

COMPTROLLER OF THE CURRENCY
BANK ACCOUNTING ADVISORY SERIES
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This edition of the Bank Accounting Advisory Series expresses the Office of the Chief Accountant's current views on accounting topics of interest to national banks. Banks prepare their Consolidated Reports of Condition and Income (call reports) using generally accepted accounting principles (GAAP) and regulatory requirements. Accordingly, responses contained in the series are based on GAAP and regulatory requirements.

These advisories are not official rules or regulations of the Comptroller of the Currency (OCC). Rather, they represent either interpretations by the OCC's Office of the Chief Accountant of generally accepted accounting principles, or OCC interpretations of regulatory capital requirements.

Nevertheless, national banks that deviate from these stated interpretations may be required to justify those departures to the OCC. The series is intended to inform the banking community of the Office's views and rationale on issues of broad accounting interest. Additional releases will be issued in the future on emerging accounting issues that affect banks.

Topic 11D, Fair Value Accounting, has been added. The following questions have been added or revised in this edition:

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TOPIC 1: INVESTMENT SECURITIES

1A. INVESTMENTS IN DEBT AND EQUITY SECURITIES

Facts:

Under Statement of Financial Accounting Standards No. 115 (SFAS 115) banks must classify their investment securities in one of three categories: available-for-sale, held-to-maturity, or trading. Securities categorized as held-to-maturity are reported at amortized cost, while available-for-sale and trading securities are reported at fair market value. Banks include the net unrealized holding gains and losses on available-for-sale securities in accumulated other comprehensive income (loss), rather than as part of the bank's net income (loss). Net unrealized holding gains and losses on trading securities are reported immediately in net income.

However, national banks do not include the net unrealized holding gains and losses attributable to available-for-sale debt securities in their calculation of regulatory capital. The net unrealized holding gains and losses on available-for-sale equity securities that have readily determinable fair values are included in Tier 2 regulatory capital calculations, up to 45 % of the pretax unrealized gain.

Question 1: (September 2001)

Should the net unrealized holding gains and losses on available-for-sale securities be included in the calculation of a bank's lending limit?

Staff Response:

The net unrealized holding gains and losses attributable to available-for-sale securities do not affect the computation of a bank's legal lending limit (i.e., the amount that a bank can legally lend to one customer). This limit is based on an institution's Tier 1 and Tier 2 capital, adjusted to include the portion of the ALLL that was excluded for capital purposes.

Question 2: (September 2001)

How should a bank account for the unrealized gains or losses on investments denominated in a foreign currency?

Staff Response:

The net unrealized holding gains and losses on available-for-sale investments denominated in a foreign currency should be excluded from net income and reported in accumulated other comprehensive income. The entire unrealized gain or loss, including both of the portions related to interest rate and foreign currency rate changes, is accounted for as an unrealized holding gain or loss and reported in the separate component of stockholders' equity. Therefore, the income statement effect of foreign currency gains and losses is deferred until the security is sold.

However, the gain or loss attributable to changes in foreign currency exchange rates would be recognized in income, if the investment is categorized as held-to-maturity. Banks should follow the accounting guidance provided in Statement of Financial Accounting Standards No. 52 for such investments.

Question 3:

(September 2001)

What is the appropriate accounting for transfers between investment categories?

Staff Response:

Transfers between investment categories are accounted for as follows:

- Held-to-maturity to available-for-sale — The unrealized holding gain or loss at the date of the transfer shall be recognized in accumulated other comprehensive income.
- Available-for-sale to held-to-maturity — The unrealized holding gain or loss at the date of transfer shall continue to be reported in accumulated other comprehensive income, but shall be amortized over the remaining life of the security as a yield adjustment. This amortization of the unrealized holding gain or loss will offset the effect on income of amortization of premium or discount (see question 4).
- All transfers to the trading category — The unrealized gain or loss at the date of transfer shall be recognized in earnings immediately.
- All transfers from the trading category — The unrealized gain or loss at the date of transfer will have already been recognized in earnings and shall not be reversed.

Facts:

A bank purchased a \$100 million bond on December 31, 1996 at par. The bond matures on December 31, 2001. Initially, the bond was placed in the available-for-sale category. However, on December 31, 1997, the bank decides to transfer the security to the held-to-maturity portfolio. The market value of the security on the date of transfer is \$92 million.

Question 4:

(September 2001)

How should the bank account for the transfer?

Staff Response:

The bank should record the security at its market value, \$92 million, at the date of transfer. In essence, this becomes the security's amortized cost. The \$8 million unrealized holding loss on the date of transfer is not recognized in net income, but is included in accumulated other comprehensive income. In addition, the unamortized discount of \$8 million remains as an offset to the security's face amount of \$100 million, so that the security is valued at its market value (\$92 million) when transferred.

Furthermore, future net income from this discount will not be affected. Although the \$8 million discount is amortized to interest income over the remaining life of the security, the amount in accumulated other comprehensive income separate is amortized simultaneously against interest income. Those entries offset each other and future income is not affected.

Question 5:

(September 2001)

Do any restrictions exist on the types of securities that can be placed in the held-to-maturity category?

Staff Response:

Generally, there are few restrictions on how bank management chooses to allocate the securities in their portfolio among the investment categories. However, Statement of Financial Accounting Standards No. 140 (SFAS 140) amended SFAS 115 to require that a security, such as an IO strip, not be accounted for as held-to-maturity, if it can be prepaid contractually or otherwise settled, so that its holder would not recover substantially all of its recorded investment.

Additionally, an institution may not include a convertible debt security as held-to-maturity. Convertible debt bears a lower interest rate than an equivalent security without such a feature, because it provides the owner with potential benefits from stock price appreciation. However, use of this feature requires the owner to dispose of the debt security prior to maturity.

Accordingly, the acquisition of such a security implies that the owner does not intend to hold it to maturity.

No restrictions prevent a bank from pledging held-to-maturity securities as collateral for a loan. A bank may also enter held-to-maturity securities into a repurchase agreement if the agreement is not effectively a sale.

Question 6:

(December 2008)

How should banks account for investments in mutual funds under SFAS 115?

Staff Response:

By investing in a mutual fund, the bank gives up the ability to control whether the underlying securities are held to maturity. Therefore, at acquisition, the bank must evaluate whether the investment should be classified as “trading” or “available-for-sale.” A mutual fund bought principally for sale in the near term should be classified as a trading investment. For a mutual fund that is not bought principally for sale in the near term, a bank can elect to classify the fund as trading or available-for-sale at the time of purchase. Net unrealized holding gains and losses on trading investments are included in income, while net unrealized holding gains and losses on available-for-sale investments are included in accumulated other comprehensive income until they are realized.

Question 7:

(September 2001)

How should gains and losses be reported when the mutual fund investments are sold?

Staff Response:

Realized gains and losses should be included in determining net income for the period in which they occur. They should be recorded as “Other noninterest income” or “Other noninterest expense,” as appropriate. If mutual fund investments classified as available-for-sale are sold, the

component in accumulated other comprehensive income should be adjusted to remove any previously included amounts applicable to them.

Question 8:

(December 2001)

When may a bank sell held-to-maturity securities and not “taint” the portfolio?

Staff Response:

SFAS 115 establishes the following “safe harbors” under which held-to-maturity securities may be sold without tainting the entire portfolio:

- Evidence of a significant deterioration in the issuer’s creditworthiness.
- A change in the tax law that eliminates or reduces the tax-exempt status of interest on the debt security (but not a change in tax rates).
- A major business combination or disposition that necessitates the sale of the securities to maintain the bank’s existing interest rate risk position or credit risk policy.
- A change in statutory or regulatory requirements that significantly modifies either the definition or level of permissible investments that may be held.
- A significant increase in regulatory capital requirements that causes the bank to downsize.
- A significant increase in the risk weights of debt securities for risk-based capital purposes.

There is also a limited exclusion for certain unusual events.

Question 9:

(December 2001)

What are the ramifications of selling debt securities that have been classified as held-to-maturity and that do not meet any of the “safe harbor” exemptions set forth in question 8?

Staff Response:

A sale outside of the “safe harbor” exemptions would “taint” the portfolio. Once a portfolio is tainted, all remaining securities in the existing held-to-maturity portfolio must be transferred to the available-for-sale category. In addition, future purchases of securities must be classified as available-for-sale. Consistent with the views of the Securities and Exchange Commission, the prohibition from using held-to-maturity will apply for a two-year period.

As available-for-sale securities are carried at fair value in the financial statements, the transfer of tainted held-to-maturity securities would result in an unrealized holding gain or loss at the date of transfer. The unrealized holding gain or loss should be included in other comprehensive income, a separate component of stockholders equity. However, amounts included in other comprehensive income are excluded in the determination of the bank’s regulatory capital.

In addition, SFAS 115 requires certain disclosures for sales or transfers of securities out of the held-to-maturity category. Specifically, the amortized cost, realized or unrealized gain or loss, and circumstances leading to the sale or transfer of held-to-maturity securities must be disclosed in the bank's financial statements. For call report purposes, the amortized cost of securities sold or transferred from the held-to-maturity category should be included on Schedule RC-B, Memoranda.

Facts:

A bank sells a portion of its investment securities that were included in the held-to-maturity portfolio. The securities were sold to gain additional liquidity.

Question 10: (December 2001)

Would this sale of securities from the held-to-maturity portfolio "taint" the remaining securities in the portfolio?

Staff Response:

Yes. Except for the "safe harbor" exceptions stated in question 8, transfers out of the held-to-maturity portfolio taint the portfolio. Sales for liquidity reasons are excluded from the SFAS 115 "safe harbor" exceptions. As a result, the held-to-maturity portfolio would be considered tainted as of the sale date.

Facts:

In anticipation of converting from a taxable corporation to Subchapter S status, a bank sells some tax exempt municipal securities that had been included in the held-to-maturity portion of the investment portfolio. This resulted because the bank will no longer benefit from the tax-free status of the municipal securities and the individual shareholders do not need the tax-exempt income.

Question 11: (December 2001)

Does the sale of these securities taint the entire held-to-maturity portfolio?

Staff Response:

Yes, selling securities from the held-to-maturity portfolio, because of a change in tax status of the bank to Subchapter S is not one of the "safe harbor" exceptions included in SFAS 115. Although SFAS 115 does provide an exception for changes in tax law that eliminate or reduce the tax-exempt status of interest, this exception does not extend to changes in the tax status of the bank. Accordingly, the held-to-maturity portfolio is tainted.

This change resembles a change in tax rates more than a change in tax law. Therefore, it is not covered by the "safe harbor" exceptions in SFAS 115.

Facts:

A bank purchases trust preferred securities using its legal lending limit authority.

Question 12:

(September 2002)

Should these securities be reported as loans or securities on the bank's financial statements?

Staff Response:

The trust preferred securities should be classified and reported as securities on the bank's financial statements, including call reports. The legal means for acquiring the security is not relevant for the accounting treatment. The financial statement classification is governed by GAAP, not the legal authority under which the assets are purchased. The trust preferred securities are debt securities subject to the accounting requirements of SFAS 115.

Facts:

In 1998 Bank A purchased \$10 million of the 30-year capital securities of the Trust of Bank B. These securities have a fixed distribution (interest) rate, quarterly payment dates and a fixed maturity date. In accordance with SFAS 115, the Bank has classified these securities as available for sale debt securities.

The Trust exists for the sole purpose of investing in junior subordinated deferrable interest debentures of Bank B. Accordingly, the ability of the Trust to pay the quarterly distribution is based solely on Bank B's ability to pay interest on the debentures. Interest on the debentures is paid quarterly, unless deferred by Bank B. The agreements allow Bank B to defer interest payments on the debentures for a period of up to 20 consecutive quarters without creating a legal default. If the interest payments on the debentures are deferred, the distribution payments on the capital securities are also deferred, without creating a legal default. However, the payments are cumulative.

During 2001, Bank B began experiencing financial difficulties. Accordingly, in June of 2001 Bank B announced that the interest payment on the debentures and the Trust's distribution payment on the capital securities scheduled for July 31 will be deferred. These payments will be deferred for the last two quarters of 2001. Resumption of payments in 2002 is dependent upon Bank B returning to profitable operations. Further, the capital securities are publicly traded and selling at a discount in excess of 25 % of par value.

Question 13:

(September 2004)

Should the accrual of interest income be discontinued on a debt type security (trust preferred) that is not paying scheduled interest payments, but is not in legal default according to the terms of the instrument?

Staff Response:

Bank A should discontinue the accrual of income on its investment in the Trust's capital securities and include the securities as a nonaccrual asset on Schedule RC-N of the call report. Previously accrued interest should be reversed.

The glossary instructions to the call report set forth the criteria for placing an asset on nonaccrual status. Two of those criteria are: (1) principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection, or (2) full payment of principal and interest is not expected.

For the first criteria, both the 2001 third and fourth quarter distribution (interest) payments will not be made because of the financial condition and operating losses of Bank B. Payments may resume in 2002, but only if Bank B becomes profitable. Accordingly, there is no assurance that Bank A will receive these or future payments.

While it is true that a legal default has not occurred, the staff believes that interest should not be accrued on an asset that is impaired or when the financial condition of the borrower is troubled.

Although the nonaccrual policies of the banking agencies are not codified in GAAP, they are followed by financial institutions in the preparation of their financial statements. This has resulted in these policies being considered an element of GAAP even though not specifically included in the accounting literature.

Further, this 30-year debt investment is classified by Bank A as available for sale and is currently trading at a substantial discount from par. Therefore, in addition to the uncertainty about the collection of the income, concern exists about recovery of the principal.

Question 14: (September 2004)

Does the decline in value in this trust preferred security raise any other issues?

Staff Response:

The issue of whether the impairment in the trust preferred security should be considered as an other-than-temporary impairment must be addressed. If, upon evaluation, the impairment of the security is determined to be other-than-temporary, an impairment loss must be recognized in earnings for the difference between the security's cost and its fair value. See Topic 1B for a discussion of other-than-temporary impairment.

Facts:

A bank affected by major-category hurricanes (Category 4 storms such as Hurricane Katrina and Hurricane Rita) sells investment securities that were classified as "held to maturity" (HTM) to meet its liquidity needs.

Question 15: (May 2006)

Will the bank's intent to hold other investment securities to maturity be questioned?

Staff Response:

Under normal circumstances, the sale of any HTM investment would call into question a bank's intent to hold its remaining HTM investments to maturity. However, paragraph 8 of SFAS 115 indicates that events that are isolated, nonrecurring, and unusual for the reporting enterprise that could not be reasonably anticipated may cause an enterprise to sell or transfer an HTM security without necessarily calling into question its intent to hold other HTM debt securities to maturity. In this situation, the FASB staff indicated that they believe that this provision encompasses the sales of HTM investment securities by a bank that is required to meet its abnormally increased liquidity needs that are directly related to a major-category hurricane (such as Hurricane Katrina and Hurricane Rita) that has caused extraordinary devastation over a wide area affecting a vast number of the bank's customers.

Facts:

Company A, a credit card payment intermediary, restructures its legal form by converting from a mutual company to a stock company (demutualization). The mutual company owners receive restricted stock, and may also receive cash in the future. Pending litigation related to the company will affect the value realized of the restricted stock. Each owner has a proportional obligation for the litigation based on the member by-laws. It is determined that at the date of the restructuring the member by-laws were modified such that they are subject to FASB Interpretation No. 45 (FIN 45).

Question 16:

(December 2008)

Can a bank record the stock received upon the restructuring at fair value?

Staff Response:

No, the stock received should be recorded at the bank's historical cost, which may be zero. While no accounting standards or interpretations exist that directly address this transaction, Emerging Issues Task Force (EITF) Consensus No. 99-4 and Accounting Principles Board Opinion No. 29 (APB 29) provide analogous guidance. EITF 99-4 provides accounting guidance for stock received in a demutualization, but is applied to a one-time conversion from a mutual to a stock company. APB 29 provides guidance on the accounting for nonmonetary transactions and generally involves the use of fair value for the assets exchanged. However, APB 29 requires that there be no continuing involvement in the transferred assets for fair value to be applied. Continuing involvement presented by the pending litigation is one determinant of whether the stock received should be recorded at historical cost (carryover basis).

Question 17:

(December 2008)

What accounting literature should the bank follow when recording the obligation for the pending litigation?

Staff Response:

A bank should record, in accordance with FIN 45, the fair value of its proportionate share of all pending litigation as of the day the guarantee exists. In the event that, at the inception of the guarantee, the bank must recognize a liability under SFAS 5 for the related contingent loss, the liability to be initially recognized for that guarantee must be the greater of the amount that satisfies the fair value objective as discussed in FIN 45 or the contingent liability amount required to be recognized by SFAS 5.

Question 18:

(December 2008)

Should the pending litigation be recorded at the bank level for call report purposes?

Staff Response:

Yes. The liability for the litigation expense should be recorded at the bank level primarily because it is a result of bank activity. In this situation, the member banks have been liable for litigation since the mutual company's formation, and the banks have been the beneficiaries of related card fee income.

Question 19:

(December 2008)

What happens if the holding company legally assumes the litigation obligation without compensation from the subsidiary bank?

Staff Response:

The transfer of the liability should be measured at fair value, with a corresponding non-cash capital contribution from the holding company. Recording this intercompany transfer at fair value is consistent with arms-length, stand-alone financial reporting and is not inconsistent with GAAP.

Facts:

A few months later, Company A has an initial public offering (IPO). Approximately one fourth of the restricted stock is redeemed for cash, which results in significant gains for the existing stockholders. In certain instances the cash was distributed to the holding company rather than the bank. In addition, some of the IPO proceeds are retained in an escrow account to cover the pending litigation. The bank has considered the escrow account in recalculating its FIN 45 liability. The bank also retains its remaining restricted stock.

Question 20:

(December 2008)

Should the gain related to the receipt of cash from the IPO be recorded at the bank level for call report purposes?

Staff Response:

Yes, assuming a transfer at fair value has not already occurred and been documented between the bank and holding company. Any benefit received by the holding company because a bank activity should be reflected at the bank. Therefore cash received by the holding company on the bank's behalf (and not immediately passed on to the bank) should be reflected as a dividend to the bank holding company from the bank. If the bank transfers the stock to its holding company, the call report requires the transfer to be recorded at fair value.

Question 21:

(December 2008)

Should the establishment (funding) of the escrow account be recorded at the bank level for call report purposes?

Staff Response:

As noted in question 18, the litigation expense and liability should be recorded at the bank level primarily because it is a result of bank activity. The amount allocated to the escrow account should also be recorded at the entity where the litigation expense is recorded.

1B. OTHER-THAN-TEMPORARY IMPAIRMENT

Question 1:

(April 2005)

What is other-than-temporary impairment?

Staff Response:

A security is impaired when the fair value is less than amortized cost. SFAS 115 requires institutions to determine whether the impairment is other-than-temporary for both available-for-sale and held-to-maturity securities. For example, if it is probable that the investor will be unable to collect all the amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment should be considered to have occurred.

Question 2:

(May 2006)

What is the authoritative literature in assessing a security for other-than-temporary impairment?

Staff Response:

FASB Staff Position 115-1 (FSP 115-1) establishes the framework for determining and measuring other-than-temporary impairment. FSP 115-1 also references existing GAAP guidance in determining whether an investment is other-than-temporary. This guidance includes SFAS 115, APB Opinion No.18 (APB 18), Emerging Issues Task Force Consensus No. 99-20 (EITF 99-20), and the SEC's Staff Accounting Bulletin No. 59 (SAB 59) as codified by Topic 5M.

FSP 115-1 also establishes a three-step process for determining other-than-temporary impairment. These steps are:

- Step 1: Determine whether an investment is impaired.
- Step 2: Evaluate whether an impairment is other-than-temporary.
- Step 3: If the impairment is other-than-temporary, recognize an impairment loss equal to the difference between the investment's cost and its fair value.

FASB Emerging Issues Task Force Consensus No. 99-20 (EITF 99-20) provides guidance for securitized financial assets (for example, securities backed by assets such as loans or receivables, among other items) that are not of high credit quality and which can be contractually prepaid or settled in a way that the holder would not recover substantially all of its recorded investment. Generally an other-than-temporary impairment should be recognized for these securities if the fair value of the investment is less than its carrying amount, and an adverse change in the estimated timing or amount of cash flows on the security has occurred since the cash flows were previously estimated.

For all other securities, banks should refer to SFAS 115, APB 18, SAB 59 as codified by Topic 5M and the American Institute of Certified Public Accountants' Statement of Auditing Standards No. 92 (SAS 92), which provide criteria that are helpful in making the other-than-temporary impairment assessment.

Question 3:

(May 2006)

In Step 1, what factors indicate that a cost-method investment may be impaired?

Staff Response:

FSP 115-1's impairment indicators include, but are not limited to, the following:

- A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee.
- A significant adverse change in the regulatory, economic, or technological environment of the investee.
- A significant adverse change in the general market condition of either the geographic area or the industry in which the investee operates.
- A bona fide offer to purchase (whether solicited or unsolicited), an offer by the investee to sell, or a completed auction process for the same or similar security for an amount less than the cost of the investment.
- Factors that raise concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

Question 4:

(May 2006)

In Step 2, what factors indicate that a security impairment may be other-than-temporary?

Staff Response:

SAB 59, as codified by Topic 5M, and SAS 92 provide criteria that is helpful in making the other-than-temporary impairment assessment.

These criteria include, but are not limited, to the following:

- Length of time and extent to which fair value has been less than cost.
- Evidence of a forecasted recovery.
- Financial condition, industry environment, and near term prospects of the issuer.
- Downgrades of the security by rating agencies.
- Intent and ability of the bank to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.

Question 5:

(May 2005)

Can impairment of a security be deemed other-than-temporary even if the bank has not made a decision to sell the security?

Staff Response:

Yes. Paragraph 14 of FSP 115-1 states that an investor should recognize an impairment loss when the impairment is deemed other-than-temporary even if a decision to sell the security has not been made.

Question 6:

(April 2005)

For securities assessed under EITF 99-20, what is meant by securitized financial assets that are “not of high credit quality”?

Staff Response:

Securitized financial assets that are “not of high credit quality” have been generally viewed as those securitized financial assets below an AA rating. It appears that the EITF only intended assets to be deemed “high credit quality” when the likelihood of loss was remote. Based on review of the rating definitions, an AA rating is defined as “the obligor’s capacity to meet its financial commitment on the obligation is very strong” which appears to be consistent with the intent of the EITF when using the “high credit quality” terminology. Also, the rating definition for an investment grade rating of BBB is that of an “obligation that exhibits adequate protection parameters but that which under adverse economic conditions or changing circumstances is likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.” The staff believes that an investment grade rating of BBB is not consistent with the intent of the EITF when using the “high credit quality” terminology. This is consistent with a December 2003 SEC speech.

Question 7:

(January 2007)

If a security’s decline is deemed to be other-than-temporary, how is the security accounted for?

Staff Response:

A bank should write the investment down to fair value. This writedown to fair value must be recognized in earnings in the period it occurred. Other-than-temporary impairment results in a new (i.e., lower) cost basis of the security. The new cost basis is not adjusted through earnings by subsequent recoveries of fair value at a later date. However, in certain circumstances a security that has been restructured may qualify to be recorded at current fair value. See questions 13 and 14.

In accordance with FSP 115-1, in periods subsequent to the recognition of an other-than-temporary impairment loss for debt securities, a bank shall account for the other-than-temporary impaired debt security as if the debt security had been purchased on the measurement date of the other-than-temporary impairment. That is, the discount or reduced premium recorded for the debt security, based on the new cost basis, would be accreted or amortized over the remaining life of the debt security in a prospective manner based on the amount and timing of future estimated cash flows.

Question 8:

(January 2007)

When should a bank place a debt security on nonaccrual status and therefore not accrete or amortize the discount or reduced premium created through the other-than-temporary impairment writedown?

Staff Response:

FSP 115-1 does not address when a holder of a debt security would place a debt security on nonaccrual status or how to subsequently report income on a nonaccrual debt security. Banks should apply their nonaccrual policies and regulatory guidance in determining when a debt security should be placed on nonaccrual status.

Facts:

A bank owned a corporate debt security of ABC Corp. and carried the investment in its available-for-sale portfolio. ABC Corp. filed for bankruptcy, at which time the bank recorded an other-than-temporary impairment through earnings to write down the value of the security to zero. Several years later, ABC Corp. emerged from bankruptcy and issued new debt to its prior bondholders.

Question 9:

(January 2007)

How should the bank account for the receipt of the restructured debt instrument?

Staff Response:

Guidance regarding a creditor's accounting for a modification or exchange of debt instruments is addressed in SFAS 91 and Emerging Issues Task Force No. 01-7 (EITF 01-7). SFAS 91 requires that the restructured debt be accounted for as new debt if the following two criteria are met:

- The new debt's effective yield is at least equal to the effective yield for a comparable debt with similar collection risks not involved in a restructure.
- The modifications to the original debt are more than minor.

EITF 01-7 provides that a modification is considered more than minor if the present value of the cash flows of the new debt is at least 10 % different from the present value of the remaining cash flows of the original debt.

If both criteria noted in SFAS 91 have been met, the restructured debt would be accounted for as a new debt arrangement with the new bond recorded initially at fair value.

If both criteria are not met, the restructured debt would not be accounted for as a new debt arrangement. Therefore, no adjustment would be made to the carrying amount because the new bond would be considered a continuation of the existing one.

Question 10:

(May 2006)

If the reissued bond distributed by ABC Corp. qualifies as new debt under SFAS 91 and EITF 01-7, how should the bank account for the exchange?

Staff Response:

The bank should record the new bond in its investment portfolio at its current fair value, which results in the recognition of income through current earnings.

Question 11:

(December2008)

What is an appropriate fair value?

Staff Response:

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In other words, fair value is the price that would be received to sell an asset (exit price) as opposed to the price that would be paid to purchase an asset (entry price). This exit price should be based on the price that would be received in the bank's principal market for selling that asset. The principal market is the market the bank has historically sold into with the greatest volume. If the bank does not have a principal market for selling that asset, the exit price should assume the asset is sold into the most advantageous market. The most advantageous market is the market in which the bank would receive the most value, considering the transaction costs in the respective markets. This definition is consistent with Statement of Financial Accounting Standards No. 157 (SFAS 157). See Topic 11D for further discussion of SFAS 157.

Facts:

A bank holds a debt security that has an amortized cost basis of \$100 and is currently trading in the active market at \$70. The bank determined that the debt security is other-than-temporary impaired (OTTI) in accordance with GAAP as of the reporting date. The fair value as of the reporting date is the market quote of \$70. The bank holds approximately 25 % of the entire debt security issuance. The sale of the bank's holdings would affect the market pricing on the debt securities because of the market's availability of liquidity.

Question 12:

(December2008)

Based on liquidity, may the bank write down the debt security further than the fair value of \$70?

Staff Response:

No. Consistent with SFAS 157, the best evidence of fair value is quoted market prices in an active market. Although the sale of the bank's holdings could affect the market pricing, an adjustment of fair value or a reserve for liquidity against a security is not permitted under GAAP when the security trades in an active market. Therefore, once the security is deemed OTTI, the bank would write down the investment to the fair value of \$70 as a current period expense.

Question 13:

(April

2005)

Does other-than-temporary mean permanent?

Staff Response:

No. The staff believes that the FASB consciously chose the phrase “other-than-temporary” because FASB did not intend that the test be “permanent impairment,” as has been used elsewhere in the accounting literature. Specific facts and circumstances dictate whether other-than-temporary impairment recognition is appropriate. Therefore, this determination should be made on a case-by-case basis. The staff believes that “other-than-temporary” should be viewed differently than the absolute assurance that “permanent” impairment implies. This response is consistent with the SEC’s Staff Accounting Bulletin No. 59 as codified in Topic 5M.

Facts:

Two severe hurricanes, Hurricane Katrina and Hurricane Rita (the hurricanes), caused severe damage to certain Gulf Coast areas late in the third quarter of 2005.

Question 14:

(May 2006)

How should banks holding municipal bonds from issuers in the areas of a major hurricane (a Category 4 storm such as Hurricane Katrina or Rita) on which fair value is less than amortized cost, assess these bonds for “other-than-temporary” impairment for purposes of preparing their quarterly financial statements (call reports)?

Staff Response:

Under GAAP, when the fair value of a municipal bond has declined below its amortized cost, the bank holding the bond must assess whether the decline represents an “other-than-temporary” impairment and, if so, write the cost basis of the municipal bond down to fair value through earnings. When making this assessment, banks should apply relevant “other-than-temporary” impairment guidance as required by existing authoritative literature which includes SFAS 115 and SAB 59 as codified in Topic 5M.

In this regard, if a bank decided prior to the end of the quarter that it would sell a municipal bond after quarter-end and management did not expect the fair value of the bond, which is less than its amortized cost, to recover prior to the expected time of sale, a writedown for “other-than-temporary” impairment should be recognized in earnings in the bank’s quarterly financial statements. Otherwise, for the specific quarter financial statements, management should consider all information available prior to filing this report when assessing hurricane-affected municipal bonds for “other-than-temporary” impairment. In each subsequent reporting period, banks should continue to assess whether any declines in fair value below amortized cost of these municipal bonds are “other-than-temporary” impairments.

Question 15:

(December 2008)

Should banks record OTTI on mortgage-backed securities with subprime exposure or other affected securities when there are adverse market conditions?

Staff Response:

Measuring and recording OTTI is based on the specific facts and circumstances. Consistent with OTTI guidance, the staff believes that banks should review their securities portfolios at each reporting date and determine if writedowns are required in the current period. For example, if

the bank determines that the cause of the decline in a security's value is due to a ratings downgrade resulting from significant credit problems with the issuer, generally that decline would be considered other-than-temporary and that loss should be recorded in the current period.

TOPIC 2: LOANS

2A. TROUBLED DEBT RESTRUCTURINGS

Question 1:

(December 2008)

What is a troubled debt restructuring (TDR)?

Staff Response:

Under GAAP, a modification of a loan's terms constitutes a TDR if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. The concession could either stem from an agreement between the creditor and the debtor or be imposed by law or a court. This guidance is included in Statement of Financial Accounting Standards No. 15 (SFAS 15).

However, not all modifications of loan terms automatically result in a TDR. For example, if the modified terms are consistent with market conditions and representative of terms the borrower could obtain in the open market, the restructured loan is not categorized as a TDR. However, if a concession (e.g., below market interest rate, forgiving principal or previously accrued interest) is granted based on the borrower's financial difficulty, the TDR designation is appropriate.

If a modification meets the definition of a TDR, the specific accounting set forth in Statement of Financial Accounting Standards No. 114 (SFAS 114) must be followed. Banks should have policies and procedures in place to evaluate loan modifications for the TDR designation.

With the exception of loans accounted for at fair value under the fair value option, the TDR accounting rules apply to all types of restructured loans held for investment, including retail loans. In this respect, loans held for investment in portfolio do not include loans accounted for as held-for-sale in accordance with Statement of Financial Accounting Standards No. 65 (SFAS 65) or AICPA Statement of Position 01-6 (SOP 01-6).

Question 2:

(December 2008)

What are some examples of modifications that may represent troubled debt restructurings?

Staff Response:

SFAS 15 provides the following examples of modifications that may represent troubled debt restructurings:

- Reduction (absolute or contingent) of the stated interest rate for the remaining original life of the debt.
- Extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk.
- Reduction (absolute or contingent) of the face amount or maturity amount of the debt as stated in the instrument or other agreement.
- Reduction (absolute or contingent) of accrued interest.

Said another way, the modification is a TDR if the borrower cannot go to another lender and qualify for and obtain a loan with similar modified terms.

Question 3:

(December 2008)

How should a bank evaluate TDR loans for impairment?

Staff Response:

Loans whose terms have been modified in troubled debt restructuring transactions should be evaluated for impairment, with the appropriate allowance for loan and lease losses (ALLL) adjustments under SFAS 114. This includes loans that were originally not subject to SFAS 114 prior to the restructuring, such as individual loans that were included in a large group of smaller-balance homogeneous loans collectively evaluated for impairment (i.e., retail loans).

A loan is impaired when, based on current information and events, it is probable that an institution will be unable to collect all amounts due according to the original contractual terms of the loan agreement. Usually, a commercial restructured troubled loan that had been individually evaluated under SFAS 114 would already have been identified as impaired because the borrower's financial difficulties existed before the formal restructuring.

For a restructured troubled loan, *all amounts due according to the contractual terms* means the contractual terms specified by the original loan agreement, not the contractual terms in the restructuring agreement. Therefore, if impairment is measured using an estimate of the expected future cash flows, the interest rate used to calculate the present value of those cash flows is based on the original effective interest rate on the loan (the original contractual interest rate adjusted for any net deferred loan fees or cost or any premium or discount existing at the origination or acquisition of the loan) and not the rate specified in the restructuring agreement.

Facts:

Borrower A cannot service his \$100,000 loan from the bank. The loan is secured and bears interest at 10 %, which is also the current market rate. On June 1, 1999, the loan is restructured, with interest-only payments of 5 % required for two years and a final payment of \$105,000 (principal plus interest at 5 %) required at the end of the third year. The present value of the expected payments under the restructured terms, discounted at 10 % (the original loan interest rate), is \$87,500. The loan is neither collateral dependent nor readily marketable.

Question 4:

(September 2001)

How should a bank account for this restructuring?

Staff Response:

This modification of terms should be accounted for in accordance with Statements of Financial Accounting Standards Nos. 15, 114 and 118 (SFAS 15, 114 and 118), which require that impairment be measured based on the present value of the expected future cash flows, discounted at the effective interest rate in the original loan agreement. (However, as a practical expedient, impairment may be measured at the loan's observable market price, or the fair value of the collateral, if the loan is collateral dependent.) If the measure of the impaired loan is less than the recorded investment in the loan, the impairment is recognized through a valuation

allowance. Accordingly, in this example, the difference between the present value of the payments (\$87,500) of the restructured loan, discounted at the loan's original rate of interest, and the recorded value (\$100,000) is recognized through a valuation allowance (\$12,500).

Facts:

Same facts as question 1, except that Borrower A transfers the collateral to a new borrower (Borrower B) not related to Borrower A. The bank accepts Borrower B as the new debtor. The loan with Borrower B provides for interest-only payments of 5 % for two years and a final payment of \$105,000 (principal plus interest at 5 %) at the end of the third year. The fair value of the loan, discounted at a current market rate of interest, is \$87,500.

Question 5:

(September 2001)

How should a bank account for this restructuring?

Staff Response:

SFAS 15 requires that the receipt of a loan from a new borrower be accounted for as an exchange of assets. Accordingly, the asset received (new loan) is recorded at its fair value (\$87,500 in this example). In question 1, which involved a modification of terms, the impairment was recorded through a valuation allowance, whereas, here a loss is recognized and the new loan recorded at its fair market value. This conclusion is based on FASB Emerging Issues Task Force Consensus No. 87-19.

Facts:

A bank makes a construction loan to a real estate developer. The loan is secured by a project of new homes. The developer is experiencing financial difficulty and has defaulted on the construction loan. To assist him in selling the homes, the bank agrees to give the home buyers permanent financing at a rate that is below the market rate being charged to other new home buyers.

Question 6:

Must a loss be recorded on the permanent loan financings?

Staff Response:

Yes. The bank is granting a concession it would not have allowed otherwise, because of the developer's financial condition. Therefore, this transaction is a troubled debt restructuring. Furthermore, it represents an exchange of assets. The permanent loans provided to the home buyers must be recorded at their fair value. The difference between fair value and recorded value in the loan satisfied is charged to the allowance for loan and lease losses.

Facts:

Assume that the real estate developer in question 3 has not yet defaulted on the construction loan. He is in technical compliance with the loan terms. However, because of the general problems within the local real estate market and specific ones affecting this developer, the bank agrees to give the home buyers permanent financing at below market rates.

Question 7:

Must a loss be recorded on these permanent loan financings?

Staff Response:

Yes. Even though the loan is not technically in default, the staff believes that the concession was granted because of the developer's financial difficulties. SFAS 15 does not require that a debtor's obligations be in default for a troubled debt restructuring to occur. It only requires that the creditor, for economic or legal reasons related to the debtor's financial difficulties, grant a concession it would not have permitted otherwise.

Therefore, this restructuring would be accounted for as an exchange of assets under the provisions of SFAS 15. Again, the permanent loans provided to the home buyers must be recorded at their fair value.

Facts:

A borrower owes the bank \$100,000. The debt is restructured because of the borrower's precarious financial position and inability to service the debt. In satisfaction of the debt, the bank accepts preferred stock of the borrower with a face value of \$10,000, but with only a nominal market value. The bank agrees to reduce the interest rate from 10 % to 5 % on the remaining \$90,000 of debt. The present value of the combined principal and interest payments due over the next five years, discounted at the effective interest rate in the original loan agreement, is \$79,000.

Question 8:

(December 2008)

How should the bank account for this transaction?

Staff Response:

Securities (either equity or debt) received in exchange for cancellation or reduction of a troubled loan should be recorded at fair value. The recorded amount of the debt (\$100,000) is reduced by the fair value of the preferred stock received. Any impairment in the remaining recorded balance of the restructured loan would be measured according to the requirements of SFAS 114. In this case, if the securities have a fair value of \$1,000, the remaining loan balance of \$99,000 would be compared with the present value of the expected future payments, discounted at the effective interest rate in the original loan agreement. An allowance of \$20,000 is established through a provision for loan and lease losses. This represents the difference between the recorded balance (\$99,000) and the present value of the expected future payments (\$79,000), discounted at 10 % (the original effective interest rate).

Facts:

Assume a borrower owes the bank \$100,000, which is secured by real estate. The loan is restructured to release the real estate lien and requires no principal or interest payments for 10 years. At the end of the tenth year, the borrower will pay the \$100,000 principal. No interest payments are required.

As security, the borrower pledges a \$100,000 zero coupon bond that matures at the same time the loan is due (10 years). The borrower purchased the bond with funds borrowed from another financial institution. The real estate released in this restructuring was used as security to obtain those funds. The current fair value of the zero coupon bond is \$40,000.

Question 9:

How should the bank account for this restructuring?

Staff Response:

In essence, the bank has received the security (zero coupon bond) as satisfaction of the loan. Because loan repayment is expected only from the proceeds of the security, the bank has effectively obtained control of the collateral. Accordingly, the loan should be removed from the books of the bank, and the security should be recorded in the investment account at its fair value (\$40,000). The \$60,000 difference is charged to the allowance for loan and lease losses. This conclusion is consistent with FASB Emerging Issues Task Force Consensus No. 87-18.

Facts:

A \$10 million loan is secured by income producing real estate. Cash flows are sufficient to service only a \$9 million loan at a current market rate of interest. The loan is on nonaccrual. The bank restructures the loan by splitting it into two separate notes. Note A is for \$9 million. It is collateral dependent and carries a current market rate of interest. Note B is for \$1 million and carries a below-market rate of interest. The bank charges off all of Note B, but does not forgive it.

Question 10:

Can the bank return Note A to accrual status?

Staff Response:

Yes, but only if all of the following conditions are met:

- The restructuring qualifies as a troubled debt restructuring (TDR) as defined by SFAS 15. In this case, the transaction is a TDR, because the bank granted a concession it would not consider normally, a below market rate of interest on Note B.
- The partial loan charge off is supported by a good faith credit evaluation of the loan(s). The charge off should also be recorded before or at the time of the restructuring. Under SFAS 5, a partial charge off may be recorded only if the bank has performed a credit analysis and determined that a portion of the loan is uncollectible.
- The ultimate collectibility of all amounts contractually due on Note A is not in doubt. If such doubt exists, the loan should not be returned to accrual status.
- There is a period of satisfactory payment performance by the borrower (either immediately before or after the restructuring) before the loan (Note A) is returned to accrual status.

If any of these conditions are not met, or the terms of the restructuring lack economic substance, the restructured loan should continue to be accounted for and reported as a nonaccrual loan.

Question 11:

(December 2008)

What constitutes a period of satisfactory performance by the borrower?

Staff Response:

AICPA Practice Bulletin 5 (PB 5) requires some period of performance for loans to troubled countries. The staff generally believes this guidance should also apply to domestic loans. Accordingly, the bank normally may not return Note A to accrual status until or unless this period of performance is demonstrated, except as described in question 10.

However, neither PB 5 nor regulatory policy specify a particular period of performance. This will depend on the individual facts and circumstances of each case. Generally, we believe this period would be at least six months for a monthly amortizing loan.

Accordingly, if the borrower was materially delinquent on payments prior to the restructure, but shows potential capacity to meet the restructured terms, the loan would likely continue to be recognized as nonaccrual until the borrower has demonstrated a reasonable period of performance; again, generally at least six months (removing doubt as to ultimate collection of principal and interest in full).

If the borrower does not perform under the restructured terms, the TDR probably was not appropriately structured, and it should be recognized as nonaccrual. In this case the decision regarding accrual status would be based solely on a determination of whether full collection of principal and interest is in doubt.

Question 12:

(September 2001)

The previous response indicates that performance is required before a formally restructured loan can be returned to accrual status. When can a restructured loan be returned to accrual status without performance?

Staff Response:

The staff continues to believe that evidence of performance under the restructured terms is one of the most important considerations in assessing the likelihood of full collectibility of the restructured principal and interest. However, in rare situations, the TDR may coincide with another event that indicates a significant improvement in the borrower's financial condition and ability to repay. These might include substantial new leases in a troubled real estate project, significant new sources of business revenues (i.e., new contracts), and significant new equity contributed from a source not financed from the bank, etc. A preponderance of this type of evidence could obviate the need for performance or lessen the period of performance needed to assure ultimate collectibility of the loan.

Question 13:

Given that evidence of performance under the restructured terms will likely be relied upon to determine whether to place a TDR on accrual status, can performance prior to the restructuring be considered?

Staff Response:

Performance prior to the restructuring should be considered in assessing whether the borrower can meet the restructured terms. Often the restructured terms reflect the level of debt service that the borrower has already been making. If this is the case, and the borrower will likely be able to continue this level of performance and fully repay the new contractual amounts due, continued performance after the restructuring may not be necessary before the loan is returned to accrual status.

Question 14: (September 2001)

How would the absence of an interest rate concession on Note B affect the accrual status of Note A?

Staff Response:

If the bank does not grant an interest rate concession on Note B nor make any other concessions, the restructuring would not qualify as a TDR. Accordingly, SFAS 15 would not apply.

In substance, the bank has merely charged down its \$10 million loan by \$1 million, leaving a \$9 million recorded loan balance. The remaining balance should be accounted for and reported as a nonaccrual loan. Partial charge off of a loan does not provide a sufficient basis by itself for restoring the loan to accrual status.

Furthermore, the bank should record loan payments as principal reductions as long as any doubt remains about the ultimate collectibility of the recorded loan balance. When that doubt no longer exists, interest payments may be recorded as interest income on the cash basis.

Question 15:

Assume the bank forgives Note B. How would that affect the accounting treatment?

Staff Response:

Forgiving debt is a form of concession to the borrower. Therefore, a restructuring that includes the forgiveness of debt would qualify as a TDR and SFAS 15 would apply. It is not necessary to forgive debt for SFAS 15 to apply, as long as some other concession is made.

Question 16: (September 2001)

Assume that Note B was not charged off, but was on nonaccrual. How would that affect the accrual status and call report TDR disclosure for Note A?

Staff Response:

When a loan is restructured into two or more notes in a TDR, the restructured loans should be evaluated separately. However, since the restructured loans are supported by the same source of repayment, both would be reported as nonaccrual. Additionally, because the interest rate on Note B was below a market rate, both notes would be reported in the TDR disclosures on the call report.

Facts:

Assume, as discussed in question 16, that Note B was not charged off prior to or at the time of restructuring. Also, expected cash flows will not be sufficient to repay Notes A and B at a market rate. The cash flows would be sufficient to repay Note A at a market rate.

Question 17:

(September 2001)

When appropriate allowances, if necessary, have been established for Note B, would Note A be reported as an accruing market-rate loan and Note B as nonaccrual?

Staff Response:

No. Even after a TDR, two separate recorded balances, supported by the same source of repayment, should not be treated differently for nonaccrual or TDR disclosure. All loans must be disclosed as nonaccrual, unless the combined contractual balance and the interest contractually due is expected to be collected in full.

