Decision of the

Supervision Appeals Review Committee

In the Matter of [redacted]

Case No. 2024-07

Summary

By letter dated August 16, 2024, [redacted] (the "Bank") submitted an appeal to the Supervision Appeals Review Committee (the "Committee") seeking the Committee's review of two material supervisory determinations contained in the January 15, 2024 Report of Examination ("ROE") issued by the FDIC. As described below, the Committee finds in favor of the FDIC Division of Risk Management Supervision ("RMS") with respect to the material supervisory determinations presented for review.

Procedural History

The Bank requested the Committee to review determinations made by RMS regarding 1) the timing of the transfer of securities from the available-for-sale ("AFS") category to the held-to-maturity ("HTM") category (the "Securities Transfer Determination"), and 2) the recognition of a gain from the sale of certain precious metals (the "Precious Metal Determination," and together with the Securities Transfer Determination, the "ROE Determinations").

On June 4, 2024, the Bank filed a request for review of the ROE Determinations with the Director of RMS (the "Director"). In a letter dated July 19, 2024, the Director concurred with the ROE Determinations.

The Bank timely filed an appeal with this Committee of the Director's decision with respect to the ROE Determinations. The Committee met to hear oral presentation from the parties and consider the appeal on December 9, 2024.

Securities Transfer Determination

<u>Facts</u>

In 2022, the Bank decided to reclassify approximately [redacted] of its debt securities from AFS to HTM (the "Securities Transfer"). In its appeal, the Bank provided the following documentation as evidence to support its claim that the appropriate date for the securities transfer under U.S. GAAP is July 31, 2022:

- The minutes of an August 30, 2022 meeting of the Asset, Liability, and Capital Management ("ALCM") Committee, which describe a discussion among ALCM Committee members regarding tangible common equity ("TCE"), but do not include a discussion of the Bank's securities portfolio.

- The minutes of an October 26, 2022 special meeting of the Board of Directors, which include a discussion of "action taken by management to reclassify certain securities from [AFS] to [HTM]." The minutes indicate that the CEO of the holding company notified the Board of the reclassification before "action was finalized" for financial reporting purposes.

- The minutes of a November 29, 2022 meeting of the ALCM Committee, which include a discussion of the main purposes of the Securities Transfer: to preserve TCE while allowing for continued contingent liquidity resources.

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 [U.S. GAAP]."[1] Regulatory reporting instructions applicable to the Call Report provide that the regulatory reporting requirements related to recognition and measurement shall conform to U.S. GAAP as set forth in the Financial Accounting Standards Board's ("FASB") Accounting Standards Codification ("ASC").[2]

Relevant Accounting Standards

ASC 320-10-25-1 provides that "[a]t acquisition, an entity shall classify debt securities into one of the following three categories:

a. Trading securities...
b. [AFS] securities. Investments in debt securities not classified as trading securities or as [HTM] securities shall be classified as [AFS] securities.
c. [HTM] securities. Investments in debt securities shall be classified as [HTM] only if the reporting entity has the positive intent and ability to hold those securities to maturity."

[1] 12 U.S.C. § 1831n(a)(2)(A).

[2] Federal Financial Institutions Examination Council: Consolidated Reports of Condition and Income for the FFIEC 031 and 041 Report Forms: General Instructions, pp. 14 (September 2022 and March 2023), available at https://www.fdic.gov/bank-financial-reports/previous-quarters.

In addition, ASC 320-10-35-10B sets forth a number of actions an entity must take when accounting for debt securities transferred from AFS to HTM.[3]

Positions of the Parties

The Bank recorded the Securities Transfer as of July 31, 2022 for financial reporting and Call Report purposes. In its written appeal, the Bank asserts that under the relevant accounting standard, a security is required to be transferred from AFS to HTM as of the date the reporting entity displays the positive intent and ability to hold the security to maturity, and that such decisions and treatments are subject to a "more likely than not" standard.[4] During the hearing, the Bank clarified its view that once it has established an intent and ability to hold the securities to maturity, under U.S. GAAP the bank has discretion regarding the classification and may select a date within the applicable reporting period if it transfers securities from AFS to HTM.

According to the Bank, throughout 2022 management was focused on the impact of interest rate changes on its securities portfolio, and as it became clear that such impacts were becoming increasingly severe, management made the investment decision to hold its securities to maturity. For this reason, the Bank obtained a valuation report for the period of July 31 to August 31 (2022) and made the appropriate entries to the Bank's financial statements while the reporting period for the third quarter was still open because financial statements for that period had not yet been filed. The Bank contends that any delay in recording the transfer is attributable to the fact that that Bank took due care to ensure its financials were appropriately adjusted, and that those adjustments accurately reflected the securities' fair market value at the time of transfer—but

