

---

# **Areas of Frequent Staff Comment – Financial Institutions**

**Stephanie L. Hunsaker  
Associate Chief Accountant  
Division of Corporation Finance  
December 2009**

# Disclaimer

---

*The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. Therefore, the views expressed are my own, and do not necessarily reflect the views of the Commission or the other members of the staff of the Commission.*

# Presentation Objective

---

*These slides are intended to provide an overview of issues that the Division of Corporation Finance Staff frequently encounter when reviewing filings for community banks, although other financial institutions may also find the information useful.*

# Frequent Areas of Staff Comment

---

This section is organized in the following two ways:

1. Frequent Areas of Staff Comment– areas where comments will likely be issued if appropriate supporting disclosures are not provided to explain the matter
2. Suggestions for Enhanced Disclosure– MD&A disclosure suggestions by topical area. These suggestions are only applicable in situations where the topics are material to an understanding of the bank's financial condition, results of operations, liquidity or capital resources

# Frequent Areas of Staff Comment

---

1. Allowance for Loan Losses
2. Troubled Debt Restructurings (TDRs)
3. Other Real Estate Owned (OREO)
4. Purchased Loans
5. U.S. Treasury Mortgage Modification Programs
6. Securities Impairment
7. Goodwill Impairment
8. Deferred Tax Asset Valuation
9. Fair Value Disclosures
10. TARP Transactions
11. Regulatory Actions or Recommendations
12. FDIC Assisted Transactions

# **Allowance for Loan Loss – Areas of Staff Comment**

---

The staff is likely to request enhanced disclosure where a financial institution does not provide sufficient disclosure to explain the circumstances related to:

- ❖ **Fluctuating ratio of allowance to total loans**
- ❖ **Fluctuating coverage ratio (allowance to total non-performing loans)**
- ❖ **Large unallocated allowance presented under Guide 3**
- ❖ **Changes in methodologies or charge-off policies**
- ❖ **Large fluctuations in the provision for loan losses**
- ❖ **Large fluctuations in charge-offs or non-performing loans**

# **Allowance for Loan Loss – Areas of Staff Comment (cont'd)**

---

- ❖ **Fluctuations in the different components of the allowance to the total allowance**
- ❖ **Regulatory agreements**
- ❖ **Indication that appraisals are not timely updated for loans measured for impairment based on the collateral value**
- ❖ **Geographic or higher-risk loan type concentrations**
- ❖ **Charge-off policies for each type of loan**
- ❖ **Non-accrual policies for each type of loan**

# Enhanced Allowance Disclosure – Dear CFO Letter

---

August 2009 “Dear CFO” letter on Allowance for Loan Losses contains disclosure suggestions in the following areas:

- ❖ Disclosures Surrounding Higher-Risk Loan Products
- ❖ Changes in Practices
- ❖ Declining Collateral Values
- ❖ Risk Mitigation Activities
- ❖ Effect of Acquisitions on Allowances

• <http://www.sec.gov/divisions/corpfin/guidance/loanlossesltr0809.htm>



# **Enhanced Allowance Disclosure – 1999 Bank Holding Company Letter**

---

**January 1999 letter sent to some Bank Holding Companies – still applicable! The letter contains disclosure suggestions in the following areas:**

- ❖ Process for Developing the Allowance**
- ❖ Discussion of the Reasons for Changes in the Elements and Components of the Allowance**

**• <http://www.sec.gov/divisions/corpfin/guidance/banklla.txt>**

# Enhanced Allowance Disclosure – Changes to the Methodology

---

Where you changed your allowance methodology in recent periods, consider discussing:

- ❖ Historical loss data you used as a starting point for estimating losses
- ❖ How economic factors affecting loan quality were incorporated into the allowance
- ❖ Charge-off policy
- ❖ Level of specificity for grouping loans to estimate losses
- ❖ Application of loss factors to graded loans
- ❖ Any other estimation methods or assumptions

# **Enhanced Allowance Disclosure – Increasing Charge-offs**

---

**If you experienced a significant increase in charge-offs, enhance the disclosure surrounding how the trend of increasing charge-offs has impacted or is expected to impact the allowance. For example, consider disclosing:**