Facts:

A bank negotiates a troubled debt restructuring on a partially charged-off real estate loan. The borrower has been unable to make contractually owed payments, sell the underlying collateral at a price sufficient to repay the obligation fully, or refinance the loan. The bank grants a concession in the form of a reduced contractual interest rate. In the restructuring, the bank splits the loan into two notes that require final payment in five years. The bank believes that market conditions will improve by the time the loan matures, enabling a sale or refinancing at a price sufficient to repay the restructured obligation in full. The original interest rate was 9 %.

Note A carries a 9 % contractual interest rate. Note B, equal to the charged off portion, carries a zero percent rate. Note A requires that interest be paid each year at a rate of 5 %, with the difference between the contractual rate of 9 % and the payment rate of 5 % capitalized. The capitalized interest and all principal are due at maturity. Additionally, interest on the capitalized interest compounds at the 9 % rate to maturity.

Question 18:

(April 2005)

If the borrower makes the interest payments at 5 % as scheduled, can Note A be on accrual status?

Staff Response:

No. The terms of the restructured loan allow for the deferral of principal payments and capitalization of a portion of the contractual interest requirements. Accordingly, these terms place undue reliance on the balloon payment for a substantial portion of the obligation.

Generally, capitalization of interest is precluded when the creditworthiness of the borrower is in question. Other considerations about the appropriateness of interest capitalization are:

- Whether interest capitalization was included in the original loan terms to compensate for a planned temporary lack of borrower cash flow, or;
- Whether similar loan terms can be obtained from other lenders.

In a TDR, the answer to each of these considerations is presumed to be negative. First, the bank, in dealing with a troubled borrower, must overcome the doubt associated with the borrower's inability to meet the previous contractual terms. To do this, objective and persuasive evidence must exist for the timing and amount of future payments of the capitalized interest.

In this case, the repayment of the capitalized interest is deferred contractually until the underlying loan is refinanced or sold. A refinancing, or sale at a price adequate to repay the loan, was not possible at the time of restructuring. The bank has offered no objective evidence to remove the doubt about repayment that existed prior to the restructuring. It is relying solely on a presumption that market conditions will improve and enable the borrower to repay the principal and capitalized interest. Accordingly, the timing and collectibility of future payments of this capitalized interest are uncertain.

Second, the temporary lack of cash flow is generally the reason for a TDR. Thus, capitalization of interest was not provided for in the original loan terms. Finally, the concession was granted, because of the borrower's inability to find other market financing to repay the original loan.

Some loans, such as this example, are restructured to reduce periodic payments by deferring principal payments, increasing the amortization term relative to the loan term, and/or substantially reducing or eliminating the rate at which interest contractually due is periodically paid. These provisions create or increase the balloon payment significantly. Sole reliance on those types of payments does not overcome the doubt as to full collectibility that existed prior to the restructuring. Other evidence should exist to support the probability of collection before return to accrual status.

In this example, the conditions for capitalization of interest were not met, and sole reliance for the full repayment was placed on the sale/refinancing. Accordingly, Note A should be maintained on nonaccrual status. To the extent that the recorded principal remains collectible, interest may be recognized on a cash basis.

Facts:

A bank restructures a loan by forgiving a portion of the loan principal due and charging it off. Additionally, the bank requires that, should the borrower's financial condition recover, the borrower must pay a sum in addition to the principal and interest due under the restructured terms.

Question 19:

For the restructured loan to be eligible for return to accrual status, must the contingent payment also be deemed fully collectible?

Staff Response:

No. Contingent cash payments should not be considered in assessing the collectibility of amounts contractually due under the restructured terms.

Facts:

A \$10 million loan is secured by income-producing real estate. As a result of a previous \$1 million charge-off, the recorded balance is \$9 million. Cash flows are sufficient to service only \$9 million of debt at a current market rate of interest. The loan is classified as nonaccrual and is restructured. However, the bank protects its collateral position by restructuring the loan into two separate payment “tranches,” rather than two separate notes. Tranche A requires \$9 million in principal payments and carries a current market rate of interest. Tranche B requires \$1 million in principal payments and carries a below-market rate of interest.

Question 20:

Can the bank return Tranche A to accrual status?

Staff Response:

The use of one note with two payment tranches, instead of two separate notes, does not prevent Tranche A from being returned to accrual status, as long as it meets the conditions set forth in the staff response to question 10.

Facts:

A bank has a commercial real estate loan secured by a shopping center. The loan, which was originated 13 years ago, provides for a 30-year amortization with interest at Prime plus 2 %. Two financially capable guarantors, A and B, each guarantee 25 % of the debt.

The shopping center lost its anchor tenant two years ago and is not generating sufficient cash flow to service the debt. The guarantors have been providing funds to make up the shortfall. Because of the decrease in the cash flow, the borrower and guarantors asked the bank to modify the loan agreement. The bank agrees to reduce the interest rate to Prime, and in return, both guarantors agreed to increase their guarantee from 25 % to 40 % each. The guarantors are financially able to support this guarantee. However, even with the increased guarantee, the borrower could not have obtained similar financing from other sources at this rate. The fair market value of the shopping center is approximately 90 % of the current loan balance.

Question 21:

(September 2002)

Should the debt modification be reported as a troubled debt restructuring (TDR) since only the interest rate was reduced?

Staff Response:

SFAS 15 states that a restructuring of a debt is a TDR if a creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession that it would not otherwise consider. This may include a reduction of the stated interest rate for the remaining original life of the debt. However, a consensus was reached in on FASB Emerging Issues Task Force Consensus No. 02-4 (EITF 02-4) that no single characteristic or factor, taken alone, determines whether a modification is a TDR.

EITF 02-4 establishes a model to determine whether a modification or exchange of debt instruments falls within the scope of SFAS 15. The model first determines whether the borrower is experiencing financial difficulties, and if so, whether the creditor has granted a concession. If both factors are present, the restructuring will qualify as a TDR.

The consensus lists six factors that indicate the debtor is experiencing financial difficulties. These factors are:

- Default.
- Bankruptcy.
- Doubt as to whether the debtor will continue as a going concern.
- De-listing of securities.
- Insufficient cash flows to service the debt.
- Inability to obtain funds from other sources at a market rate for similar debt to a non-troubled borrower.

In this case, the borrower was experiencing financial difficulties, because the primary source of repayment (cash flows from the shopping center) was insufficient to service the debt, without reliance on the guarantors. Further, it was determined that the borrower could not have obtained similar financing from other sources at this rate, even with the increase in the guarantee percentage. The capacity of the guarantor to support this debt may receive favorable consideration when determining loan classification or allowance provisions. However, since the borrower was deemed to be experiencing financial difficulties and the bank granted an interest rate concession it normally would not have given, this restructuring would be considered a TDR.

Facts:

A bank made a \$95 million term loan with a maturity of June 2006 to a power company in 2001. The loan was secured by all of the property, plant, and equipment of the power plants and had an estimated fair value of \$98 million. Under the terms of the note, periodic interest payments were required. Principal payments were based on a cash flow formula.

The power plants did not generate sufficient cash flows in 2002 or 2003 to fully service the interest payments. The parent company of the power company funded the deficiencies in 2002 and 2003. In April 2004, the power company failed to make the required interest payment because of its inability to generate sufficient cash flows. Principal payments, based on the contractual cash flow formula, had not been required in any period between 2001 and 2004.

In July 2004, the parent paid \$10 million of the principal, plus all outstanding interest and fees, thereby bringing the loan fully current. This reduced the outstanding loan balance from \$95 million to \$85 million. The loan was then restructured and the remaining \$85 million was split into two notes.

- Note A is for \$45 million, with interest at current market rates. Periodic interest payments are required, and the principal is due at maturity in 2010. The bank received a first lien on the collateral. The bank maintained this note on accrual status.
- Note B is for \$40 million, with interest at current market rates capitalized into the loan balance. All principal and interest is due at maturity in 2010. The bank received a second lien on the collateral. This loan was placed on nonaccrual status.

The parent agreed to inject \$4 million in new equity into the power company in July 2005 and July 2006 to pay the required interest on Note A for two years. While the company continues to experience net losses in 2005, it is expected that cash flows will be sufficient to cover interest by the third quarter of 2006. Further, the parent has indicated that it will continue to cover interest payments on Note A until the company can generate sufficient cash flows. In addition, the fair value of the collateral is estimated at \$98 million, exceeding the combined amount of the restructured notes by approximately \$13 million.

Question 22:

(October 2005)

Should this restructuring be accounted for as a troubled debt restructuring (TDR)?

Staff Response:

Yes. SFAS 15 states that the restructuring of a debt is a TDR if a creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession that it would not otherwise consider. The company was experiencing financial difficulties as demonstrated by the default on the interest payments. Further, while there was no forgiveness of interest or principal, a concession was granted by extending the maturity date and agreeing to capitalize interest on Note B.

Question 23:

(October

2005)

Should both Notes A and B be on a nonaccrual status?

Staff Response:

Not necessarily. While the nonaccrual rules would normally require that both notes be on nonaccrual status, Note A has a unique structure and financial backing that distinguishes it from most restructured loans. Although both notes are supported by the same cash flows and secured by the same collateral, these unique structural differences result in different conclusions for each note regarding the appropriateness of interest accrual. These structural differences also result in a different conclusion than was reached in certain of the previous examples in this Topic.

The parent paid \$10 million (plus interest and fees) to bring all past due amounts current and has demonstrated the intent and ability to continue to support the power company by its commitment to inject \$4 million capital into the company in 2005 and 2006. The parent has also indicated that additional financial support will be provided, as necessary. This capital injection and future

support is sufficient to meet all required payments on Note A. Further, the previous actions of the parent sufficiently demonstrate its intent to support the borrowing. In addition, after the \$10 million payment by the parent, the collateral value exceeds all current outstanding balances by approximately \$13 million and exceeds the balance of Note A by approximately \$53 million. Based on these factors, the collection of all principal and interest is deemed reasonably assured for Note A. Accordingly accrual status is appropriate for Note A.

Facts:

A borrower has a revolving line of credit in the amount of \$35 million and a term loan in the amount of \$28 million with the bank. Payments are current but the loans are in default because of major financial covenant violations. Further, there is serious concern regarding the borrower's ability to continue to make payments in accordance with the terms of the loans. Accordingly, both loans have been placed on a nonaccrual status.

The credit line is restructured into a new revolving line of credit at an interest rate of Prime + 3 %. This rate and terms are considered to be at market terms and do not involve a concession. Further, it is considered to be both fully collectible and fully secured.

The term loan is restructured into two new term loans, Loan X and Loan Y. Loan X matures in three years and has an interest rate of Prime + 3 %. It requires periodic principal payments during the second and third years and a balloon payment at maturity. The repayment structure is not uncommon for this type of loan, is considered to be at market terms, and does not involve any concessions by the bank. Repayment capacity and collateral are considered sufficient to assure repayment of the loan.

The second loan, Loan Y, provides for a below market interest rate. It also matures in three years, but does not require principal or interest payments until maturity. The terms of this loan are considered concessionary because of the below market interest rate and the repayment terms. Accordingly, this restructuring is considered a troubled debt restructuring. Further, since the analysis of the borrower's repayment capacity and collateral are considered inadequate to repay any portion of this loan, it is required to be charged off.

After a sufficient period of satisfactory payment performance on the revolving line of credit and Loan X, the lender expects to return those two loans to accrual status.

Question 24:

(January 2007)

What factors should be considered before returning the revolving line of credit and Loan X to accrual status?

Staff Response:

This restructuring would be analyzed using the A/B structure described in the previous examples. In this case, the revolving line and Loan X would be considered the A portion, whose collectibility is not in doubt, and Loan Y is the uncollectible charged-off portion (portion B).

Consistent with the previous question 8, the revolving line of credit and Loan X may be returned to accrual status when there has been a period of satisfactory payment performance by the borrower. In this situation, however, Loan X does not require principal payments during the first

year. Accordingly, consideration should be given to whether the borrower can continue making the required payments after the first year.

Question 25: (January 2007)

Does the revolving line of credit and Loan X have to be senior to Loan Y (i.e., a senior/subordinated structure) for the performing loans to be returned to accrual status?

Staff Response:

No, a senior/subordinated structure is not required for the revolving line of credit and Loan X (the A portion of the restructured loan) to be returned to accrual status.

Question 26: (January 2007)

How should any payments received on Loan Y, the charged-off loan, be accounted for?

Staff Response:

Recoveries related to Loan Y would not be recorded until the recorded loans (the revolving line and Loan X) are paid off. Accordingly, any payments received for Loan Y would be applied to the revolving line of credit and Loan X, until they are paid off. Additional amounts would be recorded as recoveries.

Question 27: (December 2008)

What is the impact on the ALLL determination under SFAS 114 for TDR loans?

Staff Response:

Since SFAS 114 requires impairment assessment for all TDRs, both retail and commercial transactions must be evaluated. Given the financial difficulties of these borrowers, material impairment (i.e. additional ALLL provisions) is possible.

When measuring impairment on an individual basis under SFAS 114, a bank must choose one of the following methods: (1) the present value of expected future cash flows discounted at the loan's effective interest rate (i.e., the contractual interest rate adjusted for any net deferred loan fees or costs, premium, or discount existing at the origination or acquisition of the loan), (2) the loan's observable market price, or (3) the fair value of the collateral, if the loan is collateral dependent.

SFAS 114 requires that if a loan's contractual interest rate varies based on subsequent changes in an independent factor, such as an index or rate (for example, the prime rate, the London interbank offered rate (Libor), or the U.S. Treasury bill rate weekly average), the loan's effective interest rate may be calculated based on the factor as it changes over the life of the loan or be fixed at the rate in effect at the date the loan meets the impairment criterion. This method used shall be applied consistently for such loans. Further, projections of future changes in the factor should not be considered when determining the effective interest rate or estimate of expected future cash flows.

For most retail loan TDRs, the present value of expected future cash flows will be the method to use since the loans are not collateral dependent upon modification, and obtaining a market price for the loan is usually not practicable. If impairment is measured using an estimate of the expected future cash flows, the interest rate used to discount the cash flows (i.e., present value) is based on the *original effective interest rate* on the loan and not the rate specified in the restructuring agreement. If the present value of the modified terms is less than the recorded investment in the loan, bank management must include the difference in their ALLL analysis.

For practical reasons and as allowed in SFAS 114, pools of smaller-balance homogeneous TDRs (generally retail loans) could be reviewed on a pooled basis. Some impaired loans have risk characteristics unique to an individual borrower, and the bank should apply one of the three measurement methods noted above on a loan-by-loan basis. However, some impaired loans may have risk characteristics in common with other impaired loans. A bank may aggregate those loans and may use historical statistics, such as average recovery period and average amount recovered, along with a composite effective interest rate to measure impairment of those loans. In certain circumstances, grouping retail TDR loans together to measure impairment may help banks arrive at the best estimate of expected future cash flows.

Question 28: (December 2008)

How is the ALLL amount for TDRs established under SFAS 114?

Staff Response:

If the SFAS 114 measurement of a TDR is less than the recorded investment in the loan, impairment is typically recognized by adjusting the existing ALLL for the difference with a corresponding charge to “Provision for Loan and Lease Losses.”

Question 29: (December 2008)

Should retail loans that are TDRs be placed on nonaccrual status and reported on RC-N?

Staff Response:

It depends. If the bank does not expect payment in full of both principal and interest, then the loan may be put on nonaccrual status. If the loan is carried on nonaccrual status, it is reported in RC-N. However, banks may apply other alternative methods of evaluation (e.g., establish an “interest and fee” contra asset or valuation allowance against the accrued interest receivable reported in other assets) for retail loans to assure that the bank’s net income is not materially overstated. If that method is used, the loans would not be included as nonaccrual loans in RC-N, but the methods being used should assure that the bank is not overstating interest income. However, if the loans are not placed on nonaccrual status, but are past due 30 days or more and still accruing under their modified terms, they should be included in RC-N in the appropriate past due column (i.e., 30 through 89 days or 90 days or more, as appropriate).

Facts:

In 2005, a 2/28 hybrid ARM loan is made to a borrower with an initial rate of 5 % and a scheduled reset to $\text{Libor} + 2\%$ as of September 1, 2007. In August 2007, while the loan is still at the initial rate of 5%, the lender becomes aware that the borrower can not make payments at the reset rate. As of August 2007 Libor is 6%, so the loan’s interest rate is expected to increase

to 8%. Because of the borrower's financial difficulty, the bank agrees to modify the terms of the loan at a fixed rate of 6% until maturity, which is below the current market rate for a loan in this risk category.

Question 30:

(December 2008)

Is it acceptable for the bank to use the 5% initial rate as the effective interest rate to calculate the present value of the modified terms of this loan?

Staff Response:

No. The SFAS 114 analysis should reflect the "concession" made (i.e., the lost interest) since this interest rate modification results in the loan being considered a TDR. The effective interest rate for calculating the present value of the modified terms is not the 5% initial rate. Instead, the effective interest rate should be a blend of the 5% rate over the term of the initial period and the scheduled 8% reset rate for the remaining 28 years of the loan. In addition, shortcut methods may be used for the original effective rate calculation that may not result in a material difference from the blended rate (e.g., a bank may decide to use the full reset rate of 8%).

With respect to the reset rate, SFAS 114 does not allow projected changes in the independent factor, in this case Libor, to be considered in calculating the effective interest rate; thus, the 8% rate during the reset period is the current Libor, 6%, plus 2%.

Facts:

Bank X has a fixed rate mortgage from Borrower A in its held for investment portfolio. Borrower A's mortgage is part of a portfolio of mortgages that are evaluated collectively for impairment and for which an ALLL has been established even though no specific loan has been identified as impaired. Borrower A is having difficulty making payments. Bank X has determined that it is in the bank's best interest to modify Borrower A's loan by lowering the interest rate from 7% to 6%. The 6% rate is lower (i.e., not market) than the rate the bank would typically charge a borrower with similar credit risk as Borrower A. The lower interest rate results in a payment of \$603.56 per month. Because of this interest rate concession, the loan is a TDR and subject to SFAS 114. The terms of the original loan and the modified loans are as follows:

Original loan terms:		Modified loan terms:	
Payment: \$665.30	Paym	ent: \$603.56	
Interest Rate: 7 %		Interest Rate: 6%	
Remaining Term: 27 years		Remaining Term: 27 years	
Loan Balance: \$96,727	Loan	Balance: \$96,727	

Present value of payments of \$603.56 discounted at the original rate: \$87,750.

For simplicity, the treatment of any accrued interest receivable is not considered in this example.

Question 31:

(December 2008)

How is the impairment calculated?

Staff Response:

In practice, assumptions about collectibility should be incorporated into the estimation of expected cash flows. In this example, for ease of calculation and presentation, it is assumed that the expected cash flows for the loan are the \$603.56 per month for the entire remaining term of the mortgage and no defaults occur. Under this approach, the present value of payments of \$603.56 discounted at the original rate is \$87,750.

The present value of the modified loan's expected cash flows discounted at the original interest rate of \$87,750 is less than the current loan balance of \$96,727. The difference of \$8,977 is the SFAS 114 measurement of impairment. Whether or not an additional "Provision for Loan and Lease Losses" amount would need to be recognized for this loan would depend on the bank's ALLL analysis. For example, if the balance in the ALLL is no longer appropriate after including the \$8,977 in the ALLL analysis, the bank would need to increase the ALLL through an increase in the Provision for Loan and Lease Losses.

Question 32:

(December 2008)

When would a charge-off be required at the time of the restructuring for a commercial loan?

Staff Response:

Although the restructuring should have improved the collectibility of the loan in accordance with a reasonable repayment schedule, it does not relieve bank management from their responsibility to promptly and appropriately risk rate the credit and charge-off all identified losses. If a portion of the TDR loan is uncollectible (including forgiveness of principal), the uncollectible amount should be charged off against the ALLL at the time of the restructuring.

The credit quality of restructured commercial loans should be regularly reviewed. The bank should periodically evaluate the collectibility of the restructured loan to determine whether additional amounts, if any, should be recorded to or charged off through the ALLL. In addition, bank management should disclose material information about the TDR in their GAAP financial statements.

2B. NONACCRUAL LOANS

Facts:

The bank made an equipment loan and advanced funds in the form of an operating loan. Both loans have been placed on nonaccrual status, and a portion of the equipment loan has been charged off. The loan balances are classified, and doubt as to full collectibility of principal and interest exists.

Question 1:

(September 2001)

Can a portion of the payments made on these loans be applied to interest income?

Staff Response:

No. Interest income should not be recognized. The instructions to the call reports require that, when doubt exists about the ultimate collectibility of principal, wholly or partially, payments received on a nonaccrual loan must be applied to reduce principal to the extent necessary to eliminate such doubt.

Placing a loan in a nonaccrual status does not necessarily indicate that the principal is uncollectible, but it generally warrants revaluation. In this situation, because of doubt of collectibility, recognition of interest income is not appropriate.

Facts:

Assume the same facts as in question 1, except that cash flow projections support the borrower's repayment of the operating loan in the upcoming year. However, collectibility of the equipment loan is in doubt, because of the borrower's inability to service the loan and insufficient collateral values.

Question 2:

Can the bank accrue interest on the operating loan, even though the equipment loan remains on nonaccrual status?

Staff Response:

Loans should be evaluated individually. However, the borrower's total exposure must be considered before concluding that doubt has been removed over the collectibility of either loan. Additionally, the analysis should consider a time period beyond the first year.

Projections indicate that the borrower will be able to service only one of the loans for one year. Therefore, doubt still exists about total borrower exposure over the long term. Accordingly, interest recognition generally is inappropriate.

Facts:

The bank has a loan on nonaccrual, and a portion of the principal has been charged off. The remaining principal has been classified as substandard, because of the borrower's historical

nonperformance and questionable ability to meet future repayment terms. Collateral values covering the remaining principal balance are adequate.

Question 3:

(September 2001)

Since the collateral is sufficient, can payments be applied to income on the cash basis?

Staff Response:

In determining the accounting for individual payments, the bank must evaluate the loan to determine whether doubt exists about the ultimate collectibility of principal. The overall creditworthiness of the borrower and the underlying collateral values should be considered. For example, doubt about collectibility of troubled loans often exists when regular payments have not been made, even when a loan is fully collateralized. Collateral values are not sufficient, by themselves, to eliminate the issue of ultimate collectibility of principal.

When the bank can demonstrate doubt about the ultimate collectibility of principal no longer exists, subsequent interest payments received may be recorded as interest income on the cash basis. Banks may record the receipt of the contractual interest payment on a partially charged-off loan by allocating the payment to interest income, reduction of principal, and recovery of prior charge-offs. Banks may also choose to report the receipt of this contractual interest as either interest income, reduction of principal, or recovery of prior charge-offs, depending on the condition of the loan, consistent with other accounting policies that conform to GAAP.

Facts:

A loan is currently on nonaccrual status as a result of being delinquent in principal and interest payments for a period exceeding 90 days. The estimated uncollectible portion of the loan has been charged off. The remaining balance is expected to be collected.

Question 4:

Since the recorded balance of the loan is expected to be collected in full, can it be returned to accrual status?

Staff Response:

No. The Glossary instructions to the call report preclude the accrual of interest for any asset for which full payment of contractual interest or principal is not expected. Therefore, accrual of interest on the loan would not be appropriate.

Facts:

A bank purchases a loan with a face value of \$100,000. Because of the risk involved and other factors, the loan is purchased at a substantial discount of \$50,000. The loan is on nonaccrual status. The bank renegotiates the loan with the borrower. The new loan has a face value of \$125,000, and the borrower receives \$25,000 of new funds. In return, the borrower pledges additional collateral, the value of which is sufficient to support the face amount of the new loan.

Question 5:
2005)

(April

Upon refinancing the loan, may the bank record a \$50,000 gain (the amount of the discount)?

Staff Response:

No, it is not appropriate to recognize any gain on this refinancing. Further, the loan should remain on nonaccrual status until the borrower has demonstrated the ability to comply with the new loan terms.

Facts:

A bank has two loans to a real estate developer for two different projects. Loan A is secured by a fully leased office building. The collateral value exceeds the loan obligation. Loan B is secured by an apartment building with relatively few units leased to-date. A collateral shortfall exists relative to the loan obligation. The obligors are separate corporations wholly owned by the developer. However, there is no cross-collateralization of the notes and no personal guarantees by the developer. Loan A is current and the bank expects to be repaid in full as to principal and interest. Cash flows from the project's rentals are adequate to fully service principal and interest. Loan B is placed on nonaccrual status because of cash flow deficiency and collateral shortfall. An appropriate allowance has been recorded in accordance with SFAS 114.

Question 6:

Must the bank automatically place both loans to the borrower on nonaccrual status when one loan becomes nonaccrual?

Staff Response:

No, not automatically. When one loan to a borrower is placed on nonaccrual, a bank should examine the surrounding circumstances to determine whether its other loans to that borrower should be placed on nonaccrual.

In this case, the two loans are not linked legally. Although these loans comprise the bank's total relationship with a single real estate developer, they are actually two separate obligations having no personal guarantee by the developer and no cross-collateralization. Accordingly, the collectibility of each loan should be evaluated separately. Because Loan A is current and is expected to be repaid in full, it may remain on accrual status.

Question 7:

The bank subsequently negotiates a cross-collateralization agreement with the developer. Must Loan A also be placed on nonaccrual status?

Staff Response:

The cross-collateral agreement alone should not stop interest accrual on Loan A. The bank has merely taken steps to improve its relative position with the borrower. Thus, to the extent that cross-collateralization does not change the repayment pattern of the notes or endanger Loan A's

full repayment in due course, Loan A can remain on accrual status, even if Loan B is on nonaccrual status.

Facts:

Loans A and B are related to separate real estate projects of a borrower and are not cross-collateralized. Loan A is fully performing and has expected cash flows sufficient to repay in full. The cash flows from Project B are, and clearly will be, insufficient to repay Loan B in full. The bank has an obligation to fund additional monies on Project B. Because Project A had sufficient equity, additional funding was provided by a second mortgage, Loan C, on Project A. However, because of current economic conditions, the cash flows from Project A can no longer keep Loan C current. The debt service required on Loans A and C combined exceeds available cash flows. Also, the loan-to-value ratio on this project exceeds 100 %. An appropriate allowance has been recorded under SFAS 114.

Question 8:

Can Loan A remain on accrual status?

Staff Response:

Neither Loan A or C should be on accrual status. Senior and junior liens on the same property generally should be considered as one loan. Regardless that Project A can fully support and repay the original Loan A, it may not be able to repay both Loans A and C. Accordingly, until *both* Loans A and C are current and fully expected to be repaid, they both must be placed on nonaccrual status.

Facts:

Loans A and B are related to separate real estate projects of a borrower and were cross-collateralized initially. Loan A is fully performing and has expected cash flows sufficient to repay in full. The cash flows from Project B are, and clearly will be, insufficient to repay Loan B in full. But Project A has excess cash flows to meet the shortfall on Project B to provide for the debt service shortfall on Loan B and to ensure its full contractual collectibility. The developer can and does use these funds to keep Loan B current.

Question 9:

Can both Loans A and B be reported as accruing loans?

Staff Response:

Yes. The borrower has made this possible by making the excess cash flow and equity of Project A available to service and fully repay Loan B. The borrower services debt obligations to the bank as if they were one, i.e., using any available funds to keep both obligations current. The bank should assess the accrual status by comparing the aggregate cash flows available from all repayment sources with the combined obligation.

In this situation, both Loans A and B can stay on accrual status if the combined cash flows from primary and secondary sources are considered adequate and remain available to meet fully the combined contractual obligations, and the loans remain current.

Facts:

Loans A and B are related to separate real estate projects of a borrower and were cross-collateralized initially. Project A has the cash flows to repay Loan A in full, but no excess to meet the shortfall in Project B. Accordingly, Project B is past due.

However, in this case, the developer has not dedicated cash flows from Project A to the timely repayment of Loan A. The developer has used available cash at its discretion to make periodic payments on Loan B and other obligations. Loan A is less than 90 days past due, but would be current if the developer applied all Project A cash flows to Loan A. An appropriate allowance has been recorded under SFAS 114.

Question 10:

Can Loan A be maintained on accrual status?

Staff Response:

No, both loans should be placed on nonaccrual status. In this instance, the total obligation of the developer should be evaluated to consider the total cash flows. The developer effectively handles these two loans as one obligation. The relative equity of the developer in each property and its value to the developer drive the debt service. Because, in this example, the combined available cash flows are not likely to be sufficient to repay the combined principal and interest due on Notes A and B, both loans should be placed on nonaccrual.

Facts:

Same facts as in question 10, except that the developer has personally guaranteed both notes and provides a significant source of outside cash flow.

Question 11:

Must both notes be placed on nonaccrual status?

Staff Response:

No, not necessarily. If the developer can and intends to meet the debt service requirements of both notes, the bank could leave both loans on accrual status.

If the developer has some financial capability, but is unlikely to be able to support both notes, they both should be placed on nonaccrual. Because the notes are cross-collateralized, collectibility must be evaluated on a combined basis. Furthermore, the developer, as guarantor on both notes, is the ultimate source of repayment for the total debt. Thus, placing only Note B on nonaccrual would not reflect properly the fact that the collectibility of the entire debt, not only Note B, is in doubt.

Facts:

Loans A and B are related to separate real estate projects of a borrower and were cross-collateralized initially. Project A has the cash flows to repay Loan A in full, but no excess to make up the shortfall in Loan B. In the aggregate, the combined cash flows of Projects A and B

are not likely to repay the outstanding principal and interest in full on both loans. But, Loan A is current and has a consistent dedicated source of repayment. Although Loan B is both collateral and cash flow deficient, the bank asserts that the cross-collateralization of the loans is unlikely to hinder the ability of Loan A to be repaid fully according to the contractual terms. An appropriate allowance on Note B has been recorded under SFAS 114.

Question 12:

Can Loan A be maintained on accrual status?

Staff Response:

Possibly. However, the assertion that cross-collateralization of the loans will not affect the orderly and contractual repayment of Loan A must be supported. Support would include the existing lender-borrower relationship and the bank's history in working with troubled borrowers. This includes the current likelihood of the lender to work with the borrower to avoid foreclosure or of the borrower to take steps to cure Loan B and preserve some equity in Project A. If facts exist to support the bank's assertion that the timely and complete repayment of Loan A will proceed in due course, Loan A can remain on accrual status.

Facts:

A bank takes a partial charge off on a loan because it believes that part of the obligation will be uncollectible ultimately. The loan is also placed on nonaccrual status. One year later, with two years remaining in the loan term, the borrower's financial condition improves dramatically. The loan is brought contractually current, and the bank now fully expects to collect the original contractual obligation, including the amount previously charged off.

Question 13:

Can the loan be returned to accrual status?

Staff Response:

Yes. If the doubt about full collectibility, previously evidenced by the charge off, has been removed, the loan meets the call report definition for return to accrual status.

Facts:

A loan with a borrower is past due in principal and interest. The bank takes a partial charge off on the loan because it believes that it will be unable to collect part of the obligation. The loan is also placed on nonaccrual status. One year later, the borrower's financial condition improves dramatically. The borrower has made regular monthly payments and is paying additional amounts to reduce the past due amount. However, although the bank now fully expects to collect the original contractual obligation, including the amount previously charged off, the loan is not yet contractually current.

Question 14:

(September 2001)

Can this loan be returned to accrual status?

Staff Response:

Yes. A loan, on which the borrower has resumed paying the full amount of the scheduled contractual obligation, may be returned to accrual status, even though it has not been brought fully current if: (a) all principal and interest amounts contractually due are reasonably assured of repayment within a reasonable period of time; and, (b) there is a sustained period of repayment performance by the borrower.

Facts:

A bank placed a loan on nonaccrual status because the borrower's financial condition has so deteriorated that it does not expect full repayment of contractual principal and interest. Simultaneously, the bank reversed previously accrued and unpaid interest in accordance with the call report instructions. The bank's credit evaluation concludes that no charge-off of principal is necessary. However, because of doubt about collectibility, certain interest payments were applied to reduce principal.

One year later the borrower's financial condition has improved. During the past year some principal and interest payments have been made, and although the loan is not yet contractually current, the bank now expects full payment of contractual principal and interest. Accordingly, the bank no longer has any doubt about the full repayment of all amounts contractually due.

Question 15:

(September 2001)

Can the bank, either now or when the loan is brought contractually current, reverse the application of interest payments to principal?

Staff Response:

No. Application of cash interest payments to principal was based on a determination that principal may not be recovered. It should not be reversed when that determination changes. The staff believes that in those situations, the previously foregone interest should be recognized as interest income when received.

The staff also disagrees with reversing the application of interest payments to principal in those cases, because such treatment is analogous to using a "suspense account" to record interest payments when doubt exists about the collectibility of recorded principal.

If the loan eventually returns to accrual status, interest income would be recognized based on the effective yield to maturity on the loan. This effective interest rate is the discount rate that would equate the present value of the future cash payments to the recorded amount of the loan. This will result in accreting the amount of interest applied to principal over the remaining term of the loan.

Facts:

A bank has a \$500,000 loan, of which \$400,000 is classified doubtful and \$100,000, as substandard. A \$10,000 payment, designated by the borrower as interest, is received. The bank applies \$8,000 to reduce principal and \$2,000 as interest income on the premise that this proration reflects the collectibility of the differently classified portions of the loan.

Question 16:

Is this an acceptable treatment?

Staff Response:

No. Because doubt exists about the ultimate collectibility of the recorded loan balance, all payments must be applied to reduce principal until such doubt is removed.

Facts:

A loan is guaranteed by the U.S. government (or a government-sponsored agency). The guarantee covers 90% of the principal and interest. The borrower experiences financial difficulty and is past due more than 90 days on loan payments. Collection of the guaranteed portion is expected. However, collection of the unguaranteed portion is uncertain.

The bank proposes to place 90% of the loan (the guaranteed portion) on accrual status and classify the remaining 10% as nonaccrual. Interest income would also be recognized accordingly.

Question 17:

Is the proposed accounting treatment that would place the guaranteed portion of the loan on accrual status and recognize interest income thereon acceptable?

Staff Response:

No. The call report instructions require that accrual of interest income cease on a loan when it is 90 days or more past due, unless it is both well secured and in the process of collection. These Instructions apply to the remaining *contractual* obligation of the borrower. In this situation, collection of the full contractual balance is not expected. Accordingly, the entire loan must be placed on nonaccrual status.

Question 18:

In determining when a loan is “in the process of collection,” a 30-day collection period has generally been applied. Is this 30-day collection period intended as a benchmark or as an outer limit?

Staff Response:

The 30-day period is intended as a benchmark, not as an outer limit. Each loan must be evaluated separately when determining whether it should be considered “in the process of collection.” When the timing and amount of repayment is reasonably certain, a collection period of greater than 30 days should not prevent a loan from being considered to be “in the process of collection.”

Facts:

A bank placed a loan on nonaccrual status, because the borrower’s financial condition had deteriorated and it did not expect full repayment of contractual principal and interest. Accrued

interest was reversed and, as a result of the bank's credit evaluation, a charge-off of principal was recorded.

However, one year later the borrower's financial condition has improved greatly, and the bank expects to recover all amounts contractually due.

Question 19:

(December 2008)

Can the bank reverse the charge-off and rebook the principal and accrued interest?

Staff Response:

No. The decision to place the loan on nonaccrual indicates that there was doubt about full collection of principal and interest. The charge-off was based on management's determination that recovery of the principal was not expected. The reversal of the interest was based on the determination that the accrued interest may not be collected. The determination of collectibility is an accounting estimate as defined by SFAS 154. SFAS 154 requires changes in accounting estimates to be accounted for in the period of change and future periods when the change affects both. Accordingly, payments would be accounted for in accordance with GAAP, and recoveries recorded as received. This would apply to both principal and interest payments.

Facts:

A bank pursues collection efforts on a past due loan by a state mandated mediation process. The state requires mediation before banks may foreclose on real estate. Sufficient collateral exists to support all contractual principal and interest. The call report instructions indicate an asset is "in the process of collection" if collection of the asset is proceeding in due course through legal action, including judgment enforcement procedures.

Question 20:

(June 2003)

Can this loan remain on accruing status because it is "in process of collection"?

Staff Response:

No. The meaning of "in process of collection" requires that the timing and amount of repayment be reasonably certain. The definition entails more than initiating legal action or pursuing a well-reasoned plan for collection. The commencement of collection efforts, plans to liquidate collateral, ongoing workouts, foreclosing on or repossessing collateral, restructuring or settlement do not, in and of themselves, allow a loan to meet the definition. There must be evidence that collection in full of amounts due and unpaid will occur shortly.

The same reasoning applies to a mandated mediation process, which may be part of a well-documented plan of liquidation. In actuality, the mediation process will likely prolong the collection process and infuse additional uncertainty into the timing and amount of repayment.

Facts:

A bank has designated a loan of \$200,000 in nonaccrual status. The bank had previously accrued late fees of \$500 prior to the loan's designation in nonaccrual status.

Question 21:

(June 2003)

Is it permissible for the bank to continue to accrue late fees on a loan that has been designated in nonaccrual status?

Staff Response:

No. Loan fees, including late fees, should not be accrued on a loan designated in nonaccrual status. Since the loan was placed on nonaccrual because of the uncertainty of future payments on principal and interest, it is the staff's position that other expected payments from the borrower are also uncertain.

Question 22:

(June 2003)

How should the late fee receivable of \$500 be accounted for because of this uncertainty?

Staff Response:

As set forth in the call report instructions for previously accrued interest, one acceptable accounting treatment includes a reversal of all previously accrued, but uncollected, amounts applicable to assets placed in a nonaccrual status against appropriate income and balance sheet accounts. Hence the late fees that are also accrued, but uncollected, should also be reversed. This would also apply to any other fees that may have been accrued on this loan.

Facts:

A bank has a \$150,000 loan secured by a single-family residence with an estimated fair value of \$200,000 based on a recent appraisal. The loan is 110 days past due. The mortgage loan agreements allow the bank to pay delinquent real estate taxes and add the amount to the contractual balance of the loan. Accordingly, the bank paid \$4,000 in delinquent property taxes and added this amount to the contractual balance due from the borrower per the terms of the agreement. The bank has sent the borrower a demand letter advising that if the note is not brought current within the next 30 days, the bank will begin foreclosure proceedings on the property.

Question 23:

(April 2005)

May the bank capitalize the \$4,000 paid for the delinquent property taxes?

Staff Response:

Yes. As long as the recorded balance of the loan does not exceed (a) the amount contractually owed by the borrower and (b) the fair value of the collateral less estimated costs to sell, the bank may capitalize the \$4,000 in out-of-pocket costs for the delinquent property taxes.

Facts:

Certain sections of the country were devastated by two major category hurricanes. Many banks doing business in the affected areas renegotiated the repayment terms of specific loans for customers in the affected areas. These renegotiations took various forms.

Some banks engaged in programs to provide temporarily borrowers affected by the hurricanes additional flexibility in repaying loans. For example, the bank may have encouraged consumer and small business borrowers that were affected by the hurricanes to contact the bank to work out new repayment arrangements (e.g., waiving late fees and deferring interest and principal payments for a short period of time, such as 30 - 90 days). Other banks may have provided similar repayment arrangements across-the-board to all borrowers in the affected area.

Banks may also be working with certain commercial borrowers affected by the hurricanes to provide additional flexibility in repaying loans. In this regard, some banks renegotiated the repayment terms of specific loans with such borrowers, based on their current situation and ability to repay.

Question 24: (May 2006)

How should loans subject to such renegotiated terms be reported for past due status?

Staff Response:

Past due reporting status of loans affected by the hurricanes should be determined in accordance with the contractual terms of a loan as its terms have been renegotiated or revised under a temporary payment deferral program, either as agreed to with the individual borrower or provided across-the-board to all affected borrowers. Accordingly, if all payments are current in accordance with the revised terms of the loan, the loan would not be reported as past due.

Furthermore, for loans subject to a payment deferral program on which payments were past due prior to the hurricanes, the delinquency status of the loan may be adjusted back to the status that existed at the date of the applicable hurricane (i.e., “frozen”) for the duration of the payment deferral period.

Question 25: (May 2006)

Should commercial loans subject to such renegotiated terms be placed on nonaccrual status?

Staff Response:

Not necessarily. In general, banks shall not accrue interest on any commercial loan: (1) which is maintained on a cash basis because of deterioration in the financial condition of the borrower, (2) for which payment in full of principal or interest is not expected, or (3) upon which principal or interest has been in default for a period of 90 days or more, unless the loan is both well secured and in the process of collection. Accordingly, if interest or principal has been waived on a commercial loan, the loan generally should be placed on nonaccrual status.

However, if interest or principal has been deferred (i.e., no payments are required during the deferral period), but not waived, judgment should be used to determine whether the loan should be placed on nonaccrual status (e.g., by evaluating whether or not full payment of principal and interest is expected).

Question 26: (May 2006)

May interest income be recognized while the loan is on nonaccrual status?

Staff Response:

While a commercial loan is in nonaccrual status, some or all of the cash interest payments received may be treated as interest income on a cash basis as long as the remaining book balance of the loan (i.e., after charge-off of identified losses, if any) is deemed to be fully collectible.

Facts:

The borrower on a commercial loan filed for Chapter 11 bankruptcy more than 90 days ago. The bankruptcy filing delays any collection activity by creditors until approved by the court. However, the loan agreement defines bankruptcy as an event of default. Because the loan is in default, the loan maturity is accelerated to the date of the bankruptcy filing.

Prior to confirmation of a bankruptcy plan, the bankruptcy court required that payments adequate to cover the interest be made to the lender. However, the collection of principal is delayed and the loan remains in default.

Question 27:

(January 2007)

Should this loan be placed on nonaccrual status, even though interest is being paid and principal collections have been delayed by the bankruptcy court?

Staff Response:

Yes. As a result of the default provisions, the due date on this loan is the date of the bankruptcy filing. As long as the loan is 90 days or more past due and not in the process of collection, the loan should be classified as nonaccrual. Further, because of the uncertainty about this loan and bankruptcy filing, it may have been appropriate to place this loan on nonaccrual prior to it being 90 days delinquent.

Question 28:

(December 2008)

What is the accounting for a purchased loan that was classified by the previous owner as nonaccrual and for which cash flows cannot be reasonably estimated under AICPA Statement of Position 03-3 (SOP 03-3)?

Staff Response:

The SOP does not prohibit placing (or keeping) loans on nonaccrual. At inception or thereafter, the bank may place a purchased loan on nonaccrual, if the conditions in paragraph 6 of the SOP are met. Generally, this would require that the loan be placed on nonaccrual when it is not possible to reach a reasonable expectation of the timing and amount of cash flows to be collected on the loan. This response is consistent with the AICPA's Technical Questions and Answers, Section 2130.

Facts:

A loan is classified as nonaccrual by a seller because the debtor was not meeting its obligations under the loan's contractual terms. That loan is sold to a bank who determines that the loan meets the requirements of SOP 03-3.

Question 29:

(December 2008)

If the purchasing bank can reasonably estimate cash flows, should the bank classify the loan as an accruing loan?

Staff Response:

Yes, if the bank can reasonably estimate cash flows, it should recognize an accretable yield and report the loan as an accruing loan (see paragraph 6 of the SOP). This paragraph requires that the loan be placed on accrual status when the bank can reach a reasonable expectation about the timing and amount of cash flows to be collected on the loan. This response is consistent with the AICPA's Technical Questions and Answers, Section 2130.

Facts:

Assume instead that the bank cannot reasonably estimate cash flows and, therefore, follows the cost recovery method on the loan. The loan has been brought current for a period of time.

Question 30:

(December 2008)

Can the bank return the loan to accrual status and account for the loan as a new loan?

Staff Response:

If the loan was within the scope of the SOP when it was purchased, it is not accounted for as a new loan but is always accounted for in accordance with the SOP, even if its performance improves. However, as discussed in question 29, the loan should be accruing income whenever the bank can reasonably estimate cash flows. Also, if the currently expected cash flows exceed the originally expected cash flows, the SOP requires that income be recognized using the updated cash flow estimates, which may result in recognizing income at a higher yield than originally expected. This response is consistent with the AICPA's Technical Questions and Answers, Section 2130.

2C. COMMITMENTS

Facts:

A bank has off-balance sheet financial instruments, such as commitments to extend credit, guarantees, and standby letters of credit that are subject to credit risk. These financial instruments are off-balance sheet in accordance with GAAP and are not considered to be derivatives under Statement of Financial Accounting Standards No. 133 (SFAS 133). The bank evaluates and estimates the credit losses associated with these off-balance sheet instruments. In some instances the counterparty to the off-balance sheet instrument is also a borrower of the bank.

