds for the Committee to overturn the decision.

Conclusion

The Committee concludes that the Securities Transaction does not fall within the safe harbor provision contained in ASC 320-10-25-9, as clarified by ASC 320-10-25-10 and 320-10-25-11. Accordingly, the Committee concludes that the Securities Transaction tainted the HTM portfolio as of the date of the Securities Transaction.

By direction of the Supervision Appeals Review Committee of the FDIC, dated March 25, 2024.