- ❖ the triggering events or other circumstances that impact the timing of when an allowance is established**
- ❖ how the increasing level of charge-offs is factored in the determination of the different components of the allowance**

# **Enhanced Allowance Disclosure – Loans with Concentration of Credit Risk**

---

To the extent that a few loans make up the majority of the non-accrual loans, and thus there is a concentration of credit risk, discuss your lending relationships:

- ❖ **General information about the borrower (commercial, residential land developer, commercial business)**
- ❖ **Type of collateral securing the loan**
- ❖ **Amount of total credit exposure**
- ❖ **Amount of allowance for the impaired loan**
- ❖ **Any special circumstances surrounding the loan, such as whether out-of-market, loan participation, etc.**

# **Enhanced Allowance Disclosure – Interest Reserves**

---

**If you have a material amount of construction loans with interest reserves, consider disclosing the following:**

- ❖ Policy for recognizing interest income on those loans**
- ❖ How you monitor the projects throughout their lives to make sure the properties are moving along as planned to ensure appropriateness of continuing to capitalize interest**
- ❖ Whether you have extended, renewed or restructured terms of the related loans and the reasons for the changes**
- ❖ Your underwriting process for the loans with interest reserves and any specific differences in how you underwrite loans with interest reserves and those without interest reserves**
- ❖ Whether any of your loans with interest reserves are currently non-performing**

## **Enhanced Allowance Disclosure – Loans Measured for Impairment Based on the Collateral Value**

---

If you have a significant amount of loans measured for impairment based on the collateral value, consider disclosing:

- ❖ How and when updated third party appraisals are obtained and how this impacts the amount and timing of recording the loan loss provision and charge-offs
- ❖ Whether you make any adjustments to the appraisals and why
- ❖ Type of appraisal, such as “retail value” or “as is” value
- ❖ How partially charged-off loans measured for impairment based on the collateral value are classified and accounted for subsequent to receiving an updated appraisal. For example, disclose whether the loans are returned to performing status or whether they remain as nonperforming

## **Enhanced Allowance Disclosure – Loans Measured for Impairment Based on the Collateral Value (cont'd)**

---

- ❖ Typical timing surrounding the recognition of loan as non-accrual and recording of any provision or charge-off
- ❖ Procedures performed between receipt of updated appraisals to ensure impairment of loans measured for impairment based on the collateral value are measured appropriately
- ❖ How you determine the amount to charge-off
- ❖ In the event external appraisals are not used to determine the value of the underlying collateral or where the appraisal has not been updated, disclose your processes and procedures for estimating the value of the collateral for those loans

## **Enhanced Allowance Disclosure – Loans Measured for Impairment Based on the Collateral Value (cont'd)**

---

If you have a significant amount of loans measured for impairment based on the collateral value, describe how charge-offs for confirmed losses impact the coverage ratio (total allowance for loan losses divided by total nonperforming loans). For example, consider providing the following types of disclosure:

- ❖ **Nonperforming loans for which the full loss has been charged-off to total loans**
- ❖ **Nonperforming loans for which the full loss has been charged-off to total nonperforming loans**
- ❖ **Charge-off rate for nonperforming loans for which the full loss has been charged-off**



## **Enhanced Allowance Disclosure – Loans Measured for Impairment Based on the Collateral Value (cont'd)**

---

- ❖ **Coverage ratio net of nonperforming loans for which the full loss has been charged-off**
- ❖ **Total Allowance / (Total loans – Nonperforming loans for which the full loss has been charged-off )**
- ❖ **Allowance for individually impaired loans / Total loans that are individually impaired**

# **Troubled Debt Restructurings (TDRs) – Enhanced Disclosure**

---

To the extent that you have a material amount of TDRs, consider disclosing:

- ❖ **TDRs quantified by loan type (residential, home equity, commercial, credit cards, etc), classified/quantified separately as accrual and non-accrual**
- ❖ **Policy regarding how many payments the borrower needs to make on the restructured loans before returning the loan to accrual status**
- ❖ **Quantification of types of concessions made – reduction in interest rate, payment extensions, forgiveness of principal, forbearance or other actions and discussion of the bank's success with the different types of concessions**