Question 1:

(September 2004)

Should the bank record a provision for credit losses on off-balance sheet financial instruments, such as standby letters of credit, to the ALLL or to a separate liability account?

Staff Response:

In accordance with the American Institute of Certified Public Accountant's (AICPA) Audit and Accounting Guide for Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies and the call report instructions, credit losses related to off-balance sheet financial instruments, such as standby letters of credit, should be accrued and reported separately as liabilities and not reported in the allowance for loan and lease losses (ALLL). This is the appropriate treatment even if the counterparty of the off-balance sheet financial instrument is also a borrower of the bank. However, GAAP stipulates that the recognition of the provision for losses must meet the criteria set forth in the Statement of Financial Accounting Standards No. 5 (SFAS 5), which requires recognition of a loss if the loss is both probable and the amount reasonably estimable. The AICPA's guidance also notes that the methodology used for evaluating "loan losses" may be useful in evaluating and estimating credit losses for these off-balance sheet financial instruments.

Question 2:

(February 2004)

Can the bank include the liability for off-balance sheet credit exposure in Tier 2 capital for risk-based capital purposes?

Staff Response:

Yes. Previously, the ALLL included a component for credit exposure related to off-balance sheet instruments. Accordingly, the risk-based capital requirements have been revised so that banks may continue to include this liability for off-balance sheet credit exposure in Tier 2 capital (subject to specified limitations), as had been previously allowed. From a risk-based capital perspective, this is not a policy change, but rather a continuation of previous requirements.

Question 3:

(December 2008)

How should the bank account for losses on off-balance sheet loan commitments?

Staff Response:

As noted in question 1, SFAS 5 requires recognition of a loss when the loss is both probable and the amount reasonably estimable. When the bank must fund the commitment and does not expect the counterparty to repay the resulting loan, the requirements of SFAS 5 are met. In this situation, the bank must recognize the loss and record a liability to a separate liability account for the expected obligation. The bank cannot wait until the counterparty actually exercises the commitment to record the loss.

A bank must report its “allowance for credit losses on off-balance sheet credit exposures” as an “other liability” and not as part of its “allowance for loan and lease losses.” The provision for credit losses on off-balance sheet credit exposures is reported as “other noninterest expense.”

Facts:

A bank has off-balance-sheet financial instruments, such as commitments to extend credit to commercial customers and on home equity lines of credit for which the bank has charged a commitment fee or other consideration. Under the terms of the agreement, the bank is obligated to fulfill any draws made by the borrower on those commitments.

The bank also has commitments to extend credit that are cancelable at any time at the bank’s discretion. An example is the credit lines in the bank’s credit card portfolios. Although the credit lines are cancelable at any time, the bank typically fulfills charges or draws by the borrower on these credit lines. Further, because borrowers with financial difficulty may draw down most or all of their credit line prior to the bank identifying these difficulties, these lines often are substantially funded.

Question 4:

(April 2005)

When evaluating and estimating the credit losses associated with off-balance sheet instruments, should the bank include these commitments that are cancelable at the bank’s discretion?

Staff Opinion:

Yes. If it is probable a bank will fund these commitments, regardless of whether they are cancelable, then these commitments should be included in the bank’s written analysis. A bank’s willingness to fund these commitments will vary and will be evaluated based on historical experience of the bank’s practices and procedures.

SFAS 5 requires recognition of a loss contingency when the loss is both probable and the amount reasonably estimable. In this situation, the bank may conclude that it has a loss contingency because it typically funds these commitments and does not expect all of these amounts to be repaid. Accordingly, the requirements of SFAS 5 are met. As noted in question 1, these SFAS 5 loss contingencies associated with off-balance sheet financial instruments are required to be reported separately as other liabilities and are not included in the ALLL.

Question 5:

(October 2005)

Under what circumstances would a loan commitment be recorded as a derivative in accordance with SFAS 133?

Staff Response:

SFAS 133 defines a derivative as a financial instrument or other contract with the following characteristics: (1) it has one or more underlyings and one or more notional amounts, (2) it requires little or no initial net investment, and (3) its terms require or permit net settlement or the equivalent thereof. Loan commitments typically satisfy characteristics (1) and (2). However, certain loan commitments may meet the net settlement provisions required by characteristic (3) and others may not.

SFAS 133, as amended by Statement of Financial Accounting Standards No. 149 (SFAS 149), provides additional guidance for accounting for loan commitments as derivatives. It states that, notwithstanding the derivative characteristics noted above, potential lenders shall account for loan commitments related to the origination of mortgage loans that will be held for sale as derivatives.

SFAS 133, as amended, also provides scope exceptions for commitments to originate mortgage loans that will be held for investment and for commitments to originate other types of loans (i.e., other than mortgage loans). Therefore, loan commitments not related to the origination of mortgage loans that will be held for sale are not subject to SFAS 133 and are not accounted for as derivatives. Rather, these commitments should be reported as “unused commitments” in the call report.

Question 6:

(December 2008)

What is the accounting for commitments to originate mortgage loans?

Staff Response:

Commitments to originate mortgage loans that will be held-for-sale are derivatives under SFAS 133, as amended by Statement of Financial Accounting Standards No. 149 (SFAS 149). They must be accounted for at fair value on the balance sheet by the issuer, with changes in fair value recorded in current period earnings. Commitments to originate mortgage loans that will be held-for-investment are not accounted for as derivatives and therefore are not recorded at fair value, unless the bank has elected to apply the fair value option.

The initial fair value of a derivative loan commitment should be determined in accordance with SFAS 157. SFAS 157 nullified prior guidance in EITF 02-3 that precluded immediate recognition in earnings of an unrealized gain or loss, measured as the difference between the transaction price and the fair value of the instrument at initial recognition, if the fair value of the instrument was determined using significant unobservable inputs. See Topic 11D for a discussion of SFAS 157.

Question 7:

(October 2005)

How should a bank subsequently account for a loan commitment related to the origination of a mortgage loan that will be held for sale (i.e., a derivative loan commitment)?

Staff Response:

Subsequent changes in the fair value of a derivative loan commitment should be recognized in financial statements and call reports (e.g., changes in fair value attributable to changes in market

interest rates). Any such changes in fair value are included in earnings in the periods in which the changes occur.

A bank should report a derivative loan commitment at fair value as an “other asset” or an “other liability” in its call report based upon whether the individual commitment has a positive (asset) or negative (liability) fair value.

Question 8:

(December 2008)

How should a bank estimate the fair value of a loan commitment related to the origination of a mortgage loan that will be held for sale (i.e., a derivative loan commitment)?

Staff Response:

Observable market prices for derivative loan commitments generally are not available, as there is not an active market in which such commitments trade. As such, a bank generally will be required to estimate the fair value of these loan commitments using a valuation technique that considers current secondary market loan pricing information for comparable mortgage loans.

Based on the guidance in SEC Staff Accounting Bulletin No. 109 (SAB 109), the expected future cash flows related to the associated servicing of loans should be considered in recognizing derivative loan commitments. This is consistent with Statement of Financial Accounting Standards No. 156 (SFAS 156) and Statement of Financial Standards No. 159 (SFAS 159). However, SAB 109 also indicates that no other internally-developed intangible assets (such as customer relationship intangible assets) should be recognized as part of derivative loan commitments.

In estimating the fair value of a derivative loan commitment, a bank must also consider the probability that the derivative loan commitment will ultimately result in an originated loan (i.e., the “pull-through rate”). Estimates of pull-through rates should be based on historical information for each type of loan product adjusted for potential changes in market conditions (e.g., interest rates) that may affect the percentage of loans that will ultimately close.

Question 9:

(October 2005)

Is it appropriate for a bank to use a single pull-through rate in estimating the fair values of all its loan commitments related to the origination of mortgage loans that will be held for sale (i.e., derivative loan commitments)?

Staff Response:

No. The staff believes it would generally be inappropriate for a bank to use a single pull-through rate in estimating the fair values of all its derivative loan commitments.

Pull-through rates vary due to numerous factors including (but not limited to) the origination channel, the purpose of the mortgage (purchase versus refinancing), the stage of completion of the underlying application and underwriting process, and the time remaining until the expiration of the derivative loan commitment. As such, a bank should have sufficient granularity (i.e., stratification) in its pull-through rate assumptions to ensure that it appropriately considers the probabilities that its derivative loan commitments will result in originated loans.

Question 10:

(October 2005)

For call report purposes, how should pull-through rates be considered in reporting loan commitments related to the origination of mortgage loans that will be held for sale (i.e., derivative loan commitments)?

Staff Response:

As indicated in question 8, pull-through rates should be considered in estimating the fair values of derivative loan commitments to be reported in the call report. However, a bank should not consider pull-through rates when reporting the notional amount of derivative loan commitments in the call report. Rather, a bank must report the entire gross notional amount of derivative loan commitments.

Facts:

A bank maintains a mortgage operation that originates 1- 4 family residential mortgages to be sold in the secondary market under various loan programs. The bank chooses to hedge its mortgage pipeline (i.e., its loan commitments related to the origination of mortgage loans that will be held for sale) through the use of best efforts loan sale agreements.

Question 11:

(October

2005)

How should the bank account for this hedging strategy?

Staff Response:

As discussed in questions 5–7, loan commitments related to mortgage loans that will be held for sale are derivatives. These commitments should be reported at fair value on the balance sheet with changes in fair value included in earnings.

Best efforts loan sale agreements must be evaluated under SFAS 133 to determine whether the agreements meet the definition of a derivative (refer to the characteristics of a derivative in question 5). Best efforts loan sales agreements that meet the definition of a derivative should also be reported at fair value on the balance sheet with changes in fair value included in earnings.

Question 12:

(October 2005)

How should a bank account for a loan purchase agreement for 1- 4 family mortgage loans that are closed by a correspondent in the correspondent's name?

Staff Response:

Regardless of whether the bank intends to hold the mortgage loans to be purchased under the agreement for investment or resale, the bank must evaluate the characteristics of the loan purchase agreement to determine whether the agreement meets the definition of a derivative under SFAS 133 (refer to the characteristics of a derivative in question 5). Loan purchase agreements that meet the SFAS 133 definition of a derivative should be reported at fair value on the balance sheet.

Question 13:

(December 2008)

When must banks recognize the mark-to-market for commitments to purchase securities?

Staff Response:

Banks must recognize the change in fair value (mark-to-market) of a commitment to purchase a security when the commitment meets the SFAS 133 definition of a derivative. This also pertains when the bank has elected to account for the commitment at fair value under the SFAS 159 fair value option. Commitments to purchase securities are accounted for as derivatives when the contracts allow for net settlement or when the securities to be purchased are readily convertible to cash. For the securities to be considered readily convertible to cash, quoted prices must be available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price. Commitments to purchase securities that do not meet the accounting definition of a derivative are accounted for only at fair value when the bank has elected the fair value option or meets the criteria below.

For those commitments to purchase debt securities that are not accounted for at fair value, the bank should consider the guidance in EITF 96-11. EITF 96-11 states that changes in the fair value of forward contracts to purchase securities that will be accounted for as trading should be recognized in earnings as they occur. Changes in the fair value of forward contracts to purchase securities that will be accounted for as available-for-sale should be recognized in other comprehensive income unless the decline is considered other than temporary (in which case the loss would be recognized in income). Additionally, changes in the fair value of forward contracts to purchase securities that will be accounted for as held-to-maturity should not be recognized unless the decline is considered other-than-temporary.

2D. ORIGINATION FEES AND COSTS (including premiums and discounts)**Question 1:**

(September 2001)

Does a bank have to apply Statement of Financial Accounting Standards No. 91 (SFAS 91) if it does not charge loan origination fees?

Staff Response:

Yes. SFAS 91 requires that both net fees and costs be deferred and amortized. The fact that the failure to adopt SFAS 91 would lower income and lead to a “conservative” presentation does not relieve the bank of its obligation to comply with generally accepted accounting principles.

Question 2:

May a bank use average costs per loan to determine the amount to be deferred under SFAS 91?

Staff Response:

SFAS 91 provides for deferral of costs on a loan-by-loan basis. However, the use of averages is acceptable provided that the bank can demonstrate that the effect of a more detailed method would not be materially different. Usually, averages are used for large numbers of similar loans, such as consumer or mortgage loans.

Facts:

A bank purchases loans for investment. As part of those purchases, the bank incurs internal costs for due diligence reviews on loans that were originated by another party (the seller).

Question 3:

Can the bank capitalize these internal costs as direct loan origination costs?

Staff Response:

No. The bank’s investment in a purchased loan or group of purchased loans is the amount paid to the seller, plus any fees paid or less any fees received. Under SFAS 91, additional costs incurred or committed to purchase loans should be expensed. Furthermore, only certain direct loan origination costs should be deferred under SFAS 91. Because the loans have been originated already by the seller, additional costs incurred by the buyer do not qualify as direct loan origination costs.

Question 4:

SFAS 91 requires that loan origination fees and direct loan origination costs be deferred and accounted for as an adjustment to the yield of the related loan. How should these amounts be amortized for balloon or bullet loans?

Staff Response:

SFAS 91 was designed to recognize the effective interest over the life of the loan. In addition, accounting is based usually on the economic substance of a transaction when it differs from the

legal form. Therefore, the terms of the loan and the historical relationship between the borrower and the lender must be analyzed.

The net deferred fees should be amortized over a normal loan period for that type of loan, if the balloon repayment date is merely a repricing date. In such cases, additional fees to refinance the loan generally are not charged or are nominal in amount. In substance, the balloon loan is nothing more than a floating rate loan that reprices periodically.

On the other hand, if the bank prepares new loan documentation and performs a new credit review and other functions typical of funding a new loan, the old loan has essentially been repaid at that date. In this case a fee is often charged on the refinancing. As a result, the net deferred fees from the original loan should be amortized over the contractual loan period to the balloon date. This results because the lender has, in substance, granted a new loan to the borrower.

Question 5:

What period should be used to amortize fees and costs for credit card originations?

Staff Response:

Credit card fees and related origination costs should be deferred and amortized over the period that the cardholder is entitled to use the card. This is consistent with the FASB Implementation Guide for SFAS 91. Normally, the customer is entitled to use the credit card for a period of one to three years. In some cases the actual period of repayment on advances from the card may exceed that period. However, the amortization period is deemed to be the period that the cardholder can use the card, not the expected repayment period of the loan.

Facts:

A bank has an outstanding unfunded letter of credit. It originally determined the chances were remote that the letter of credit would be exercised. Accordingly, a portion of the commitment fees was recognized as income. However, all remaining fee income was deferred after the bank concluded that the underlying obligor's financial difficulties made it no longer remote that the letter of credit would be drawn upon. Additionally, the bank has incurred substantial legal fees to prevent future losses and assure collection on the letter of credit.

Question 6:

Can those legal costs be offset against the unamortized deferred fee income?

Staff Response:

No. Legal fees incurred by the bank for litigation should be expensed as incurred. Only legal fees that represent the direct costs of originating the commitment can be offset against the deferred fee income. SFAS 91 requires fees and direct costs of originating a loan commitment to be offset similar to loan origination fees and costs. However, legal fees to recover or prevent potential losses are not direct costs of origination under SFAS 91 and should be expensed as incurred.

Question 7:

(September 2004)

How should premiums and discounts on securities be accounted for?

Staff Response:

Premiums and discounts generally should be accounted for as adjustments to the yield of the security. SFAS 91 generally requires institutions to follow the “interest method” when amortizing a premium or accreting a discount on a security. A premium must be amortized, and a discount must be accreted from the date of purchase to the *maturity date*, not an earlier call date.

Question 8:

(September 2004)

Are there any exceptions to the use of the maturity date?

Staff Response:

Yes. Paragraph 19 of SFAS 91 permits expected maturity dates to be used only for holdings of similar debt securities for which prepayments are probable and the timing and amount of the prepayments can be reasonably estimated. In practice, mortgage backed securities (MBSs) and collateralized mortgage obligations (CMOs) generally meet those conditions. For MBSs, CMOs, and other mortgage related securities that meet the conditions of paragraph 19 of SFAS 91, banks should consider estimates of prepayments in determining the appropriate amortization period for the premium or discount.

Facts:

A bank purchased a CMO tranche, classified as held-to-maturity, that has moderate prepayment risk. The acquisition price includes a premium over par. Prepayment estimates have been considered in establishing the constant yield rate under SFAS 91.

Question 9:

(September

ber 2004)

If the underlying mortgages that collateralize this CMO experience prepayments at a rate significantly different from the estimated rate, how should the difference be accounted for?

Staff Response:

The bank should calculate a new effective yield on the investment to reflect the actual prepayment results and anticipated future prepayments. The net investment in the CMO should be adjusted to the amount that would have existed had the new amortization rate (effective yield) been applied *since acquisition* of the CMO. The investment should be adjusted to the new balance with a corresponding charge or credit to the *current* period’s interest income. This method is commonly referred to as the “retroactive” method. The “prospective” method, which amortizes the adjustment into the yield over the remaining life of the security, is not consistent with SFAS 91.

Question 10:

(December 2001)

The bank enters into an agreement with a related party, such as its holding company, to perform certain loan solicitation and origination activities. How should these costs be accounted for?

Staff Response:

These costs should be accounted for in the same manner as if they had been incurred by the bank. Accordingly, if the costs meet the requirements of paragraph 6 of SFAS 91 for capitalization, they would be capitalized. All other lending related costs should be expensed as incurred. This is consistent with the guidance included in the FASB's implementation guide for SFAS 91.

Facts:

In accordance with SFAS 91, a bank capitalized net direct origination costs relating to credit card accounts. Subsequently, the bank identifies specific credit card accounts and transfers the receivable balances (but not account relationships) to a revolving credit card securitization trust. The trust issues certificates that are sold to third party investors in a transaction that qualifies as a sale pursuant to SFAS 140. The identified credit card accounts are assigned to the trust such that if there are future balances and future collections of fees and finance charges, those balances and collections will be transferred or remitted to the trust. The bank is limited in its ability to remove specific accounts from the trust.

Question 11:

(September 2002)

Should the deferred origination costs be included in the gain/loss on the sale at the time of the first transfer?

Staff Response:

No. The bank has sold the receivable balances, but not the relationship that allows the customer to borrow funds. SFAS 91 requires that credit card fees (and expenses) be deferred and recognized over the period that the cardholder is entitled to use the card. In this context, SFAS 91 considers the origination fees to be loan commitment fees and requires amortization over the period that the cardholder may use the card. The FASB Guide to Implementation of Statement 91 establishes the same treatment for origination costs.

Facts:

A bank originates \$100,000,000 of residential mortgage loans, which it intends to sell. It charged loan origination fees totaling \$2,000,000 and incurred direct loan origination costs of \$1,000,000. The bank holds the loans for two months and sells them for \$99,500,000.

Question 12:

(June 2003)

How should the bank account for its investment in the loans held for sale?

Staff Response:

The net fees or net costs related to these loans held for sale are reported as part of the recorded investment in the loans, the same as they would be for any other loans. Accordingly, the recorded investment in the loans should be \$99,000,000 (\$100,000,000 less the net fees and costs of \$1,000,000). However, on loans held for sale, the loan origination fees and direct loan origination costs are not amortized. Consistent with SFAS 91, these fees and costs are deferred until the loan is sold.

Question 13:

(June 2003)

What should the bank record for the sale of the loans?

Staff Response:

When the loans are sold, the difference between the sales price and the recorded investment in the loans is the gain or loss on the sale of the loans. In this case, the bank would record a gain on the sale of \$500,000 (\$99,500,000 less \$99,000,000). Since the bank was not amortizing the loans' origination fees and costs, the basis remains at \$99,000,000 until the loans are sold.

Question 14:

(January 2007)

What is the proper accounting treatment of net deferred loan fees associated with a loan that has been charged off?

Staff Response:

The deferred loan fees are recognized through the allowance for loan losses, resulting in a reduction of the charge off. This results because the recorded investment in a loan includes principal, accrued interest, net deferred loan fees or cost, and unamortized premium or discount. Consistent with SFAS 91, the deferred loan fees are accreted into income as a yield adjustment over the life of the loan. At the time a loan is charged off, the unamortized deferred loan fees would effectively reduce the recorded investment in the loan, and therefore the amount of the charge off.

2E. LOANS HELD FOR SALE

Question 1:

(September 2003)

What loans are covered under the Interagency Guidance on Certain Loans Held for Sale?

Staff Response:

The Interagency Guidance on Certain Loans Held for Sale applies when:

- An institution decides to sell loans that were not originated or otherwise acquired with the intent to sell, and
- The fair value of those loans has declined for any reason other than a change in the general market level of interest or foreign exchange rates.

Question 2:

(September 2003)

What loans are not covered under the Interagency Guidance on Certain Loans Held for Sale?

Staff Response:

Loans not covered by this guidance include mortgage loans held for sale that are subject to SFAS 65 and other loans originated with the intent to sell, including syndicated credits and other loans, or portions of other loans, originated with the intent to sell.

Facts:

A bank decides to sell a portion of a loan that is not considered impaired. However, some negative trends have developed that have caused the loan's fair value to decline. For example, the industry sector has slowed down, and the borrower has recently experienced weaker financial performance, but not enough to warrant a downgrade on the loan. If there is no decision to sell, the amount of the allowance for loan and lease losses (ALLL) associated with this loan would not change.

Question 3:

(September 2003)

What is the proper accounting for the portion of the loan to be sold?

Staff Response:

Although the loan is not considered impaired, its fair value has declined due to credit quality concerns. Once the decision to sell has been made, the portion of the loan to be sold should be transferred to a held for sale (HFS) account at the lower of cost or fair value. Any reduction in value should be reflected as a writedown of the recorded investment resulting in a new cost basis. This writedown should be charged against the ALLL. To the extent that the loan's reduction in value has not already been provided for in the ALLL, an additional loss provision should be made to maintain the ALLL at an adequate level.

Question 4:

(September 2003)

With respect to the loan in question 3, should the bank also write down the portion of the loan remaining in the loan portfolio?

Staff Response:

No, not necessarily. HFS accounting does not apply to the portion of the loan remaining in the loan portfolio that the bank does not intend to sell. The need for any writedown on that portion of the loan should be evaluated in accordance with the bank's normal credit review and charge-off policies.

Facts:

A bank has identified certain loans in its portfolio that it may sell in the future, but there is no definitive sales plan or sale date. Although these loans are not considered impaired, the fair value may be less than the carrying amount.

Question 5:

(September 2003)

Should adjustments be made to reflect any decrease in fair value?

Staff Response:

No. If the bank has not made the decision to sell these loans, they should continue to be accounted for on a historical cost basis and evaluated in accordance with the bank's normal credit review policies. HFS accounting is not applicable until the bank has made a decision to sell the loans.

Facts:

A bank is targeting obligors or industries for exposure reduction in general, without identifying a specific loan.

Question 6:

(September 2003)

At what point should such loans be transferred to HFS?

Staff Response:

A bank should transfer the loans to HFS and begin applying the HFS guidance once it has decided to sell the loans and identified the specific loans, or portions of loans, that it intends to sell.

Facts:

Banks that syndicate loans will offer these loans periodically in the secondary market. This may occur because of desirable pricing, or the bank's needs to reduce outstanding balances to allow for future transactions.

Question 7:

(September 2003)

Does the HFS guidance imply that all syndicated loans are to be reclassified as HFS, since in effect they remain held for sale even after the initial distribution period has closed?

Staff Response:

If syndicated loans are originated or acquired with the intent to sell all or at least a portion of the loans, they do not fall within the scope of this guidance. However, all loans originated with the intent to sell are reported at the lower of cost or fair value.

Facts:

A bank purchased a loan at a premium, but its fair value has declined because of credit quality concerns. The bank has decided to sell the loan, and its fair value is less than the recorded investment.

Question 8:

(September 2003)

How should the bank treat the unamortized premium on the loan at the time of the transfer to HFS?

Staff Response:

In accordance with SFAS 91, the premium is part of the recorded investment in the loan. The bank should compare the loan's recorded investment with its fair value to determine the amount of the write-off. This difference is then recorded as a credit loss, and the loan is written down by that amount, resulting in a new cost basis at the time of the transfer to HFS.

Facts:

A bank has guaranteed student loans that it may sell once the loans begin repaying. The repayment stage may not begin until a few years after the loans were originated.

Question 9:

(September 2003)

When should these loans be reported as held for sale?

Staff Response:

The bank has not yet decided to sell the loans. Accordingly, HFS accounting would not apply until the decision to sell a specific loan or loans is made.

Facts:

A bank that transfers a loan to HFS must record the initial fair value reduction as a writedown of the recorded investment and a charge to the ALLL, unless the change in fair value is due *only* to changes in general market rates and not credit concerns on the loan.

Question 10:

(September 2003)

What factors should be considered in determining whether the decline in the fair value of a loan that a bank has decided to sell was caused by reasons other than credit concerns?

Staff Response:

The HFS guidance presumes that declines in the fair value of loans are attributable to declines in credit quality. Any exceptions to this presumption should be adequately supported by objective, verifiable evidence and properly documented. This evidence should show that the fair value decline resulted only from changes in interest or foreign exchange rates. Appropriate documentation showing that the decline in fair value was related solely to these market factors would be necessary, even if the loans were sold very shortly after they were originated or purchased.

Question 11:

(May 2006)

How should the transfer to HFS be accounted for if it can be demonstrated that the decline in fair value resulted from reasons other than credit concerns?

Staff Response:

The loan to be sold should be transferred to the HFS account at the lower of cost or fair value. The reduction in value is reflected through the establishment of a valuation allowance. Since this reduction in value did not result from credit concerns, it should be recorded as other non-interest expense, and not as a charge to the ALLL.

Facts:

In the loan market, revolving credit facilities tend to trade at lower prices than funded term-loan facilities of the same company, even though the remaining term to maturity may be shorter. For example, a bank has granted both a \$10 million term loan and a \$10 million revolving credit facility to Company B. Both loans have the same interest rate. The revolving facility is currently funded at 50 % or \$5 million, while the term loan is funded fully at \$10 million. A commitment fee is charged on the unfunded portion of the revolving facility.

The secondary market generally is unwilling to pay the same price (as a percentage of outstanding balances) for both the term loan and the partially funded revolving credit facility. This is because the loss of expected interest income if the unused commitment on the revolving credit is never funded. Thus, the fair value of the partially funded revolving credit facility is less than the fair value of the term loan.

Question 12:

(September 2003)

If the bank decides to sell the revolving credit facility, how would the difference between the fair values of the revolving credit and the term loan be viewed when determining whether the revolving credit facility should be classified as HFS?

Staff Response:

If the bank decides to sell the partially funded revolving credit facility, the bank should determine the reasons for any decline in the fair value of this facility. As indicated in the response to question 10, the HFS guidance presumes that declines in the fair value of loans are attributable to declines in credit quality. Unless it can be determined that the decline in the fair value of the partially funded revolving credit facility is attributable only to a change in interest or foreign exchange rates, the decline would be considered a decline in credit quality. Accordingly, the differences between the fair value of these two credit facilities would not be a factor.

Question 13:

(September 2003)

Is there any prohibition on designating loans as HFS, and then subsequently transferring them back into the loan portfolio?

Staff Response:

There is no prohibition on transferring HFS loans back into the loan portfolio. However, the loan must be transferred into the portfolio at the lower of cost or fair value on the transfer date, thereby establishing a new cost basis for that loan. After the transfer back into the portfolio, the loan should be evaluated in accordance with the bank's normal credit review policies.

Facts:

Upon origination or purchase, a bank "intends to sell" a portion of a loan and designates it as HFS, but the bank is not successful in selling it.

Question 14:

(September

ber 2003)

Is there a period of time within which the bank would be allowed to move this portion of the loan back into HTM at its original cost basis?

Staff Response:

Once a decision has been made to sell a loan or portion of a loan, HFS accounting applies. There is not a period of time within which the bank is allowed to initially designate loans as HFS, and then move them into the loan portfolio at their original cost basis. Rather, as indicated in the response to question 13, loans should be transferred from HFS to the loan portfolio at the lower of cost or fair value on the transfer date.

Facts:

An institution originates or acquires a loan and intends to sell a portion of it on a "best efforts" basis. However, the institution is unable to sell this portion of the loan.

Question 15:

(September 2003)

Is the unsold portion considered HFS?

Staff Response:

If an institution intends to sell a loan or a portion of a loan on a “best efforts” basis, the loan, or portion thereof, should be reported as HFS. If some portion of this loan cannot be sold, the HFS designation of that portion does not change. Question 13 discusses the accounting if a bank subsequently transfers a credit that is designated as HFS to the loan portfolio.

Facts:

A bank enters into a contract to sell a specified group of loans that have declined in credit quality. However, the contract contains several conditions that must be met before the sale can be consummated.

Question 16: (September 2003)

Should the bank wait until all of the conditions have been met before transferring the loans to HFS?

Staff Response:

No. By entering into a sales contract, the bank has demonstrated that it has decided to sell the loans. The HFS guidance requires that loans be transferred to HFS when the decision to sell the loans has been made.

Question 17: (September 2003)

How should the origination fees and costs associated with loans transferred to the HFS account be accounted for?

Staff Response:

SFAS 91 provides accounting guidance for loan origination fees and costs. The net fees or costs are part of the recorded investment in a loan. Under SFAS 91, on a loan held for sale, loan origination fees and costs are deferred until the loan is sold (rather than be amortized). Therefore, if a loan is transferred to the HFS account, amortization of the deferred net origination fees or costs ceases. When the loan is sold, the difference between the sales price and the recorded investment in the loan is the gain or loss on the sale of the loan.

Facts:

Bank A is a participant with Bank B in the ownership of a portfolio of loans. Bank A desires to sell its interest in the loans to another party, but must receive Bank B’s agreement before such a sale can be made.

Question 18: (September 2004)

Should Bank A’s interest in these loans be transferred to the HFS account and be accounted for at the lower of cost or market?

Staff Response:

Yes. The HFS guidance is based on whether a bank has the intent to sell a loan or portfolio of loans, and does not consider whether the bank currently has the ability to sell the loan or portfolio of loans.

Question 19:

(April 2005)

If a bank sells loans from its permanent loan portfolio that were not previously designated as HFS, are there any “tainting” provisions similar to the treatment for held-to-maturity securities under SFAS 115?

Staff Response:

There are no restrictions on sales of loans from the permanent portfolio. Unlike the treatment for securities, loans may be sold from either category or transferred between categories without limitations on the future designation of loans as either in the permanent portfolio or in the HFS category. However, transfers between categories must be recorded at lower of cost or fair value.

Question 20:

(May

2006)

Should the portion of the ALLL attributable to this loan be included with the loan in the carrying value?

Staff Response:

Yes, if the portion of the ALLL attributable to the transferred loan can be determined, that portion should be included in the HFS amount. Accordingly, the loan should be recorded in the HFS account net of the associated ALLL amount.

Question 21:

(May 2006)

Does the response in the previous question apply to the SFAS 5 portion of the ALLL attributed to a group of loans that included loans transferred to the HFS account?

Staff Response:

Yes. As noted in the previous question, if the portion of the ALLL attributable to the transferred loan can be determined, the loan transferred to HFS should be recorded net of the ALLL amount. For loans that were evaluated on a group basis under SFAS 5, the ALLL amount or percentage provided for the group or segment that the loan was evaluated with would normally be used to determine the amount of ALLL to be attributable to the loan or loans.

Question 22:

(December 2008)

What additional factors should be considered in determining fair value for mortgage loans HFS in a market under stress?

Staff Response:

The fair value of portfolios in such market conditions should be reasonable and supported by

documented rationale. Difficult valuations of fair value should be discussed with the bank's external auditor and with the examiners. Under GAAP, a market under stress is still a market. When models are being used because observable market prices are not available, the assumptions should be consistent with those that a market participant would use.

Question 23: (December 2008)

Once fair value is determined, how and when is the valuation allowance established?

Staff Response:

The valuation allowance is established when the fair value is below cost for an individual loan or a group of loans. SFAS 65 notes that either the aggregate or individual loan basis may be used in determining the lower of cost or fair value for each type of loan.

Facts:

A bank has a portfolio of residential HFS loans of varying categories (e.g. conforming and non-conforming 1- to 4-family). For certain loan categories fair value is less than cost, whereas for others the fair value exceeds cost.

Question 24: (December 2008)

Should the losses be recognized for the loan categories when the fair value is less than cost and gains in other loan categories more than offset the losses in those categories?

Staff Response:

At a minimum, paragraph 9 of SFAS 65 requires that separate determinations be made for residential and commercial mortgage loans. There is no requirement in GAAP to further disaggregate different types of residential mortgage loans to determine the lower of cost or fair value. It may be reasonable to base such categorization on the manner in which management analyzes the portfolio for business purposes, or in a manner similar to that used for mortgage servicing rights stratification.

Question 25: (December 2008)

After the loan is funded and the original intent was designated, when would it be appropriate to recognize a bank's change of intent to hold its loans for investment when the bank previously intended to sell?

Staff Response:

This is only appropriate when bank management has the positive intent and ability to hold the loans for the foreseeable future or until maturity, and no longer has the intent to sell. The loan must be transferred to the held-for-sale category at the lower of cost or fair value when the bank decides not to sell the loan. This is consistent with the mortgage loan HFS treatment in SFAS 65 which states that transfers "to a long-term-investment classification shall be transferred at the lower of cost or market value on the transfer date." The bank must document that management now has the positive intent and ability to hold the loans for the foreseeable future or until maturity. Such documentation should include management's definition of foreseeable future as

it relates to the type of loans transferred to held-to-investment, which must be consistent for homogenous loans. Additionally, the documentation should include consideration of budgets that support the bank's ability to hold these loans into the foreseeable future.

The transfer date is important, because the lower of cost or fair value on that date is used to establish a new cost basis for that loan. Upon transfer the loan is initially reported at its then fair value (or cost if the loan's fair value is greater than cost), with no initial allowance for loan losses. After the transfer into the portfolio, the loan should be evaluated in accordance with the bank's normal credit review policies to establish an allowance for loan losses related to any probable losses that are incurred after the transfer. A bank changing its intention and selling the loan(s) or transferring the loan(s) back to the HFS portfolio would likely cause increased skepticism and scrutiny by the auditor and examiner, especially if the sale or transfer occurred during the period the bank originally considered its foreseeable future.

Question 26:

(December 2008)

When would it be appropriate to transfer loans from held for investment back to the HFS category?

Staff Response:

A bank should transfer loans from the held for investment category to the HFS category when it no longer has the intent and ability to hold the loans for the foreseeable future or until maturity or payoff. However, as noted previously, such changes in intent followed by subsequent sales of the loan in the near term would likely cause increased skepticism and scrutiny by the auditor and examiner, especially if the sale or transfer occurs during the period the bank originally considered its foreseeable future.

Facts:

A bank commits to fund a non-mortgage loan with the intention of syndicating it. After the commitment date, disruptions in the market make it difficult to sell or syndicate the loan. The bank subsequently decides that it no longer wants to sell or syndicate the loan.

Question 27:

(December 2008)

Is this a loan commitment that must be accounted for as a derivative at fair value?

Staff Response:

No. SFAS 133, as amended by SFAS 149, states that commitments to originate loans (other than those of mortgage loans that will be HFS) are not subject to SFAS 133 and are not accounted for as derivatives with a fair value adjustment.

Question 28:

(December 2008)

How should this loan commitment be accounted for?

Staff Response:

As noted above, this commitment is not subject to SFAS 133 derivative fair value accounting. This commitment would be accounted for at fair value only if the bank had elected the fair value option under SFAS 159. Although not recorded at fair value with gains and losses recognized in income, the bank may need to recognize a loss related to this commitment. The determination and consideration of any such loss (i.e., whether market and/or credit changes must be considered) depends on the bank's intent to either sell or hold the loan after origination.

Loan commitments that a bank intends to hold for investment should be evaluated for possible credit impairment in accordance with SFAS 5. Similar to the accounting for loans held for investment, losses on commitments for these loans should be based on credit-related losses, not market-related losses. Loan commitments, or portions of loan commitments, that the company intends to sell should not be considered held for investment.

The Center for Audit Quality (CAQ), a nonprofit trade group comprised primarily of auditors of public companies, released three issue papers referred to as "white papers." These papers were intended to help auditors address certain accounting issues that relate to a distressed market environment. They are not authoritative, but summarize existing authoritative guidance and provide some consensus views of the CAQ member auditors. The intent is to assist auditors in understanding the application of existing GAAP in the context of illiquid market conditions. One of these papers, titled "Accounting for Underwriting and Loan Commitments," presents two acceptable alternatives for accounting for loan commitments that relate to loans a bank intends to hold for sale (syndicate).

Under alternative A, the bank would account for these loan commitments at the lower of cost or fair value. The bank would recognize a loss and record a liability to the extent that the terms of the committed loans are below current market terms. Under alternative B, the bank would account for these loan commitments under SFAS 5. Under SFAS 5 the bank would immediately recognize a loss and record a liability related to the fact that the commitment terms are below the current market terms, when the bank determines that it is probable the loan will be funded under the existing terms of the commitment (even though the commitment has not yet been funded).

Guidance in the white papers state, "The premise under both Alternative A and Alternative B is that it is inappropriate to delay recognition of a loss related to declines in the fair value of a loan commitment until the date a loan is funded and classified as HFS. If it is probable that a loss has been incurred because it is probable that an existing loan commitment will be funded and the loan will be sold at a loss, then the loss on that commitment should be recognized in earnings." The OCC would expect banks to follow one of these two methods.

Question 29:

(December 2008)

During the commitment phase, when would it be appropriate to recognize a bank's change of intent to hold their loans for investment when they previously intended to sell?

Staff Response:

OCC Advisory Letter 99-4 (AL 99-4) states, "Agent banks should clearly define their hold level before syndication efforts begin." Generally there is no prohibition in GAAP for a bank changing its intent to sell. However, to comply with AL 99-4, sufficient documentation of the

bank's reasons for changing its intent should be completed in a timely manner. This would include the bank's rationale for the change. It would also contain the bank's analysis from a credit and interest rate risk perspective of how the intent change is consistent with the bank's overall risk management policies and procedures.

Question 30:

(December 2008)

Why is the bank's intent during the commitment phase of the commercial loan commitment important?

Staff Response:

As noted above, market-based impairment is only considered for accounting purposes when the bank intends to sell the loan once funded.

Question 31:

(December 2008)

When the loan is funded, should the bank recognize the loan at an amount less than cost because the changes in market interest rates and secondary loan market movements that took place since the terms of the loan were agreed to?

Staff Response:

The answer again depends on whether the bank changed its intent. If the bank can demonstrate that during the commitment phase and once funded the loan is now held for investment, the bank will not recognize the decline in the fair value of the loan (unless the fair value option has been elected). Similar to the guidance in SFAS 65, AICPA Statement of Position 01-6 (SOP 01-6) states that non-mortgage loans should be accounted for only as held for investment if "management has the intent and ability to hold for the foreseeable future or until maturity or payoff."

2F. LOAN RECOVERIES

Facts:

The bank had previously charged off an \$800,000 loan as uncollectible. Subsequently, the borrower agreed to transfer a paid-up whole life insurance policy to the bank in full satisfaction of the loan. The borrower has a fatal disease, which according to actuarial studies, will cause death in three years. The cash surrender value of the policy at the transfer date is \$250,000, and the death benefit proceeds amount to \$600,000.

Question 1:

Since the actuarial studies indicate death will result in three years, can the bank record the present value of the \$600,000 death benefit proceeds as a loan loss recovery at the transfer date?

Staff Response:

No. The staff believes that the anticipated proceeds at death are a contingent gain. SFAS 5 indicates that contingent gains are usually not booked, since doing so may result in revenue recognition prior to its realization. However, because the bank can currently realize the cash surrender value of the policy, a loan loss recovery of \$250,000 should be recorded at the transfer date.

Facts:

A bank repossesses the collateral securing a loan with an outstanding balance of \$100,000. The bank records the collateral as other assets at its fair value (less estimated cost to sell) of \$50,000 and charges \$50,000 to the allowance for loan and lease losses. The asset is later sold for \$40,000, and the bank records a loss on the sale of \$10,000. The bank obtains and files a judgment against the borrower for the \$60,000 difference between the loan amount and the proceeds from the sale of the collateral.

Question 2:

(October 2005)

May the bank record a recovery when the \$60,000 judgment is filed?

Staff Response:

The \$60,000 judgment itself does not represent a recovery. Proceeds from the judgment, as they are received, would be the basis for the recovery. If the \$60,000 is actually received by the bank, the proceeds would be a recovery of both the previously charged-off loan and the loss on the sale of the collateral. Accordingly, the bank would record \$50,000 as a loan loss recovery and \$10,000 as other noninterest income.

Facts:

A bank made a \$500,000 unsecured loan to a corporation that is 100 % owned by one person. The corporation experienced economic problems and was unable to perform on the loan. Collection of the loan was considered unlikely, and it was charged-off.

Subsequently, the bank advanced an additional \$400,000 to the owner of the corporation. In exchange, the bank received title to five undeveloped building lots that had an appraised value in excess of \$900,000. The exchange agreement provides the borrower with a four-year option to repurchase the land. Additionally, the agreement provides that during this four-year period the bank is precluded from disposing of the property.

The agreement also provides for a repurchase price of \$930,000 during the first year. That price increases in each of the next three years. Further, the borrower pays the bank an annual renewal fee for the repurchase option. This fee is approximately equal to the real estate taxes the bank pays.

Question 3:

Can a loan loss recovery be recorded on this transaction?

Staff Response:

No. The substance of the transactions is that the bank restructured the unsecured loan with the borrower into a four-year loan secured by real estate. In exchange for receiving collateral, the bank also agreed to advance additional funds. The bank effectively does not have economic control of the property.

Accordingly, the bank should report the \$400,000 advance as a loan. The acquisition of the real estate should not be reported as other real estate owned. Since \$500,000 of the loan has been previously charged-off, only the \$400,000 amount would be included in the recorded loan amount. Recovery of the previously charged-off portion is not appropriate, until it is converted into cash or cash equivalents. Further, because of the financial condition of the borrower and the uncertainty of loan collectibility, income on the loan should not be accrued.

Facts:

A bank sells loan receivables for \$5,000 to an independent third party that have a contractual balance of \$100,000. The receivables had been previously charged off through the ALLL four months prior and therefore have a current book value of zero.

Question 4:

(April 2005)

How do you account for the bank's bulk sale of previously charged-off loan receivables to an independent third party?

Staff Response:

The sale should be accounted for as a recovery with the proceeds recorded through the ALLL, consistent with how the bank had charged off the loan receivables.

TOPIC 3: LEASES

3A. LEASE CLASSIFICATION AND ACCOUNTING

Question 1:

(September 2003)

From the standpoint of the bank as a lessor, what is the difference between a capital (direct financing) lease and an operating lease?

Staff Response:

With a capital lease, the lessor, having transferred substantially all of the risks and rewards of ownership, removes the leased asset from its financial statements and records a lease receivable. Lease payments received are accounted for as interest income and principal reduction. Since the lessor does not record the leased asset on its financial statements, no depreciation is recorded.

If the lease is an operating lease, the leased asset remains on the lessor's financial statements, and depreciation is recorded. Payments received are recorded as rental income.

Question 2:

(September 2003)

What criteria must be met for a bank, as lessor, to classify a lease as a capital lease?

Staff Response:

Statement of Financial Accounting Standards No. 13 (SFAS 13) establishes two sets of criteria that must be considered. For capital lease treatment, the bank, as lessor, must meet *at least one* of the ownership criteria and *both* of the realizability criteria.

Ownership Criteria

- The lease transfers ownership of the property to the lessee.
- The lease contains a bargain purchase option.
- The lease term equals or exceeds 75% of the economic life of the property.
- The present value of the minimum lease payments equals or exceeds 90% of the fair value of the property at the inception of the lease.

Realizability Criteria

- Collectibility of payments is reasonably predictable.
- There are no important uncertainties surrounding the amount of unreimbursable cost yet to be incurred by the lessor.

Question 3:

(Septem

ber 2003)

One of the ownership criteria is based on the value of the minimum lease payments. What is included in the minimum lease payments?

Staff Response:

Minimum lease payments include the rental payments, the bargain purchase option amount, the guaranteed residual value, and the penalty for failure to renew. From the standpoint of the lessor, the residual value guarantee may be from the lessor or an independent third party. Therefore, insurance contracts may be used to satisfy this requirement.