[3] "For a debt security that is transferred into the HTM category from the AFS category, an entity shall: a) Reverse in earnings any allowance for credit losses previously recorded on the AFS debt security at the transfer date; b) Reclassify and transfer the debt security to the HTM category at its amortized cost basis (which is reduced by any previous writeoffs but excludes any allowance for credit losses) plus or minus the amount of any remaining unrealized holding gain or loss reported in accumulated comprehensive income; c) Evaluate the debt security for an allowance for credit losses by following the guidance in Subtopic 326-20; and d) Continue to report the unrealized holding gain or loss at the date of the transfer in a separate component of shareholders' equity, such as comprehensive income, but that gain or loss shall be amortized over the remaining life of the security as an adjustment of yield in a manner consistent with the amortization of any premium or discount. The amortization of an unrealized holding gain or loss reported in equity will offset or mitigate the effect on interest income of the amortization of the premium or discount (discussed in the following sentence) for that HTM security. For a debt security transferred into the HTM category, the transfer may create a premium or discount that, under amortized cost accounting, shall be amortized thereafter as an adjustment of yield in accordance with Subtopic 310-20 on receivables—nonrefundable fees and other costs."

[4] That is, the only question is whether Bank management believed it more likely than not that the Bank would hold the securities to maturity as of July 31, 2022.

such delay does not change the fact that the Bank had the positive intent and ability to hold the securities to maturity on July 31.[5]

RMS asserts that October 26, 2022 is a more appropriate "as of" date for the Securities Transfer because that is the earliest date for which the Bank provided any supporting evidence. RMS does not consider the earlier-dated evidence provided by the Bank as supportive of a decision to transfer securities from AFS to HTM prior to that date because such evidence reflects general discussions of interest rates and the related impact on the Bank's balance sheet and capital position, which are normal course discussions among Bank management and not reflective of any specific decision regarding the Securities Transfer. In addition, RMS notes that the ALCM Committee minutes state that the Bank chose July 31, 2022 as the date of transfer because it approximated the most advantageous rate environment during the third quarter and for which valuation reporting was available.

RMS further argues that the Bank misinterprets ASC 320-10-25-1, as it does not *require* the Bank to record the Securities Transfer as of the first date on which the Bank had the positive intent and ability to hold the securities to maturity, nor does it permit the Bank to select a date within the relevant reporting period provided the Bank has demonstrated an intent and ability to hold the securities to maturity. RMS instead argues that according to ASC 320-10-35-10B, the transfer of securities from AFS to HTM requires the Bank to complete multiple steps. RMS further argues that the transfer must be accompanied by contemporaneous documentation, as opposed to being an automatic reclassification based on a change of intent. RMS also claims that no evidence was provided to demonstrate that the Bank completed any of these additional steps contemporaneous to July 31, 2022. Further, RMS did not challenge the Bank's positive intent or ability to hold the debt securities to maturity.[6]

Precious Metals Determination

Facts

On March 17, 2023, the Bank, through an authorized agent, engaged in two transactions involving the same precious metals—gold and silver coins with a book value of [redacted]. In the first transaction, the Bank sold the precious metals to a third party (the "Precious Metals Counterparty") for [redacted]. In the subsequently adjacent transaction, the Bank repurchased the same precious metals from the Precious Metals Counterparty for [redacted] (together with the first transaction, the "Precious Metals Transactions"). As a result, the Bank recognized a gain

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[5] Separately, the Bank asserts that the transfer was not "backdated" as backdating can occur only when a prior, completed report is re-opened to record transactions that have not occurred during that period, and in any event its auditor did not identify the transaction as backdated.

[6] RMS also notes that under ASC 320-10-25-1, it is possible for a bank to have a positive intent and ability to hold a debt security to maturity but continue to classify the security as AFS.

of [redacted] on the sale. The two transactions did not involve separate payments. Instead, the Bank transferred the difference between them—approximately $1 million—to the Precious Metals Counterparty.

<u>Positions of the Parties</u>

The Precious Metals Determination effectively involves a dispute over which accounting standards apply to the Precious Metals Transactions and, as a result, whether the Bank is permitted to recognize a corresponding gain on sale.

The Bank asserts that ASC Subtopic 610-20, Gains and Losses from the Derecognition of Nonfinancial Assets, which applies to nonfinancial transactions with commercial substance, applies to the first transaction—the sale of the precious metals—and allows the recognition of a [redacted] gain on the sale.[7] Under U.S. GAAP, a transaction exhibits commercial substance if the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract.[8]

In its appeal, the Bank asserts that the sale has commercial substance because legal title (and therefore, risk) transferred to the Precious Metals Counterparty pursuant to the UCC. The Bank contends that such transfer is further evidenced by the fact that a representative of the Counterparty inspected the precious metals on March 21, 2023, several days after the date of the transaction. According to the Bank, physical delivery is not required to transfer legal title, and the Counterparty would not have sent a representative to inspect the precious metals if the transaction lacked commercial substance.

During the December 9, 2024 oral presentation, the Bank further argued that the sale and subsequent repurchase evidenced commercial substance because it increased the cost basis of the precious metals. This adjustment would impact the calculation of any gain or possible loss in future sales. The Bank indicated this change in future gain potential, should it sell the precious metals, also would impact the amount of future cash flows.