# **Troubled Debt Restructurings (TDRs)**

## **– Enhanced Disclosure (cont'd)**

---

- ❖ **Separately discuss restructurings made for “covered loans” that are accounted for under loss sharing agreements with the FDIC**
- ❖ **If impairment is measured based on the present value of expected future cash flows, disclose policy election regarding how the entire change in present value is reflected in the financial statements. For example, disclose whether the amount is recorded entirely within the provision for loan losses or whether a portion reflecting the amount attributable to the passage of time is recorded as interest income. To the extent that part of the amount is reflected within interest income, the amount of interest income recognized should be disclosed (ASC 310-10-45)**

# Other Real Estate Owned (OREO) – Enhanced Disclosure

---

To the extent you have a significant amount of OREO, consider providing:

- ❖ Breakout of OREO by category – lot loans, commercial real estate, residential, etc.
- ❖ Rollforward of OREO – beginning balance, additions, capitalized improvements, valuation adjustments, dispositions, ending balance
- ❖ Discussion of actual prices received upon sale of OREO versus amounts recorded in the financial statements
- ❖ Disclosure of the line item in the income statement where gains/losses recognized upon disposition of OREO are recorded
- ❖ Typical foreclosure decision-making process – if significant concentrations within certain states, discuss general foreclosure timelines /processes in those states

# **Purchased Loans – Areas of Staff Comment**

---

## **SOP 03-3 –Loans and Debt Securities Acquired with Deteriorated Credit Quality (ASC 310-30)**

- ❖ Policy disclosures regarding how purchased loans are accounted for, including scope and amount of loans in which ASC 310-30 guidance is applied**
- ❖ Lack of all disclosures required by ASC 310-30 for loans accounted for in accordance with the guidance in ASC 310-30**
- ❖ Lack of compliance with all the accounting guidance (including the pool criteria) for loans accounted for in accordance with ASC 310-30**

# **Purchased Loans – Enhanced Disclosure**

---

**To the extent you had a significant purchase of loans accounted for in accordance with the guidance in ASC 310-30, consider providing the following disclosures:**

- ❖ Discussion of the effect on nonperforming loans / total loans ratios if nonperforming loans acquired are classified as performing upon acquisition**
- ❖ If loans within the scope are not classified as part of the table showing contractually past due loans and still accruing (Guide 3 disclosures), provide clear disclosure in the footnote to the table and quantify the amount of loans excluded and why**

# **U.S. Treasury Mortgage Modification Programs – Enhanced Disclosure**

---

The U.S. Treasury has announced several programs to try to stabilize the U.S. housing market, including mortgage modification programs under the Making Home Affordable (MHA) Program.

- ❖ If the federal financial assistance provided under the program is reasonably likely to have a current or future effect on your financial condition, results of operations, liquidity or capital resources that is material, disclosure should be provided. Disclosure should include the nature, amounts, and effects of government assistance, including your accounting policy for such assistance.



# U.S. Treasury Mortgage Modification Programs – Enhanced Disclosure (cont'd)

---

- ❖ The amount and description of on-balance sheet loans, off-balance sheet loans you service and loans collateralizing subordinated interests held in off-balance sheet securitization vehicles that are participating in the mortgage programs
- ❖ An estimated amount and description of loans (based on same categories above) that are not currently participating in the program, but you believe are eligible for participation, along with a discussion of the methodology used to determine the amounts
- ❖ A description of the loan modifications made under the modification program and the nature of the government assistance provided, including information about the changes to loan terms made under the program and amount and timing of government assistance payments anticipated as a result of the modifications



# **U.S. Treasury Mortgage Modification Programs – Enhanced Disclosure (cont'd)**

---

- ❖ **The events that would require the U.S. Treasury to make a payment and contingencies that could affect the U.S. Treasury's obligation to make payments**
- ❖ **The amount of assistance payments received to date under the program, including amounts currently receivable, from the U.S. Treasury**
- ❖ **The impact of expected government assistance on the balance sheet as of the reporting date, including the present value of expected government assistance payments that are included in your allowance for loan losses, valuation of retained interests and estimate of the fair value of mortgage servicing rights**