Question 4:

(April 2005)

How is a capital lease recorded on the balance sheet?

Staff Response:

The sum of the minimum lease payments (as defined in SFAS 13) plus the unguaranteed residual value accruing to the benefit of the lessor is recorded in loans and lease financing receivables (net of unearned income).

Question 5:

(April 2005)

What is the definition of the residual value of a lease?

Staff Response:

SFAS 13 defines residual value as the estimated fair value of the leased property at the end of the lease. In this context, the statement defines fair value as the price at which the property could be sold in an arm's length transaction between unrelated parties. The guidance for determining fair value included in SFAS 13 differs in certain aspects from that included in Statement of Financial Accounting Standards No. 144 and Statement of Accounting Concepts No. 7. However, it is important to note that SFAS 144 requires that lessors' capitalized leases be accounted for under SFAS 13.

Facts:

In certain situations the current lessee may be willing to pay a higher price for the property at the end of the lease than a non-lessee third-party buyer would pay. This could occur because the property has previously been installed at the lessee's facility and does not require additional installation cost.

Question 6:

(April 2005)

What amount should be used for the residual value of the property?

Staff Response:

When there is no residual value guarantee, the staff believes that the amount that an independent third-party (non-lessee) would pay most accurately represents the market's assessment of fair value and is the preferable value to use. However, as described in question 7 (that follows), the staff is aware that other valuation techniques are used, and based on the facts and circumstances of each situation, has accepted their use.

Facts:

The residual value of the property at the termination of a capitalized lease may vary depending on the manner in which the property is sold. As an example, at the end of the lease an automobile may be sold to the lessee, or may be sold to a third-party buyer at either retail or wholesale, or may be sold at auction. Each of these sales methods may yield a different sales price for the property. At the origination of the lease it is not known how the bank will dispose of the automobile. However, the bank (lessor) has sufficient experience to determine the expected proceeds from each method and the percentage of sales for which each method will be used.

Question 7:

(April 2005)

What amount should be used for the residual value of the property when it is not known how the property will be disposed of at the end of the lease?

Staff Response:

Under such circumstances the use of a weighted average would be appropriate for determining the residual value of the property. This weighted average would take into account the expected proceeds from each sales method and the percentage of time the automobile is expected to be sold using each method.

Facts:

Rather than return the property to the lessor at the termination of the lease, the lessee continues to use the property and remit monthly lease payments. This arrangement continues on a month-to-month basis, with the lessee having the right to return the property and discontinue payments. This practice is most commonly used for small office equipment such as copier machines, telephone systems, and computers.

Question 8:

(April 2005)

How should the residual value of this property be determined?

Staff Response:

The residual value is the price at which the property could be sold in an arms-length transaction at the termination of the lease. The present value of future lease payments may be used in determining residual value only when they are required by a lease or other legal agreement. It is not appropriate, under SFAS 13, to use the present value of the expected future lease payments for periods that are not covered by the lease or other legal agreement.

Facts:

The bank (lessor) has a portfolio of automobile leases that are classified and accounted for as capital leases by the bank. In classifying these leases, the bank is relying on the minimum lease payment criteria to satisfy the ownership criteria. In this respect, the bank purchased an insurance policy that guarantees the required minimum residual value on a portfolio basis. That is, the guarantee is for a portfolio of leased automobiles that are subject to separate leases, but not for any individual lease.

As an example, assume the bank has an insurance contract that guarantees the residual values so that the minimum lease payments are 90%. Also assume that the calculation of minimum lease payments, without including the effects of the insurance contract, is 95% on half of the automobiles in the portfolio and 85% on the other half. If the insurance contract covers each individual automobile, the bank would receive a payment from the insurance company on those automobiles for which the minimum lease payment was only 85%. However, if the insurance contract covers the portfolio as a whole, the bank would not be entitled to any payment from the insurance company because the portfolio as a whole has 9% coverage.

Question 9:

(September 2003)

Can the bank include the residual value guarantees for a portfolio of leased assets in the calculation of minimum lease payments of an individual lease?

Staff Response:

No. SFAS 13 is lease specific and requires that the determination of the lease classification be performed on a lease-by-lease basis. The residual value guarantees of a portfolio of leased assets preclude a lessor from determining the amount of the guaranteed residual value of any leased asset within the portfolio at the inception of the lease. Accordingly, the guarantee from the insurance contract may not be included in the minimum lease payments. This accounting is established in a Securities and Exchange Commission (SEC) announcement to FASB Emerging Issues Task Force Topic No. D-107.

Question 10:

(September 2003)

Should the bank restate its financial statements for any leases when the residual value guarantee is on a portfolio basis?

Staff Response:

Not necessarily. In the announcement discussed in question 4, the SEC advised registrants who are lessors that if the residual value guarantee insurance contracts are revised prior to the end of 2003, the lessor would not need to restate prior period financial statements. The OCC concurs with this arrangement.

Facts:

A bank as lessor entered into an equipment lease contract with a lessee. At the time the lease was entered into there was no residual value guarantee was in place. Subsequently, the bank entered into an arrangement with a third party to provide the guarantee.

Question 11:

(September 2003)

May the bank include this guarantee when calculating the minimum lease payments?

Staff Response:

SFAS 13 requires that the calculation of the minimum lease payments be performed at the inception of the lease. Therefore, this guarantee would not be included in the calculation. Any previously issued financial statements should be revised accordingly, if material.

Question 12:

(October 2005)

Can a methodology consistent with SFAS 114 be used to measure impairment for direct financing leases?

Staff Response:

Yes. While direct financing leases are excluded from SFAS 114, bank management can use a methodology consistent with SFAS 114. Direct financing leases have many similar characteristics to loans. The methodology for estimating impairment contained in SFAS 114 is consistent with the guidance that applies to direct financing leases in SFAS 5.

3B. SALE AND LEASEBACK TRANSACTIONS

Statement of Financial Accounting Standards No. 98 (SFAS 98) requires that sale/leaseback transactions involving real estate qualify as a sale under the provisions of Statement of Financial Accounting Standards No. 66 (SFAS 66) for sales treatment to be used. Otherwise, the transaction will be accounted for either as a financing or under the deposit method. Accordingly, in the following examples, it is assumed that the transaction qualifies for sales recognition under SFAS 98.

Facts:

A bank transfers its premises (building) to its holding company through a dividend. The holding company sells the building to a third party, who leases it back to the bank.

Question 1:

(December 2008)

How should this transaction be accounted for?

Staff Response:

12 CFR 5.66 requires that a “dividend in kind” be recorded “at actual current value” which has been interpreted to be the fair value of the property. Therefore, the book value of the building is increased to its fair value. The fair value is charged to undivided profits as a non-cash dividend. However, an effective sale/leaseback has occurred in the bank’s leasing of the premises back from the purchasing third party.

SFAS 13 requires that the resulting gain from the increase from book value to fair value be deferred and amortized over the lease term. Involvement by the holding company is ignored (except for the dividend transaction), since the substance of the transaction is the same as if the bank had actually sold the building, leased it back, and distributed the sales proceeds by dividend to the holding company. In this example, capital has been reduced since the dividend is recorded on the basis of fair value, but the gain is deferred.

Question 2:

Assume the same situation in question 1, except that the holding company returns the sales proceeds to the bank in the form of a capital contribution. How is this transaction accounted for?

Staff Response:

The accounting for this transaction would be the same as in question 1, except that the bank would also record the amount of the capital contribution. Therefore, total capital remains essentially the same as it was prior to the sale/leaseback. However, the bank’s ability to pay future dividends has decreased, because undivided profits have been reduced by the amount of the dividend, and the capital contribution has been credited to surplus.

Question 3:

A bank transfers its premises to its holding company through a dividend. The holding company leases the building back to the bank. The lease may be either on a short-term basis (i.e., one or two years) or month to month. How should this transaction be accounted for?

Staff Response:

As previously discussed, a dividend in kind is recorded on the basis of the fair value of the property transferred. Therefore, the book value of the building is increased to its fair value, and a dividend is recorded based on this amount.

SFAS 13 requires that the resulting gains (from the increase to fair value) be deferred and amortized over the minimum lease term. However, in a related party lease, the stated lease term often does not represent the intent of the parties. This results because the bank usually intends to remain in the building for many years, even though the lease term is often very short and does not represent this intent.

Therefore, the staff has concluded that gains resulting from related party sale/leaseback transactions be deferred and amortized over the remaining useful economic life of the building. This conclusion assumes that the holding company controls the bank and the terms of the lease. A rare exception has been granted when the bank could demonstrate that the lease terms were representative of transactions with independent third-party lessors available in their local marketplace.

As in question 1, capital has been reduced since the dividend is recorded at fair value, but the gain is deferred.

Question 4:

Assume the same facts as in question 3, except that instead of a dividend, the holding company purchases the building at fair (appraised) value and leases it back to the bank. How should this transaction be accounted for?

Staff Response:

The sale at fair value to the holding company results in a gain which, as in question 3, would be deferred and amortized over the remaining useful life of the building. Capital has not been reduced, since a dividend is not involved and the building was actually sold to the holding company for cash. However, the deferral of the gain results in no immediate increase to capital.

Question 5:

(December 2008)

Assume, as in question 4, that the holding company purchases the building. However, the purchase price equals the recorded cost basis of the building rather than fair value. How should this transaction be accounted for?

Staff Response:

Since transactions between affiliates are recorded at fair value (see question 1), a non-cash dividend would be recorded for the difference between the fair value of the property and the amount paid by the holding company. Again, because of the lease provisions, the resulting gain on the sale would be deferred and amortized over the remaining life of the building.

Question 6:

In some cases the sale/leaseback may occur with a related party other than the holding company. It could be with a major shareholder or a partnership composed of major shareholders and/or board members. How should such transactions be accounted for?

Staff Response:

The accounting for related party transactions should be used when the same person, persons, or control group exerts significant influence over both entities (i.e., the bank and the purchaser). Such determination is made case by case. However, the control group does not always have to possess a voting majority (over 50 % in each entity) to be considered as exerting significant influence. In a bank that has numerous shareholders, a person possessing a 15 or 20 % stock interest can be deemed to have significant influence.

However, a shareholder with 40 % interest may not possess such influence if another shareholder has controlling interest. Therefore, one should use judgment in making that determination.

3C. LEASE CANCELLATIONS

Facts:

The bank has a remaining lease that exceeds one year on a branch office site. The lease is accounted for as an operating lease. The bank has decided to close the branch and abandon it without canceling the related lease. The bank must make payments on the lease in the future.

Question 1: (December 2008)

How should the bank account for the lease payments due after the closing of the branch site?

Staff Response:

Statement of Financial Accounting Standards No. 146 (SFAS 146) provides guidance on how to account for costs associated with exit or disposal activities. SFAS 146 requires the bank to recognize a liability on the date that the bank closes the branch for the lease costs that will be incurred without economic benefit.

Costs associated with the closing of the branch site should be included in income from continuing operations, unless it is part of a discontinued business segment, in which case it would be included in the results of discontinued operations.

Question 2: (December 2008)

How should the loss be determined?

Staff Response:

The fair value of the obligation under the lease contract should be recognized based on the remaining lease rentals, reduced by estimated sublease rentals that could be reasonably obtained for the property, even if the bank does not intend to enter into a sublease. A liability for other costs associated with closing the branch should not be recognized until the costs are incurred, even if those costs are a direct result of the bank closing the branch.

Question 3: (December 2008)

Would the responses to the previous questions be different if the leased property was equipment the bank would no longer use instead of a branch office site?

Staff Response:

No. The decision to stop using leased equipment has the same economic effect as abandoning a branch site. The leased equipment has no substantial future use or benefit. Consequently, the remaining lease payments, reduced by any estimated sublease rental that could reasonably be obtained, should be recognized as a loss. This conclusion is consistent with SFAS 146.

TOPIC 4: ALLOWANCE FOR LOAN AND LEASE LOSSES

4A. ALLOWANCE FOR LOAN AND LEASE LOSSES

Question 1:

(September 2001)

Regulatory guidance included in the *Comptroller's Handbook* "Allowances for Loan and Lease Losses" discusses the concept of "inherent loss." What is "inherent loss," and how does it differ from "future loss?"

Staff Response:

In defining "inherent loss," the handbook does not introduce a new concept to estimate the ALLL. Rather, it describes the use of concepts developed in Statement of Financial Accounting Standards No. 5 (SFAS 5), a process that bankers, accountants, and examiners have performed for years.

"Inherent losses" are losses that meet the criteria in SFAS 5 for recognition of a charge to income. This requires a conclusion that an asset has probably been impaired. Proper accounting recognition of a loan impairment requires that a provision be made to the ALLL in the period when the loss event probably occurred, and the loss amount can be estimated. Earnings would be charged at that time. It is inappropriate to wait to charge earnings until the loss is confirmed or realized (i.e., the asset is charged off).

A "loss event" is an event that probably has occurred that impairs the value of a loan. If such a loss event occurred, even though it cannot be identified specifically, a charge is made to earnings and a provision to the ALLL. The occurrence of a "confirming event" results in the asset being classified loss and charged off against the ALLL.

A provision to the ALLL ensures that impairments or loss events that have occurred, but have not yet been identified specifically, are provided for in the period in which they occurred. Thus, the ALLL is an estimate.

Question 2:

(December 2008)

What are "estimated credit losses?"

Staff Response:

The Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL) (2006 Policy Statement), included in OCC Bulletin 2006-47, defines "estimated credit losses" as an estimate of the current amount of loans that it is probable the institution will be unable to collect given facts and circumstances as of the evaluation date. Thus, estimated credit losses represent net charge-offs that are likely to be realized for a loan or group of loans. These estimated credit losses should meet the criteria for accrual of a loss contingency (i.e., through a provision to the ALLL) set forth in GAAP. When available information confirms that specific loans, or portions thereof, are uncollectible, these amounts should be promptly charged off against the ALLL.

SFAS 5 requires the accrual of a loss contingency when information available prior to the issuance of the financial statements indicates it is probable that an asset has been impaired at the date of the financial statements, and the amount of loss can be reasonably estimated. These

conditions may be considered in relation to individual loans or groups of similar types of loans. If the conditions are met, accrual should be made even though the particular loans that are uncollectible may not be identifiable.

Under SFAS 114, an individual loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. It is implicit in these conditions that it must be probable that one or more future events (“confirming event”) will occur confirming the fact of the loss.

Question 3:

(December 2008)

How should a bank identify loans to be individually evaluated for impairment under SFAS 114?

Staff Response:

Determining loan impairment is a multi step process. First, the bank must set the criteria for determining loans to be reviewed for impairment under SFAS 114. Second, based on those criteria, the bank would identify the loans to be individually evaluated for impairment. Finally, the selected loans are reviewed for impairment.

Footnote 1 of SFAS 114 identifies the following sources of information that is useful in identifying loans for individual evaluation for impairment:

- A specific materiality criterion.
- Regulatory reports of examination.
- Internally generated listings such as “watch lists,” past due reports, overdraft listings, and listings of loans to insiders.
- Management reports of total loan amounts by borrower; historical loss experience by type of loan.
- Loan files lacking current financial data related to borrowers and guarantors.
- Borrowers experiencing problems such as operating losses, marginal working capital, inadequate cash flow, or business interruptions.
- Loans secured by collateral that is not readily marketable or that is susceptible to deterioration in realizable value.
- Loans to borrowers in industries or countries experiencing economic instability.
- Loan documentation and compliance exception reports.

Question 4:

(December 2008)

What documentation should a bank maintain to support its measurement of impairment on an individually impaired loan under SFAS 114?

Staff Response:

In general, the bank should document the analysis that resulted in the impairment decision for each loan and the determination of the impairment measurement method used. Additional documentation would depend on which of the three impairment measurement methods is used.

For example, for collateral-dependent loans for which a bank must use the fair value of collateral method, the institution should document: how fair value was determined including the use of appraisals, valuation assumptions, and calculations; the supporting rationale for adjustments to appraised values, if any; the determination of costs to sell, if applicable; and quality, expertise, and independence of the appraisal. This is consistent with the 2001 Policy Statement, which discusses the supporting documentation needed.

Question 5:

(December 2008)

Are large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment within the scope of SFAS 114?

Staff Response:

Generally, no. Large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment are not included in the scope of SFAS 114. Such groups of loans may include, but are not limited to, “smaller” commercial loans, credit card loans, residential mortgages, and consumer installment loans. SFAS 114 would apply, however, if the terms of any of these loans are modified in a troubled debt restructuring as defined by SFAS 15. Otherwise, the relevant accounting guidance for these groups of smaller-balance homogeneous loans is contained in SFAS 5.

Question 6:

(December 2008)

Can “larger” versus “smaller” balance loans be quantified to identify loans that should be evaluated for impairment under SFAS 114?

Staff Response:

A single-size test for all loans is impractical because a loan that may be relatively large for one bank may be relatively small for another. Deciding whether to individually evaluate a loan is subjective and requires a bank to consider the individual facts and circumstances, along with its normal review procedures in making that judgment. In addition, the bank should appropriately document the method and process for identifying loans to be evaluated under SFAS 114.

Question 7:

(December 2008)

When should a bank remove a loan from a pool and specifically allocate an amount for that loan?

Staff Response:

There are valid reasons to review a loan individually rather than in a pool of loans. Loans should be evaluated separately when sufficient information exists to make a reasonable estimate of the inherent loss. Individual loan review is generally applicable for large or otherwise significant (i.e., classified doubtful) credits, loans to companies in a deteriorating industry, or a combination

of the above. In such situations, substantial information on the credit should be available, and a separate review is appropriate. If an individually analyzed loan is determined to be impaired, it should be specifically allocated for in accordance with SFAS 114, and not as part of the pool.

Pool evaluation is appropriate when information is insufficient to make such an estimate for an individual loan.

Question 8:

(September 2001)

Does criticism of a loan indicate an inherent loss?

Staff Response:

Criticism of a loan, an important signal, does not always indicate existence of an inherent loss in the credit. The degree of criticism is important. For example, all loans classified doubtful have, by definition, inherent loss. The risk of loss on the loan is probable, even though the timing and exact amount has not been determined.

In a substandard credit, the loan is inadequately protected by the current sound worth and paying capacity of the borrower or the collateral. Although a distinct possibility exists that the bank may sustain a loss if weaknesses in the loan are not corrected, this is only potential loss. Further, in substandard loans, inherent loss generally cannot be identified on a loan-by-loan basis.

Nevertheless, inherent losses do exist in the aggregate for substandard (and to a lesser extent, special mention and pass) loans. This inherent, but unidentified, loss on such loans should be provided for in the ALLL. This provision usually is based on the historical loss experience, adjusted for current conditions, for similar pools of loans.

Question 9:

(September 2001)

What are some examples of loss events and confirming events affecting pools of loans?

Staff Response:

Loss events for loans in pools are the same as those for individual loans. Commercial loans could suffer from a decline in the economy or in profits, or an event that affects their future prospects. Consumer loans might be affected by the loss of a job or personal bankruptcy. Delinquency statistics are the most common indicators of the level of inherent losses in pools. However, external events, such as changes in the local or national economy, can also signal problems for a pool of loans before one can see change in delinquency rates.

Confirming events for pools of loans will differ between consumer and commercial credits. Again, the confirming event occurs when information reveals that the loan is no longer bankable and should be charged off. In consumer pools, charge offs are typically taken based on established thresholds (i.e., a specific number of days past due) rather than on specific adverse information about a borrower. A charge-off should be taken if adverse information about a specific borrower is received before the threshold date. Specific adverse information about borrowers usually causes the decision to charge off commercial loans analyzed in pools.

Question 10:

(December 2008)

May banks project or forecast changes in facts and circumstances that arise after the balance sheet date when estimating the amount of loss under SFAS 5 in a group of loans with similar risk characteristics at the balance sheet date?

Staff Response:

No. SFAS 5 only allows the recognition of estimated losses at the measurement date based on the facts and circumstances present at the date. In developing loss measurements for groups of loans with similar risk characteristics, a bank should consider the impact of current qualitative or environmental factors that exist as of the balance sheet date. It should also document how those factors were used in the analysis and how they affect the loss measurements. For any adjustments to the historical loss rate reflecting current environmental factors, a bank should support and reasonably document the amount of its adjustments and how the adjustments reflect current information, events, circumstances, and conditions. Questions 11 through 16 illustrate this concept.

Facts:

A bank evaluates a real estate loan for estimated credit loss. The loan was made during a recent boom period for the real estate industry. However, both the general real estate market and the loan currently are troubled. Loan repayment will come primarily from the operation and eventual sale or refinancing of the collateral. Further, the value of the underlying collateral is declining. A properly performed appraisal indicates that the value of the property is 95 % of the outstanding loan balance.

Historically, three real estate cycles have occurred in the last 25 years. In each cycle, real estate values fluctuated significantly. However, it is not possible at this time to determine whether local real estate properties will experience additional declines in value.

Question 11:

(December 2008)

How should the bank determine the estimated credit loss on the loan?

Staff Response:

The bank should determine the amount of the credit loss for this loan based on the information in the current collateral appraisal, because it is the best estimate of current value and impairment. This current appraisal, which reflects the facts and conditions that presently exist, measures the loss that has probably occurred as opposed to future loss. Future impairments will be recognized in the periods in which the evidence indicates they probably occurred. Current recognition of those potential declines would amount to recognition of future losses rather than inherent ones. See question 29 for further discussion.

Facts:

A local military base, which employs a significant percentage of the local civilian work force, may close. Goods and services supplied to the base by local businesses contribute greatly to their economy.

Question 12:

(September 2001)

How should the local bank, in analyzing the adequacy of its ALLL, respond to rumors that the military base may appear on the list of possible closures?

Staff Response:

On a continuous basis, the bank should review the concentrations of credit risk arising from its loans to businesses and individuals associated with or dependent upon the base. The bank's assessment of the effect of the closing on the local economy and its borrowers should be regularly updated. But an unsubstantiated rumor is not an event that would require increased provisions to the ALLL. However, a concentration of credit centered on the military base is relevant to the assessment of the bank's capital adequacy.

Question 13:

(December 2008)

Suppose that the rumors of the local base as a closure candidate are confirmed, and the decision is expected in six months. How would that affect the analysis?

Staff Response:

The consideration of the possible base closure does not, by itself, trigger a need for provisions to the ALLL on any individual credit. Further, in considering possible subjective adjustments to the historical loss rates on pools of loans, it is also premature to increase the loss factor. This conclusion results from the absence of a firm decision and adequate information.

Question 14:

(December 2008)

How would an announcement of base closure over an 18-month period, beginning in six months, affect the evaluation of the ALLL adequacy?

Staff Response:

A loss event has now occurred that probably will result in the bank subsequently charging off loans to a number of its borrowers. The bank's loan review system should identify those significant, individual borrowers that should be evaluated for impairment under SFAS 114. This standard requires that loan impairment be measured based on the present value of the expected future cash flows discounted at the loan's effective interest rate. However, as a practical expedient, SFAS 114 allows the use of the loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. In reviewing the loan portfolio, the bank should address issues, such as the effect of the closing on:

- Borrowers with investments in the local real estate and housing rental markets.
- Borrowers operating businesses dependent on the base or its employees, and general retail trade.

For loans previously identified as impaired, an increased provision to the ALLL may be warranted, depending on whether the base closing affects the bank's estimate of the probable loss on these credits. For loans reviewed under SFAS 5, the bank should begin to adjust the historical loss rates as its estimates of probable loss increase for smaller criticized loans in a pool

of similar loans, especially those credits that are currently performing and not criticized, but that are likely to be affected adversely by the base closing. The bank should review and monitor such credits. Although the amount of probable loss on those individual credits cannot be estimated yet, it can be measured for pools of similar loans. Those pools should encompass all loans not identified as individually impaired expected to be affected by the base closing, including loans in the commercial, real estate, and consumer portfolios. The more homogeneous are the pools, the easier it will be to analyze and adjust the historical loss rates. The ALLL should reflect the probable increased exposure to loss arising from loans to this group of borrowers.

The staff recognizes that the estimates of the adjustments are subjective. Accordingly, they must be reviewed and refined as it becomes easier to measure the effects of the base closing.

Question 15:

(December 2008)

How is the bank's analysis of the ALLL affected in the 12- to 18-month period following the announcement by the base closing?

Staff Response:

The bank should continue to focus on identifying, monitoring, and measuring the effect of the base closing on its borrowers, and on adjusting the ALLL to cover its best estimate of the inherent loss in its portfolio. Estimates of the probable loss should be refined as additional information becomes available. The risk ratings of these loans should also be appropriately adjusted. Additional provisions should be made to the ALLL, when necessary, and loans charged off when they are no longer bankable assets. As the actual effect of the base closing becomes easier to measure, the bank should continue to adjust the loss rates it applies to its loan pools. In time, the bank can identify most of the borrowers affected and have risk rated and provided appropriately for their loans. Estimates of probable losses on both individual loans and pools of loans should continue to be refined, and appropriate adjustments made to historical loss factors and the balance of the ALLL. This is an ongoing process, and should not be calendar driven.

Facts:

State government officials announce their decision six months after the base closing to open a new minimum security prison facility on the former base site. Conversion of the site will begin in three months, and the prison will open in 12 months.

Question 16:

How will this announcement affect the analysis of the adequacy of the ALLL?

Staff Response:

The bank should begin to consider the possible effects of this "good" news on the local economy and its borrowers. The following questions should be raised:

- Will the business opportunities provided by the new facility improve repayment prospects?

- What will be the effect of the new facility on local employment?
- What will be its effect on the demand for residential and commercial real estate?

Over the next 12 months these questions will become easier to answer. As the local economy and the condition of the credits improve, the bank may be able to revise downward its estimates of probable losses and an adequate level for the ALLL.

Question 17:

(September 2001)

Can a bank individually review substandard loans which are not impaired, if such analysis results in a lower estimate of inherent loss?

Staff Response:

Pool analysis is used because there is generally insufficient information to reach loan-by-loan conclusions about the exposure to loss on substandard loans. Accordingly, adequate measurement of the inherent loss may require a pool analysis. As noted in question 2, inherent losses do exist in the aggregate for substandard loans and an estimate of the inherent loss in a pool of loans generally can be made. The estimate is based on the bank's historical loss experience, adjusted for current conditions, on similar pools of loans.

To estimate the level of ALLL required for all substandard loans, some banks differentiate between levels of exposure to loss on significant, individual credits in the substandard category. However, the assertion that individually analyzed substandard loans require a level of allowances that is significantly below the historical loss rate for pools of similar loans must be supported clearly by the nature of the collateral or other circumstances that distinguish the loan from similarly classified credits.

Further, removal of loans with less exposure to loss changes the pool's characteristics. No two loans are alike, and the substandard classification is applied to loans with varying degrees of risk. If the lower risk loans are removed from the pool and analyzed individually, the remaining pool will consist of loans with a higher degree of exposure to loss. In providing for the inherent loss in this pool, consideration must be given to the current characteristics of the pool. This generally will lead to increased provisions to the ALLL for this pool.

Facts:

Under the banking agencies' regulatory classification guidelines, "Substandard" assets are defined as assets that are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.

Question 18:

(December 2008)

How should an allowance be established for a commercial loan adversely classified as "Substandard" based on this regulatory classification framework?

Staff Response:

Given the definition, a “Substandard” loan that is individually evaluated for impairment under SFAS 114 (and that is not the remaining recorded investment in a loan that has been partially charged off) would not automatically meet the definition of impaired. However, if a “Substandard” loan is significantly past due or is in nonaccrual status, the borrower’s performance and condition provide evidence that the loan is impaired, i.e., that it is probable that the bank will be unable to collect all amounts due according to the contractual terms of the loan agreement. An individually evaluated “Substandard” loan that is determined to be impaired must have its allowance measured in accordance with SFAS 114.

For “Substandard” loans that are not determined to be impaired in accordance with SFAS 114, experience has shown that there are probable incurred losses associated with a group of “Substandard” loans that must be provided for in the ALLL under SFAS 5. Many banks maintain records of their historical loss experience for loans that fall into the regulatory “Substandard” category. A group analysis based on historical experience, adjusted for qualitative or environmental factors, is useful for such loans.

For groups of loans with similar risk characteristics that include both loans classified “Substandard” (and not determined to be impaired) and loans that are not adversely classified, the bank should separately track and analyze the “Substandard” loans in the group. This analysis will aid in determining whether the volume and severity of these adversely classified loans differs from such loans during the period over which the bank’s historical loss experience was developed. This will aid in determining the qualitative adjustment necessary for the group of loans under SFAS 5.

Question 19:

(December 2008)

Assume a substandard credit has its ALLL allocation measured in accordance with SFAS 114. Does a percentage relationship between the allocation amount and loan balance suggest the assignment of nonaccrual status and/or doubtful classification?

Staff Response:

There is no allocation percentage that would automatically require a doubtful classification and/or nonaccrual status for a substandard loan. However, specific allocations for individual substandard loans measured in accordance with SFAS 114 raise some difficult questions. First, doesn’t a bank’s estimate of the amount of allowance necessary for the loan present prima facie evidence that there is doubt about its collectibility? Further, if there is doubt about its collectibility, shouldn’t the loan be classified doubtful and put on nonaccrual? While the response to the nonaccrual issue is straight forward, the classification issue is more difficult. With respect to the nonaccrual issue, the call report instructions require that a bank not accrue interest on any loan for which payment in full of principal or interest is not expected. If a loan has been determined to be impaired, doubt of collectibility in accordance with its contractual terms therefore exists. This requires the loan to be placed on nonaccrual in accordance with the call report instructions.

The classification issue requires careful judgment. No two loans are alike. Each classification definition must be applied to loans that possess varying degrees of risk. In most portfolios, a few substandard loans will fall on the line between special mention and substandard, and a few others

will be almost doubtful. Although some loans classified as substandard are weaker than others, it may be appropriate to determine that those weaknesses are not so severe as to warrant a doubtful classification. One must keep in mind when deciding whether to make individual allocations for substandard loans that two elements of risk are reflected in our classification system. The risk that the loan will not perform as agreed (the risk of default), and the risk that it will not be repaid in full (the risk of loss).

Loans are classified as substandard because their weaknesses do not reflect the risk of default that warrants a doubtful classification. Nevertheless, in the event of default, varying degrees of exposure to loss will occur within the substandard category. Consideration of collateral, guarantees, etc., is necessary. Exposure to loss on a large, unsecured substandard loan may be substantially greater than on a similarly sized substandard loan that is secured by real estate.

Question 20:

(September 2001)

What is a migration analysis and when is it used?

Staff Response:

Migration analysis is a methodology for determining, through the bank's experience over a historical analysis period, the rate of loss incurred on pools of similar loans. Migration analysis may take many forms, ranging from a simple average of the bank's historical loss experience over time to a sophisticated analysis that also weighs differences in underwriting standards, geographic locations, seasoning of loans, etc. The staff has not identified any particular form of migration analysis as being the best, or most appropriate, for all banks.

Question 21:

(December 2008)

If a bank concludes that an individual loan specifically identified for evaluation is *not* impaired under SFAS 114, should that loan be included in the assessment of the ALLL under SFAS 5?

Staff Response:

Yes, that loan should be evaluated under SFAS 5. If the specific characteristics of the individually evaluated loan that is not impaired indicate that it is probable that there would be an incurred loss in a group of loans with those characteristics, the loan should be included in the assessment of the ALLL for that group of loans under SFAS 5. Banks should measure estimated credit losses under SFAS 114 only for loans individually evaluated and determined to be impaired.

Under SFAS 5, a loss is recognized if characteristics of a loan indicate that it is probable that a group of similar loans includes some estimated credit losses even though the loss cannot be identified to a specific loan. Such a loss would be recognized if it is probable that the loss has been incurred at the date of the financial statements and the amount of loss can be reasonably estimated. This response is consistent with EITF D-80, question 10.

Question 22:

(December 2008)

If a bank assesses an individual loan under SFAS 114 and determines that it is impaired, but it measures the amount of impairment as zero, should that loan be included in the assessment of the ALLL under SFAS 5?

Staff Response:

No. For an impaired loan, no additional loss recognition is appropriate under SFAS 5 even if the measurement of impairment under SFAS 114 results in no allowance. An example would be when the recorded investment in the impaired loan has been written down to a level where no allowance is required. This response is consistent with EITF D-80, question 12.

However, before concluding that an impaired SFAS 114 loan needs no associated loss allowance, the bank should determine and document that its measurement process is appropriate and that it considered all available and relevant information. For example, for a collateral-dependent loan, the following factors should be considered in the measurement of impairment under the fair value of collateral method: volatility of the fair value of the collateral, timing and reliability of the appraisal or other valuation, timing of the bank's or third party's inspection of the collateral, confidence in the bank's lien on the collateral, historical losses on similar loans, and other factors as appropriate for the loan type.

This response is consistent with the *Policy Statement on the Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions* (2001 Policy Statement), question 3, and the Securities and Exchange Commission's Staff Accounting Bulletin No. 102, question 7.

Question 23:

(December 2008)

Is the practice of "layering" the ALLL appropriate?

Staff Response:

No. Layering is the inappropriate practice of recording in the ALLL more than one amount for the same estimated credit loss. When measuring and documenting estimated credit losses, banks should take steps to prevent the layering of loan loss allowances. One example of inappropriate layering occurs when a bank includes a loan in one loan category, determines its best estimate of loss for that loan category, and then includes the loan in another loan category, which receives an additional ALLL amount.

Another example of inappropriate layering occurs when an allowance has been measured for a loan under SFAS 114, but the loan is then included in a group of loans with similar risk characteristics for which an ALLL is estimated under SFAS 5. The allowance provided for an individually impaired loan under SFAS 114 can not be supplemented by an additional allowance under SFAS 5. Inappropriate layering occurs when a bank includes a loan in two different SFAS 5 pools of loans for purposes of providing an allowance. When measuring and documenting estimated credit losses, banks should take steps to prevent the layering of loan loss allowances. This is consistent with the 2001 Policy Statement, Appendix B.

Question 24:

(September 2001)

Assume the loan review and allocation process operates satisfactorily, and losses are recognized promptly. Is it acceptable for there to be no provision to the ALLL for a pool of uncriticized loans?

Staff Response:

By definition, uncriticized loans do not have inherent loss individually. However, experience indicates that some loss could occur even when loan review systems provide timely problem loan identification. A lack of information or misjudgment could result in failure to recognize that an uncriticized credit has become impaired.

Accordingly, banks must include a provision in the ALLL for those existing, but unidentified, losses in pools of uncriticized loans. The loss factor for pools of pass loans in banks possessing a reliable loan review system should be much smaller than it is in banks lacking adequate loan review systems.

Migration analysis is often applied to pools of past due and/or classified loans, because their classification reflects the fact that a loss event has probably already occurred.

Question 25:

(December 2008)

Is it appropriate to estimate an allowance for “pass” loans?

Staff Response:

Yes. In determining an appropriate level for the ALLL, a bank must analyze the entire loan and lease portfolio for probable losses that have been incurred that can be reasonably estimated. A loan designated “pass” generally would not be impaired if individually evaluated. However, if the specific characteristics of such a loan indicate that it is probable that there would be an estimated credit loss in a group of loans with similar characteristics, then the loan should be included in the assessment of the ALLL for that group of loans under SFAS 5.

Under SFAS 5, the determination of estimated credit losses may be considered for individual loans or in relation to groups of loans with similar characteristics. This determination should be made on a group basis even though the loans that are uncollectible in the group may not be individually identifiable. Accordingly, the ALLL for a group of loans with similar risk characteristics, which includes loans designated as “pass,” should be measured under SFAS 5.

Question 26:

(September 2001)

Do specific guidelines exist for the “qualitative” or “environmental” adjustment factors?

Staff Response:

These factors require judgments that cannot be subjected to exact mathematical calculation. There are no formulas for translating them into a basis-point adjustment of the bank’s historical loss rate for a pool of loans. The adjustment must reflect management’s overall estimate of the extent to which current losses on a pool of loans will differ from historical loss experience. It would include management’s opinion on the effects of current trends and economic conditions on a loss rate derived through historical analysis of a pool of loans.

Those adjustments are highly subjective estimates that should be reviewed at least quarterly in light of current events and conditions. Management should document carefully the qualitative factors considered and the conclusions reached.

Question 27:

(December 2008)

How should a bank document and support the qualitative or environmental factors used to adjust historical loss experience to reflect current conditions as of the financial statement date?

Staff Response:

As noted in the 2006 Policy Statement, banks should support adjustments to historical loss rates and explain how the adjustments reflect current information, events, circumstances, and conditions in the loss measurements. Management should maintain reasonable documentation to support which factors affected the analysis and the impact of those factors on the loss measurement. Support and documentation includes descriptions of each factor, management's analysis of how each factor has changed over time, which loan groups' loss rates have been adjusted, the amount by which loss estimates have been adjusted for changes in conditions, an explanation of how management estimated the impact, and other available data that supports the reasonableness of the adjustments. Examples of underlying supporting evidence could include, but are not limited to, relevant articles from newspapers and other publications that describe economic events affecting a particular geographic area, economic reports and data, and notes from discussions with borrowers.

Management must exercise significant judgment when evaluating the effect of qualitative factors on the amount of the ALLL because data may not be reasonably available or directly applicable for management to determine the precise impact of a factor on the collectibility of the institution's loan portfolio as of the evaluation date. For example, the bank may have economic data that shows commercial real estate vacancy rates have increased in a portion of its lending area. Management should determine an appropriate adjustment for the effect of that factor on its current portfolio that may differ from the adjustment made for the effect of that factor on its loan portfolio in the past. It is management's responsibility to use its judgment to determine the best estimate of the impact of that factor and document its rationale for its best estimate. This rationale should be reasonable and directionally consistent with changes that have occurred in that factor based on the underlying supporting evidence previously discussed.

Question 28:

(December 2008)

If a bank measures impairment based on the present value of expected future cash flows for SFAS 114 purposes, what factors should be considered when estimating the cash flows?

Staff Response:

The bank should consider all available information reflecting past events and current conditions when developing its estimate of expected future cash flows. All available information would include a best estimate of future cash flows taking into account existing "environmental" factors (e.g., existing industry, geographical, economic, and political factors) that are relevant to the collectibility of that loan. This response is consistent with EITF D-80, question 16.

Facts:

A bank writes down an individually impaired loan to the most recently appraised value of the collateral because that portion of the loan has been identified as uncollectible, and, therefore, is deemed to be a confirmed loss.

Question 29:

(December 2008)

Should there be a loan loss allowance under SFAS 114 associated with the remaining recorded investment in the loan?

Staff Response:

Generally, yes. Typically, the most recent appraised value will differ from fair value (less costs to sell) as of the balance sheet date. For an impaired collateral-dependent loan, the bank should generally charge off any portion of the recorded investment in excess of the fair value of the collateral. Estimated costs to sell also must be considered in the measure of the ALLL under SFAS 114 if these costs are expected to reduce the cash flows available to satisfy the loan.

Although the bank should consider the appraised value of the collateral as the starting point for determining its fair value, the bank should also consider other factors and events that may affect the current fair value of the collateral since the appraisal was performed. The bank's experience with realization of the appraised values of impaired collateral-dependent loans should also be taken into account. In addition, the timing of expected cash flows from the underlying collateral could affect the fair value of the collateral if the timing differs from that contemplated in the appraisal. This may result in the appraised value of the collateral being greater than the bank's current estimate of the collateral's fair value (less costs to sell).

As a consequence, the bank's allowance for the impaired collateral-dependent loan under SFAS 114 is based on fair value (less costs to sell), but the charge-off (the confirmed "loss") is based on the higher appraised value. The remaining recorded investment in the loan after the charge-off will have a loan loss allowance for the amount by which the estimated fair value of the collateral (less costs to sell) is less than its appraised value. This is consistent with the guidance in Appendix B of the 2001 Policy Statement, which notes that the bank would classify as "Loss" the portion of the recorded investment deemed to be the confirmed loss, and classify the remaining amount as "Substandard."

Facts:

Some banks remove loans that become adversely classified from a group of "pass" loans with similar risk characteristics in order to evaluate the loans individually under SFAS 114 (if deemed impaired) or collectively in a group of adversely classified loans with similar risk characteristics under SFAS 5.

Question 30:

(September 2001)

How does this removal of loans from the pool affect the calculation of the historical loan rates?

Staff Response:

Loans that have been analyzed individually and provided for in the ALLL should be included in their respective pools of similar loans to determine the bank's historical loss experience. This will provide a more meaningful analysis of loss ratios or percentages on loans with similar characteristics. *However, to avoid double accounting of inherent loss, any loan that has been provided for should be excluded from the current pool of loans when applying the historical loss factor to estimate the losses in the remaining pool.*

Question 31:

(December 2008)

May a bank include amounts designated as “unallocated” in its ALLL?

Staff Response:

Yes, the ALLL may include an amount labeled as “unallocated” as long as it reflects estimated loan losses determined in accordance with GAAP and is properly supported. The term “unallocated” is not defined in GAAP, but has various meanings in practice. For example, some banks refer to the portion of the ALLL based on qualitative or environmental factors as “unallocated,” while others consider those adjustments to be an element of the “allocated” ALLL under SFAS 5. Still others believe “unallocated” refers to any ALLL amounts that are not attributable to or were not measured on any particular groups of loans.

Economic developments that surface between the time management estimates credit losses and the date of the financial statements, as well as certain other factors such as natural disasters that occur before the date of the financial statements, are examples of environmental factors that may cause losses that apply to the portfolio as a whole and are difficult to attribute to individual impaired loans or to specific groups of loans and, as a consequence, result in an “unallocated” amount.

An “unallocated” portion of the ALLL may or may not be consistent with GAAP. If a bank includes an amount labeled “unallocated” within its ALLL that reflects an amount of estimated credit losses that is appropriately supported and documented, that amount would be acceptable as part of management’s best estimate of credit losses. The label “unallocated,” by itself, does not indicate whether an amount so labeled is acceptable or unacceptable within management’s estimate of credit losses. Rather, it is management’s objective evidence, analysis, and documentation that determine whether an “unallocated” amount is an acceptable part of the ALLL under GAAP.

Appropriate support for any amount labeled “unallocated” within the ALLL should include an explanation for each component of the “unallocated” amount, including how the component has changed over time based upon changes in the environmental factor that gave rise to the component. In general, each component of any “unallocated” portion of the ALLL should fluctuate from period to period in a manner consistent with the factors giving rise to that component (i.e., directional consistency).

Question 32:

(December 2008)

Is there a specific period of time that should be used when developing historical experience for groups of loans to estimate the SFAS 5 portions of the ALLL?

Staff Response:

There is no fixed period of time that banks should use to determine historical loss experience. During periods of economic stability, a relatively long period of time may be appropriate. However, during periods of significant economic expansion or contraction, the relevance of data that are several years old may be limited. Accordingly, the period used to develop a historic loss rate should be long enough to capture sufficient loss data. At some banks, the length of time used varies by product; high-volume consumer loan products generally use a shorter time period than more specialized commercial loan products.

A bank should maintain supporting documentation for the techniques used to develop its loss rates. Such documentation includes evidence of the average and range of historical loss rates (including gross charge-offs and recoveries) by common risk characteristics (e.g., type of loan, loan grade, and past due status) over the historical period of time used. At larger banks, this information is often further segmented by originating branch office or geographic area. A bank's supporting documentation should include an analysis of how the current conditions compare to conditions during the time period used in the historical loss rates for each group of loans assessed under SFAS 5. A bank should review the range of historical losses over the time period used, rather than relying solely on the average historical loss rate, and should identify the appropriate historical loss rate from within that range to use in estimating credit losses for the groups of loans. This ensures that the appropriate historical experience is captured and is relevant to the bank's current portfolio.

Question 33:

(December 2008)

How should a bank that has had a very low or zero historical loss rate over the past several years use this historical loss experience in calculating estimated credit losses for loans that are not determined to be impaired?

Staff Response:

As noted in the 2006 Policy Statement, historical loss experience provides a reasonable starting point for the bank's analysis. However, historical losses, or even recent trends in losses, are not by themselves a sufficient basis to determine the appropriate level for the ALLL. Because the bank's historical loss experience is minimal, any SFAS 5 allowances that exceed the historical loss experience should be based on qualitative or environmental factors. Management should consider such factors as changes in lending policies, changes in the trend and volume of past due and adversely classified loans, changes in local and national economic conditions, and effects of changes in loan concentrations. This will ensure that the ALLL reflects estimated credit losses in the current portfolio.