RMS asserts that ASC Subtopic 610-20 does not apply because the sale and subsequent repurchase lacks commercial substance. RMS advances two main arguments in support of this position—first, the Bank's economic position remained unchanged before and after these transactions and, second, the available documentation does not set forth a business justification for the transaction or the premium paid in connection with the repurchase transaction.[9]

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[7] *See* ASC 610-20-32-2.

[8] *See* ASC 606-10-25-1 and ASC 610-20-25-5.

[9] RMS highlights an *ex ante* email exchange between the parties, which purportedly reflects an agreement designed to treat this as a single transaction, eliminate the need for physical delivery, and settle the transaction on a net basis.

Specifically, RMS asserts that with the exception of the premium paid on the repurchase transaction, the Bank is in the identical economic position before and after the transaction, including with respect to the risk, timing, and amount of any future cash flows associated with the transaction. RMS adds that this is the type of transaction the commercial substance requirement is intended to address—the FASB noted that without it, "entities might transfer goods or services back and forth to each other (often for little or no cash consideration) to artificially inflate their revenue."[10] RMS also noted that FASB further stated that, "without commercial substance it is questionable whether an entity has entered into a transaction that has economic consequences."[11]

Instead, RMS argues that ASC Topic 845 (Nonmonetary Transactions), which applies to transactions with little or no monetary assets or liabilities, is the accounting standard relevant to the sale and repurchase of the precious metals. RMS points out that the sale involves little or no monetary assets or liabilities and lacks commercial substance because the risk, timing, and amount of future cash flows remain identical before and after the sale and repurchase. As a result, instead of recognizing a gain, RMS contends that the Bank should increase the cost basis of the precious metals by the amount of premium paid for the repurchase (approximately $1 million).[12]

The Committee's Findings

The Committee reviews an appeal "for consistency with the policies, practices, and mission of the FDIC and the overall reasonableness of, and the support offered for, the positions advanced."[13] The Committee's review is "limited to the facts and circumstances as they existed prior to, or at the time the material supervisory determination was made, even if later discovered, and no consideration will be given to any facts or circumstances that occur or corrective action taken after the determination was made."[14]

The Committee acknowledges the Bank's position that U.S. GAAP standards are inherently subjective and involve a range of possible interpretations. For the following reasons, however, the Committee finds that the Bank did not provide sufficient evidence to overturn the determinations of RMS with respect to the Securities Transfer and Precious Metals Transactions.

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[10] Accounting Standards Update No. 2014-09, Basis for Conclusions paragraph BC40.

[11] *Id, Basis for Conclusions paragraph BC41.*

[12] RMS notes the Bank would still be able to recognize any gain on sale in a future transaction if the exchange has a commercial substance, and the gain or loss would be calculated as the difference between the sale proceeds and the new cost basis.

[13] Guidelines for Appeals of Material Supervisory Determinations § G(7).

[14] *Id.*

Securities Determination

There is no dispute among the parties as to the relevant accounting standard for the Securities Transfer. Therefore, the issue for the Committee to determine is whether the appropriate "as of" date for the Securities Transfer is (1) the date when the Bank first claims to have had positive intent and ability to hold the securities to maturity, or alternatively a date chosen by the Bank during the reporting period once the Bank had positive intent and ability to hold the securities to maturity; or (2) the earliest date for which the Bank had documentation supporting its intent to transfer the securities from AFS to HTM.

Although the Committee acknowledges that intent to hold to maturity appears to be a critical element in determining whether to classify debt securities as AFS or HTM for purposes of ASC 320-10-25-1, the Committee's role in this matter, and all matters, is limited to reviewing appeals "for consistency with the policies, practices, and mission of the FDIC and the overall reasonableness of, and the support offered for, the positions advanced." The Committee members were told at the hearing by RMS staff that RMS expects to see contemporaneous documentation in order to evidence positive intent. Given the lack of documentation prior to October 26, 2022 indicating that the Bank had the intent to transfer the securities at an earlier date, the Committee is unable to overturn RMS's decision. The other documentation submitted by the Bank as evidence to support its position was not sufficiently specific to allow the Committee to permit the use of an earlier date.

Precious Metals Determination

With respect to the Precious Metals Determination, the main issue before the Committee is whether the transaction exhibits commercial substance. The answer to this question determines whether the relevant accounting standard is ASC 610-20, which permits the Bank to recognize a gain on sale in connection with the transfer of the precious metals, or ASC Topic 845, which results in an increased cost basis for the precious metals by the premium paid in connection with the repurchase transaction without gain recognition.

Although the Committee acknowledges that in certain instances a transaction designed to increase revenue may evidence commercial substance, the Committee also recognizes that the stated purpose of the commercial substance requirement is to prevent entities from transferring goods or services back and forth so as to artificially inflate the entities' revenues. Given the absence of a stated business justification for the transaction in the underlying documentation, the Committee does not find there is sufficient evidence to overturn RMS's position.

Conclusion

The Committee concludes that there is insufficient evidence to overturn the determinations made by RMS with respect to the Securities Transfer and the Precious Metals Transactions.

By direction of the Supervision Appeals Review Committee of the FDIC, dated January 17, 2025.