# **U.S. Treasury Mortgage Modification Programs – Enhanced Disclosure (cont'd)**

---

- ❖ **The impact of government assistance during the period on the income statement, including the amount of government assistance reflected in interest income and servicing income during the period.**
- ❖ **Loans modified under the programs may have credit characteristics that diverge from the unmodified portfolio, resulting in a concentration of credit risk that requires disclosure pursuant to FSP SOP 94-6-1 (ASC 825-10-55). For example, extended amortization periods, balloon payments, payment terms that expose borrower to higher payment after end of five year participation period.**

# **Securities Impairment**

---

- **Areas of Staff Comment Applicable to all Securities**
- **Trust Preferred Securities**
- **Mortgage-Backed Securities**
- **Equity Securities**
- **Investment in Federal Home Loan Bank (FHLB) Stock**

# Securities Impairment – All Securities - Areas of Staff Comment

---

- ❖ No cumulative effect adjustment recorded upon the adoption of FSP FAS 115-2 (ASC 320-10-65) and impairment charges were recorded in recent historical periods
- ❖ All disclosures required not provided – some of most commonly missed disclosures are the ones required by SFAS 115 (ASC 320-10-50) and FSP 115-1 (ASC 320-10-50) that are now required in QUARTERLY and annual reports, as well as the tabular rollforward of credit losses and the disclosures of assumptions and methodology to measure the credit loss (ASC 320-10-50)
- ❖ Presentation of total other-than-temporary impairment loss outside of non-interest income (required by Article 9 of S-X)
- ❖ Determination of “major security” type (ASC 320-10-50)

# **Securities Impairment– Trust Preferred Securities (TPS) – Areas of Staff Comment**

---

## **I. Methodology for Determining Fair Value**

- ❖ Whether security-specific collateral was used in projecting defaults, deferrals, recovery, or prepayment assumptions**
- ❖ Discount rates or prepayment rate assumptions used in the valuation**
- ❖ Whether all information becoming available prior to issuance of the financial statements was considered**
- ❖ Changes to valuation techniques**

# **Securities Impairment– Trust Preferred Securities (TPS) – Areas of Staff Comment**

**(cont'd)**

---

## **II. Methodology for measuring credit impairment**

- ❖ Whether security-specific collateral was used in projecting defaults, deferrals, recovery, or prepayment assumptions**
- ❖ Discount rates or prepayment rate assumptions used in the measurement of credit impairment**
- ❖ Whether all information becoming available prior to issuance of the financial statements was considered**

# Securities Impairment– Trust Preferred Securities (TPS) – Enhanced Disclosure

---

If material amount of TPS/Pooled TPS, or impairment of a significant amount of TPS could reasonably likely have a material effect on the Bank's operations or capital, consider disclosing the following for those TPS with at least one rating below investment grade:

- ❖ Single-issuer or pooled
- ❖ Class held
- ❖ Book value
- ❖ Fair value
- ❖ Unrealized gain/loss
- ❖ Lowest credit rating assigned
- ❖ Number of issuers currently performing

## **Securities Impairment– Trust Preferred Securities (TPS) – Enhanced Disclosure (cont'd)**

---

- ❖ **Actual defaults and deferrals as a percentage of original collateral**
- ❖ **Expected deferrals and defaults as a percentage of the remaining performing collateral (along with disclosure about assumption on recoveries for both deferrals and defaults)**
- ❖ **For the security tranche you hold, the additional defaults/deferrals in excess of both the current projected defaults/deferrals the trust can absorb before the security tranche you hold experiences any credit impairment**



# **Securities Impairment - Mortgage Backed Securities – Enhanced Disclosure**

---

The nature and type of assets underlying any asset-backed securities. For example:

- ❖ the types of loans (sub-prime, Alt-A, or home equity lines of credit)
- ❖ the years of issuance (vintage)
- ❖ current credit ratings of the securities, including changes or potential changes to those ratings

# **Securities Impairment– Equity Securities – Areas of Staff Comment**

---

- **Large unrealized losses for a period of time**
- **Policies that may not appear to comply with GAAP and SAB 111**
  - **Recovery solely based on historical returns**
  - **Very long recovery periods**
  - **Lack of consideration of issuer-specific indicators**
  - **Reliance solely on analyst report projections of stock price in future periods**