Question 34:

(December 2008)

How should guarantor payments and proceeds anticipated from conversion of collateral be handled when measuring impairment under SFAS 114 using the present value of expected cash flows method?

Staff Response:

All expected cash flows should be included when measuring the amount of impairment for an individually evaluated credit. Per SFAS 114, estimated cash flows should be based on reasonable and supportable assumptions and projections considering all available evidence. Anticipated payments directly from the borrower serve as the primary component in the discounted cash flow model. In addition, any anticipated repayment from a guarantor or through collateral conversion (reduced by estimated selling costs) should be captured in the expected cash flow analysis.

Question 35:

(September 2001)

Do "trends" in describing the qualitative factors imply recognition of future losses?

Staff Response:

The word “trends” refers to the effect of current trends on the historical rate of loss. It refers only to effects through the evaluation date and does not imply that the bank should try to capture the effects of possible future events in its adjustment for historical loss factors. Qualitative adjustments to historical loss experience are important in estimating the level of loss inherent in the current loan portfolio. As an example, a recent adverse trend in delinquencies and nonaccruals reflects loss events that have already occurred. The resulting increase in charge-offs may not yet be reflected fully in the historical loss experience. However, this trend must be considered when determining the adequacy of the ALLL.

Similarly, a recent deteriorating trend in the local economy is, in itself, an event that has adversely affected the bank’s borrowers and will probably result in its charging off loans at a greater rate than its historical loss experience indicates. The bank’s historical loss factor should, therefore, be adjusted to provide for an increased level of charge-offs.

Finally, a recent change in the volume and terms of loans being originated may affect (either positively or negatively) charge-offs. If, for example, the bank tightened its approval standards for new credit card borrowers, or increased the level of holdback on discounted paper, it could reasonably expect lower levels of loss on those pools of loans in the future.

Question 36:

In the “Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans,” the discussion of the ALLL urges consideration of “. . . reasonably foreseeable events that are likely to affect the collectibility of the loan portfolio.” Does this statement conflict with the guidance given in the previous responses?

Staff Response:

The staff does not believe that conflict exists. The interagency policy statement addresses troubled, collateral-dependent real estate loans. For such a loan, the value of the collateral is critical in determining the loan classification and the level of the ALLL. Expectations about the effects of reasonably foreseeable events are inherent in the valuation of real estate.

For example, a real estate loan may be secured by a property with a significantly above market (but soon to expire) lease. This lease will not be renewed at its current rate. This reasonably foreseeable event should be considered in valuing the property. Another reasonably foreseeable event would be construction of a new commuter rail station. It would almost certainly affect nearby property values in a positive manner.

The departure of the tenant and completion of construction resemble “confirming events” more than “loss events.” In the first example, the value decline is inherent in the fact that an existing lease will expire and will no longer generate the current above market level of income. In the second example, property values will increase well before construction is complete.

Question 37:

(December 2008)

Will a bank be subject to criticism if its methodology is inappropriate, but its ALLL balance is appropriate?

Staff Response:

Yes. The OCC places increased emphasis on an ALLL evaluation process that is sound, based on reliable information, and well documented. Even if a bank's current ALLL balance is appropriate, management does not have a sound basis for determining an appropriate level for the ALLL on an ongoing basis if its evaluation process is deficient.

Question 38:

(December 2008)

Must bank management review the appropriateness of the ALLL quarterly?

Staff Response:

The appropriateness of the ALLL must be reviewed at least quarterly. Otherwise, management may not be able to determine the accuracy of the bank's call reports. However, significant loans analyzed individually should be monitored regularly, and provisions made to the ALLL as events occur. This should be a continuous, and not calendar driven, process.

The amount of time that elapses between reviews for pools of loans and other less significant, individually analyzed loans affects the strength of the loan review process. The process should also react to internal and external events that might indicate problems in a particular credit or group of credits.

Question 39:

(September 2001)

Do materially excessive allowances also pose a problem?

Staff Response:

The risk of error or imprecision is inherent in the entire allocation process. Accordingly, as noted in Emerging Issues Task Force Topic D-80, most guidance has discussed the ALLL in the context of a range of reasonable estimates. A bank should recognize its best estimate within its estimated range of losses. In this process, banks should take into account all available information existing as of the measurement date, including "environmental" factors.

However, an ALLL that clearly and substantially exceeds the required level misstates both the earnings and condition of the bank and constitutes a violation of 12 USC 161. Elimination of such excess ALLL should be accounted for as a credit to (or reduction in) the provision for loan and lease losses. If an improper estimate or error is discovered after a call report is filed, the guidance in the call report instructions for accounting changes should be consulted.

Question 40:

(December 2008)

What action must a bank take when its ALLL is not appropriate?

Staff Response:

The staff believes that an ALLL established in accordance with the 2006 Policy Statement and the 2001 Policy Statement falls within the range of acceptable estimates determined in accordance with GAAP. When the reported amount of a bank's ALLL is not appropriate, the bank will be required to adjust its ALLL by an amount sufficient to bring the ALLL reported on

its call report to an appropriate level as of the evaluation date. This adjustment should be reflected in the current period provision or through the restatement of prior period provisions, as appropriate in the circumstances.

Facts:

A bank has overdraft accounts of approximately \$2 million. As of the reporting period date, approximately \$200,000 is deemed to be uncollectible.

Question 41:

(April 2005)

How should the bank account for losses related to the overdraft accounts?

Staff Response:

Any losses related to these accounts should be charged against the ALLL. In accordance with the AICPA Audit and Accounting Guide for Depository and Lending Institutions, checking accounts that are overdrawn should be reclassified as loans and should, therefore, be evaluated for collectibility as part of the evaluation of the ALLL. Since the bank's ALLL methodology is required to consider the overdraft accounts, the subsequent charge offs of the overdraft accounts would be charged against the ALLL.

If the bank did not properly consider the overdraft accounts part of its ALLL methodology, it would not be appropriate to charge off losses to the ALLL without recording a corresponding provision for these accounts. The bank would need to reassess the provision for the outstanding overdraft accounts and make an appropriate adjustment to the ALLL, as necessary.

Facts:

A bank offers an overdraft protection program to a specific class of customers under which it may at its discretion pay overdrafts up to a specified amount. The overdraft protection essentially serves as a short-term credit facility; however, no analysis of the customer's creditworthiness is performed. The bank charges the customer a flat fee each time the service is triggered, and a daily fee for each day the account remains overdrawn. As of the reporting period date, the bank has overdraft account balances of \$2 million (excluding associated fees), of which \$200,000 is deemed to be uncollectible.

Question 42:

(April 2005)

How should the bank account for uncollectible overdraft protection fees?

Staff Response:

The bank may provide a loss allowance for uncollectible fees or recognize in fee income only that portion of earned fees estimated to be collectible. The bank may charge off uncollected overdraft fees against the ALLL only if such fees are recorded with overdraft account balances as loans, and the estimated losses on the fees are provided for in the ALLL.

Question 43:
2003)

(June

Since the call report instructions do not require consumer credit card loans to be placed on nonaccrual based on delinquency status, how should a bank determine that income is recorded accurately?

Staff Response:

Because a portion of the accrued interest and fees on credit card accounts is generally not collectible, banks must evaluate the collectibility of the accrued interest and fees. In this respect, a bank may provide a loss allowance for these uncollectible interest and fees, or place the delinquent loans and impaired receivable on nonaccrual status. This allowance may be included in the ALLL, as a contra account to the credit card receivables, or in other liabilities. However, regardless of the method employed, banks must ensure that income is measured accurately.

Question 44:

(June 2003)

How should banks treat over-limit credit card accounts in their ALLL methodologies?

Staff Response:

Bank ALLL methodologies do not always recognize fully the loss inherent in over-limit credit card accounts. For example, if borrowers are required to pay over-limit and other fees, in addition to the minimum payment amount each month, roll rates and estimated losses may be higher than indicated on the overall portfolio analysis. Accordingly, banks should ensure that their ALLL methodology addresses the incremental losses that may be inherent on over-limit credit card accounts.

Question 45:

(December 2008)

How should banks provide for the loss inherent in credit card workout programs?

Staff Response:

As noted in question 5, large groups of smaller-balance homogeneous loans, such as credit card loans, that are collectively evaluated for impairment are not included in the scope of SFAS 114, and the guidance for groups of smaller-balance homogeneous loans contained in SFAS 5 is applied. However, if the smaller-balance loan has been modified in a troubled debt restructuring as defined by SFAS 15, impairment should be assessed in accordance with SFAS 114. Banks should determine whether the credit card workout program qualifies as troubled debt restructurings.

Banks should ascertain that their ALLL provides appropriately for the estimated credit loss in credit card workout programs. Accounts in workout programs should be segregated for performance measurement, impairment analysis, and monitoring purposes. When the bank has multiple programs with different performance characteristics, each program should be reviewed separately.

An appropriate allowance should be established and maintained for each program. Generally, the ALLL allocation should equal the estimated loss in each program based on historical

experience adjusted for current conditions and trends. These adjustments should take into account changes in economic conditions, volume and mix of the accounts, terms and conditions of each program, and collection history.

Question 46:

(June 2003)

After a credit card loan is charged off, how should banks account for subsequent collections on the loan?

Staff Response:

Recoveries represent collections on amounts that were previously charged off against the ALLL. Accordingly, the total amount credited to the ALLL as a recovery on a credit card loan (which may include amounts representing principal, interest, and fees) is limited to the amount previously charged off against the ALLL on that loan. Any amounts collected in excess of the amount previously charged off should be recorded as income.

In certain instances the OCC has noted that the total amount credited to the ALLL on an individual loan exceeds the amount previously charged off against the ALLL for that loan. Such a practice understates a bank's net charge-off experience, which is an important indicator of the credit quality and performance of a bank's portfolio. Accordingly, such a practice is not acceptable.

Facts:

Two severe hurricanes caused severe damage to certain geographic regions late in the third quarter of 200X.

Question 47:

(May 2006)

How should banks with borrowers affected by the hurricanes determine the appropriate amount to report for their ALLL in their financial statements for the third quarter of 200X?

Staff Response:

For banks with loans to borrowers in the affected area, it may be difficult at that date to determine the overall effect that the hurricanes will have on the collectibility of these loans. Many of these banks will need time to evaluate their individual borrowers, assess the condition of underlying collateral, and determine potential insurance proceeds and other available recovery sources.

For its financial statements, management should consider all information available about the collectibility of the bank's loan portfolio to make its best estimate of probable losses within a range of loss estimates, recognizing that there is a short time between the storms' occurrence and the required filing date for the third quarter financial statements. Consistent with GAAP, the amounts included in the ALLL in third quarter call reports for estimated credit losses incurred as a result of the hurricanes should include those amounts that represent probable losses that can be reasonably estimated. As banks are able to obtain additional information about their loans to borrowers affected by the hurricanes, the estimates of the effect of the hurricanes on loan losses could change over time and the subsequent estimates of loan losses would be reflected in the banks' subsequent financial statements.

In particular, for commercial loans whose terms have been modified in a TDR that provides for a reduction of either interest or principal (referred to as a modification of terms), banks should measure the impairment loss on the restructured loan in accordance with SFAS 114. In this regard, a credit analysis should be performed in conjunction with the restructuring to determine the loan's collectibility and estimated impairment. The amount of this impairment should be included in the ALLL. As additional information becomes available indicating a specific commercial loan, including a loan that is a TDR, will not be repaid, an appropriate charge-off should be recorded.

Facts:

Customer A, with a \$100,000 line of credit, draws the line of credit down fully, then intentionally pays the loan off with a bad check drawn on another institution. The customer immediately draws down an additional \$100,000 before the check clears. Customer A now owes the bank \$200,000, although the amount of credit extended was only \$100,000. The customer does not have the ability to repay the debt.

Question 48:

(December 2008)

Is \$100,000 charged against the ALLL and \$100,000 classified as an operational loss?

Staff Response:

No. This entire loss should be recorded through the ALLL. While a portion of the loss includes apparently fraudulent actions on the part of Customer A, the activity occurred within the bank's legitimate lending function. Even though the credit limit was \$100,000, the bank ultimately loaned the borrower \$200,000. Since the losses relate to the bank's actions for Customer A's credit, it is considered a credit loss and charged against the ALLL.

The staff considers the following definitions to distinguish fraud as operational losses charged to other noninterest expense or as credit losses charged against the ALLL:

Credit Loss

Losses that arise from a contractual relationship between a creditor and a borrower (i.e. the bank still has legal ability to collect from a borrower).

Credit losses arise from the contractual relationship between a creditor and a borrower and may result from the creditor's own underwriting, processing, servicing or administrative activities along with the borrower's failure to pay according to the terms of the loan agreement. While the creditor's personnel, systems, policies or procedures may affect the timing or magnitude of a credit loss, they do not change its character from credit to operational.

The accounting guidance for credit losses provides that creditors recognize credit losses when it is probable that they will be unable to collect all amounts due according to the contractual terms of a loan agreement.

Operational Loss

Losses that arise outside of a relationship between a creditor and a borrower (i.e., the bank does not have the legal ability to collect from a borrower) are considered operational losses. If these

losses are “probable” and “reasonably estimable” as defined in SFAS 5, an expense should be accrued and another liability recorded. Once the actual losses are confirmed, they should be charged against the other liability.

Facts:

An independent third party steals the identification and credit card numbers of various individuals and then uses an illegal credit card machine to create counterfeit credit cards bearing the names and card numbers of the individuals. Subsequently, charges are made on these counterfeit cards, and losses are incurred by the bank.

Question 49:

(December 2008)

Should these losses be charged against the ALLL?

Staff Response:

No. This would be considered an operational loss as the bank did not issue the credit cards and did not have a contractual relationship with a borrower. The bank could not legally collect from a borrower because it was not the borrower’s charges.

TOPIC 5: OTHER ASSETS**5A. REAL ESTATE****Question 1:**

(December 2008)

How should banks account for their investment in other real estate owned (OREO) property?

Staff Response:

Detailed accounting guidance for OREO is provided in the call report instructions. These instructions require that OREO and its sales be accounted for in accordance with generally accepted accounting principles. In this respect, Statement of Financial Accounting Standards Nos. 15, 114 and 144 (SFAS 144) provides the general guidance for the recording of OREO. Sales of OREO are accounted for in accordance with Statement of Financial Accounting Standards No. 66 (SFAS 66). Statement of Financial Accounting Standards No. 67 (SFAS 67) provides guidance on the accounting for costs during the development and construction period, and Statement of Financial Accounting Standards No. 33 (SFAS 33) provides guidance on capitalization of interest costs.

Upon receipt of the real estate, OREO should be recorded at the fair value of the asset less the estimated cost to sell, and the loan account reduced for the remaining balance of the loan. This transfer at fair value, less estimated cost to sell, results in a new cost basis for the OREO property. The amount by which the recorded investment in the loan exceeds the fair value (net of estimated cost to sell) of the OREO is charged to the ALLL.

Subsequent declines in the fair value of OREO below the new cost basis are recorded through the use of a valuation allowance. Changes in fair value must be determined on a property-by-property basis. An allowance allocated to one property may not be used to offset losses incurred on another property. Unallocated allowances are not acceptable. Subsequent increases in the fair value of a property may be used to reduce the allowance, but not below zero.

SFAS 157 provides guidance on measuring the fair value of OREO property. Although the fair value of the property normally will be based on an appraisal (or other evaluation), the valuation should be consistent with the price that a market participant will pay to purchase the property at the measurement date. Circumstances may exist that indicate that the appraised value is not an accurate measurement of the property's current fair value. Examples of such circumstances include changed economic conditions since the last appraisal, stale appraisals, or imprecision and subjectivity in the appraisal process (i.e., actual sales for less than the appraised amount).

Facts:

A bank is in the process of foreclosing on a \$150,000 loan. It is secured by real estate with a fair value, based on a current appraisal, of \$180,000. The cost to sell this property is estimated at \$15,000.

Question 2:

(September 2004)

At what value should the OREO be recorded?

Staff Response:

Upon receipt of the real estate, the property should be recorded at \$165,000 in accordance with SFAS 15, 114 and 144. This represents the fair value of \$180,000 less the \$15,000 cost to sell the property. However, because of safety and soundness concerns, the fair value determined in the appraisal should be scrutinized closely. Since the appraisal indicates that the borrower has equity in the property, the bank should address the issue of why the borrower would risk losing the property in foreclosure. If concern exists about the accuracy of the appraisal, further analysis should be performed. However, if the appraisal properly supports the fair value, the \$15,000 increase in value is recorded at the time of foreclosure. This increase in value may be reported as noninterest income unless there had been a prior charge-off, in which case a recovery to the ALLL would be appropriate.

Facts:

A bank acquires real estate in full satisfaction of a \$200,000 loan. The real estate has a fair value of \$190,000 at acquisition. Estimated costs to sell the property are \$15,000. Six months later the fair value of the property has declined to \$170,000.

Question 3:

(September 2003)

How should the OREO be accounted for?

Staff Response:

Upon receipt of the real estate, the property should be recorded at \$175,000. This represents the fair value (\$190,000) at acquisition less the cost to sell (\$15,000) the property. The amount by which the recorded investment in the loan (\$200,000) exceeds the fair value less cost to sell (\$175,000) should be recorded as a charge against the ALLL. Accordingly, a \$25,000 charge against the ALLL is recorded.

Subsequent to the acquisition date, the OREO is carried at the lower of cost (\$175,000) or fair value less cost to sell. When the fair value declines to \$170,000, the fair value less cost to sell would be \$155,000. This represents a \$20,000 decline in value, which is recorded through a valuation allowance.

Facts:

Continuing with question 3, two years later the fair value of the property is \$195,000.

Question 4:

(September 2003)

How should the increase in value be accounted for?

Staff Response:

The increase in the fair value (\$25,000) can be recognized only up to the new recorded cost basis of the OREO, which was determined at the foreclosure date. Accordingly, the valuation allowance of \$20,000 would be reversed. The additional \$5,000 increase in value would not be recognized.

Question 5:

(September 2002)

May a bank retroactively establish a valuation for properties that was reduced previously by direct write-off?

Staff Response:

No. Since the bank did not establish an allowance at the time the properties were initially written down, a new basis of accounting was established. Reversing the previous writedown and rebooking the charged off asset is not in accordance with generally accepted accounting principles.

Question 6:

(February 2004)

How should the revenues and expenses (including real estate property taxes) resulting from operating or holding OREO property be accounted for?

Staff Response:

Generally, the revenues and expenses from OREO property should be included in the Statement of Income for the period in which they occur. The call report instructions require that gross rentals from OREO be included in "Other noninterest income." The expenses of operating or holding the property should be included in "Other noninterest expense." Because the asset is held for sale, depreciation expense would normally not be recorded.

Statement of Financial Accounting Standards No. 67 (SFAS 67) provides an exception for real estate property taxes incurred "during periods in which activities necessary to get the property ready for its intended use are in progress." Therefore, real estate taxes incurred during the construction period can be capitalized, up to the fair value of the property. However, such costs incurred at other times must be expensed as incurred. In this respect, SFAS 67 states that "costs incurred for such items after the property is substantially complete and ready for its intended use shall be charged to expense as incurred." This limited exception would not cover periods in which the bank is merely holding property for future sale.

Facts:

A bank forecloses on a loan secured by a second lien on a piece of property. The bank does not formally assume the senior lien.

Question 7:

How should the bank account for the senior debt?

Staff Response:

Although a bank may not assume formally the liability of the senior lien on the property, the amount of any senior debt should be reported as a liability at the time of foreclosure. The OREO balance would be increased by a corresponding amount. However, the resultant carrying value of the OREO cannot exceed the fair value, net of sales costs, of the property.

Any excess should be charged against the allowance for loan and lease losses at the time of foreclosure.

Question 8:

(January 2007)

The bank pays delinquent real estate taxes on a property to avoid lien attachment by the taxing authority. Is this accounted for in the same manner as assuming a prior lien?

Staff Response:

No. Although a tax delinquency effectively creates a prior lien, the accounting differs. All costs of foreclosure should be expensed as incurred. The staff believes that settling real estate tax delinquencies are costs incidental to foreclosure and must be expensed. Real estate taxes on property held as OREO are considered holding costs and expensed as incurred. An exception to this rule exists for property under construction. Generally accepted accounting principles allow for capitalization of property taxes during the development period of the property.

Additionally, other such costs paid by the bank during, or in anticipation of, foreclosure should be expensed. These costs include items the bank may contractually obtain reimbursement from the borrower, such as credit life insurance or property insurance premiums.

Question 9:

(February 2004)

The bank purchases the real estate tax lien certificate on the property, rather than paying the delinquent real estate taxes. Would this change the response to question 8?

Staff Response:

No. The substance of this transaction when the bank purchases the tax lien certificates on property on which it has a lien or has foreclosed is the same as if the bank were paying the property taxes on the property directly. Accordingly, the guidance in question 8 would apply.

Question 10:

When can a sale of OREO be accounted for under the full accrual method of accounting?

Staff Response:

The full accrual method may be used when all of the following conditions have been met:

- A sale has been consummated.
- The buyer's initial investment (down payment) and continuing investment (periodic payments) are adequate to demonstrate a commitment to pay for the property.
- The receivable is not subject to future subordination.
- The usual risks and rewards of ownership have been transferred.

Question 11:

What constitutes an adequate down payment for use of the full accrual method of accounting?

Staff Response:

The down payment requirement of SFAS 66 considers the risk involved with various types of property. The required down payments range from 5 % to 25 % of the sales price of the OREO.

For example, only a 10 percent down payment is required for commercial property subject to a long-term lease and that has cash flows sufficient to service all indebtedness. On the other hand, a 25 % down payment is required for commercial property, such as hotels, motels, or mobile home parks, in a start-up phase or having cash flow deficiencies.

Question 12:

If a transaction does not qualify as a sale under the full accrual method of accounting, what other methods are available for accounting for the transaction?

Staff Response:

SFAS 66 provides four other methods for accounting for sales of real estate. They are: the installment method, the cost recovery method, the reduced-profit method, and the deposit method.

In the past, many banks have used only the deposit method to account for dispositions of OREO that did not qualify for immediate sales recognition under the full accrual method. However, depending on the circumstances, use of one of the other methods may be more appropriate. Often a disposition will qualify for immediate sales recognition under the installment method. This method recognizes a sale and the corresponding loan. Any profits on the sale are recognized as the bank receives the payments from the purchaser.

This method is used when the buyer's down payment is not adequate to allow use of the full accrual method, but recovery of the cost of the property is reasonably assured if the buyer defaults. Assurance of recovery requires careful judgment case by case. Factors that should be considered include: the size of the down payment, loan to value ratios, projected cash flows from the property, recourse provisions, and guarantees.

Since default on the loan usually results in the seller's reacquisition of the real estate, reasonable assurance of cost recovery may often be achieved with a relatively small down payment. This is especially true for loans *with recourse* to borrowers who have verifiable net worth, liquid assets, and income levels. Reasonable assurance of cost recovery may also be achieved when the purchaser/borrower pledges additional collateral.

Dispositions of OREO that do not qualify for either the full accrual or installment methods may be accounted under the cost recovery method. It recognizes a sale and the corresponding loan, but all income recognition is deferred.

The deposit method is used when a sale of the OREO has not been consummated. It may also be used for dispositions that could be accounted for under the cost recovery method. Under this method, a sale is *not* recorded and the asset continues to be reported as OREO. Further, no profit or interest income is recognized. Payments received from the borrower are reported as a liability until sufficient payments or other events have occurred that allow the use of one of the other methods.

The reduced-profit method is used when the bank receives an adequate down payment, but the continuing investment is not adequate. This method recognizes a sale and corresponding loan, and apportions any profits over the life of the loan, based on the present value of the lowest level of periodic payments.

Facts:

A bank sells a parcel of OREO property (undeveloped land) for \$100,000 and receives a \$40,000 down payment. But the bank agrees to extend a line of credit for \$35,000 to the buyer.

Question 13:

Does this transaction qualify as a sale under the full accrual method of SFAS 66?

Staff Response:

No. SFAS 66 requires that funds provided directly or indirectly to the buyer by the seller (bank) be subtracted from the buyer's down payment in determining whether the down payment criteria have been met. Therefore, in determining the buyer's initial investment, the \$40,000 down payment is reduced by the \$35,000 line of credit.

There is one exception to this rule. If the bank makes a loan conditional on the proceeds being used for specified development or construction activities related to the property sold, the loan need not be subtracted in determining the buyer's investment in the property. However, the loan must be on normal terms and at fair market interest rates.

Facts:

The bank sells a parcel of OREO (undeveloped land) at a profit. The sales price is \$200,000 and the bank receives a \$50,000 down payment. The terms of the mortgage require that the purchaser make interest only payments for five years. The entire principle balance is due at that time.

Question 14:

May the bank account for this sale using the full accrual method of accounting?

Staff Response:

No. SFAS 66 establishes the requirements for recording the transaction under the full accrual method. It requires that the buyer's continuing investment (periodic payments) be at least equal to the level annual payments needed to amortize the debt over 20 years for land and the customary first mortgage period (usually 20 to 30 years) for other types of property. In this situation, the loan balance is not being amortized during the five-year period. Therefore, this transaction does not qualify for recognition under the full accrual method of accounting. The reduced-profit method probably would be used.

Facts:

OREO property with a book value of \$110,000 is sold for \$120,000. The bank finances the sale and receives no cash down payment. The terms of the note require 120 monthly payments of

\$1,000 plus interest at market rates. SFAS 66 requires a minimum initial investment of 20 % for this type of property. Because of the inadequate initial investment, the bank has accounted for the sale using the deposit method of accounting. During the first year, the bank receives a total of \$26,000 in payments - \$12,000 in principal and \$14,000 in interest.

Question 15:

(December 2008)

Have the minimum initial investment requirements of SFAS 66 been met at the end of the first year?

Staff Response:

Yes. The minimum initial investment requirements of SFAS 66 have been met. This results because SFAS 66 allows the inclusion of both principal and interest payments in determining whether the down payment is adequate when the deposit method is used. Therefore, the \$26,000 received by the bank during the first year exceeds 20 % of the sales price (\$24,000).

Facts:

A bank owns a piece of OREO recorded at an appraised value of \$15 million. The bank agrees to sell the property for \$13.5 million to a buyer after negotiating from an original offer of \$11 million. Immediately prior to closing, the buyer has difficulty obtaining financing for the purchase, and the deal falls through.

Question 16:

(December 2008)

Must the bank adjust its recorded investment in the OREO?

Staff Response:

Yes, the bank should reduce the carrying value of the OREO to \$13.5 million. The bank received a better indication of the asset value by negotiating a fair sale price with a willing buyer. But for the buyer's last minute difficulties in obtaining financing, the bank (a willing seller) would have sold the property at a loss in a market transaction.

Question 17:

Assume the appraised value is the same as in question 11, except that the bank places the property for sale in an auction. The bank must set a minimum acceptable bid to attract only serious bidders. The bank sets a minimum of \$11 million. Must the bank write the OREO down to \$11 million, if the property is not sold?

Staff Response:

Not necessarily. If the bid is set for the purpose described and the bank is not required to accept an \$11 million bid if it is the only bid, then \$11 million may not be a fair price negotiated by a willing buyer and seller.

Also, the absence of bids does not necessarily mean that the minimum bid was unacceptable to any buyer. In these situations, evidence of a market price is inconclusive because a market has not been established, i.e., no willing buyer or willing seller. Accordingly, a source of fair value

independent of a single market transaction, such as an appraisal, would continue to be used to determine the carrying value of the property.

Facts:

In June 200X, a bank sells for \$2 million OREO property (a motel) with a book value of \$1.9 million, and receives a cash down payment of \$300,000 (15 % of the sales price). At the time of sale, the cash flow from the motel is not sufficient to service all indebtedness.

Because of the insufficient cash flows, SFAS 66 requires a minimum initial investment (down payment) of 25 % for use of the full accrual method of accounting in this situation. Had the motel been generating sufficient cash flows to service all indebtedness, only a 15 % down payment would have been required. Accordingly, this sale is accounted for using the installment method of accounting, and only a portion of the gain is recognized at the time of sale. This portion of gain recognized is based on the ratio of the down payment to the sales price. In this case, 15 % of the gain or \$15,000 is recognized at the time of sale. The remainder of the gain is deferred.

Question 18:

(December 2001)

Can the bank recognize periodic interest income on this loan that is accounted for under the installment method of accounting?

Staff Response:

Yes. Under the installment method, interest income is recognized at the contractual interest rate. In addition, a portion of the deferred gain (from the sale) would be recognized with each payment. However, should the loan experience delinquency problems, the nonaccrual rules would apply.

Question 19:

(December 2001)

Five months later, in November 200X, the motel's business is thriving and its cash flows are now sufficient and are expected to remain sufficient to service all indebtedness. Can the bank now reduce the down payment requirement to 15 % and recognize the sale under the full accrual method?

Staff Response:

Yes. Appendix B to SFAS 66 states that if the transaction later meets the requirements for the full accrual method, the seller (bank) may change to that method. The requirements for use of the full accrual method are met when the borrower's cash flow became sufficient to service the debt. Accordingly, at that time the bank can change to the full accrual method of accounting.

Question 20:

(December 2001)

Would the remainder of the deferred gain be recognized at this time?

Staff Response:

Yes. The deferred gain would be recognized in earnings at the time of the change to the full accrual method of accounting.

Facts:

A bank sells a shopping center that currently is classified as Other Real Estate Owned and finances the transaction. The buyer makes a 30 % down payment and enters into a 20-year amortizing mortgage at current market rates.

The mortgage is structured in two pieces, an A note and a B note. The B note is equal to 10 % of the total loan amount. If a certain major tenant vacates the property within five years and the borrower refinances the A note with an independent third-party lender within the next 180 days, the B note is forgiven. If the tenant remains in the shopping center for at least five years, both loans remain in effect. Both loans also remain in effect if the tenant vacates, but the borrower does not refinance within the stated time period. All other terms are consistent with those generally included in a mortgage on commercial real estate.

Question 21:

(February 2004)

How should this sales transaction be accounted for?

Staff Response:

This sale qualifies for sales treatment under the full accrual method of accounting. However, because of the bank's exposure with respect to note B, the bank has retained continuing involvement in the property in that it has retained certain risks of ownership. SFAS 66 establishes the accounting when a portion of the risk is retained.

In this respect, the Statement requires that when the risk is limited in amount, the profit recognition should be reduced by the maximum exposure to loss. Accordingly, the profit would be reduced (or loss increased) by the amount of note B.

Question 22:

(February 2004)

When would this portion of the gain be recognized?

Staff Response:

The gain would be recognized into income when the contingency expires. That would occur at the end of five years, or if the tenant vacates the property, at the end of the 180-day refinancing period. However, if the tenant vacates the property and the borrower does not refinance, a careful evaluation of this loan for impairment would be appropriate.

Facts:

A bank forecloses on a construction loan on a house that is unfinished. The recorded balance of the loan is \$120,000. The "as is" appraised value of the house is \$100,000, and the estimated disposal costs are \$10,000. The "when completed" appraised value of the house is \$150,000,

and the estimated disposal costs are \$15,000. The estimated cost to complete construction of the house is \$40,000.

Question 23:

(September 2004)

At what value should the OREO be recorded?

Staff Response:

The OREO should be recorded at \$90,000 in accordance with SFAS 15 and SFAS 144. This amount represents the current “as is” fair value of \$100,000 less the \$10,000 estimated costs to sell the property.

Question 24:

(September 2004)

Can the bank capitalize the costs incurred to complete the construction of the house?

Staff Response:

The subsequent costs incurred to complete the construction may be capitalized as long as the recorded balance of the OREO does not exceed the “when completed” fair value less estimated costs to sell. The bank should monitor the estimated cost to complete construction to ensure that the estimated cost does not exceed original estimates. The recorded balance of the OREO should never exceed fair value less estimated costs to sell.

Facts:

A bank acquired a commercial building upon the default of its borrower. The property was placed into OREO at \$5,000,000. This amount represents the property’s fair value (less disposal costs) at the time the bank took possession. Subsequently, a tenant who was paying an above market rent rate terminated its lease by paying the bank an early termination penalty fee of \$500,000.

Question 25:

(April 2005)

How should this \$500,000 fee be recorded?

Staff Response:

The \$500,000 fee should be included in the bank’s other noninterest income. The loss of this tenant may be an indication of impairment in the value of the property. Therefore, the bank should update its appraisal to determine whether the estimated fair value of the building has become further impaired due to the departure of the tenant. Any decline in fair value should be recorded in an OREO valuation account, if the decline is temporary, or as a direct writedown of the OREO balance.

Facts:

A bank sells a parcel of OREO property in a transaction that meets the four criteria (see question 10) set forth in SFAS 66 for use of the full accrual method of accounting. However, the bank

provides the purchaser/borrower with a mortgage loan at a preferential rate (i.e., below market rate) of interest.

Question 26:

(January 2007)

Would the granting of a preferential interest rate preclude use of the full accrual method of accounting?

Staff Response:

No. As noted, this transaction meets the four criteria set forth in SFAS 66 for use of the full accrual method of accounting. Accordingly, the transaction qualifies for use of the full accrual method. The preferential rate of interest does not affect that determination. However, the sales price, amount of gain (or loss), and future recording of interest income would be affected.

Question 27:

(January 2007)

How would the sales price, gain (or loss) on the transaction, and future interest income be determined?

Staff Response:

The loan should be discounted and recorded at its fair value, using a market rate of interest. This discount would also reduce both the effective sales price of the property and any gain (or increase the loss). The difference between the fair value and the contractual or face value of the loan is deferred interest income and is recognized into income as a yield adjustment over the life of the loan.

Facts:

A bank originates a mortgage loan and contemporaneously obtains lender paid mortgage insurance as part of the underwriting. Subsequently, the borrower defaults on the loan and the bank forecloses. The bank pays the premium for the insurance, and the cost is a factor in determining the loan's interest rate. The mortgage insurance does not meet the scope of a credit derivative under SFAS 133.

Question 28:

(December 2008)

At what amount should the OREO property be recorded?

Staff Response:

Upon receipt of the real estate, OREO should be recorded at the fair value of the asset less the estimated costs to sell, and the loan account reduced for the remaining balance of the loan (see question 1). The receivable related to the mortgage insurance should not be included in determining the fair value less costs to sell of the mortgage loan nor recorded as part of OREO. It is recorded as a separate asset.

Question 29:

(December 2008)

Should the bank record a mortgage insurance receivable?

Staff Response:

The bank should evaluate the probability that the mortgage insurance claim will be paid. SFAS 5 states that contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization. However, if realization of the mortgage insurance claim is assured, then a receivable may be recognized. Determining if the realization of the mortgage insurance claim is assured requires the bank to assess the mortgage insurance company's intent and ability to pay the claim. This includes assessing the mortgage insurance company's creditworthiness, propensity for litigating claims, and history of paying claims. The bank should not recognize a receivable for the mortgage insurance claim if there are concerns about the mortgage insurance company's creditworthiness, the mortgage insurance company's history of litigating claims, or the loans in question are subject to any uncertainty because of litigation.

Facts:

A bank sells the Small Business Administration (SBA) guaranteed portion of a loan. The borrower subsequently defaults on the loan. To facilitate foreclosure proceedings, the bank repurchases the guaranteed portion of the defaulted loan.

Question 30:

(December 2008)

At what amount should the purchase of the defaulted SBA loan be recorded?

Staff Response:

The purchased loan should be recorded at its fair value. While the repurchased loan is "guaranteed" by the SBA, the fair value may be less than par because of the time value of money and the length of time it takes to get a liquidation plan accepted by the SBA. This difference would be recorded as a loan loss against the ALLL.

Question 31:

(December 2008)

At what amount should a foreclosed SBA loan be recorded in OREO?

Staff Response:

The OREO should be recorded at fair value less estimated costs to sell when the loan is foreclosed or the bank receives physical possession of the property. The amount that the bank anticipates receiving from the SBA should be recorded as a receivable if the bank believes it is probable that its SBA claim will be paid.

Facts:

A bank has a nonaccrual SBA loan that is on the books for \$150,000 secured by property with a fair value of \$125,000. The bank estimates the cost to sell this property to be \$12,500. The SBA guaranty is for 75% of any loss. The SBA will probably pay the guaranteed amount when the property is sold.

Question 32:

(December 2008)

What would the accounting entries be for this loan when it is transferred to OREO?

Staff Response:

The OREO property is initially recorded at \$112,500 (fair value of \$125,000 less cost to sell of \$12,500). The estimated loss is the recorded value of the loan (\$150,000) less the recorded value of the OREO (\$112,500) or \$37,500. Since the SBA guarantees 75% of the loss, the SBA claim is expected to be \$28,125.

The entry to record the transaction would be:

	DEBIT	CREDIT
OREO	\$112,500	
ALLL (Charge-Off)	9,375	
SBA Receivable	28,125	
Loans		\$150,000

5B. LIFE INSURANCE AND RELATED DEFERRED COMPENSATION

Facts:

A bank has purchased split-dollar life insurance policies on the life of several key officers. These are cash value policies wherein both the bank and the officer's family are beneficiaries. The bank's benefit is limited to a refund of the gross premiums paid. All other benefits are designated for the officer's beneficiaries.

Question 1:

(December 2008)

How should these split-dollar life insurance policies be accounted for?

Staff Response:

Consistent with FASB Technical Bulletin No. 85-4 (TB 85-4) and Emerging Issues Task Force No. 06-5 (EITF 06-5), the bank should record the amount that it could realize under the insurance policy (i.e., its portion of the cash surrender value) as of the date of the financial statements as an "other asset." Further, consistent with Emerging Issues Task Force No. 06-4 (EITF 06-4), the bank should recognize a liability for future benefits. Based on the substantive agreement with the employee, the liability would be determined in accordance with SFAS 106 (if a postretirement benefit plan exists) or APB Opinion 12 (if the arrangement is an individual deferred compensation contract).

Facts:

Bank A has purchased "key-man" life insurance policies on the life of several key officers. These are cash value policies. However, they differ from the policies discussed in question 1 in that the bank is the sole beneficiary.

Questions 2:

(September 2008)

How should these "key-man" life insurance policies be accounted for?

Staff Response:

Consistent with TB 85-4 and EITF 06-5, the bank should record the amount that it could realize under the insurance policy (i.e., the cash surrender value) as of the date of the financial statements as an "other asset." The change in cash surrender value during the period is an adjustment of the premium paid in determining the expense (other noninterest expense) or income (other noninterest income) to be recognized for the period.

Facts:

A bank enters into deferred compensation agreements with each of its three executive officers.

Question 3:

(February

2004)

Which accounting pronouncements provide guidance for the accounting for such transactions?

Staff Response:

Statement of Financial Accounting Standards Nos. 87 and 106 apply to deferred compensation contracts with individual employees if those contracts, taken together, are equivalent to a postretirement income plan, or a postretirement health or welfare benefit plan, respectively. Other deferred compensation contracts should be accounted for in accordance with AICPA Accounting Principles Board Opinion No. 12 (APB 12), as amended by SFAS 106.

Question 4:

(February 2004)

Are the deferred compensation agreements with the three executive officers equivalent to a postretirement income *plan* or a postretirement health or welfare benefit *plan*?

Staff Response:

The determination of whether deferred compensation contracts, taken together, are equivalent to a postretirement *plan* should be based on facts and circumstances. Consideration should be given to the number of employees covered and the commonality of terms of the contracts. SFAS 106 states that an employer's practice of providing postretirement benefits to selected employees under individual contracts with specific terms determined on an individual-by-individual basis does not constitute a postretirement benefit *plan*. In this situation, the bank's deferred compensation agreements with only three employees do not constitute a *plan*. Accordingly, these contracts would be accounted for in accordance with APB 12, as amended by SFAS 106.

Facts:

A bank purchases a single premium bank-owned life insurance (BOLI) policy to provide funds for a deferred compensation agreement with a bank executive. The agreement states that the bank executive is entitled to receive deferred compensation based on the "excess earnings" of this insurance policy. The compensation agreement provides for a base earnings amount on the initial investment in the policy to be computed using a defined index. All earnings over this base amount (the "excess earnings") accrue to the benefit of the employee, during both employment and retirement years. However, payment is made to the employee during his/her retirement years.

The deferred compensation agreement provides for a "primary" and "secondary" benefit. The earnings on the policy that accumulate for the employee's benefit prior to retirement are paid out in 10 equal installments upon retirement and is the "primary benefit." The "secondary benefit" is the earnings that accrue for the employee's benefit after retirement. These amounts are paid each year in addition to the primary benefit. The secondary benefit will continue to accrue and be paid to the employee throughout his/her life.

Question 5:

(February 2004)

How should the bank account for the costs associated with this deferred compensation agreement?

Staff Response:

These benefits should be accounted for in accordance APB 12, as amended by SFAS 106. The present value of the expected future benefits to be paid to the employee from the deferred

compensation plan should be based on the terms of the individual contract. It should be accrued in a systematic and rational manner over the required service periods to the date the employee is fully eligible for the benefits.

The future payment amount is not guaranteed, but is based on the expected performance of the insurance policy. That fact does not release the bank from the requirement that it recognize the compensation expense over the employee's expected service period. However, the estimate of the expected future benefits should be reviewed periodically and revised, if needed. Any resulting changes should be accounted for prospectively, as a change in accounting estimate.

Question 6:

(September 2004)

What discount rate should be used in determining the present value of the expected future benefit payments to be made to the employee?

Staff Response:

Accounting Principles Board Opinion No. 12, as amended by SFAS 106, does not specify how to select the discount rate to measure the present value of the expected future benefit payments to be made to an employee. Therefore, other relevant accounting literature must be considered in determining an appropriate discount rate. The staff believes the bank's incremental borrowing rate and the current rate of return on high-quality fixed-income debt securities to be acceptable discount rates to measure a deferred compensation agreement obligation. The bank must select and consistently apply a discount rate policy that conforms to relevant accounting literature.

Facts:

A bank purchased a bank-owned life insurance (BOLI) policy with a face value of \$250,000 as key-person life insurance on its chairman approximately twenty years ago. The chairman recently retired and purchased the policy from the bank for its current surrender cash value of \$147,308.

Question 7:

(January 2007)

How should this transaction be recorded?

Staff Response:

The bank should estimate the fair value of the BOLI policy based on the net present value of cash flows using the expected premium payments, death benefit, and expected mortality. The difference between the estimated fair value and the \$147,308 paid for the policy would be reported as gain on sale with an offsetting employee compensation expense (i.e., retirement bonus) amount. The cash surrender value would be removed from the books because the bank is no longer entitled to it. This would not affect earnings or capital because the gain on sale and employee compensation expense would offset each other.

5C. ASBESTOS AND TOXIC WASTE REMOVAL COSTS

Facts:

Various federal, state, and local laws require the removal or containment of dangerous asbestos or environmental contamination from building and land sites. Such removal or containment of dangerous materials can be expensive, often costing more than the value of the property. However, in certain jurisdictions the property owners may be required to “clean-up” the property, regardless of cost. Further, sometimes a company may be required to clean-up property that it does not currently own. For banks, this liability may extend, not only to bank premises, but also to other real estate owned.

Question 1:

Should asbestos and toxic waste treatment costs incurred for clean-up be capitalized or expensed?

Staff Response:

Clean-up costs for asbestos may be capitalized only up to the fair value of the property. Clean-up costs for asbestos discovered when the property was acquired are part of the acquisition costs. Costs incurred to “clean-up” waste on existing property represent betterments or improvements. This opinion is consistent with FASB Emerging Issue Task Force Consensus No. 89-13.

Generally, environmental contamination (toxic waste) treatment costs should be charged to expense. However, when recoverable, these costs may be capitalized if one of the following is met:

- The costs extend the life, increase the capacity, or improve the safety or efficiency of property owned by the company.
- The costs mitigate or prevent future environmental contamination. In addition, the costs improve the property’s condition as compared with its condition when constructed or acquired, if later.
- The costs are incurred in preparing for sale a property currently held for sale.

This opinion is consistent with FASB Emerging Issues Task Force Consensus No. 90-8.

5D. COMPUTER SOFTWARE COSTS**Question 1:**

(September 2001)

How should a bank account for the costs associated with the development of software for internal use?

Staff Response:

In 1998 the AICPA issued Statement of Position (SOP) 98-1 with respect to the accounting for costs associated with the development of software for internal use. This SOP requires the capitalization of certain costs associated with obtaining or developing internal use software. Specifically, the software development process is separated into three stages. They are: the preliminary project stage, application development stage, and post-implementation/operational stage. The costs associated with the application development stage (the second stage) are capitalized. This includes the external direct costs of materials and services, salary and related expenses directly associated with the project, and certain interest expense. All costs associated with the first and third stages are expensed as incurred.