## **Securities Impairment - Investments in Federal Home Loan Bank (FHLB) Stock – Areas of Staff Comment**

---

- ❖ **Classification as AFS securities -should be separately presented from other securities – (ASC 942-325-45)**
- ❖ **Inappropriate impairment policy – SOP 01-6 (ASC 942-325-35) provides guidance for evaluating FHLB stock for impairment (it is a cost method, restricted stock investment that is evaluated for impairment)**

## **Securities Impairment - Investments in Federal Home Loan Bank (FHLB) Stock – Enhanced Disclosure**

---

**Provide a detailed impairment policy for the investment in FHLB stock, including all positive and negative evidence considered in concluding that the investment is not impaired. For example, discuss how any suspensions of dividends or redemptions, as well as any net losses and declining equity balances at the FHLB were taken into consideration in concluding that the investment was not impaired.**

# **Goodwill Impairment – Areas of Staff Comment**

---

**Lack of interim impairment tests given existence of factors such as:**

- ❖ **Going concern opinion**
- ❖ **Cease & desist orders or other regulatory agreements**
- ❖ **Significant net losses and further deterioration expected**
- ❖ **Management changes**
- ❖ **Market capitalization significantly below book value of equity and has been for several quarters**
- ❖ **Full valuation allowance on deferred tax assets**

# **Goodwill Impairment – Areas of Staff Comment (cont'd)**

---

**Is valuation technique appropriate? Were multiple valuation techniques considered? Are assumptions reasonable?**

- ◆ **Staff may request valuation reports prepared by the Bank or a third-party valuation firm, as determined necessary**
- ❖ **Were appropriate disclosures made surrounding the key judgments?**

# Goodwill Impairment – Enhanced Disclosure

---

For each reporting unit at risk of failing Step 1 of the Test, consider disclosing the following information:

- ❖ Percentage by which fair value exceeded carrying value as of the date of the most recent test;
- ❖ Amount of goodwill allocated to the reporting unit;
- ❖ Description of the methods and key assumptions used and how the key assumptions were determined;
- ❖ Discussion of the degree of uncertainty associated with the key assumptions. The discussion regarding uncertainty should provide specifics to the extent possible (e.g., the valuation model assumes recovery from a business downturn within a defined period of time); and
- ❖ Description of potential events and/or changes in circumstances that could reasonably be expected to negatively affect the key assumptions.

# **Deferred Tax Assets (DTA) Valuation Allowance – Areas of Staff Comment**

---

- ❖ **In evaluating cumulative loss scenario, excluding the significant increase in the loan loss provision during the current year**
- ❖ **Non-objective evidence in supporting how DTA will be realized, particularly if based substantially on income not expected to be achieved for several years in the future**
- ❖ **Lack of disclosure supporting the appropriateness of a partial valuation allowance**



# **DTA Valuation Allowance – Enhanced Disclosure**

---

- ❖ **Disclose both the positive and negative evidence considered in determining the extent of any valuation allowance**
- ❖ **To the extent there is reliance on tax planning strategies or offset of deferred tax liabilities in lieu of future taxable income for the realization of the DTAs, disclosure of these facts and a description of such strategies**

# Fair Value Disclosures – Areas of Staff Comment

---

- ❖ Disclosures required by FSP FAS 107-1 and APB 28-1 (ASC 825-10-50) not provided in interim financial statements
- ❖ Unclear application of FSP FAS 157-4 (ASC 820-10-35)
  - ◆ Example –loans measured for impairment based on the collateral value, and appraisal values are not considered at all in the valuation
- ❖ Classification in the fair value hierarchy
- ❖ Lack of disclosure regarding non-recurring measurements required by par. 33 of FAS 157 (ASC 820-10-50)

# Fair Value Disclosures – Enhanced Disclosure

---

- DCF staff issued two “Dear CFO” letters providing suggestions for additional fair value disclosures in MD&A with goal of improving transparency surrounding fair value measurements

- ❖ March 2008

- ◆ <http://www.sec.gov/divisions/corpfin/guidance/fairvalue/tr0308.htm>

- ❖ September 2008

- ◆ <http://www.sec.gov/divisions/corpfin/guidance/fairvalue/tr0908.htm>

# Fair Value Disclosures – Enhanced Disclosure (cont'd)

---

“Dear CFO” letters covered a wide range of topics:

- **March 2008**

- ❖ Sensitivity Analysis
- ❖ Transfers to Level 3 and related effects
- ❖ Collateral underlying ABS

- **September 2008**

- ❖ Consideration of credit risk in FV determination
- ❖ Use of brokers and pricing services
- ❖ Impact of illiquidity on techniques and assumptions

# TARP Transactions – Enhanced Disclosure

---

Enhance disclosure surrounding Issuance of Preferred Stock and Warrants to Treasury:

- ❖ Assumptions used to calculate the fair value of the preferred stock and warrants
- ❖ Disclosure regarding whether the relative fair value method was used to allocate the consideration to the preferred stock and the warrants
- ❖ Disclosure of the discount rate used to value the preferred stock
- ❖ Method used to amortize the discount on the preferred stock
- ❖ Discussion of any management plans for repayment

# FDIC Assisted Transactions – Areas of Staff Comment

---

To the extent the Bank has entered into a loss sharing agreement with the FDIC in connection with an acquisition of a failed financial institution:

- ❖ The assets covered by the loss sharing agreements should be recorded in their respective balance sheet categories (i.e., loans, OREO, securities) – it is acceptable to have a separate sub-heading for those “covered” versus “non-covered” assets
- ❖ The loss sharing agreement should be valued and recorded separately on the face of the balance sheet or grouped within other assets if not material – appropriate guidance in FAS 141R (ASC 805) for indemnification assets should be followed if obtained in connection with the acquisition of a business

# FDIC Assisted Transactions – Areas of Staff Comment (cont'd)

---

The allowance for loan losses should be determined without giving consideration to the loss sharing agreement (since the loss sharing agreement is separately accounted for and thus “gross” on the balance sheet)

- ❖ The provision for loan losses may be net of changes in the amount receivable from the loss sharing agreement, with appropriate disclosure of the effects of the loss sharing agreement on the provision for loan losses
- ❖ The Guide 3 disclosures should include the assets subject to the loss sharing agreement, with separate footnote disclosure regarding the special nature of the assets, or potentially these assets should be presented separately within the Guide 3 disclosures.

# **Regulatory Actions or Recommendations – Enhanced Disclosure**

---

## **Formal Agreements:**

- ❖ Summary of all provisions**
- ❖ Describe steps taken or to be taken to comply with each provision**
- ❖ Describe current compliance with each provision**
- ❖ Describe the material impact on future operations**
- ❖ Describe the potential consequences if there is a failure to comply**



# **Regulatory Actions or Recommendations – Enhanced Disclosure (cont'd)**

---

## **Memorandum of Understanding (MOUs) or Informal Agreements:**

- ❖ **Not required to be disclosed if prohibited by banking regulations**
- ❖ **Must disclose actions taken or to be taken if they have a material impact on future operations**

## **TARP Recipients:**

- ❖ **If adopted by the SEC, “say on pay” requirements will apply to all TARP recipients**

# SAB 1:K Waivers – Acquisitions of Troubled Financial Institutions

---

- ❖ To the extent the Bank acquires a “troubled financial institution” as defined in SAB 1:K, and is unable to provide all of the historical and pro forma information for a significant acquisition pursuant to the requirements in Rule 3-05 of Regulation S-X and Article 11 of S-X, the DCF staff may be able to provide relief under SAB 1:K
- ❖ Requests for relief should be submitted to the Division of Corporation Finance’s Chief Accountant’s Office
  - ◆ Attn: Wayne Carnall, Chief Accountant
  - ◆ [dcaoletters@sec.gov](mailto:dcaoletters@sec.gov)
  - ◆ Fax: (202) 772-9213

# Useful Guidance and Tools

---

- **Compliance & Disclosure Interpretations**  
<http://www.sec.gov/divisions/corpfin/cfguidance.shtml>
- **Financial Reporting Manual**  
<http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml>
- **Guidance for Consulting with the Office of the Chief Accountant**  
<http://www.sec.gov/info/accountants/ocasubguidance.htm>