5E. DATA PROCESSING SERVICE CONTRACTS

Facts:

A bank decides to convert from its current in-house data processing arrangement to a third-party data processing servicer. The bank enters into a long-term contract (e.g., seven years) with the servicer. The contract states that the servicer will purchase the bank's data processing equipment at book value (\$1,000,000), although fair value is significantly less (\$400,000).

Question 1:

May the bank record the sale of its equipment at book value (\$1,000,000), recognizing no loss on the sale?

Staff Response:

Generally, no. In most cases, the bank is borrowing from the servicer the amount received in excess of the fair value of the equipment. The rebuttable presumption is that the servicer will recoup this excess payment over the life of the service contract.

Therefore, the bank should record the sale of its equipment at fair value, recognizing the loss of \$600,000 (\$1,000,000 - \$400,000). Furthermore, the bank should record a liability to the servicer for \$600,000, and amortize this amount in accordance with the terms of the contract. In addition, interest expense should be recorded on the unamortized portion of this liability in accordance with AICPA Accounting Principles Board Opinion No. 21.

Facts:

A bank decides to convert from its current in-house data processing arrangement to a third-party data processing servicer. The bank enters into a long-term contract (e.g., seven years) with the servicer. The bank will continue to own its data processing equipment, but anticipates that most of it will be replaced once conversion to the servicer occurs.

Question 2:

(December 2008)

Is the bank required to adjust the carrying amount of its data processing assets as a result of entering into this contract?

Staff Response:

No. SFAS 144 requires that the equipment be accounted for as held for use as long as the equipment is still being used. As a result of entering into this contract, the bank should revise the estimated useful life of the equipment to reflect the shortened useful life. Once the bank has stopped using the old data processing equipment, the equipment should be accounted for at the lower of amortized cost or fair value less cost to sell.

5F. TAX LIEN CERTIFICATES

Facts:

When a property tax bill becomes delinquent, the taxing authority places a tax lien on the property. In many states, the taxing authority is authorized to sell tax liens by issuing tax lien certificates. A tax lien certificate transfers to a third party the taxing authority's right to collect delinquent property taxes and the right to foreclose on the property. A tax lien has a superior priority status that supersedes any existing non-tax liens, including first mortgages, and accrues interest and fees.

Question 1:

(April 2005)

How should a bank report the acquisition of a tax lien certificate in the call report?

Staff Response:

Tax lien certificates should be reported in "Other assets" in Schedule RC and Schedule RC-F. The staff does not believe a tax lien certificate meets the definition of a loan provided in the call report instructions, because an interest in a tax obligation does not result from direct negotiations between the holder of the certificate and the property owner, or between the taxing authority and the property owner.

Question 2:

(April 2005)

Should a bank accrue interest on a tax lien certificate?

Staff Response:

Accrual status should be determined in accordance with call report instructions and the bank's nonaccrual policy. Delinquency should be calculated from the date the taxes were due the taxing authority. At the time a bank purchases a tax lien certificate, the property owner's tax obligation generally meets the criteria for nonaccrual status set forth in the call report instructions; therefore, tax lien certificate income should generally be recognized on a cash basis. As a consequence, tax lien certificates should be reported in the past due and nonaccrual schedule of the call report (Schedule RC-N) in the item for "Debt securities and other assets" in nonaccrual status. When income is recognized on a tax lien certificate, it should be reported as "Other noninterest income" in Schedule RI and Schedule RI-E.

TOPIC 6: LIABILITIES

6A. ACCOUNTING FOR CONTINGENCIES

Facts:

A legal action was brought against a bank. The court issued a judgment against the bank, and it has appealed. The bank has not provided any provision (liability) for the possible loss resulting from this litigation.

Question 1:

Should the bank provide a provision for this loss since a judgment has been awarded against it?

Staff Response:

Generally accepted accounting principles (SFAS 5) require that a loss contingency be recorded when a loss is probable and the amount can be estimated reasonably. In making a determination of whether a loss is probable, the expected outcome of the bank's appeal must be assessed. This is a legal determination that requires an evaluation of the bank's arguments for reversal of the judgment. Therefore, the bank's counsel should provide a detailed analysis of the basis for the appeal and the probability of reversal.

The circumstances of the case and the opinion of legal council will be used to determine whether a loss is probable and the amount can be estimated reasonably. Sound judgment must be exercised in reaching that determination. Furthermore, if it can be shown that a loss is probable, but there is a range of possible losses, a liability should be recorded for at least the minimum amount of loss expected.

If counsel cannot provide an opinion or analysis to support the position that the judgment will be reversed or reduced substantially, the staff believes that a liability should generally be recorded for its amount. This is based on the fact that a lower court has decided against the bank, and no additional information is being provided to support its position.

Facts:

Fraudulent acts by former officers cost a bank losses totaling \$2 million (\$1,900,000 in loan losses and \$100,000 in legal fees). The bank filed a claim with its fidelity bond carrier for payment of the total amount of coverage under the bond, aggregating \$2 million. The losses have reduced bank capital below a level that the regulators find acceptable.

Question 2:

Should the bank record a receivable for the \$2 million when the claim is filed with the insurer?

Staff Response:

No. It is usually inappropriate for a fidelity claim to be recognized before a written settlement offer has been received from the insurer. The staff believes that the potential recovery of the loss from anticipated insurance proceeds is a contingent asset. SFAS 5 indicates that contingent assets usually are not recorded, because revenue might be recognized prior to its realization.

Further, recognition of the actual loss should not be deferred, because of the possibility of future recovery under fidelity insurance coverage.

This conclusion is based on the uncertainty that often exists for insurance coverage of bonding claims. Bonding policies normally are complicated and contain numerous exceptions. Accordingly, it is not certain whether the claim will be honored ultimately and, if so, for what amount. Insurers investigate these claims carefully and generally do not acknowledge their validity or the amount for which they are liable until shortly before payment.

Question 3:

Assume the previous facts, but the insurer offers a settlement of \$1 million. How would the accounting differ?

Staff Response:

As noted in the previous question, a gain contingency may be recorded when the contingent event has a high probability of occurring, and the amount of the gain may be estimated with a reasonable degree of accuracy. If management and counsel can conclude that these conditions have been met because of the settlement offer from the insurer, it would be appropriate to record the amount of the offer.

Facts:

A bank originates mortgage loans which are sold in the secondary market. The sales agreements include the normal “reps and warranties” clause that requires the bank to repurchase any loan that has incomplete documentation or has an early payment default (e.g., during the first 90 days after the sale).

Question 4:

(December 2008)

How should the bank account for this recourse?

Staff Response:

The requirement to repurchase loans with incomplete documentation or early payment default represents a recourse obligation. SFAS 140 requires the bank to recognize a liability at the time of the sale in the amount of the fair value of the recourse obligation. If it is not practicable to estimate the fair value, the bank should recognize no gain on the sale. This recourse obligation is recorded as an “Other Liability” rather than as part of the ALLL since these loans have been sold by the bank and are no longer part of its loan portfolio.

Subsequently, the bank should assess whether there has been a change in probable and reasonably estimable losses related to its recourse obligation. The bank should adjust its “Other Liability” amount to the extent that probable and reasonably estimable losses related to its recourse obligations (based on historical experience adjusted for current trends) are different from the carrying amount of the related liability.

TOPIC 7: INCOME TAXES

7A. DEFERRED TAXES

Facts:

Banks must report income tax amounts, including deferred tax assets, in the call report in accordance with Statement of Financial Accounting Standards No. 109 (SFAS 109).

However, the amount of certain deferred tax assets that national banks can include in regulatory capital is limited to the lesser of:

- The amount of deferred tax assets that the institution expects to realize within one year of the quarter-end report date, based on its projection of future taxable income (exclusive of tax carryforwards and reversal of existing temporary differences for the year); or
- Ten % of Tier 1 capital, net of goodwill and all identifiable intangible assets other than servicing rights and purchased credit card relationships, and before any disallowed deferred tax assets are deducted.

The amount of deferred tax assets reported on the bank's call report in excess of the recommended limitation is to be deducted from Tier 1 capital and reported on Schedule RC-F, memorandum item 1, "Deferred tax assets disallowed for regulatory capital purposes."

Question 1: (September 2001)

How do changes in the tax law, including tax rate changes, affect a bank's deferred tax assets and liabilities?

Staff Response:

A bank must adjust its deferred tax assets and liabilities to reflect changes in tax rates or other provisions of tax law. The bank should recalculate deferred tax assets and liabilities to consider the provisions and rates of any new tax law. Any resulting adjustments should be recorded in the period that the new legislation is signed into law.

Question 2: (September 2001)

The regulatory capital limit applies only to "deferred tax assets that are dependent upon future taxable income." How are such deferred tax assets determined?

Staff Response:

A bank's deferred tax assets that depend upon future taxable income are those deferred tax assets that the bank will realize only if it generates sufficient taxable income in the future. To apply the regulatory capital limit, the amount of those deferred tax assets that depend upon future taxable income is equal to:

- The bank's net deferred tax assets (net of deferred tax liabilities and any valuation allowance) from Schedule RC-F, item 2, less

- The amount of income taxes previously paid that are potentially recoverable through the carryback of net operating losses (carryback potential).

Question 3:

(September 2001)

May a bank use existing forecasts of future taxable income that it prepared for its budget to estimate realizable amounts under SFAS 109 or to apply the regulatory capital limit?

Staff Response:

Banks routinely prepare budgets and income forecasts for the future. These projections will typically serve as the starting point for the bank's estimate of future taxable income in applying SFAS 109, as well as the regulatory capital limit. The assumptions underlying these projections must be reasonable, and supported by objective and adequately verifiable evidence.

Question 4:

(September 2001)

A bank's income projections are prepared typically each fiscal year. When applying the regulatory capital limit at an interim quarter-end report date, may a bank use the income projections for its fiscal year to approximate its income for the one-year period following the report date?

Staff Response:

Yes. A bank may use its fiscal-year income projections when applying the proposed capital limit at an interim quarter-end report date, *provided* that those projections are not expected to differ significantly from the estimate of future taxable income for the one-year period following the quarter-end report date.

Question 5:

(September 2001)

In determining the regulatory capital limit, is there a specific method a bank must follow to estimate the amount of deferred tax assets it expects to realize within one year of the quarter-end report date?

Staff Response:

A bank may use any reasonable approach to estimate one year's future taxable income. However, whatever method the bank chooses, it must make the calculation exclusive of tax carryforwards and reversals of existing temporary differences.

One acceptable approach is to estimate future taxable income by taking the bank's pretax income (per the amount reported in the call report) and adjusting it for events or transactions that do not have tax consequences. The pretax income is adjusted for those items by deducting the amount of income that is never subject to income tax (e.g., tax-free interest income on municipal securities) and adding the amount of expenses that are never deductible (e.g., the disallowed portion of meals and entertainment expense). The projected taxable income is multiplied by the applicable tax rate. (The tax rate expected to apply during the one-year period following the report date based on the tax law existing at the report date.)

However, the OCC recognizes that other methods of estimating future taxable income are also acceptable. Accordingly, banks may calculate one year's future taxable income using any reasonable method.

Question 6: (September 2001)

Are any adjustments required when applying the 10% of the Tier 1 capital portion of the limit?

Staff Response:

Yes. A bank should apply the 10% limit to Tier 1 capital before the deduction of disallowed servicing assets, disallowed purchased credit card relationships, and disallowed deferred tax assets. This amount can be determined by subtracting goodwill and other intangible assets, except servicing assets and purchased credit card relationships, from the components of Tier 1 capital.

Question 7: (December 2008)

How does the valuation allowance that may be required under SFAS 109 relate to the regulatory capital limit?

Staff Response:

The required valuation allowance (if any) under SFAS 109 is not the same as the amount of deferred tax assets that must be deducted from regulatory capital under its limit. The regulatory capital limitation is based on the net amount after deducting the required SFAS 109 valuation allowance.

A bank should determine the amount of deferred tax assets for reporting on its call report in accordance with SFAS 109 and FASB Interpretation No. 48 (FIN 48). Under SFAS 109, a bank calculates deferred tax assets by multiplying its deductible temporary differences by the applicable tax rate (the rate expected to apply during the period in which the deferred tax assets will be realized). Under FIN 48, a bank can only recognize the benefit of a tax position if that tax position is "more likely than not" to be sustainable assuming the taxing authority has full knowledge of the position and all relevant facts.

If necessary, a bank should record a valuation allowance to reduce the amount of deferred tax assets to an amount that is "more likely than not" to be realized. A bank should consider all available positive and negative evidence in assessing the need for a valuation allowance.

Banks should report the amount of their net deferred tax assets (i.e., deferred tax assets net of any valuation allowance and net of deferred tax liabilities) on Schedule RC-F, item 2. This net deferred tax asset amount is the starting point for applying the regulatory capital limit.

Question 8: (September 2001)

When both positive and negative evidence exists of a bank's ability to earn future taxable income, what specific guidance should a bank follow to determine if a valuation allowance is needed?

Staff Response:

All available evidence, both positive and negative, should be considered to determine whether a valuation allowance is needed. Accordingly, a bank should consider its current financial position and the results of operations for current and preceding years. Historical information should be supplemented by currently available information for future years.

A bank must use judgment when both positive and negative evidence exist. In such situations, examples of positive evidence that might support a conclusion for no valuation allowance include:

- A strong earnings history, exclusive of the loss that created the future tax deduction, coupled with evidence that the loss was an unusual or extraordinary item.
- A change in operations, such as installation of new technology, that permanently reduces operating expenses.
- A significant improvement in the quality of the loan portfolio.

Examples of negative evidence include:

- A history of operating losses or tax credit carryforwards expiring unused.
- An expectation that operating losses will continue in early future years, and that positive income will not be realized until the more distant future.
- Unsettled circumstances that if unfavorably resolved would continuously affect future operations and profit levels adversely in future years.

The weight given to the potential effects of negative and positive evidence should be commensurate with the extent to which it can be verified objectively. For example, a history of operating losses would likely carry more weight than a bank's assessment that the quality of its loan portfolio has improved.

Facts:

A bank has been in existence for five years. Although it has had profitable quarters from time to time, it has never shown positive annual income. Its cumulative losses exceed \$2,000,000. In the latest fiscal year, its best year ever, the bank lost \$150,000. The bank's total assets have been growing steadily, and management believes it will reduce costs and begin earning positive operating income in the coming year.

Management estimates the bank will show taxable income of \$200,000 next year. Management bases its estimate on several factors, including an improved loan portfolio and a higher net interest margin, which it believes will result from decreases in market interest rates.

Question 9:

(September 2001)

How should the bank account for its deferred tax assets?

Staff Response:

The bank should record a valuation allowance for the full amount of its deferred tax assets. The lack of a strong earnings history raises doubt that the bank can generate sufficient positive income to recover its deferred tax assets, although positive operating income is not a prerequisite for recording a deferred tax asset.

The recent history of operating losses provides objective evidence of the bank's inability to generate profits. Such evidence should be given more weight than less quantifiable data that depend on subjective data (i.e., future interest rate forecasts).

Facts:

A bank has a net unrealized holding gain on available-for-sale debt securities of \$1,000,000. Its composite tax rate is 40%, so it has recorded a \$400,000 deferred tax liability relating to the unrealized gain. The bank also has gross deferred tax assets of \$4,000,000 and other deferred tax liabilities of \$300,000. Taxes paid for the current year and prior three years that could potentially be recovered through loss carrybacks total \$2,000,000. Its Tier 1 capital before deducting disallowed deferred tax assets is \$5,000,000. The bank does not have servicing assets or purchased credit card relationships. The bank has a strong record of earnings and expects continued profitability in the future. Therefore, it has not recorded a valuation allowance.

Question 10:

(September 2001)

Net unrealized holding gains and losses on available-for-sale securities (SFAS 115 gains and losses) are excluded from regulatory capital. When calculating the deferred tax limitation, should the bank also exclude from this calculation the tax effect of gains and losses on available-for-sales securities?

Staff Response:

For regulatory capital purposes, the OCC allows banks to establish their own policy on the inclusion of gains and losses on available-for-sales securities in their computation of the deferred tax limitation. However, the bank must apply consistently the method that it chooses.

The decision on how to treat the SFAS 115 tax effects will affect a bank's regulatory capital levels and its leverage and risk-based capital ratios. The following example, based on the previous facts, displays the potential affect on the bank's regulatory capital.

	Scenario 1	Scenario 2
	Eliminate SFAS 115 Tax Effects	Include SFAS 115 Tax Effects
Gross Deferred Tax Asset	\$4,000,000	\$4,000,000
Carryback Potential	2,000,000	2,000,000
Deferred Tax Liability	300,000	700,000
Net Deferred Tax Assets Dependent upon Future Taxable Income	1,700,000	1,300,000
10% of Tier 1 Capital (before deductions)*	500,000	500,000
Amount Disallowed	1,200,000	800,000
Tier 1 Capital	\$3,800,000	\$4,200,000

* For purposes of this example, assume the tax effect of a bank's estimate that one year's future taxable income exceeds 10% of Tier 1 capital.

This situation, which included a net unrealized holding gain on the available-for-sale securities, resulted in higher regulatory capital under scenario 2. However, if a net unrealized holding loss occurred on these securities, scenario 1 would have produced the most favorable regulatory capital result.

Question 11:

(September 2001)

Under the regulatory capital limit, deferred tax assets that depend upon future taxable income are limited to the amount of deferred tax assets that could be realized within one year of the quarter-end report date. Does the one-year limit on projections of future taxable income also apply when assessing the need for a valuation allowance under SFAS 109?

Staff Response:

No. The one-year limit applies only when determining the amount of deferred tax assets that may or may not be included in regulatory capital. The one-year limit does not apply when determining the amount of deferred tax assets, net of any valuation allowance, that should be reported on the call report.

As noted in question 7, a valuation allowance should be established, when necessary, to reduce the amount of deferred tax assets to the amount that is "more likely than not" to be realized. SFAS 109 does not specify a time period during which projections of future taxable income may be relied upon to support recognition of deferred tax assets. Typically, however, the further into the future income projections are made, the less realizable they may be.

Question 12:

(September 2001)

When determining a bank's carryback potential under SFAS 109 and the regulatory capital limit, how should a bank consider taxes paid in prior years at effective rates different than the applicable tax rate used to record deferred tax assets?

Staff Response:

In determining its carryback potential to apply SFAS 109 and the capital limitation, banks should consider the actual amount of taxes it could potentially recover through the carryback of net operating losses.

7B. TAX SHARING ARRANGEMENTS

Facts:

The bank is a member of a consolidated group subject to a tax sharing agreement with its parent holding company. During the current year, the bank incurs a loss that would result in a tax benefit on a separate entity basis. However, the consolidated group previously has carried back its losses and recovered all available tax refunds from the IRS.

Question 1:

Should the bank record a tax receivable for the benefit of its current year loss?

Staff Response:

Yes. The bank should record the tax benefit for its current year tax loss, and the holding company should refund this amount to the bank. The call report instructions generally require that a bank subsidiary compute its taxes on a separate entity basis. Because the bank has NOL carryback potential available on a separate entity basis, it should receive the tax benefit of its current year loss.

From a regulatory perspective, a holding company that has the financial capability should be required to reimburse the bank. If the holding company cannot do so, the amount of the tax benefit should be recorded as a dividend.

The call report instructions prohibit the adoption of a tax sharing agreement that results in a significant difference from what would have occurred on a separate entity basis. In this case, the bank would have received a tax refund if it had filed a separate return. Therefore, it should record the tax benefit of its current year loss and receive this amount from its parent.

Facts:

The bank is a subsidiary of a holding company that files a consolidated return. In accordance with the tax sharing agreement, the subsidiary banks calculate and remit their estimated taxes to the parent holding company quarterly.

Question 2:

(September 2001)

May a subsidiary bank remit estimated tax payments to its parent holding company during periods when the consolidated group does not have, or expect to have, a current tax liability?

Staff Response:

Yes. Although the Interagency Policy Statement, "Statement on Income Tax Allocation in a Holding Company Structure," prohibits banks from paying their deferred tax liability to the holding company, it was not intended to restrict the payment of a bank's current tax liability. The call report instructions allow a bank to remit the amount of current taxes that would have been calculated on a separate entity basis. However, the tax sharing agreement between the subsidiary bank and the holding company must contain a provision to reimburse the bank when it incurs taxable losses that it could carryback on a separate entity basis.

Such remittances may be made quarterly, if the bank would have been required to make such payments on a separate entity basis. This is appropriate even if the parent has no consolidated tax liability.

Facts:

The bank is a subsidiary of a holding company that files a consolidated return. The consolidated group incurs a loss in the current year and carries it back to prior years, resulting in a refund of substantially all taxes previously paid to the IRS. Under the tax sharing agreement, the subsidiary banks that produced the loss will receive a *pro rata* share of the total tax refund from the IRS. However, some subsidiaries filing as separate entities would be entitled to additional tax refunds.

Question 3:

How should the bank subsidiaries record the tax benefit of their individual losses?

Staff Response:

The call report instructions require that individual bank subsidiaries compute and record the tax benefit of a loss as separate entities. Additionally, they should receive that benefit as if they had filed for a refund as separate entities.

The *pro rata* allocation of the tax benefit received from the IRS understates the tax benefit due the subsidiaries on a separate entity basis. From a regulatory perspective, a holding company that has the financial capability should be required to reimburse the amount due on a separate entity basis. If the holding company does not have the financial capability, the amount should be recorded as a dividend.

Facts:

The bank is a member of a consolidated group subject to a tax sharing agreement. During the current year, the bank incurs a taxable loss which it can carry back as a separate entity. However, a mortgage banking subsidiary of the bank is profitable for the year.

Question 4:

Should the mortgage banking subsidiary be included with the bank in determining its income tax expense/benefit as a separate company?

Staff Response:

As previously noted, the call report instructions require that a bank compute its taxes as a separate entity. However, at the bank level, the reporting entity includes its mortgage banking subsidiary and any other subsidiaries that the bank may own. Payment of taxes to and refunds from the holding company would be based on the consolidated tax position of the bank and its subsidiaries. The mortgage banking subsidiary would pay taxes to the bank, not to the holding company. This applies the separate entity concept to each subsidiary level.

7C. MARGINAL INCOME TAX RATES

Facts:

The bank is a subsidiary of a holding company that files a consolidated return. Because of their common ownership, the affiliated companies are entitled to only one surtax exemption. Current IRS regulations permit the arbitrary allocation of the surtax exemption to any member of a group under common control, even if a consolidated return is not filed. As a result, the holding company, which was operating at a loss, allocated the entire surtax exemption to itself.

Question 1:

For regulatory purposes, what is the proper allocation of the surtax exemption among subsidiaries when determining the amount of tax payments to be forwarded to the holding company?

Staff Response:

The one surtax exemption should be allocated among the affiliates in an equitable and consistent manner. Additionally, the surtax exemption should be allocated to profitable entities, since it is used only to compute the tax liability.

A bank subsidiary of a holding company that files a consolidated return must report as current taxes and pay to its parent holding company the amount that would otherwise be due had it filed a tax return as a separate entity. Accordingly, the amount of the subsidiary's current tax liability should include the allocation of the available surtax exemption. This accounting treatment is set forth in the call report instructions.

Question 2:

Would the answer to question 1 be different if it was the only subsidiary of a one bank holding company?

Staff Response:

No. The bank should receive an allocated portion of the consolidated group's surtax exemption in accordance with the call report instructions regardless of the number of subsidiaries involved.

Facts:

Assume the marginal tax rate for corporate taxable income over \$10 million is 35%. Under this rate structure, a consolidated group could have taxable income in excess of \$10 million that would be taxed at 3%, and the taxable income of the banks within the consolidated group, measured on a separate entity basis, may be taxed at a 34% rate, because their taxable income is less than \$10 million.

Question 3:

What rate should the bank use to compute its income tax expense as a separate entity?

Staff Response:

The bank may use an income tax rate of 35%. The call report instructions require that a bank's income tax expense be computed on a separate entity basis. However, those instructions also allow adjustments to allocate additional amounts among the subsidiary banks, provided the allocation is equitable and applied consistently. An adjustment for the consolidated groups' incremental tax rate, properly applied, would satisfy that requirement.

TOPIC 8: CAPITAL

8A. CAPITAL TREATMENT FOR ASSET SALES AND SECURITIZATIONS

The Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation, the Federal Reserve Board (Board), and the Office of Thrift Supervision published a final rule on the Capital Treatment of Recourse, Direct Credit Substitutes and Residual Interests in Asset Securitizations in November of 2001 (the recourse rule). The recourse rule became effective on January 1, 2002, and has generated several questions from the industry regarding proper implementation and application. Questions 3 through 11, taken from OCC Bulletin 2002-22, provide interpretive guidance on various issues raised by the recourse rule. Questions 12 through 20, taken from OCC Bulletin 2002-20, provide guidance on implicit recourse in assets securitizations. Please refer to the recourse rule and these bulletins for additional information.

Question 1:

(September 2001)

How are *pro rata* loss-sharing agreements treated for risk-based capital purposes?

Staff Response:

Certain transactions limit the seller's risk, on a *pro rata* basis, to a fixed percentage of any losses that might be incurred. Assuming there are no other provisions resulting in uneven retention of risk, either directly or indirectly, by the seller, risk-based capital is held only against the percentage of principal for which the seller is at risk.

For example, assume \$100,000 of assets are sold with a provision requiring the seller and buyer to share proportionately in losses incurred on a 10% and 90% basis, respectively. The seller is not liable for any other retention of risk. Capital need not be held against the \$90,000 of assets. Risk-based capital would be held only against the remaining \$10,000.

Facts:

A bank securitized credit card receivables through a master trust. Sometime thereafter, the loans in the trust began to experience adverse performance because of credit quality problems. To correct that problem, the bank will purchase receivables from the trust to facilitate their sale to an independent third party. The purchased receivables will include both performing and delinquent accounts. The trust will be paid par value for the receivables. The bank will immediately sell all of the purchased receivables for an amount equal to or greater than par value to a third party. The sale to the third party will be agreed upon prior to removing the assets from the trust. Consequently, the bank will not be exposed to any risk of loss.

Question 2:

(September 2001)

Must the bank hold risk-based capital against the assets in this securitization?

Staff Response:

No, the bank need not hold risk-based capital against the assets remaining in the trust. This transaction may assist the bank in returning the trust to a healthy financial condition. The bank,

however, is not exposed to any risk of loss since it will sell the loans to a third party buyer for a price that at least equals the amount it paid for those loans.

Question 3:

(June 2003)

Are spread accounts that function as credit enhancements “credit-enhancing interest-only strips” and, therefore, subject to the concentration limit?

Staff Response:

The recourse rule defines “credit-enhancing interest-only strip” as “an on-balance sheet asset that, *in form or in substance*, (i) represents the contractual right to receive some or all of the interest due on the transferred assets; and (ii) exposes the banking organization to credit risk that exceeds its *pro rata* claim on the underlying assets whether through subordination provisions or other credit enhancing techniques.” The preamble to the recourse rule elaborates on this definition. “In determining whether a particular interest cash flow functions as a credit-enhancing I/O strip, the Agencies will look to the economic substance of the transaction, and will reserve the right to identify other cash flows or *spread-related assets* as credit-enhancing I/O strips on a case-by-case basis.”

A spread account is an on-balance sheet asset that functions as a credit enhancement and that can represent an interest in *expected* interest and fee cash flows derived from assets a bank has sold into a securitization. In those cases, the spread account is considered to be a “credit-enhancing interest-only strip” and is subject to the concentration limit. However, any portion of a spread account that represents an interest in cash that has already been collected and is held by the trustee is a “residual interest” subject to dollar-for-dollar capital, but not a credit enhancing interest-only strip subject to the concentration limit.

For example, assume that a bank books a single spread account asset that is derived from two separate cash flow streams:

(1) a receivable from the securitization trust that represents cash that has already accumulated in the spread account. In accordance with the securitization documents, the cash will be returned to the bank at some date in the future after having been reduced by the amounts used to reimburse investors for credit losses. Based on the date when the cash is expected to be paid out to the bank, the present value of this asset is currently estimated to be \$3.

(2) a projection of future cash flows that are expected to accumulate in the spread account. In accordance with the securitization documents, the cash, to the extent collected, will also be returned to the bank at some date in the future after having been reduced by amounts used to reimburse investors for credit losses. Based on the date when the cash is expected to be paid out to the bank, the present value of this asset is currently estimated to be \$2.

Both components of the spread account are considered to be residual interests under the current capital standards because both represent on-balance sheet assets subject to more than their *pro rata* share of losses on the underlying portfolio of sold assets. However, the \$2 asset that represents the bank’s retained interest in future cash flows exposes the organization to a greater degree of risk because the \$2 asset presents additional uncertainty as to whether it will ever be collected. This additional uncertainty associated with the recognition of future subordinated

excess cash flows results in the \$2 asset being treated as a credit-enhancing interest-only strip, a subset of residual interests.

Under the recourse rule, the face amount of all of the bank's credit-enhancing interest-only strips is first subject to a 2% of Tier 1 capital concentration limit. Any portion of this face amount that exceeds 25% of Tier 1 capital is deducted from Tier 1 capital. This limit will affect both a bank's risk-based and leverage capital ratios. The remaining face amount of the bank's credit-enhancing interest-only strips, as well as the face amount of the spread account receivable for cash already held in the trust, is subject to the dollar-for-dollar capital requirement established for residual interests, which affects only the risk-based capital ratios.

Question 4:

(June 2003)

How are instruments that are derived from a securitization and assigned separate ratings for principal and interest (split/partially-rated instruments) treated in the recourse rule?

Staff Response:

The recourse rule does not specifically address the treatment of split/partially-rated instruments. However, in its discussion of the ratings-based approach, the preamble to the recourse rule indicates that the ratings-based approach "provides a way for the agencies to use determinations of credit quality . . . to differentiate the regulatory capital treatment for loss positions representing different gradations of risk." The rule contemplated treating each "position" in its entirety. Thus, for those banks that hold split/partially-rated instruments, the OCC will apply to the entire instrument the risk weight that corresponds to the lowest component rating. For example, a purchased subordinated security where the principal component is rated BBB, but the interest component is rated B, will be subject to the gross-up treatment accorded to direct credit substitutes rated B or lower as set forth in the recourse rule. Similarly, if a portion of an instrument is unrated, the entire position will be treated as if it is unrated. In addition to this regulatory capital treatment, the OCC may also, as appropriate, adversely classify and require writedowns for other than temporary impairment on unrated and below investment grade securities, including split/partially-rated securities. The OCC also reminds banks that the OCC may override the use of certain ratings or the ratings on certain instruments, either on a case-by-case basis or through broader supervisory policy, if necessary or appropriate to address the risk that an instrument poses to banks. See 66 Fed. Reg. 59614 and 59625.

Question 5:

(June 2003)

Do corporate bonds or other securities not related in any way to a securitization or structured finance program qualify for the ratings-based approach?

Staff Response:

No. Only mortgage- and asset-backed securities, recourse obligations, direct credit substitutes, and residual interests (except credit-enhancing interest-only strips) retained, assumed, or issued in connection with a securitization or structured finance program, as defined in the recourse rule, qualify for the ratings-based approach. "Securitization" is defined as "the pooling and repackaging by a special purpose entity of assets or other credit exposures that can be sold to investors." A "structured finance program" is defined as "a program where receivable interests and asset-backed securities issued by multiple participants are purchased by a special purpose

entity that repackages those exposures into securities that can be sold to investors.” Corporate debt instruments, municipal bonds and other securities that are not related to a securitization or structured finance program do not meet these definitions and, thus, do not qualify for the ratings-based approach.

Question 6:

(June 2003)

Concerning the repurchase of assets pursuant to a clean-up call, the preamble to the recourse rule states that a “banking organization should repurchase the loans at the lower of their estimated fair value or their par value plus accrued interest.” May the bank determine an aggregate fair value for all repurchased assets or should each repurchased loan be individually evaluated?

Staff Response:

Banks that repurchase assets as a result of the exercise of a clean-up call may do so based on the *aggregate* fair value of all repurchased assets. The OCC did not intend for each individual loan remaining in the pool at the time a clean-up call is exercised to be individually evaluated to determine its fair value. Rather, the overall repurchase price should reflect the aggregate fair value of the assets being repurchased so that the bank is not overpaying for the assets and, in so doing, providing credit support to the trust investors. The OCC will review the terms and conditions relating to the repurchase arrangements in clean-up calls to ensure that transactions are done at the lower of fair value or par value plus accrued interest. Banks should be able to support their fair value estimates. Should the OCC conclude that a bank has repurchased assets at a price that exceeds the lower of these two amounts, the clean-up call provisions in a bank’s future securitizations may be treated as recourse obligations or direct credit substitutes.

Question 7:

(June 2003)

The recourse rule states that “clean-up calls that are 10% or less of the original pool balance and that are exercisable at the option of the [bank]” are not recourse or direct credit substitutes. May this treatment also apply to clean-up calls written with reference to less than 10% of the outstanding principal amount of *securities*?

Staff Response:

Yes. The OCC will not require recourse or direct credit substitute treatment for clean-up calls written with reference to 10% of the outstanding principal amount of the securities. The purpose of treating large clean-up calls as recourse or direct credit substitutes is to ensure that banks are not able to provide credit support to the trust investors by repaying their investment when the credit quality of the pool is deteriorating without holding capital against the exposure. A clean-up call based on 10% of outstanding securities would not defeat the purpose of the rule and, oftentimes, may be a more conservative benchmark than 10% of the pool balance.

Question 8:

(June 2003)

Does the mere existence of a clean-up call in a securitization trigger treatment as a recourse obligation or direct credit substitute or must the clean-up call be exercised in order to trigger this treatment?

Staff Response:

The recourse rule includes clean-up calls as an example of both a “recourse” arrangement and a “direct credit substitute.” The rule focuses on the arrangement itself, and not the exercise of the call. Thus, the existence, not the exercise, of a clean-up call that does not meet the requirements laid out in the final rule will trigger treatment as a recourse obligation or a direct credit substitute. A clean-up call can function as a credit enhancement because its existence provides the opportunity for a banking organization (as servicer or as an affiliate of the servicer) to provide credit support to investors by taking an action that is within the contractual terms of the securitization documents.

Question 9:

(June 2003)

Does the recourse rule change the risk weight/conversion factor for performance standby letters of credit?

Staff Response:

No. “Performance standby letters of credit,” as defined in the OCC’s risk-based capital standards, generally do not meet the definition of a direct credit substitute. Therefore, they are not covered under the recourse rule and will still be converted at 50% and generally risk weighted at 100%.

Question 10:

(June 2003)

The recourse rule states that for an internal credit risk rating system for an asset-backed commercial paper program to be adequate, “an internal audit procedure should periodically verify that internal risk ratings are assigned in accordance with the banking organization’s established criteria.” Does the internal audit procedure have to be performed by the internal audit department or can it be performed by another independent entity within the bank?

Staff Response:

The recourse rule does not require the internal audit of the internal credit risk rating system to be performed by the internal audit department. Any group within the organization that is qualified to audit the system and independent of both the group that makes the decision to extend credit to the asset-backed commercial paper program and the groups that develop and maintain the internal credit risk rating system may perform the internal audit of the system.

Question 11:

(June 2003)

How is the capital treatment described in the Synthetic Collateralized Loan Obligations guidance published by the OCC and the Board in November 1999 affected by the recourse rule?

Staff Response:

The preamble to the recourse rule addresses the modification of the treatment of credit derivative transactions outlined in the November 1999 guidance. “With the issuance of this final rule, the agencies reaffirm the validity of the structural and risk-management requirements of the December 1999 guidance on synthetic securitizations issued by the OCC and the Board, while modifying the risk-based capital treatment detailed therein with the treatment presented in this

final rule.” The following detailed information will clarify the risk-based capital treatment appropriate to the credit derivative transactions presented in the November 1999 guidance.

The guidance on synthetic collateralized loan obligations discussed the risk-based capital treatment of three specific types of synthetic securitization transactions, subject to the sponsoring bank’s compliance with minimum risk management requirements. The objective of these capital interpretations was to recognize the effective transference of the economic risk of loss in these synthetic securitization transactions. As discussed more fully below, the risk-based capital treatment of the first two structures described in the November 1999 guidance remains largely unchanged. The qualification requirements for the second structure (Bistro-type transactions) have been modified to eliminate the restriction on the size of the retained first loss position. The recourse rule has the greatest effect on the risk-based capital treatment of the third structure. As indicated in the preamble to the recourse rule, the risk management requirements contained in the joint guidance are still in force.

In the first structure the sponsoring bank, through a synthetic collateralized loan obligation (CLO), hedges the entire notional amount of a reference asset portfolio. The credit protection is obtained through the issuance of credit-linked notes (CLNs), the proceeds of which fully collateralize a portfolio of the bank’s loans. The zero risk-weight on the cash-collateralized loans is not affected by the recourse rule.

In structure 2 (Bistro-type) transactions, the sponsoring bank hedges a portion of the reference portfolio and retains a high quality senior risk position that absorbs only those credit losses in excess of the junior loss positions. There is no change in the capital treatment for this type of transaction under the recourse rule: dollar-for-dollar capital on the retained first loss piece and a 20 % risk weight on the retained senior piece if it is senior to AAA-rated CLNs. (If the bank can obtain a rating of BB or better on the first position loss, and the first position loss is not a credit-enhancing interest-only strip then the bank may be able to apply a more favorable risk weight to the first position loss.) The recourse rule expressly permits “inferred” ratings. To obtain that capital treatment, it is no longer necessary to limit the retained first loss piece to “a small cash reserve, sufficient to cover expected losses” as specified in the guidance. A bank entering into a structure 2-type transaction still must satisfy the risk management conditions contained in the annex of the guidance in order to receive the risk-based capital treatment described above.

In a structure 3 transaction, the sponsoring bank retains a subordinated position that absorbs first losses in a reference portfolio. The guidance identified three distinguishing features of a structure 3-type transaction: (1) the sponsoring bank retains a first loss position greater than expected loss, (2) an intermediary OECD bank establishes a special purpose entity (SPE) to issue the AAA-rated CLNs, and (3) the sponsoring bank purchased protection on both the second loss and the senior positions from the intermediary bank. Under the guidance, the capital treatment was the larger of two alternative approaches: (1) dollar-for-dollar capital on the retained first loss piece or (2) application of the risk weight of the underlying exposures to the face amount of the first loss piece, plus zero -percent risk weight on the collateralized mezzanine position, and plus 20% risk weight on the retained senior position protected by a credit derivative from the intermediary bank. The final rule changes this capital treatment.

Under the recourse rule, a sponsoring bank entering into a structure 3-type transaction would hold dollar-for-dollar capital on the retained first loss piece. The senior loss position would receive a 20% risk weight when protected by a credit derivative from an OECD bank or from

certain qualifying securities firms. The mezzanine, second-loss position that is collateralized by U.S. Treasury securities would continue to receive a zero percent risk weight.

This interpretation, particularly the lifting of the restriction on the size of the retained first loss piece on structure 2 transactions, removes the main structural distinction between structure 2 and structure 3 transactions. (The other structural difference, the issuance of the CLNs by an SPE established by an intermediary bank, does not affect the credit protection obtained by the sponsoring bank.) In both structures, the second loss position is collateralized by U.S. Treasury securities. Thus, a sponsoring bank's credit risk exposure for the first and second loss positions is virtually identical whether it employs structure 2, and forms an SPE directly to issue the CLNs, or structure 3, and purchases credit protection from an intermediary that forms the SPE to issue the CLNs. If the sponsoring bank satisfies all of the risk management conditions contained in the annex of the guidance, a structure 3 transaction may be classified as a structure 2 transaction and qualify for the risk-based capital treatment for such transactions. In other words, the sponsoring bank no longer is required to purchase protection on the senior loss position in order to assign a 20% risk weight to that position. Rather, it can assign a 2% risk weight based on the inferred rating of the subordinate credit linked notes. However, if the sponsoring bank does not meet the risk management conditions, it must purchase credit protection from an OECD bank or securities firm that qualifies for a 20% risk weight, before assigning a 20% risk weight to the retained senior position. If the sponsoring bank decides to use an intermediary that is not an OECD bank or a securities firm that qualifies for a 20% risk weight, the sponsoring bank must assign a 100% risk weight to the senior position.

Additionally, because the zero -percent risk weight on the second loss position is due to the U.S. Treasury securities collateral, not the type of intermediary that establishes the SPV, the sponsoring bank could use a non-depository institution as an intermediary. However, because synthetic transactions expose banks to risk other than credit risk, the intermediary should be of high quality, e.g., at least investment grade.

Facts:

A bank originates and services credit card receivables throughout the country. The bank decides to divest those credit card accounts of customers who reside in specific geographic areas where the bank lacks a significant market presence. To achieve the maximum sales price, the sale must include both the credit card relationships and the receivables. Because many of the credit card receivables are securitized through a master trust structure, the bank needs to remove the receivables from the trust. The affected receivables are not experiencing any unusual performance problems. In that respect, the charge-off and delinquency ratios for the receivables to be removed from the trust are substantially similar to those for the trust as a whole.

The bank enters into a contract to sell the specified credit card accounts before the receivables are removed from the trust. The terms of the transaction are arm's-length, wherein the bank will sell the receivables at market value. The bank separately agrees to purchase the receivables from the trust at this same price. Therefore, no loss is incurred as a result of removing the receivables from the trust. The bank will only remove receivables from the trust that are due from customers located in the geographic areas where the bank lacks a significant market presence, and it will remove all such receivables from the trust.

Question 12:
2003)

(June

Does the removal of these receivables from the trust constitute implicit recourse for regulatory capital purposes?

Staff Response:

No, the transaction does not constitute implicit recourse. Supporting factors for this conclusion are:

- The bank's earnings and capital are not exposed to actual or potential risk of loss as a result of removing the receivables from the trust.
- There is no indication that the receivables are removed from the trust due to performance concerns.
- The bank is removing the receivables from the trust for a legitimate business purpose other than to systematically improve the quality of the trust's assets. The legitimate business purpose is evidenced by the bank's pre-arranged, arm's-length sale agreement that facilitates exiting the business in identified geographic locations.

Supervisors should review the terms and conditions of the transaction to ensure that the market value of the receivables is documented and well supported before concluding that this transaction does not represent implicit recourse. Supervisors should also ensure that the selling bank has not provided the purchaser with any guarantees or credit enhancements on the sold receivables.

Facts:

After the establishment of a master trust for a pool of credit card receivables, the receivables in the trust begin to experience adverse performance. A combination of lower-than-expected yields and higher-than-anticipated charge-offs on the pool causes spreads to compress significantly (although not to zero). The bank's internally generated forecasts indicate that spreads will likely become negative in the near future. Management takes action to support the trust by purchasing the low-quality (delinquent) receivables from the trust at par although their market value is less than par. The receivables purchased from the trust represent approximately one-third of the trust's total receivables. This action improves the overall performance of the trust and avoids a potential early amortization event.

Question 13:

(June 2003)

Does the purchase of low-quality receivables from a trust at par constitute implicit recourse for regulatory capital purposes?

Staff Response:

Yes, this activity constitutes implicit recourse because the purchase of low quality receivables at an above-market price exposes the bank's earnings and capital to potential future losses from assets that had previously been sold. Accordingly, the bank is required to hold risk-based capital

for the remaining assets in the trust as if they were retained on the balance sheet, as well as for the assets that were repurchased.

Facts:

Months after the issuance of credit card asset-backed securities, charge-offs and delinquencies on the underlying pool of receivables rise dramatically. A rating agency places the securities on “watch” for a potential rating downgrade, causing the bank to negotiate additional credit support for the securitized assets. The securitization documents require the bank to transfer new receivables to the securitization trust at par value. However, to maintain the rating on the securities, the bank begins to sell replacement receivables into the trust at a discount from par value.

Question 14:

(June 2003)

Does this action constitute implicit recourse for regulatory capital purposes?

Staff Response:

Yes, the sale of receivables to the trust at a discount constitutes implicit recourse. The sale of assets at a discount from the price specified in the securitization documents, par value in this example, exposes earnings and capital to future losses. The bank must hold regulatory capital against the outstanding assets in the trust.

Facts:

A bank established a credit card master trust. The receivables from the accounts placed in the trust were, on average, of lesser quality than the receivables from accounts retained on the bank’s balance sheet. Under the criteria for selecting the receivables to be transferred to the master trust, the bank was prevented from including the better-performing affinity accounts in the initial pool of accounts because the affinity relationship contract was expiring. The bank and the affinity client subsequently revised the terms of their contract, enabling the affinity accounts to meet the selection criteria and be included in future securitization transactions. Later, rising charge-offs within the pool of receivables held by the trust caused spread compression in the trust. To improve the performance of the assets in the trust, the bank began to include the better-performing and now eligible receivables from the affinity accounts among the receivables sold to the trust. This action improves the trust’s performance, including spread levels and charge-off ratios. However, the replacement assets were sold at par in accordance with the terms of the trust agreement, so no current or future charge to the bank’s earnings or capital will result from these asset sales. This action also results in the performance of the trust’s assets closely tracking the performance of the credit card receivables that remain on the bank’s balance sheet.

Question 15:

(June 2003)

Do these actions constitute implicit recourse for regulatory capital purposes?

Staff Response:

No, these actions do not constitute implicit recourse. The bank did not incur any additional risk to earnings or capital after the affinity accounts met the selection criteria for replacement assets and the associated receivables were among the receivables sold to the trust. The replacement

assets were sold at par in accordance with the terms of the trust agreement, so no future charge to earnings or capital will result from these asset sales. The sale of replacement assets into a master trust structure is part of normal trust management.

In this example, the credit card receivables that remain on the bank's balance sheet closely track the performance of the trust's assets. Nevertheless, supervisors should ascertain whether a securitizing bank sells disproportionately higher quality assets into securitizations while retaining comparatively lower-quality assets on its books and, if so, consider the effect of this practice on the organization's capital adequacy.

Facts:

A bank establishes a credit card master trust comprised of receivables from accounts that were generally of lower quality than the receivables retained on the bank's balance sheet. The difference in the two portfolios is primarily due to logistical and operational problems that prevent the banking organization from including certain better-quality affinity accounts in the initial pool from which accounts were selected for securitization. Rising charge offs and other factors later result in margin compression on the assets in the master trust, which causes some concern in the market regarding the stability of the outstanding asset-backed securities. A rating agency places several securities on its watch list for a potential rating downgrade. In response to the margin compression as part of the bank's contractual obligations, spread accounts are increased for all classes by trapping excess spread in conformance with the terms and conditions of the securitization documents.

To stabilize the quality of the receivables in the master trust as well as to preclude a downgrade, the bank takes several actions beyond their contractual obligations:

- Affinity accounts are added to the pool of receivables eligible for inclusion in the trust. This change results in improved overall trust performance. However, these receivables are sold to the trust at par value, consistent with the terms of the securitization documents, so no current or future charge to the bank's earnings or capital will result from these asset sales.
- The charge-off policy for cardholders who have filed for bankruptcy is changed from criteria that were more conservative than industry standards and the FFIEC Uniform Retail Credit Classification and Account Management Policy to criteria that conform to these standards and the agencies' policy.
- Charged-off receivables held by the trust are sold to a third party. The funds generated by this sale, effectively accelerating the recovery on these receivables, improves the trust's spread performance.

Question 16:

(June 2003)

Do these actions constitute implicit recourse for regulatory capital purposes?

Staff Response:

No, the actions do not constitute implicit recourse. None of the noncontractual actions (above) results in a loss, or exposes the bank's earnings or capital to the risk of loss. Because of the margin compression, the organization is obligated to increase the spread accounts in

conformance with the terms and conditions of the securitization documents. To the extent this results in an increase in the value of the subordinated spread accounts (residual interests) on the bank's balance sheet, the organization will hold additional capital on a dollar-for-dollar basis for the additional credit risk retained by the bank. In contrast, if the bank increased the spread accounts beyond its contractual obligation under the securitization documents in order to provide additional protection to investors, this action would be considered a form of implicit recourse.

With respect to the other actions the bank took:

- Because the additions of receivables from the new affinity accounts are made at par value in accordance with the securitization documents, as they are with other additions to credit card trusts, they do not affect the banking organization's earnings or capital.
- The trust's policy on the timing of charge-offs on accounts of cardholders who have filed for bankruptcy was changed to meet the less stringent standards of the industry and those required under the agencies' policy in order to, at least temporarily, improve trust performance. Nonetheless, this change does not affect the bank's earnings or capital.
- In accordance with the securitization documents, proceeds from recoveries on charged-off accounts are the property of the trust. These and other proceeds continue to be paid out in accordance with the pooling and servicing agreement. No impact on the bank's earnings or capital resulted.

Facts:

A bank's credit card master trust is experiencing problems due to deteriorating credit quality. A nonbank subsidiary of the bank holding company, i.e., an affiliate of the bank, provides financial support in the form of cash contributions to the trust.

Question 17:

(June 2003)

Does the nonbank affiliate's support constitute implicit recourse by the bank for regulatory capital purposes? Is the bank required to hold risk-based capital against the remaining assets in the trust?

Staff Response:

No. Support provided to the trust by a nonbank affiliate does not represent implicit recourse for the bank. Because the bank did not provide the support, its earnings and capital were not exposed to potential risk of loss. The bank is not required to hold additional risk-based capital for the assets held by the trust.

However, these facts and circumstances would result in implicit recourse at the bank holding company level.

Facts:

In performing the role of servicer for its securitization, a bank is authorized under its pooling and servicing agreement to modify loan repayment terms when it appears that this action will improve the likelihood of repayment on the loan. These actions are part of the bank's process of working with customers who are delinquent or otherwise experiencing temporary financial

difficulties. All of the modifications are consistent with the bank's internal loan policy. However, in modifying the loan terms, the contractual maturity of some loans may be extended beyond the final maturity date of the most junior class of securities sold to investors. When this occurs, the bank repurchases these loans from the securitization trust at par.

Question 18:

(June 2003)

Does the modification of terms and repurchase of loans held by the trust constitute implicit recourse for regulatory capital purposes?

Staff Response:

Yes. The combination of the loan term modification for securitized assets and subsequent repurchase constitutes implicit recourse. While the modification of loan terms is permitted under the pooling and servicing agreement, the repurchase of loans with extended maturities at par exposes the bank's earnings and capital to potential risk of loss.

Facts:

A wholly-owned subsidiary of a bank originates and services a portfolio of home equity loans. After liquidation of the collateral for a defaulted loan, the subsidiary makes the trust whole in terms of principal and interest if the proceeds from the collateral are not sufficient. However, there is no contractual commitment that requires the subsidiary to support the pool in this manner. The payments made to the trust to cover deficient balances on the defaulted loans are not recoverable under the terms of the pooling and servicing agreement.

Question 19:

(June 2003)

Does the subsidiary's action constitute implicit recourse to the bank for regulatory capital purposes?

Staff Response:

Yes, this action is considered implicit recourse because it adversely affects the bank's earnings and capital since the banking organization absorbs losses on the loans resulting from the actions taken by its subsidiary. Further, no mechanism exists to provide for, and ensure that, the subsidiary will be reimbursed for the payments made to the trust. In addition, supervisors will consider any servicer advance a credit enhancement if the servicer is not entitled to full reimbursement or the reimbursement is subordinate to other claims. A servicer advance will also be considered a form of credit enhancement if, for any one loan, nonreimbursable advances are not contractually limited to an insignificant amount of the loan's outstanding balance.

Facts:

A bank sponsoring a securitization arranges for an unrelated third party to provide a first-loss credit enhancement, such as a financial standby letter of credit (L/C), that will cover losses up to the first 10% of the securitized assets. The bank agrees to pay a fixed amount as an annual premium for this credit enhancement. The third party initially covers actual losses that occur in the underlying asset pool in accordance with its contractual commitment under the L/C. Later, the selling bank agrees, not only to pay the credit enhancer the annual premium on the credit enhancement, but also to reimburse the credit enhancer for the losses it absorbed during the

preceding year. This reimbursement for actual losses was not originally provided for in the contractual arrangement between the bank and the credit enhancement provider.

Question 20:

(June 2003)

Does the selling bank's reimbursement of the credit enhancement provider's losses constitute implicit recourse?

Staff Response:

Yes, the bank's subsequent reimbursement of losses sustained by the credit enhancement provider goes beyond the contractual obligations of the bank and, therefore, constitutes implicit recourse. Furthermore, the OCC would consider any requirement contained in the original credit-enhancement contract that obligates the bank to reimburse the credit-enhancement provider for its losses to be a recourse arrangement.

8B. SALES OF STOCK

Facts:

A bank has a stock offering and finances its sale by issuing unsecured loans to the purchasers of the shares. Those loans are for the exact amount as the stock purchases. The documentation indicates that the loans are for “investment purposes,” but does not state that the intention of the investment is to purchase the bank’s own stock.

Question 1:

Should the notes received in exchange for the bank’s capital stock be classified as an asset or as a deduction from stockholders’ equity?

Staff Response:

Notes received in exchange for capital stock should be classified as a deduction from stockholders’ equity. Those notes should not be recorded as an asset, and the bank’s capital should not be increased as a result of this sale of stock.

Generally accepted accounting principles require the offsetting of stock loans against capital. This requirement has been formalized with a consensus of the FASB Emerging Issues Task Force in Issue No. 85-1. The consensus requires that stock loans be recorded as a reduction of stockholders’ equity, except when the loan is secured by irrevocable letters of credit or other liquid assets. Examples of other liquid assets would be a certificate of deposit or U.S. Treasury security. Furthermore, there must be substantial evidence of the ability and intent to pay the loan within a reasonably short period of time (usually 90 days or less).

Whether or not these loans are actually secured by bank stock does not alter the conclusion. This accounting is also applied to unsecured loans whenever the facts demonstrate that the borrowed funds are used to purchase bank stock.

Facts:

Bank A has a stock offering. The purchasers finance the stock purchase by obtaining unsecured loans from an unaffiliated bank, Bank B. Several years later, Bank A acquires Bank B. Accordingly, the loans to Bank A shareholders are now owned by Bank A.

Question 2:

(January 2007)

After the acquisition of Bank B by Bank A, should the loans funded by Bank B and used to purchase the stock of Bank A in the prior transaction continue to be classified as an asset or as a deduction from the stockholders’ equity of Bank A?

Staff Response:

The loans issued by Bank B and used to purchase capital stock of Bank A should be recorded as an asset of the bank. This situation differs from question 1 in that it was not the intent of Bank A to finance the sale of its own stock. At the time of the transaction the funds were not used to

purchase stock of the bank that issued the notes.

Facts:

A bank has a successful common stock offering. The bank incurs certain costs directly related to the securities offering for legal, accounting, and printing expenses.

Question 3:

(January 2007)

How should these expenses that are directly related to the stock offering be accounted for?

Staff Response:

Expenses that are directly related to a successful stock offering are accounted for as a reduction of the amount of the offering. Accordingly, they would be included as a reduction of the surplus account and not charged to current operations through the income statement. This response is consistent with AICPA Technical Questions and Answers, Section 4110.

Question 4:

(January 2007)

How should these expenses be accounted for if the stock offering is not successful (i.e., no stock is sold)?

Staff Response:

Expenses that are related to an unsuccessful stock offering are charged to current operations through the income statement.

8C. QUASI-REORGANIZATIONS

Question 1:

What is a quasi-reorganization?

Staff Response:

A quasi-reorganization is an accounting procedure whereby a bank, without undergoing a legal reorganization, revalues its existing assets and liabilities and reorganizes its equity capital. This allows for removal of a cumulative deficit in undivided profits. Chapter 7A of Accounting Research Bulletin No. 43, issued by the American Institute of Certified Public Accountants, describes a quasi-reorganization. It is based on the concept that an entity that has previously suffered losses, but has corrected its problems, should be allowed to present its financial statements on a “fresh start” basis.

Under generally accepted accounting principles, an entity undergoing a quasi-reorganization must revalue all its assets and liabilities to their current fair value. The effective date of the readjustment of values should be as near as possible to the date on which the shareholders gave their approval to the reorganization. The tax benefits of loss carryforwards arising before the quasi-reorganization should be added to capital surplus when realized.

Question 2:

(September 2001)

As part of the revaluation of its assets and liabilities to their current fair values, can the bank record a core deposit intangible for the intangible value of its own deposit base?

Staff Response:

No. As noted in question 1, a quasi-reorganization requires the entity to present its existing assets and liabilities at current fair value, on a “fresh start” basis. This “fresh start” allows the entity accounting treatment similar to that of a new or start-up company. However, the use of fair value has created the misconception that a quasi-reorganization should be recorded in a manner similar to a business combination accounted for as a purchase. This is not the case. In a quasi-reorganization, the existing assets and liabilities are recorded as fair value. New intangible assets should not be recorded. Intangible assets from previous business combinations may be carried forward, but should be reviewed for impairment.

Question 3:

(September 2001)

Can total capital increase as a result of the quasi-reorganization process and the revaluing of the bank’s net assets?

Staff Response:

No. Although the individual elements that make up equity capital may increase or decrease, generally accepted accounting principles do not permit an increase in total capital, because of a quasi-reorganization. This is based upon the historic cost model and the conservative concept in accounting that generally precludes recognition of gains until realized.

Question 4:

12 USC 56 does not allow the payment of dividends by banks that have an accumulated deficit in undivided profits. How does the fact that the bank has entered into a quasi-reorganization to eliminate the deficit affect the payment of dividends?

Staff Response:

The elimination of the accumulated deficit in undivided profits through a quasi-reorganization applies to the payment of dividends under 12 USC 56 and to financial statement presentation. Therefore, in applying 12 USC 56, only the undivided profit amount since the date of the quasi-reorganization would be considered. Losses prior to the date of the quasi-reorganization are ignored. However, prudent judgment should be employed nevertheless in determining the appropriateness of dividend payments, because of the bank's financial condition and anticipated future financial needs.

8D. EMPLOYEE STOCK OPTIONS

Facts:

In December 2004 the FASB amended Statement of Financial Accounting Standards No. 123 (SFAS 123R) with respect to the accounting for employee stock options and other share-based payments. This amendment is effective for fiscal years beginning after December 15, 2005 (fiscal year 2006) and requires that the cost of share-based payments be recognized in the financial statements. SFAS 123R requires entities to recognize compensation expense in an amount equal to the fair value of the share-based payments. This compensation will generally be recognized over the period that the employee is required to provide services to the entity.

Question 1:

(May 2006)

If bank holding company stock is issued rather than bank stock, must the compensation expense be recorded (pushed-down) in the financial statements of the bank?

Staff Response:

Yes. SFAS 123R requires that share-based payments awarded to an employee of an entity (bank) by a related party as compensation for services provided be accounted for as a share-based payment of that entity (bank) unless the transaction is clearly for a purpose other than compensation. In this respect, paragraph 11 of SFAS 123R notes that the substance of such a transaction is that the issuer of the shares (the holding company) made a capital contribution to the reporting entity (bank).

TOPIC 9: INCOME AND EXPENSE RECOGNITION

9A. ACCOUNTING FOR ASSET SALES AND SECURITIZATIONS

Facts:

A bank originates \$1,000,000 of mortgage loans that will yield 8.5% interest income. The bank transfers (sells) the principal plus the right to receive interest at 6.5% to another entity for par (\$1,000,000). The bank will continue to service the loans. The contract states that the bank will receive a servicing fee of 1%, paid from the interest income not sold. The remaining interest income not sold (previously considered excess servicing under SFAS 65) is considered to be an interest-only (IO) strip under SFAS 140. At the date of transfer, the fair value of the loans (with a yield of 8.5%), including servicing, is \$1,100,000. The fair value of the servicing is \$44,000 and the fair value of the IO strip is \$56,000. The fair value of the principal and interest sold is its sales price of \$1,000,000. Assume the transaction meets the requirements of SFAS 140 for a sale of the portion transferred.

Question 1:

(December 2008)

How should this sale of assets be accounted for?

Staff Response:

This sale of assets is accounted for in accordance with SFAS 140, as amended by Statement of Financial Accounting Standards No. 156 (SFAS 156). In accordance with SFAS 156, the servicing asset received is considered proceeds of the sale and not a retained interest in the loans sold. Accordingly, the bank should allocate the previous carrying amount between the loans sold (cash proceeds and servicing asset) and the retained interest in the loans sold (IO strip) based on their relative fair value at the date of transfer. Cost would be allocated as follows:

	Fair Value (FV) Amount	% of Total FV	Allocated Carrying
Assets sold	\$1,044,000	95%	\$ 950,000
IO strip	<u>56,000</u>	<u>5%</u>	<u>50,000</u>
Total Fair Value	\$1,100,000	100%	\$1,000,000

The bank would record a gain of \$94,000 (sales price of \$1,044,000 less allocated carrying amount of \$950,000). The retained interest in the loans (IO strip) would be recorded at its allocated carrying amount of \$50,000.

Question 2:

(December 2008)

How should the servicing asset be accounted for on an ongoing basis?

Staff Response:

The subsequent accounting for servicing rights is based on the bank's election. Separately for each class of servicing asset, the bank can choose either:

- An amortization method, under which the servicing assets are amortized in proportion to and over the period of estimated net servicing income; or
- A fair value measurement method (Statement of Financial Accounting Standards No. 159), under which the servicing assets are reported at fair value at each reporting date with changes in the fair value of servicing assets reported in earnings in the period in which the changes occur.

When the bank elects the fair value measurement method for a class of servicing asset, that election cannot be changed. If the bank elects the amortization method for a class of servicing asset, in addition to amortizing the asset, the bank must regularly (at least quarterly) evaluate and measure that asset for impairment.

Question 3:

(September 2001)

How should the IO strip be accounted for on an ongoing basis?

Staff Response:

SFAS 140 requires that the IO strip, and any other asset that can be contractually prepaid or otherwise settled in a manner that the holder would not recover substantially all of its recorded investment, be accounted for similar to an investment in debt securities classified as available-for-sale or trading under SFAS 115. Accordingly, it would be recorded at fair value. In the above example, the IO strip would be written up to \$56,000 immediately after the sales transaction.

In addition, the IO strip would be assessed for impairment consistent with the guidance in FASB Emerging Issues Task Force Consensus No. 99-20. See question 7 for additional information.

Question 4:

(September 2001)

Assume the same facts as in question 1 except that the loan being sold is an SBA loan and only its guaranteed portion is being sold. Would the accounting be the same?

Staff Response:

Yes, the bank would account for this sale and allocate the carrying amount of the SBA loan in the same manner. However, when allocating cost between the guaranteed and unguaranteed portions of an SBA loan, the two portions have substantially different risks and require different rates of return. Accordingly, the fair value of the two portions normally would be substantially different.

Facts:

A bank securitized \$150 million of its credit card loans. The transaction was accounted for as a sale. The next year the bank sold a portion of the underlying credit card account relationships to a third party (other than the buyer of the loans) for cash. These account relationships were sold at a premium of \$25 million. At that time, these credit card loans had a material amount of loan balances still outstanding.

Question 5:

(September 2001)

How should the sale of the account relationships be accounted for?

Staff Response:

The bank should recognize the \$25 million premium on the sale of the account relationships. Essentially, this transaction is similar to the sale of the mortgage servicing rights on loans owned by other parties. Under FASB Emerging Issues Task Force Consensus No. 85-13, a gain can be recognized if the rights are sold outright for cash. This transaction is not covered by SFAS 140 because the account relationships do not meet the definition of a financial asset.

Facts:

A bank originates, funds, and services credit card accounts. The bank enters into a transaction whereby it will sell the future gross income stream (i.e., interest income and late fees) from its existing credit card balances. However, it will continue to own and make advances to the credit card customers. Any income received on new credit card advances accrue to the bank. The bank will also continue to service the accounts for a monthly fee. Further, the bank may cancel the sales transaction through payment of a lump sum amount to the purchaser.

Question 6:

(September 2001)

Should this transaction be accounted for as a sale?

Staff Response:

No. The proceeds from the sale of the future income stream on the credit card accounts should be accounted for as a borrowing. Therefore, the proceeds are recorded as a liability and amortized using the interest method over the estimated life of the accounts. This conclusion is based on FASB Emerging Issues Task Force Consensus No. 88-18. Under that consensus, the sales proceeds may be classified as either debt (a borrowing) or deferred income (sale) depending on the specific facts and circumstances. In this respect, the consensus set forth six criteria for determining whether the sales proceeds should be classified as debt or deferred income. If the transaction meets any of those criteria, the sales proceeds generally would be reported as debt. This transaction meets two of the six criteria for debt classification. First, the bank has a significant continuing involvement in the generation of cash flows, since it will continue to service and fund the credit card receivables. Additionally, the transaction is cancelable by the bank through payment of a lump sum amount.

Question 7:

(September 2001)

How does one determine whether a fair market value adjustment to an IO strip represents permanent impairment?

Staff Response:

Institutions should follow the guidance in FASB Emerging Issues Task Force Consensus No. 99-20 (EITF 99-20) to determine whether an adjustment should be made to the recorded value of an IO strip to recognize impairment. The impairment test in EITF 99-20 involves two triggers:

- A decline in the fair value of the IO strip below the investor's carrying amount, and
- An adverse change in the timing or amount of the estimated future cash flows associated with the IO strip.

If the fair value is less than the amortized cost and the estimated cash flows have decreased since the last estimate of fair value was made, then the security must be written down to its new fair value by taking a charge through earnings.

Facts:

Under SFAS 140, as amended by SFAS 156, servicing assets purchased and all servicing liabilities are initially measured at fair value. A servicing asset results when the benefits of (revenues from) servicing are expected to provide more than "adequate compensation" to the servicer. If the benefits of servicing are not expected to compensate a servicer adequately for performing the servicing, the contract results in a liability.

Question 8:

(December 2008)

For purposes of this determination, how is "adequate compensation" defined in SFAS 140?

Staff Response:

SFAS 140 defines "adequate compensation" as "the amount of benefits of servicing that would fairly compensate a substitute servicer should one be required, which includes the profit that would be demanded in the marketplace." The FASB Implementation Guide for Statement 140 adds that "Adequate compensation is the amount of contractually specified servicing fees and other benefits of servicing that are demanded by the marketplace to perform the specific type of servicing. Adequate compensation is determined by the marketplace; it does not vary according to the specific costs of the servicer."

It is important to note that this definition is consistent with SFAS 140's emphasis on fair value. Specifically, the recorded value of a servicing contract is based on the marketplace. Accordingly, a servicing asset is based on the servicing revenue an institution expects to receive relative to the compensation a third party would require and is not based on an institution's own cost of servicing. As a result, an inefficient servicer incurring losses may not be required to record a servicing liability, if the servicing income is sufficient to compensate fairly a substitute (third party) servicer.

Facts:

A bank originates a SBA loan and sells the guaranteed portion. It receives a premium on this sale. The sale includes a provision that requires the seller to refund any premium received if the borrower fails to make any of the first three payments. This transaction qualifies for sales treatment under SFAS 140. On this particular loan the bank is unable to estimate either the likelihood of the borrower failing to make one of the first three payments, or the fair value of this recourse obligation.

Question 9:

(September 2001)

How should the bank account for the recourse obligation?

Staff Response:

Normally the bank would record a liability for the fair value of the recourse obligation. However, in this situation the bank is unable to estimate the amount of the liability. Appendix A of SFAS 140 covers situations when an entity is unable to estimate the amount of the fair value of the liability. It requires that any gain be deferred until the recourse period has expired.

This will require that gain recognition be deferred for three months.

Facts:

A bank forms a \$1 billion pool of receivables from credit card accounts and transfers the receivables to a trust. The bank then sells undivided participation interests in the trust's receivables or in the trust and retains the remaining undivided participation interest in the receivables or in the trust. During a specified reinvestment period (i.e., 48 months), the trust will purchase additional credit card receivables generated by the selected accounts. During the revolving period, the investors' dollar investment remains constant, because principal payments, allocated to the investors' interest are reinvested in additional credit card receivables. The up front transaction expenses of \$5,000,000 consist of legal fees, accounting fees, rating agency fees, and underwriting fees.

Question 10:

(September 2003)

How should the bank account for the up-front transaction expenses of the securitization?

Staff Response:

The transaction costs relating to the sale of the receivables may be recognized over the five-year revolving period, in a rational and systematic manner unless the transaction results in a loss.

According to SFAS 140, transaction costs for a past sale are not an asset and thus are part of the gain or loss on sale. Accordingly, transaction expenses for securitizations of term loans are expensed as incurred. However, FASB Emerging Issues Task Force Consensus No. 88-22 indicates that in a securitization of revolving assets, such as a credit card securitization, some of the transaction costs incurred at inception of the securitization relate to future sales that will occur during the reinvestment period. These transaction costs are equivalent to prepaid expenses, and may be treated as an asset and amortized into earnings in a rational and systematic manner.

Facts:

A bank securitized \$200 million of its credit card receivables in a transaction accounted for as a sale. To enhance the credit rating of the beneficial interests issued by the qualifying special purpose entity, a cash reserve account was established for the transfer. The cash reserve account was funded with cash contributed by the bank, and a specified portion of the cash flows to which the bank as residual holder would otherwise be entitled are deposited in the cash reserve account for possible distribution to the other beneficial interest holders if specified collection targets are not met. If the specified collection targets are met, the amount in excess of the specified collection target is distributed from the cash reserve account to the bank.

Question 11:

(February 2004)

How should the cash reserve account be accounted for?

Staff Response:

The securitization of the credit card receivable is accounted for in accordance with SFAS 140. Accordingly, the bank should allocate the previous carrying amount between the assets transferred and the assets retained based on their relative fair values at the date of transfer. Under SFAS 140, a cash reserve account is considered a retained interest. Therefore, the bank should include the carrying amount of the cash deposited into the cash reserve account in the relative fair value allocation.

Subsequent to initial recognition of the cash reserve account, the bank should account for the cash reserve account as a retained interest and measure it as an investment in debt securities classified as available-for-sale or trading under SFAS 115 (i.e., at fair value). As a retained interest, the cash reserve account should be reported as an Other Asset.

Question 12:

(February 2004)

How should the fair value of the cash reserve account be determined?

Staff Response:

When estimating the fair value of the cash reserve account, the bank's assumptions should include the period of time that its use of the cash deposited is restricted, any reinvestment income, and potential losses due to uncertainties. An acceptable valuation technique is the "cash-out" method. Under the cash-out method, cash flows are discounted using an appropriate discount rate from the date the cash reserve account becomes available to the bank. The bank must carefully analyze the terms of the securitization agreements to determine when it has control over the cash flows represented by the cash reserve account.

The "cash-in" method (i.e., discounting cash flows based upon when the cash is expected to come into the cash reserve account) is not an appropriate method to estimate the fair value of the cash reserve account as it does not appropriately consider the entire period that the cash is restricted and may not consider all of the credit uncertainties the market would consider.

Facts:

A bank securitizes financial assets, such as credit cards or commercial real estate loans and accounts for the securitization, as a sale under the guidance of SFAS 140. Subsequently, the bank regains control of the transferred assets in an event that invalidates the characterization of the securitization as a sale. Examples of such events are: (1) a change that causes a qualifying special-purpose entity to no longer be qualified, or (2) when the transferor holds a contingent right, such as a contingent call option, and the contingency has been met. This type of event is referred to often as a "paragraph 55" event because that paragraph within SFAS 140 provides the guidance for such events.

Question 13:

(February 2004)

How should the bank account for the assets for which it regains control?

Staff Response:

The bank should account for the regained transferred assets as though it had purchased them from the former transferee in exchange for assuming the related liabilities. Accordingly, the bank would recognize the assets in its financial statements together with liabilities to the former transferee. Initially, the bank would record the assets and liabilities at fair value on the date of the change, in a manner similar to the bank purchasing the assets and assuming the liabilities on that date. This is consistent with the consensus to issue 2 of FASB Emerging Issues Task Force Consensus No. 02-9 (EITF 02-9).

Question 14:

(February 2004)

How should the bank account for the retained beneficial interest that existed prior to regaining control?

Staff Response:

The bank would not recognize any gain or loss in the retained beneficial interests. The bank may recognize gain or loss for the difference between the fair value of repurchased assets and the exercise price of contingent rights, such as a return-of-accounts provision (ROAP). This is consistent with the consensus to issue 1 of EITF 02-9.

Question 15:

(February 2004)

May the bank recognize a loan loss allowance upon the repurchase of previously transferred loans?

Staff Response:

No. The bank should not initially recognize a loan loss allowance for loans that are repurchased for this event. However, subsequent to the initial repurchase, the bank should continue to review the assets for impairment, at which time a loan loss allowance provision may be appropriate. This is consistent with the consensus to issue 3 of EITF 02-9.

Question 16:

(February 2004)

In connection with the repurchase of the previously transferred financial assets, how should the bank account for the servicing asset or liability related to the repurchased asset?

Staff Response:

The bank should not change its accounting for the servicing asset or liability related to the transferred and repurchased financial assets. The bank would continue to recognize its right and obligation to perform servicing of the financial assets on behalf of the transferee. The bank should continue to assess the servicing asset for impairment as required by SFAS 140.

This is consistent with the consensus to issue 4 of EITF 02-9.

Question 17:

(February 2004)

How should the bank account for its retained interest (seller's interest) in this event?

Staff Response:

The bank should continue to account for its retained interest (seller's interest) separately from any repurchased assets. However, if the bank actually reclaims the financial assets (e.g., exercises a contingent right or consolidation under FASB Interpretation No. 46(R)), it should combine the repurchased assets with its seller's interest and report the amount as a single asset.

Facts:

A bank issues Government National Mortgage Association (GNMA) mortgage-backed securities, which are securities backed by residential mortgage loans that are insured or guaranteed by the Federal Housing Agency (FHA), the Veterans Administration (VA), or the Farmers Home Administration (FmHA). This program allows the bank to buy back individual delinquent mortgage loans that meet certain criteria from the securitized loan pool for which the bank is servicing. At the servicer's (bank) option and without GNMA's prior authorization, the servicer may repurchase such a delinquent loan for an amount equal to 100% of the remaining principal balance of the loan.

Question 18:

(September 2004)

Can the bank account for this transaction as a sale of the mortgage loans?

Staff Response:

Yes. When the loans backing a GNMA security are initially securitized, SFAS 140 permits the issuer of the security to treat the transaction as a sale for accounting purposes because the conditional or contingent nature of the buy-back option means that the issuer does not maintain effective control over the loans. Accordingly, the loans are removed from the bank's balance sheet.

Question 19:

(September 2004)

When individual loans later meet GNMA's specified delinquency criteria and are eligible for repurchase, how should the bank account for the loans?

Staff Response:

When individual loans later meet the delinquency criteria and are eligible for repurchase, the issuer (bank), providing the issuer is also the servicer, is deemed to have gained effective control over the loans. Accordingly, under SFAS 140, the loans can no longer be reported as sold. The loans must be brought back on the issuer-servicer's (bank's) books as an asset and initially recorded at fair value, regardless of whether the bank intends to exercise the buy-back option. An offsetting liability also would be recorded.

Question 20:

(September 2004)

How should these assets and liabilities be reported on the call report (balance sheet)?

Staff Response:

These loans should be reported as either loans held for sale or loans held for investment, based on the facts and circumstances, in accordance with generally accepted accounting principles. These loans should not be reported as “Other assets.” The offsetting liability should be reported as “Other borrowed money” on the call report.

Facts:

A bank transfers \$500 million of its credit card receivables to a trust in a transaction accounted for as a sale. The trust sells a 90% interest in the credit card receivables to third-party investors through the issuance of \$450 million of Class A and Class B notes. The bank receives \$450 million as proceeds of the sale and retains a \$50 million undivided interest in the transferred receivables (i.e., a 10% seller’s interest in the trust’s receivables).

Question 21:

(April 2005)

How should the bank account for the 10% seller’s interest at the date of transfer?

Staff Response:

The transfer of the credit card receivables is accounted for in accordance with SFAS 140. SFAS 140 requires retained interests in transferred assets to be measured at the date of transfer by allocating the previous carrying amount between the assets sold and the retained interests (e.g., IO, servicing, accrued interest receivable), based on their relative fair values. Accordingly, the bank should include the seller’s interest in the relative fair value allocation and gain (or loss) on sale calculation. As a result, the seller’s interest would be recorded at its allocated carrying amount at the date of transfer.

Question 22:

(April 2005)

How should the bank account for the 10% seller’s interest subsequent to its initial recognition?

Staff Response:

If the seller’s interest is certificated (i.e., in the form of a security), it should subsequently be accounted for in accordance with SFAS 115 as an available-for-sale or trading security at fair value.

A seller’s interest that is not certificated is generally accounted for as a loan. SFAS 140 does not provide specific guidance on accounting for the difference between the allocated carrying amount of the seller’s interest at the date of transfer and the seller’s interest in the principal balance of the transferred receivables. The staff believes this difference should be treated similarly to a loan premium or discount and amortized as a yield adjustment over the average life of the retained interest (i.e., the average life of the transferred receivables). Because a non-certificated seller’s interest is not carried at fair value, it must also be periodically assessed for impairment. Accordingly, banks that treat a non-certificated seller’s interest as a loan should include an appropriate allowance for impairment losses in the ALLL.

9B. CREDIT CARD AFFINITY AGREEMENTS

Facts:

In 200X, a bank entered into a 12-year contract with an affinity group for the exclusive right to offer credit cards to the group's members in return for a nonrefundable payment to the group of \$50 million per year. The affinity group has a stable membership, and therefore, the number of credit card customers is expected to remain relatively constant. Further, the services performed by the parties are constant throughout the life of the contract.

The contract also contains a royalty calculation provision that uses an escalating scale that bears no relationship to the expected earnings from the credit card portfolio or services performed under the contract. Under this escalating scale, the royalty provision provides for a \$10 million amount in the first year and in excess of \$100 million in the final year of the contract. While the excess of the annual payment over the royalty amount is not refundable, it may be used to offset future royalties. The bank proposes to record expense of \$10 million the first year and include the \$40 million amount difference as a prepaid expense (other asset) on its balance sheet.

Question 1:

(June 2003)

Is it appropriate for the bank to capitalize \$40 million of the \$50 million payment related to this affinity agreement as a prepaid asset because of the royalty calculation provision?

Staff Response:

No. Generally accepted accounting principles require that the expense be determined in a systematic and rational manner to the periods in which the payments are expected to provide benefit. In this situation, the benefits of the relationship and the services of the affinity group are being provided consistently throughout the contract period. Further, the royalty calculation provision in the contract is not related to the expected earnings on the portfolio or the services performed by the affinity group.

Accordingly, an accounting method that recognizes expense on a periodic basis relative to the benefits received should be used. In this case, the periodic payments from the bank to the affinity group are the best measurement of that benefit. This accounting is consistent with FASB Statement of Accounting Concepts No. 5. SFAS 13 also provides guidance. This standard requires that leases with accelerated payment structures be accounted for by recognizing income or expense on a straight-line basis or another income recognition method that provides a systematic pattern consistent with the benefits derived.

9C. ORGANIZATION COSTS

Question 1:

(June 2003)

What are start-up activities and organization costs?

Staff Response:

Start-up activities are defined broadly as those one-time activities related to opening a new facility, introducing a new product or service, conducting business in a new territory, conducting business with a new class of customer, or commencing a new operation. Start-up activities include activities related to organizing a new entity, such as a new bank, that are commonly referred to as organization costs.

Organization costs for a bank are the direct costs incurred to incorporate and charter the bank. Such costs include, but are not limited to, professional (e.g., legal, accounting, and consulting) fees and printing costs directly related to the chartering or incorporation process, filing fees paid to chartering authorities, and the cost of economic impact studies.

Question 2:

(June 2003)

What is the accounting for start-up activities, including organization costs?

Staff Response:

Costs of start-up activities, including organization costs, should be expensed as incurred. Costs of acquiring or constructing premises and fixed assets and getting them ready for their intended use are capitalized as fixed assets. However, the costs of using such assets that are allocated to start-up activities (e.g., depreciation of computers) are considered start-up costs. For a new bank, pre-opening expenses such as salaries and employee benefits, rent, depreciation, supplies, directors' fees, training, travel, postage, and telephone, are considered start-up costs.

Guidance on the accounting and reporting for the costs of start-up activities, including organization costs, is set forth in AICPA Statement of Position 98-5 (SOP 98-5) and the call report instructions.

Question 3:

How should a bank account for the organizational costs of forming a bank holding company?

Staff Response:

Although bank holding company fees and other related costs are sometimes paid by the bank, they are the holding company's organizational costs. Accordingly, any unreimbursed costs paid on behalf of the holding company should be recorded as a cash dividend paid by the bank to the holding company. Similarly, if the bank holding company application is unsuccessful or abandoned, the costs are the responsibility of the organizers. Therefore, unreimbursed amounts should be recorded as a dividend.

Facts:

Bank A would like to expand into a nearby state. Because of state law requirements, a bank must have an existing charter in the state for more than five years to be able to conduct business. To achieve this, Bank A purchases and merges with an existing charter, Bank B, which it acquired from Bank B's parent holding company for \$300,000. Bank B is an independent third-party institution. Bank A does not acquire any other net assets of Bank B, but now has the legal right to do business in that state.

Question 4:

(September 2004)

How should Bank A account for the \$300,000 paid to acquire Bank B since the sole purpose of the acquisition was for the right to do business in the state?

Staff Response:

Although this cost may be consistent with the definition of an organization cost, since it was created in a third-party transaction, it is considered to be an intangible asset and is accounted for under Statement of Financial Accounting Standards No. 142 (SFAS 142) rather than SOP 98-5. Accordingly, this cost may be capitalized.

Question 5:

(September 2004)

Can the intangible asset noted be accounted for as goodwill?

Staff Response:

No, it is not considered to be goodwill. In accordance with SFAS 142, assets acquired outside of a business combination do not give rise to goodwill. This asset would be considered to be an identifiable intangible asset. See Topic 10B for further guidance on the appropriate accounting for intangible assets.

Facts:

The start-up costs of forming a bank are sometimes paid by the organizing group (or founders or holding company) without reimbursement from the bank. This may occur because the organizing group or holding company wishes to contribute these funds to the bank, or because the shareholders or the OCC disallow reimbursement of certain costs.

Question 6:

(December 2008)

How should the bank account for these start-up costs that are paid by the organizers?

Staff Response:

The bank must record these start-up costs as expenses of the bank, with a corresponding entry to surplus to reflect the capital contribution. This includes direct costs paid to third parties and services that are provided by the holding company, such as legal or accounting expertise. In latter case, the holding company should estimate the cost of services provided, including salaries, and the bank should record these costs as start-up costs.

TOPIC 10: PURCHASE ACCOUNTING, CORPORATE REORGANIZATIONS, AND CONSOLIDATION

10A. ACCOUNTING FOR ACQUISITIONS

(This topic is based on Statement of Financial Accounting Standards No. 141. It has not been updated for Statement of Financial Accounting Standards No. 141R, which will be applied to business combinations with an acquisition date of January 1, 2009 or later.)

Facts:

Bank A acquires Bank B in a transaction accounted for under the purchase method in accordance with generally accepted accounting principles. The acquired loans are performing loans that do not have evidence of credit deterioration and do not fall within the scope of AICPA Statement of Position 03-3 (see question 11).

Question 1:

(October 2005)

When is it appropriate for Bank A (purchasing bank) to adjust the allowance for loan and lease losses of an acquired bank (Bank B) to reflect a different estimate of collectibility?

Staff Response:

This question arises when Bank A assigns its acquisition cost to the acquired assets of Bank B. Typically, no adjustment is allowed. Additions to the allowance are made generally through provisions for loan and lease losses, not as purchase accounting adjustments. Therefore, except as discussed later, purchase accounting adjustments reflecting different estimates of collectibility generally are considered inappropriate.

Estimation of probable loan and lease losses involves judgment. Although banks' managements may differ in their systematic approaches to this evaluation, their collectibility estimates of Bank B's loan portfolio should not vary materially. Therefore, a purchase accounting adjustment to reflect a different estimate of collectibility is inappropriate.

A purchase accounting adjustment may be appropriate only when Bank A has demonstrably different plans than Bank B for the ultimate recovery of the acquired loans. For example, Bank A may plan to sell certain loans intended by Bank B to be held to maturity. Such loans would be reported as assets held for sale and valued at the lower of cost or market value.

The staff does not suggest that acquired loans be recorded at an amount that reflects an unreasonable estimate of collectibility. If Bank B's financial statements as of the acquisition date are not stated fairly because of an unreasonable allowance for loan losses, Bank B's preacquisition financial statements should be restated to reflect an appropriate allowance.

This response is consistent with guidance issued by the Securities and Exchange Commission in Staff Accounting Bulletin No. 61 as codified in Staff Accounting Bulletin Topic 2.A.5.

Facts:

Bank A acquires Bank B in a purchase transaction. Bank A incurs costs to terminate Bank B's unfavorable data processing contracts and to make its data processing system compatible with Bank A's system.

Question 2:

(December 2001)

Should those costs be capitalized by Bank A in the acquisition?

Staff Response:

Costs incurred to terminate Bank B's unfavorable contracts, including data processing contracts, should be capitalized at the time of acquisition. This includes the cost to make Bank B's data processing system compatible with Bank A. However, costs incurred by the acquiring institution to modify, convert, or terminate its own data processing system are not considered in the cost of acquisition and must be expensed as incurred in accordance with FASB Technical Bulletin 85-5.

Statement of Financial Accounting Standards No. 141 (SFAS 141), while amending portions of the technical bulletin, retains the provision that permits only direct costs of an acquisition to be capitalized in the acquisition cost. Further, those direct costs must be "out of pocket" or incremental costs and not internal costs related to the acquisition.

Facts:

Bank A acquires Bank B from the FDIC in a total asset purchase and assumption transaction. Bank A submits a negative bid of \$5 million (i.e., the FDIC pays Bank A \$5 million to acquire Bank B).

Question 3:

How should this acquisition be accounted for?

Staff Response:

The acquisition should be accounted for as a purchase business combination. Accordingly, the assets received and liabilities assumed are recorded at their fair market value. The assistance received from the FDIC as a negative bid (i.e., the \$5 million) represents an acquired asset. Any difference between the fair value of the assets acquired and liabilities assumed would be either goodwill (if liabilities exceed assets) or negative goodwill (if assets exceed liabilities).

Facts:

Acquisitions generally are made through a bid process. Prior to submitting a bid, the acquirer (Bank A) will estimate the fair value of the assets and liabilities being acquired. However, those estimates may be performed quickly and may differ from the actual fair values of specific assets determined in a more detailed analysis following the acquisition.

Question 4:

(December 2001)

Is it appropriate, in recording the acquisition, for Bank A (the acquirer) to revise the estimated values assigned to the assets and liabilities of Bank B based on the fair values determined in the more detailed analysis?

Staff Response:

Yes, not only is it appropriate, it is required. The values assigned during the due diligence process are only estimates and must be refined. Therefore, after completing the acquisition, Bank A must determine the fair values of the acquired assets and liabilities. This process should be completed as soon as possible after the acquisition. The bank must make a good faith effort to record all purchase accounting adjustments by the next call report due date.

However, SFAS 141 permits preacquisition contingencies of purchased enterprises to be adjusted during an "allocation period." This allocation period is provided so that a contingency, such as an unresolved litigation matter, can be included as a purchase accounting adjustment when the amount becomes known. It should not be used to apply "hindsight" to the process of determining fair market value, so relatively few adjustments should occur. This period should usually not exceed one year.

Question 5:

(September 2004)

What is the acquisition date for purposes of determining the purchase price of an acquisition and the assignment of fair values to the assets acquired and liabilities assumed?

Staff Response:

SFAS 141 defines the acquisition date as "the date assets are received and other assets are given, liabilities are assumed or incurred, or equity interests are issued." This would normally be the consummation or closing date of the transaction. However, for convenience, the parties may designate an effective date at the end of an accounting period between the dates the business combination is entered into and consummated. If the effective date is other than the acquisition date, certain adjustments may be required to compensate for recognizing income before consideration has been transferred.

Question 6:

(September 2004)

If equity securities are issued in the business combination, is their value also determined as of the acquisition date?

Staff Response:

No. SFAS 141 requires that the market price for a reasonable period of time before and after the date the terms of the acquisition are agreed to and announced be considered in determining the value of the securities issued. Normally a period two days before and two days after the announcement is used.

Facts:

Bank A acquires Bank B in a transaction accounted for under the purchase method in accordance with generally accepted accounting principles. The purchase price paid at acquisition exceeds the fair value of the net assets acquired. In addition to the amount paid at the time of the acquisition, the agreements provide for additional payments by Bank A to the former owners of Bank B, based upon the occurrence of certain future events.

Question 7:

(October 2005)

Should any portion of the contingent consideration be included in the purchase price at the date of acquisition?

Staff Response:

Consistent with SFAS 141, any portion of the contingent consideration that is determinable at the date of acquisition should be included in the cost of acquiring the entity and recorded at the date of acquisition. Consideration that is dependent upon the outcome of future events or contingencies would generally not be recorded at the date of acquisition. It would be recorded when the future event or contingency becomes determinable.

Question 8:

(October 2005)

How should the excess of acquired net assets over cost (negative goodwill) be recorded?

Staff Response:

Negative goodwill should be recorded by taking a *pro rata* reduction in the amounts that otherwise would have been assigned to the acquired assets. However, the following assets should not be included in the allocation: (a) certain financial assets, (b) assets to be disposed of by sale, (c) deferred tax assets, (d) prepaid assets relating to pension and other post retirement plans, and (e) other current assets. Accordingly, the negative goodwill principally will reduce the cost basis of long-term fixed assets. Once these assets have been reduced to zero, any remaining amount of negative goodwill is recognized as an extraordinary gain in the period that the business combination is completed, unless there is a contingent payment provision (see question 9).

Facts:

Bank A acquires one hundred percent of Bank B, an unaffiliated entity. The fair value of the identifiable net assets acquired (including both tangible and intangible assets) exceeds the purchase price by \$5 million (sometimes referred to as negative goodwill). However, there is a contingent payment (earn-out) agreement between Bank A and the original shareholders of Bank B. Based on future performance, contingent payments to the shareholders will range from zero to \$50 million.

Question 9:

(October 2005)

How should this acquisition be accounted for?

Staff Response:

An amount equal to the lesser of the maximum amount of the contingent consideration (in this case \$50 million) or the excess of the fair value of the net assets acquired over the initial consideration paid at closing (\$5 million) shall be recorded as a liability. In this situation \$5 million would be recorded as a liability.

When the contingency is resolved, any excess of the contingent payment over the recorded amount of the liability is recognized as additional cost of the acquisition (goodwill). If the amount recorded as a liability exceeds the contingent payment, the excess shall be allocated as a *pro rata* reduction of amounts assigned to the acquired assets as set forth in question 8. Any amount that remains after reducing those assets to zero is recognized as an extraordinary gain. This accounting is consistent with SFAS 141, paragraphs 44 – 46.

Question 10:

Should the fair value of the loan portfolio be determined on a loan-by-loan basis or may it be determined for the entire loan portfolio?

Staff Response:

Determination of the fair value of the loan portfolio should be made on a loan-by-loan basis. It should consider both interest rate and credit risk. Additionally, any allowance for loan and lease losses included in the acquisition should be considered in the analysis. An exception to this requirement is made for groups of homogeneous consumer loans. The fair value of those loans may be determined on an aggregate basis. However, any fair value discount should be applied to all the loans in the pool on a *pro rata* basis. In this way each individual loan can be accounted for subsequently.

Question 11:

(December 2008)

May Bank A record an allowance for loan and lease losses for the acquired loans in the purchase price allocation?

Staff Response:

The answer depends on whether the loan has evidence of deterioration of credit quality since origination. For loans without such evidence, the recorded allowance amount is limited to the amount that existed on Bank B's books at the time of its closure as noted in question 1.

For loans with evidence of credit deterioration at the time of acquisition, the recorded allowance amount may not be "carried over" to the acquiring bank. Such loans are recorded at their fair value, which typically includes a discount that takes into consideration the deteriorated credit quality. This is consistent with AICPA Statement of Position 03-3 (SOP 03-3).

However, the FASB has issued SFAS 141R that prohibits the "carry over" of any allowance on acquired loans in a business combination. FAS 141R becomes effective in 2009.

Facts:

A bank acquires a loan in a business combination. At the time of the acquisition, relevant credit information is reviewed and the loan is recorded at fair value. However, the loan subsequently becomes uncollectible and is charged off.

Question 12:

How should this subsequent charge off be recorded?

Staff Response:

The charge off should be recorded against the allowance for loan and lease losses. If needed, a provision for loan loss should be recorded to restore the bank's allowance to an adequate level.

Generally it is not appropriate to revise the fair value assigned to the loan at acquisition. This is because all relevant credit information was available for estimating the loan's fair value at the date of acquisition. Only when that information is *not* available and subsequently becomes available may a change to the purchase price allocation be made in the allocation period. Otherwise, subsequent loan activity is reflected in the appropriate subsequent period's financial statements.

Facts:

A bank that acquires a thrift institution's deposits may decide to switch insurance funds from the Savings Association Insurance Fund (SAIF) to the Bank Insurance Fund (BIF). FIRREA imposes an exit fee and an entrance fee on such insurance conversions.

Question 13:

How should an acquiring bank account for an obligation to pay exit and entrance fees?

Staff Response:

The acquiring bank should record a liability when it incurs an obligation to pay exit and entrance fees. Such costs may be capitalized in the acquisition cost of the thrift and amortized over the period benefited. Since those costs are included in the acquisition of the thrift, capitalization is allowed only when the decision to switch funds is elected at acquisition time.

Facts:

Bank A acquires Bank B in a transaction accounted for under the purchase method in accordance with generally accepted accounting principles.

Question 14:

(December 2001)

In accordance with 12 USC 60(b), how should the retained net income amounts be determined when computing dividend limitations?

Staff Response:

One of the combining entities in a purchase transaction is viewed as surviving the transaction and is considered the acquiring entity. The other combining entity no longer continues to be formally recognized and its net assets are considered to be purchased by the acquiring entity. For accounting purposes, the transaction is a purchase of net assets by the acquiring bank. In addition to recording these assets at fair value, the capital accounts of the acquired entity are eliminated. Operations of the acquired entity are included only in the income statement from the date of acquisition.

Accordingly, *only the acquiring bank's* retained net income (net income less dividends paid in each year) are used when computing the dividend limitations of 12 USC 60(b). Therefore, the prior two years of retained net income plus current year net income of *only the acquiring bank* are included in the calculation. Operations of the *acquired bank* would be included from the date of acquisition.

Question 15:

(September 2002)

In a business combination effected through the exchange of equity interests, is the surviving legal entity necessarily the acquiring entity for accounting purposes?

Staff Response:

SFAS 141 notes that the application of the purchase method requires identification of the acquiring entity and establishes criteria for making that determination. In that context, the entity that issues the equity interests is generally also the acquiring entity for accounting purposes. However, this is not always the case. In certain circumstances, the entity that is acquired for accounting purposes will issue the equity interests and be the surviving charter. These transactions are commonly referred to as reverse acquisitions.

Generally, the acquiring bank for accounting purposes is the larger entity, however, all of the facts and circumstances must be considered in making this determination.

Question 16:

(September 2002)

In addition to the relative size of the combining banks, what other factors should be considered in determining the surviving entity for accounting purposes?

Staff Response:

The following factors should be considered in determining the surviving entity for accounting purposes:

- The relative ownership percentage and voting rights of the shareholders of each entity in the combined entity.
- The composition of the governing body (i.e., board of directors) or senior management.
- The existence of a large minority interest that will have significant voting influence over the combined entity.

Facts:

Bank A is the legal survivor in a business combination with Bank B. However, prior to the merger, Bank A has \$150 million in assets and Bank B has \$220 million in assets. After the merger, Bank A's former shareholders will own 40% of the outstanding stock, and Bank B's former shareholders will own 60% of the outstanding stock of the combined entity.

Further, former Bank B shareholders will have four members on the board of directors and former Bank A shareholders will have three members on the board.

Question 17:

(September 2002)

For accounting purposes, which bank is the acquiring bank?

Staff Response:

Bank B is the acquiring bank. This determination is based on the relative size of the combining banks, as well as the resulting shareholder ownership and board membership percentages. In this situation, the determination is relatively clear-cut because Bank B provided approximately 60% of the assets, and its former owners received approximately 60% of the security interests and board membership. In practice, the determination will not always be this clear.

Question 18:

(September 2002)

How is this transaction accounted for?

Staff Response:

Since Bank B is the acquiring bank for accounting purposes, its financial statements will be carried forward at historical cost. Further, for dividend limitation purposes under 12 USC 56 and 60(b), the retained net income of Bank B will be used. Bank A is accounted for as the acquired bank and its assets (including intangible assets) and liabilities are recorded at fair market value. The purchase price for the acquisition is the fair market value of the shares of stock owned by former Bank A shareholders. Goodwill is recorded for the difference between the purchase price and the fair value of the net assets acquired.

10B. INTANGIBLE ASSETS

Question 1:

(December 2001)

In July 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards No. 141 and 142 (SFAS 141 and SFAS 142). In general, how did these statements change the accounting for business combinations?

Staff Response:

These statements significantly changed the accounting for business combinations, goodwill, and intangible assets (in these statements the term “intangible assets” refers to all intangibles other than goodwill). SFAS 141 eliminated the pooling-of-interests method of accounting for business combinations, except for certain combinations initiated prior to July 1, 2001. The statement further clarified the criteria for recognizing intangible assets separately from goodwill.

Under SFAS 142, goodwill and indefinite-lived intangible assets are no longer amortized, but are reviewed at least annually for impairment. Other intangible assets (i.e., core deposit intangibles, purchased credit card relationships, etc.) that are not deemed to have an indefinite life continue to be amortized over their useful lives. The amortization provisions of SFAS 142 were effective immediately for goodwill and intangible assets acquired after June 30, 2001. For intangibles acquired prior to July 1, 2001, banks were required to adopt SFAS 142 for the year beginning January 1, 2002 and continued to amortize these intangibles in accordance with prior accounting requirements during the transition period to January 1, 2002.

Question 2:

(October 2005)

How should an intangible asset (other than goodwill and indefinite-lived intangible assets) be amortized?

Staff Response:

An intangible asset that has a finite life (e.g., core deposit intangibles, purchased credit card relationships, etc.) should be amortized over its estimated useful life using a method that reflects the pattern in which the economic benefit of the asset is consumed. This will generally result in the use of an accelerated method of amortization. If a usage pattern cannot be reliably determined, institutions should use the straight-line method.

The staff believes the estimated useful lives of core deposit intangibles and purchased credit card relationships will generally not exceed 10 years. However, in unusual circumstances, a longer useful life and amortization period may be justified.

Question 3:

(October 2005)

Should discounted or undiscounted expected future cash flows be used in assessing an intangible asset with a finite life (e.g., purchased credit card relationships) for impairment?

Staff Response:

An intangible asset with a finite life should be assessed for impairment in accordance with SFAS 144. An impairment loss shall be recognized if the carrying amount of the intangible asset is not

recoverable. The carrying amount is not recoverable if it exceeds the sum of the undiscounted expected future cash flows from the intangible asset. If the carrying amount of the asset is not recoverable, it is written down to its fair value (i.e., the sum of the discounted expected future cash flows from the intangible asset).

Facts:

Bank A acquires Bank B in a purchase transaction. Bank B is combined into Bank A. Intangible assets (core deposit intangibles and goodwill, etc.) resulting from the acquisition are recorded on the Statement of Condition of Bank A. Subsequently, Bank C acquires Bank A in a purchase transaction, and Bank A is combined into Bank C.

Question 4:

Can the intangible assets, resulting from the first acquisition, be included on the Statement of Condition for Bank C?

Staff Response:

No. The acquisition of Bank A by Bank C is recorded at the fair market value of Bank A's assets and liabilities on that acquisition date. This includes any identifiable intangible assets, such as core deposit intangibles, and unidentifiable intangible assets (goodwill). The intangible assets resulting from the first acquisition (Bank B by Bank A) are no longer relevant, because the second acquisition creates a new basis of accounting for Bank A's assets and liabilities. Accordingly, the intangible assets recorded on the financial statements of Bank C, after the acquisition of Bank A, result only from that acquisition.

Question 5:

(December 2001)

Can a bank "sell" goodwill to its parent holding company?

Staff Response:

No. Goodwill is an unidentifiable intangible asset obtained in the acquisition of an entire entity (bank) or group of assets. It cannot be acquired or sold separately. In this respect, SFAS 142 requires that goodwill be assigned to the reporting units (operating segment or sub-segment) that are expected to benefit from it.

Further, regulatory policy (call report instructions) requires that goodwill created in an acquisition by a parent holding company be "pushed-down" and recorded at the bank level. It would be inconsistent with this policy to allow the goodwill to be sold to a parent holding company or other related party and not be included on the bank's financial statements.

Facts:

A bank pays a license fee to a third party to assist the bank in establishing a new factoring program for its customers. The fee is not subject to refund and represents a contract right. The agreement gives the bank territorial exclusivity for one year. There is also a monthly license fee that is expensed each month.

Question 6:

(January 2007)

How should the license fee be accounted for?

Staff Response:

The license fee represents an intangible asset. The fee should be amortized over its useful life in accordance with SFAS 142. Paragraph 11 of SFAS 142 lists pertinent factors to consider in estimating the useful life. One factor is contractual provisions that may limit the useful life. In this case, the contract provides for one year of territorial exclusivity. Once this period expires, the value of the license is diminished. Thus, a useful life of one year appears appropriate. If a longer life is considered appropriate, the value of the intangible asset should be reviewed for impairment in accordance with SFAS 144.

10C. PUSH-DOWN PURCHASE ACCOUNTING

Question 1:

What is “push-down purchase accounting?”

Staff Response:

The term “push-down purchase accounting” typically applies when a parent (usually a bank holding company) acquires a bank and accounts for the acquisition under the “purchase method” of accounting. Following the purchase method, the parent records the acquisition by allocating the purchase price to the assets acquired and liabilities assumed based on their fair values. Hence, those assets and liabilities are assigned a new basis of accounting.

The new basis of accounting (both assets and liabilities) is “pushed-down” from the parent to the acquired bank. It is reflected on the bank’s books. Additionally, the parent’s purchase price becomes the beginning shareholder’s equity amount (capital stock and surplus) of the acquired bank. Also, the undivided profits account is adjusted to zero. Hence, push-down accounting establishes this new basis of accounting on the books of the acquired subsidiary bank.

Generally accepted accounting principles are concerned primarily with consolidated financial statement presentation. They offer only limited guidance for the use of push-down accounting for a purchase acquisition. The majority of such guidance is contained in SEC Staff Accounting Bulletins.

Question 2:

What is the regulatory policy for “push-down” accounting?

Staff Response:

Push-down accounting is *required* for financial reporting, if an arms-length purchase accounting transaction results in a change in control of at least 95% of the voting stock of the bank. However, it is not required if the bank has an outstanding issue of publicly traded debt or preferred stock. Push-down accounting is also required if the bank’s financial statements are presented on a push-down basis in reports filed with the Securities and Exchange Commission.

Push-down accounting may also be used after a change in control of at least 80%, but less than 95%. However, approval by the bank’s outside accountant and the OCC is required in these situations.

Facts:

Holding Company A acquires 75% of the stock of Bank B in a tender offer. As a result of its newly gained voting control, Holding Company A effects an interim bank merger. The assets and liabilities of Bank B are merged into newly formed Bank C, a wholly owned subsidiary of the holding company.

The minority shareholders of Bank B are paid cash for their stock. The holding company now owns 100% of the acquired bank’s net assets. The bank does not have any outstanding issues of publicly traded debt or preferred stock.

Question 3:

Should push-down purchase accounting be applied when the substantial change in control resulted from a series of acquisitions?

Staff Response:

Yes. It is required when a change in control of at least 95% of the voting control has occurred. This change of control may occur through a single arms-length transaction or a series of transactions.

Push-down accounting may be allowed (if approved) for an 80% change of control of the voting stock. However, push-down accounting is not allowed unless at least that percent of the voting stock is involved. Therefore, in this case, push-down accounting would have been required after the interim bank merger (second acquisition transaction). But it would *not* have been allowed after the tender offer (first acquisition transaction), since only 75% of the bank was acquired.

Facts:

Purchase acquisitions may involve the issuance of debt securities. The Securities and Exchange Commission, in Staff Accounting Bulletin 73 (SAB 73), describes situations when, for its filings, parent company acquisition *debt* must be “pushed-down” to the target entity. Those situations include the acquired company assuming the purchaser’s debt, the proceeds of a securities offering by the acquired company being used to retire the purchaser’s debt, or the acquired company guaranteeing or pledging its assets as collateral for the purchaser’s debt.

Question 4:

Does the OCC require the push-down of parent company debt to the financial statements of an acquired national bank?

Staff Response:

We believe that the circumstances described in SAB 73 would rarely, if ever, occur in the acquisition of a national bank. This is because national banks are generally not permitted to assume or guarantee the parent company’s debt. Nor are national banks permitted to pledge their assets as collateral. Therefore, it is unlikely that the parent company’s acquisition debt would be pushed down to the acquired bank level.

However, if that circumstance does occur, the debt should be recorded on the financial statements of the acquired bank. The offsetting entry would reduce the acquired bank’s capital accounts.

Question 5:

(October 2005)

Question 1 refers to the acquisition of a bank by a parent and notes that it is typically a holding company. Does push-down purchase accounting apply when the acquisition is made by an individual, group of individuals, or another type of entity?

Staff Response:

Yes. Push-down purchase accounting would apply whenever a new “control group” acquires at least 95% of a bank. Further, consistent with the guidance in question 2, push-down purchase accounting may be used after a change in control of at least 80%, but less than 95% has occurred. This could result from an acquisition by a corporation, partnership, voting trust, individual, or group of individuals acting together.

Facts:

Question 2 refers to push-down accounting being required when there has been an acquisition that results in a change of control of at least 95% of the voting stock of the bank. However, assume that Holding Company A owns 100% of the voting stock of Bank A. Rather than a change in the ownership of Bank A stock, the change of control results from a change of ownership of at least 95% of the holding company stock.

Question 6:

(October 2005)

Does purchase push-down accounting apply at the bank level when the change of ownership is of holding company stock?

Staff Response:

Yes. Push-down purchase accounting would be applied whenever there is a change of control of at least 95% of a bank’s ownership. This change could result from either a direct or indirect change of ownership of the bank. Further, consistent with the guidance in question 2, push-down purchase accounting may be used after a change in control of at least 80 %, but less than 95% has occurred.

Facts:

Four individuals (the purchasing group), acting together, enter into an agreement to purchase 97% of the outstanding stock from shareholders of ABC Bancorporation (Bancorp). Bancorp is a one-bank holding company that owns 100% of the stock of ABC National Bank (Bank). Subsequently, but prior to consummation of the acquisition, the purchasing group brought in 17 additional investors. The four original individuals that constitute the purchasing group acquired 70% of the outstanding shares of Bancorp. The 17 additional investors acquired 27% of the outstanding shares. Preexisting shareholders continued to own 3% of the outstanding shares.

Question 7:

(October 2005)

Should push-down purchase accounting be applied in this situation?

Staff Response:

Yes. The four individuals who constituted the purchasing group negotiated for the purchase of 97% of Bancorp. The terms of the acquisition were dictated by the agreement between the four individuals and the selling shareholders. If the purchasing group had not brought in the additional investors, push-down purchase accounting would be applied. The fact that the purchasing group brought in additional investors between the time the acquisition agreement was executed and the date the acquisition was consummated would not effect the conclusion

regarding the use of push-down purchase accounting. This results because there is a new control group in place, and there has been a change of control of at least 95%.

Facts:

A 100% interest in Bank A, a credit card bank, is acquired by an unaffiliated entity, Holding Company B. The purchase price allocation includes both purchased credit card relationships (PCCR) and goodwill.

After acquisition, the bank continues to originate credit card loans, but immediately sells the loan balances at fair value to a non bank finance subsidiary of the holding company. The bank maintains ownership of the account relationships, and receives income from this ownership arrangement. The bank also continues to service the loans and receives a monthly servicing fee from the subsidiary. All of the related party transactions and fees are at fair market amounts.

Question 8:

(May 2006)

Should the purchase adjustments, including the purchased credit card relationships and goodwill, resulting from the acquisition of Bank A be pushed-down to the bank since the bank has entered into an agreement to immediately sell off the receivable balances to a related party?

Staff Response:

As noted in question 2, push-down purchase accounting is required if an arms-length purchase accounting transaction results in a change of control of at least 95% of the voting stock of an acquired entity. In this situation there has been a 100% change of control. However, the acquired credit card business has been split, with portions of the business allocated to the bank and to the finance subsidiary. Accordingly, the net assets, including the purchased credit card relationships and goodwill, should be allocated to the bank and the finance subsidiary in a reasonable and rational manner. In this situation, the purchased credit card relationship would be allocated to the bank, since it owns the relationships. The goodwill should be allocated between the two entities based on the relative value to each.

Facts:

Corporation XYZ (XYZ) acquires 51% of Bank Holding Company, Inc. (BHC). BHC owns 100% of Bank A. Just prior to the acquisition, BHC reincorporated to another state using a new legal entity to facilitate the change. In accordance with generally accepted accounting principles, XYZ used the purchase method of accounting for the acquisition. Further, consistent with FASB Emerging Issues Task Force No. 88-16, the creation of a new legal entity in connection with a change in control (i.e., more than 50%) resulted in a new basis of accounting for BHC. Accordingly, BHC was required to revalue their assets and liabilities at fair value. BHC files consolidated financial statements and “parent only” financial statements with the Securities and Exchange Commission (SEC). The bank’s assets represent substantially all of BHC’s consolidated assets.

Question 9:

(October 2005)

Is the application of push-down purchase accounting required for the bank?

Staff Response:

No. Although BHC is required to revalue its assets and liabilities, push-down purchase accounting is not required for BHC's subsidiary bank. This results because, consistent with regulatory policy, push-down purchase accounting is not required at the bank for a change in control of only 51%. In addition, the bank's financial statements are not being presented separately in reports filed with the SEC. As noted in question 2, push-down purchase accounting is required in a change in control of at least 95% of the voting stock of the bank, or if the bank's financial statements are presented on a push-down basis in reports filed with the SEC.

Question 10:

(October 2005)

Can the bank elect to apply push-down purchase accounting for financial reporting in the call report?

Staff Response:

The bank may elect to apply push-down purchase accounting for call report purposes, provided the bank's independent auditors and the OCC concur that the application is consistent with GAAP. As noted in question 2, the OCC would normally only consider such application for push-down purchase accounting appropriate when the change of control is at least 80%. However, in unusual circumstances, such application may be appropriate when the change in control is less than 80%.

10D. CORPORATE REORGANIZATIONS

Question 1:

(September 2001)

How should a bank account for transfers of an *individual asset* or *groups of assets* between a bank and its parent holding company or other related party?

Staff Response:

The transfer of assets between a bank and a related party generally should be accounted at the asset's fair value. This maintains consistency in accounting policy for transactions involving affiliated and nonaffiliated institutions.

For regulatory purposes, each bank reports as a separate legal and accounting entity. Therefore, the bank must record, as a separate entity, each transaction based on its economic substance. Any resulting profit or loss on the transaction is based on the fair value of the assets involved. If a difference between the contract price and the fair value exists, the amount is recorded as either a dividend or capital contribution, as appropriate.

Question 2:

(October 2005)

Must a corporate reorganization that involves the combination of two or more affiliated banks be accounted for at fair value?

Staff Response:

Generally, no. A combination between two or more affiliated banks is accounted for in accordance with Appendix D to SFAS 141. This requires that such combinations be accounted for at historical cost in a manner similar to pooling of interest accounting. This accounting is appropriate when all or substantially all (90% or more) of the assets of a target entity, or assets that constitute a "business" are transferred to an affiliated entity.

However, if it involves less than substantially all (90%) of the assets of the target bank, the reorganization of affiliated banks must be accounted for at fair value (as set forth in question 1), and the banks must recognize gains and losses on the transfer as if they had sold the assets to a third party.

Question 3:

(October 2005)

What is the definition of a "business" as used in question 2?

Staff Response:

FASB Emerging Issues Task Force Consensus No. 98-3 defines a business as "a self-sustaining integrated set of activities and assets conducted and managed for the purpose of providing a return to investors. A business consists of (a) inputs, (b) processes applied to those inputs, and (c) resulting outputs that are used to generate revenues. For a transferred set of activities and assets to be a business, it must contain all of the inputs and processes necessary for it to continue to conduct normal operations after the transferred set is separated from the transferor, which includes the ability to sustain a revenue stream by providing outputs to customers."

Facts:

A holding company owns all of the stock of a thrift institution (Institution A). Institution A, in turn, owns all of the stock of two other thrift institutions (Institution B and Institution C). The holding company desires to convert these three thrift institutions to national banks. It plans to transfer the stock of Institution B and Institution C to the parent holding company, so that after the transaction the holding company will own all of the stock of the three financial institutions (now national banks).

Question 4:

(December 2001)

How should the bank account for the transfer of stock (of Institutions B and C) from Institution A to the parent holding company?

Staff Response:

The transfer of stock should be accounted for as a corporate reorganization, which is exempt from the general requirements of SFAS 141. Furthermore, since this transfer of assets involves all of the target institution's assets, it is accounted for in accordance with Appendix D of SFAS 141, at historical cost, similar to a pooling of interest.

Facts:

Two national banks owned by the same holding company are merged to form one national bank in a corporate reorganization. Under the requirements of Appendix D to SFAS 141, the combination is accounted for at historical cost. As a result, the financial statements of the two affiliates were combined at historical cost similar to pooling-of-interests treatment.

Question 5:

(December 2001)

In accordance with 12 USC 60(b), how should the retained net income amounts be determined when computing dividend limitations?

Staff Response:

As the combined national bank's financial statements represent the combination of the financial statements of the two banks at historical cost, the retained net income (net income less dividends paid in each year) for both entities should be combined when computing the dividend limitations of 12 USC 60(b). Therefore, the prior two years of retained net income plus current year net income for both banks would be considered in the calculation.

10E. RELATED PARTY TRANSACTIONS (other than reorganizations)**Facts:**

The bank sold a previously charged-off loan to related parties (i.e., members of the board of directors and stockholders). The sale price of the loan was its face value of \$800,000. An appraisal has determined that the fair value of the charged off loan is \$100,000.

Question 1:

How should the sale of this charged off loan be accounted for?

Staff Response:

The fair value of the loan (\$100,000) is credited to the allowance for loan and lease losses as a recovery. The excess of the purchase price over the fair value of the loan (\$800,000 - \$100,000 = \$700,000) is considered a capital contribution and is credited to the capital surplus account.

Question 2:

Assume the same facts as above, except that it is impossible to determine if the charged off loan has any value. How should this transaction be accounted for?

Staff Response:

Inasmuch as it is not possible to determine if the charged off loan has any value, it should be assumed the loan has only minimal value. Therefore, the entire purchase price (\$800,000) is considered to be a capital contribution and is credited to capital surplus.

Facts:

The bank sold a previously charged-off loan to related parties, i.e., members of the board of directors and stockholders, at its face value of \$800,000. It is not possible to determine if the charged off loan has any value. Further, because of a lending limit violation, the directors are liable legally to purchase the loan at its face value.

Question 3:

How is this transaction accounted for?

Staff Response:

This transaction is accounted for the same as if the lending limit violation had not existed. Therefore, the entire amount (\$800,000) is considered to be a capital contribution and is credited to capital surplus.

Facts:

The bank is a wholly owned subsidiary of a holding company. The bank buys loans at face value from unrelated parties introduced to the bank by a loan brokerage company. The loan broker is wholly owned by related parties (persons related to the key management personnel of the bank). The related parties also own a voting interest in the holding company. As a fee for introducing

the unrelated parties to the bank, the loan brokerage company receives 20% to 30% of the face amount of the loans from the seller (unrelated party). The loans have contractual rates approximating market yields and have demonstrated good repayment histories.

Question 4:

(September 2001)

How should the bank record the purchase of the loans?

Staff Response:

The purchased loans should be recorded at their fair value, which is presumed to be the net amount received by the seller (unrelated party). The excess of the purchase price over the fair value of the loans should be reported as a dividend.

In this case, the fee appears to exceed significantly a “normal” fee expected for an arms-length transaction for services of the type provided by the loan brokerage company. Further, it supports the presumption that the face amount of the loans is *not* their fair value. Therefore, in substance, they represent a dividend, with the fair value of the loans represented by the net proceeds received by the seller.

Facts:

A bank maintains escrow balances on deposits for loans serviced by certain mortgage banking affiliates of the bank’s parent holding company. The bank retains income earned on such deposits.

The mortgage banking affiliates borrow funds from the bank, paying the market rate of interest. The interest rate does not recognize the benefit of the escrow funds deposited with the bank. Furthermore, no other arrangements exist to compensate the mortgage banking affiliates for the loss of the escrow account income.

Question 5:

How should the bank account for the earnings from the use of the mortgage escrow balances?

Staff Response:

Earnings from the bank’s free use of the mortgage escrow balances provided by the mortgage banking affiliates should be credited to capital surplus as a contribution rather than recorded as income.

This response presumes that the mortgage banking affiliates can realize the benefit associated with the escrow balances. Earnings from escrow deposits provide a significant source of income to a mortgage banking operation. This income source is a significant part of the inherent value of mortgage servicing rights and a key consideration when servicing is acquired. Further, servicers often recognize part of this inherent value by negotiating a reduced interest cost on their borrowings as a result of these deposits.

Differences between the terms that prevail in the marketplace and those entered into by related parties is accounted for as a capital transaction (i.e., capital contribution or dividend). This

policy is based upon the need to maintain consistency in accounting policy for transactions between affiliated and nonaffiliated parties.

Facts:

A one-bank holding company has entered into deferred compensation agreements with its six executive officers, who are also officers and employees of the bank. When the officer terminates employment, he or she is entitled to receive the vested amount in cash. The amount is paid by the holding company. Dividends from the bank are the holding company's only source of funds.

Question 6:

(October 2005)

Should the compensation expense under the deferred compensation agreements be recorded on the books of the bank?

Staff Response:

The compensation expense resulting from these deferred compensation agreements should be recorded on the book of the entity for which the officers/employees perform services. If the holding company is a shell with little activity of its own, the compensation likely relates to services performed for the bank.

In this situation, the holding company has the contractual obligation to pay the deferred compensation to the officer/employee. However, the holding company is incurring this obligation on behalf of the bank. Therefore, the bank should record the expense and a liability for reimbursement to the holding company. If the holding company does not require or forgives reimbursement from the bank, a capital contribution from the holding company is recorded by the bank.

TOPIC 11: MISCELLANEOUS ACCOUNTING**11A. ASSET DISPOSITION PLANS****Facts:**

On January 10, 2002 a bank proposes to adopt an asset disposition plan that will result in the sale or disposition of all non-cash assets of the bank. The bank anticipates that the liquidation of the bank's assets will not be sufficient to satisfy all of the bank's liabilities. On the basis of a preliminary valuation of the loan portfolio, substantial losses are expected.

Question 1:

(September 2002)

What is the appropriate accounting for the bank at December 31, 2001?

Staff Response:

The assets and liabilities of the bank at December 31, 2001 should be recorded at fair market value. The results of operations for the period ended December 31, 2001 should include a charge for the decline in value. This is based on AICPA Statement of Position 93-3 (SOP 93-3) and FASB Emerging Issues Task Force Consensus No. 88-25 (EITF 88-25). SOP 93-3 requires that an enterprise not be considered a going concern if liquidation appears imminent. EITF 88-25 requires that assets and liabilities of a liquidating bank be recorded at fair market value.

Question 2:

(September 2002)

Does the fact that the decision to liquidate the bank was made 10 days after the year-end affect the accounting?

Staff Response:

The AICPA Auditing Standards establishes two types of subsequent events. A type one event provides additional evidence for conditions that existed at the balance sheet date. For a type one event, all evidence that becomes available prior to the issuance of the financial statements should be considered, and the financial statements should be adjusted for any changes in estimates resulting from the use of this evidence. A type two event provides evidence on conditions that did not exist at the balance sheet date. These events do not result in adjustments to the financial statements.

The adoption of the asset disposition plan would be a type one event for which inclusion of the effects in the December 31, 2001 financial statements would be required. The adoption of an asset disposition plan is the culmination of an undercapitalized position that existed prior to December 31, 2001.

11B. HEDGING ACTIVITIES

Facts:

A bank borrowed \$30 million from the Federal Home Loan Bank with interest due monthly at one-month Libor plus 15 basis points, and principal due at maturity in three years. At maturity, the bank expects the FHLB borrowing to be rolled over into a new borrowing with similar terms. The bank elected to use hedge accounting for this instrument. To hedge the risk associated with potential increasing interest rates, the bank purchased a five-year interest rate cap.

Question 1: (May 2006)

Does the hedge using an interest rate cap qualify for the short-cut method set forth in SFAS 133?

Staff Response:

No, the use of the shortcut method is only available to interest rate swaps.

Question 2: (May 2006)

Even though the shortcut method does not apply, can the bank still assume that the hedge is perfectly effective?

Staff Response:

Possibly, provided the following four criteria outlined in SFAS 133 Implementation Issue No. G20 (G20) have been met:

- The critical terms of the hedging instrument (such as its notional amount, underlying, and maturity date) completely match the related terms of the hedged forecasted transaction (such as the notional amount, the variable that determines the variability in cash flows, and the expected date of the hedged transaction).
- The strike price (or prices) of the hedging option (or combination of options) matches the specified level (or levels) beyond (or within) which the entity's exposure is being hedged.
- The hedging instrument's inflows (outflows) at its maturity date completely offset the change in the hedged transaction's cash flows for the risk being hedged.
- The hedging instrument can be exercised only on a single date, its contractual maturity date.

Question 3: (May 2006)

If the interest rate cap meets the G20 criteria and is assumed to be perfectly effective, is the bank required to perform and document an assessment of hedge effectiveness on an ongoing basis?

Staff Response:

Yes, the bank must still perform and document an assessment of hedge effectiveness at least quarterly. This assessment should include:

- Verifying and documenting whether the critical terms of the hedging instrument and the forecasted transaction have changed during the period in review;
- Determining that the forecasted transaction is still probable of occurring at the same time and location as originally projected; and
- Assessing whether there have been adverse developments regarding the risk of counterparty default. If there are no such changes in the critical terms or adverse developments regarding counterparty default, the bank may conclude that there is no ineffectiveness to be recorded.

11C. FINANCIAL STATEMENT PRESENTATION

Question 1:

(January 2007)

Can banks have a fiscal year-end financial reporting period that differs from the calendar year-end financial reporting period required for call report reporting purposes?

Staff Response:

Yes. Banks are not restricted in their choice of a fiscal year-end financial reporting period. However, for call report purposes, banks must report financial information at the end of each calendar quarter with December 31 as their year end. Also, the Code of Federal Regulations (12 CFR 18) requires all national banks to disclose annual financial and other information to the public using a December 31 year-end date.

Facts:

A bank has publicly held stock and is registered under the Securities Exchange Act of 1934. Accordingly, in addition to filing call reports, the bank also files with the OCC Forms 10-K and 10-Q under the Securities Exchange Act.

During a regulatory examination, the OCC determined that certain adjustments were required for the bank's financial statements to be in accordance with generally accepted accounting principles (GAAP). The bank disagreed and asked for a review by the OCC's Ombudsman. The Ombudsman's decision supported the position of the OCC examination staff, and the bank amended its call reports. However, the bank did not amend its Securities Exchange Act filings filed with the OCC.

Question 2:

(January 2007)

Must the bank also amend its Forms 10-K and 10-Q filed with the OCC under the Securities Exchange Act to record the adjustments required by the OCC examination staff and the Ombudsman?

Staff Response:

The general instructions to the call reports note that the instructions include reporting guidance that falls within the range of acceptable practice under GAAP. The instructions also note that when the supervisory agency issues an interpretation of GAAP application to a specific transaction, the supervisory agency may require the bank to prepare its call reports in accordance with that interpretation.

Further, the Securities Exchange Act requires that financial statements included under the act be prepared in accordance with GAAP. Therefore, bank financial statements prepared in accordance with GAAP and included in filings under the Securities Exchange Act filed with the OCC must be prepared using the same accounting interpretations or guidance as was used in the call reports.

11D. FAIR VALUE ACCOUNTING

Question 1:

(December 2008)

Does Statement of Financial Accounting Standards No. 157 (SFAS 157) substantially change the definition of fair value?

Staff Response:

SFAS 157 provides a comprehensive definition of fair value. Prior to the issuance of SFAS 157, fair value was generally defined in accounting standards as the amount at which a financial instrument “could be exchanged in a current transaction between willing parties, other than a forced or liquidation sale.” SFAS 157 refines that definition to clarify that fair value represents an exit price, not an entry price. SFAS 157 states that “fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” In other words, fair value is the price that would be received to sell an asset as opposed to the price that would be paid to purchase an asset.

SFAS 157 also clarifies that the exit price should be based on the price that would be received in the bank’s principal market for selling that asset. The principal market is the market the bank has historically sold into with the greatest volume. If the bank does not have a principal market for selling that asset, the exit price should assume the asset is sold into the most advantageous market. The most advantageous market is the market in which the bank would receive the most value, considering the transaction costs in the respective markets.

Question 2:

(December 2008)

SFAS 157 and prior fair value guidance specify that fair value represents the price that would be received in other than a forced or distressed sale. What does this mean?

Staff Response:

When estimating the price that would be received to sell an asset, the bank should base its analysis on the price that would be received in an orderly transaction. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets. Sales that are not consistent with this time frame when the seller is experiencing financial difficulty might be considered forced sales and would not represent orderly transactions. Judgment must be used in determining whether specific observable transactions represent forced or non-orderly sales.

The Center for Audit Quality (CAQ), released a white paper entitled “Measurements of Fair Value in Illiquid (or Less Liquid) Markets” which addresses fair value measurement in the context of assets backed by subprime mortgage loans. While the white paper is not authoritative, it summarizes existing authoritative guidance and provides consensus views of the CAQ member auditors.

Question 3:

(December 2008)

Does GAAP provide guidance explaining how to estimate the exit price (fair value) of an asset as of the measurement date?

Staff Response:

SFAS 157, consistent with prior fair value accounting guidance, requires that banks look first to current quoted market prices, when available, in estimating fair value. The Standard establishes a fair value hierarchy that prioritizes the use of inputs used in valuation techniques in the following three levels:

Level 1 — observable prices in active markets for identical assets and liabilities.

Level 2 — observable inputs other than quoted prices in active markets for identical assets and liabilities.

Level 3 — unobservable inputs (i.e., internally generated assumptions).

Banks must use quoted prices in active markets for the identical asset (Level 1) if they are available. When determining a value, the measurement method should maximize the use of observable inputs and minimize the use of unobservable inputs. If quoted prices are only available for similar (but not identical) assets or based on markets that are not active, those prices would be considered level 2 inputs. The measurement of fair value for an asset with only level 2 inputs available may include adjustments to the observable prices that are needed to arrive at the best estimate of the estimated exit price for that particular asset. Banks should support the adjustments made to observable prices for similar assets or in markets that are not active, as further discussed in question 4.

Question 4:

(December 2008)

Is there any specific guidance for modeling fair value?

Staff Response:

SFAS 157 provides general, but not specific, guidance when models are used. When Level 1 inputs are not available, a bank will generally need to use a valuation technique. To the extent possible, banks should base the assumptions used in modeled valuations on observable market-corroborated inputs. If observable market data can not be gathered without unreasonable cost and effort, a bank should use assumptions that represent the bank's best estimate of the assumptions that it believes a market participant would use. In estimating these assumptions, banks should not ignore information about market participant assumptions that is reasonably available. Although internally generated assumptions may need to be used, the fair value measurement objective remains the same, that is, an exit price from the perspective of a market participant. To the extent a bank needs to utilize valuation models that include unobservable inputs, SFAS 157 requires the bank to factor into the fair value measurement any adjustment for risks related to the valuation technique and inputs that a market participant would include in determining the price that a market participant would pay to acquire that asset.

Question 5:

(December 2008)

What guidance is available regarding when observable transactions should not be considered reflective of fair value or regarding what should go into valuation modeling?

Staff Response:

As noted in question 2, The Center for Audit Quality (CAQ), released a white paper titled “Measurements of Fair Value in Illiquid (or Less Liquid) Markets” that addresses these and other topics.

This white paper notes: “To summarize, in most cases, the use of a valuation model is acceptable only when quoted prices in active markets are not available. If a valuation model is used, the objective of the measurement is to obtain the exit price at the current measurement date from the perspective of the seller. If market data exists about the assumptions that marketplace participants would use in pricing the asset, including observable market prices for similar assets (whether or not in active markets), as well as other Level 2 inputs, that information must be incorporated into the entity’s assumptions. Finally, any significant unobservable assumptions, including significant adjustments to Level 2 inputs, likely render the entire measurement a Level 3 measurement.”

Facts:

A bank chose to adopt Statement of Financial Accounting Standard No. 159 (SFAS 159) and SFAS 157 as of January 1, 2007. The bank elected to apply the fair value option to selected existing available-for-sale debt securities that had unrealized losses as of January 1, 2007. Prior to the date on which the fair value option was elected, the bank had the intent and ability to hold the selected securities until recovery and had appropriately determined that the unrealized losses were not other-than-temporary.

Question 6:

(December 2008)

Does the bank’s fair value option election for the selected available-for-sale securities result in the unrealized losses as of the adoption date being recognized as an adjustment to beginning retained earnings (retained earnings as of January 1, 2007)?

Staff Response:

The Center for Audit Quality provides guidance on this issue in an Alert issued in April 2007 regarding SFAS 159 early adoption. It notes that although SFAS 159 allows for early adoption of the fair value option to available-for-sale securities, including securities that with unrealized losses, care should be exercised that the bank adopts SFAS 159 in a manner consistent to the principles and objectives outlined in the Statement.

The SFAS 159 objective of using fair value accounting is not met if the bank elected the fair value option for the designated securities so as to recognize the unrealized loss through retained earnings, with the intention of then selling those securities and not applying fair value accounting on a go forward basis. In this case, the election of the fair value option for those securities would not be considered substantive. The unrealized losses related to the securities

would be recognized in income if the losses became other-than-temporary or if the securities were sold.

If the purpose behind the bank's election was to account for the selected securities at fair value on a go forward basis, then the adoption would be considered substantive and the unrealized losses as of the adoption date would be recognized as an adjustment to the January 1, 2007 retained earnings balance.

Question 7:

(December 2008)

Is there a capital impact of applying the fair value option to selected or all available-for-sale securities?

Staff Response:

Yes. Any unrealized losses related to available-for-sale securities that are currently included in accumulated other comprehensive income do not affect current capital calculations, while any unrealized losses that are classified as an adjustment to the retained earnings as a result of applying the SFAS 159 fair value option will decrease regulatory capital. Additionally, in future periods there could be greater volatility in regulatory capital as a result of all future changes in fair value related to the selected financial assets and liabilities being included in current period earnings.

Once the fair value option is applied to available-for-sale and held-to-maturity securities, those securities are classified as trading assets. Banks that are subject to the market risk capital requirements must include securities for which the fair value option has been elected in their measurement of market risk. Unless an exemption is granted, a bank with trading assets plus trading liabilities that exceeds 10 % of total assets, or \$1 billion, is subject to the market risk capital requirements. Electing the fair value option for a significant portion of a bank's investments may cause a bank to exceed the thresholds. The agencies have the authority to exclude such banks from the market risk rule and will consider on a case-by-case basis requests for exemptions from banks that exceed these thresholds as a result of applying the fair value option.

Question 8:

(December 2008)

Does SFAS 157 provide any guidance specific to fair valuing liabilities?

Staff Response:

Yes. If a liability is reported at fair value, SFAS 157 requires that the fair value be based on the price that would be paid to transfer that liability to a market participant with the same credit standing. The transfer price does not necessarily equal the price that would be paid to settle the liability. The transfer price concept assumes that the nonperformance risk related to the liability does not change as a result of the transfer. For example, if a bank's own liability is reported at fair value, SFAS 157 requires the bank to include in the fair value measurement the effect that changes in the bank's own credit risk (credit standing) have on the fair value of the liability.

When the bank's credit standing deteriorates, the fair value of the bank's own liabilities decreases, and a gain results. Conversely, the fair value of the bank's own liabilities increase as the bank's credit standing improves, which can result in a loss. For call report purposes, when a

bank elects to account for its own liabilities at fair value, the bank should exclude from Tier 1 capital the cumulative change in the fair value of those liabilities included in retained earnings that is attributable to the bank's own creditworthiness.