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This edition of the Bank Accounting Advisory Series expresses the current views of the OCC's Office of the Chief Accountant (Chief Accountant) on topics of interest to national banks. It is intended to inform the banking community of the Office's views and rationale on broad accounting interests. Additional releases will be issued in the future on emerging accounting issues that affect banks.

Banks now prepare their Consolidated Reports of Condition and Income (call reports) using generally accepted accounting principles (GAAP). Accordingly, this series has been revised to incorporate the conversion to those principles.

These advisories represent the Chief Accountant's interpretations of generally accepted accounting principles and regulatory capital requirements. National banks that deviate from them may be required to justify their actions to the OCC.

With respect to Topic 2E, Allowance for Loan and Lease Losses (ALLL), the American Institute of Certified Public Accountants (AICPA) is currently developing a Statement of Position (SOP) that will address the accounting for the ALLL. It is expected to provide guidance on how banks should determine the ALLL in accordance with the various pronouncements of the Financial Accounting Standards Board. As the extent and nature of these changes is unresolved at this time, Topic 2E is presented substantially unchanged. However, Question 21 was clarified to recognize a recent Emerging Issues Task Force issue discussion. Additionally, Topic 2E will be revised, as necessary, to incorporate the release of the SOP.

The following questions have been added or revised in the December 2001 edition.

1A. Intangible Assets	Questions 1, 2, and 4
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TOPIC 1: PURCHASE ACCOUNTING

1A. INTANGIBLE ASSETS

Question 1: (December 2001)

In July 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards No. 141, Business Combinations (SFAS 141), and No. 142, Goodwill and Other Intangible Assets (SFAS 142). In general, how do these statements change the accounting for business combinations?

Staff Response:

These statements significantly change 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 eliminates the pooling-of-interests method of accounting for business combinations, except for certain combinations initiated prior to July 1, 2001. The statement further clarifies 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 will continue to be amortized over their useful lives. The amortization provisions of SFAS 142 are effective immediately for goodwill and intangible assets acquired after June 30, 2001. For intangibles acquired prior to July 1, 2001, banks must adopt SFAS 142 for the year beginning January 1, 2002 and will continue to amortize these intangibles in accordance with prior accounting requirements during the transition period to January 1, 2002.

Question 2: (December 2001)

How should intangible assets (other than goodwill and indefinite-lived intangible assets) be amortized?

Staff Response:

Intangible assets that have a finite life (i.e., core deposit intangibles, purchased credit card relationships, etc.) should be amortized over their estimated useful lives 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 determined, institutions should use the straight-line method.

Generally, core deposit intangibles and purchased credit card relationships should be amortized over a period of no more than 10 years. However, in unusual circumstances, a longer amortization period may be justified.

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 3:

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 4: (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.

1B. 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 percent 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 percent, but less than 95 percent. However, approval by the bank's outside accountant and the OCC is required in these situations.

Facts:

Holding Company A acquires 75 percent 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 percent 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 percent 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 percent 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 percent 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.

1C. ACCOUNTING FOR ACQUISITIONS

Facts:

Bank A acquires Bank B in a transaction accounted for under the purchase method in accordance with generally accepted accounting principles.

Question 1:

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.

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.

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: (December 2001)

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.

Question 6:

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 7:

May Bank A record an allowance for loan and lease losses for the acquired loans in the purchase price allocation?

Staff Response:

Yes. However, the amount of the allowance is limited to the amount that existed on Bank B's books at the time of its closure. In addition, the allowance should be recorded on a "clean" loan portfolio basis. This is because individual loans are recorded at fair value, including a discount for credit risk (i.e., uncollectibility).

Facts:

Bank A 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 8:

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 Bank A'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 9:

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 10: (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.

1D. 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: (December 2001)

Must a corporate reorganization that involves the combination of two or more affiliated banks be accounted for at fair value?

Staff Response:

Generally, no. Corporate reorganizations are excluded from the provisions of SFAS 141. However, Appendix D to SFAS 141 retains the requirement of AICPA Accounting Interpretation No. 39 to APB 16 that a combination between two or more affiliated entities be accounted for at historical cost in a manner similar to pooling of interest accounting.

However, if it involves less than substantially all (90 percent) 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: (September 2001)

Are there any exceptions to the fair value requirement for corporate reorganizations that involve less than substantially all of the assets of a target entity?

Staff Response:

There is a limited exception. Sometimes this fair value requirement may discourage affiliate combinations that would benefit a holding company and its subsidiary banks significantly. An example is a one-time reorganization of a business line, such as credit card operations or mortgage servicing, that would permit a holding company to transfer certain banking operations to achieve operational efficiencies. Accordingly, as a result of an Ombudsman's decision, the OCC has allowed the transfer of assets at the lower of cost or market value (LOCOM). This decision applies, on a case-by-case basis, only to a limited number of cases involving the reorganization of a single business line between wholly owned bank subsidiaries of a holding company. Further, the bank must be able to demonstrate that the use of LOCOM, in those cases, is an acceptable method under GAAP.

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.

TOPIC 2: LOANS

2A. TROUBLED DEBT RESTRUCTURINGS

Facts:

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

Question 1: (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 percent for two years and a final payment of $105,000 (principal plus interest at 5 percent) 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 2: (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 3:

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 4:

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 percent to 5 percent 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 5: (September 2001)

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 (generally market) value. However, value should be assigned to the securities only when they have demonstrated worth. Such a value may not be possible to demonstrate, because of the borrower's precarious financial condition. Accordingly, a fair value of zero would not be unusual in such cases.

The recorded amount of the debt ($100,000) is reduced by the demonstrable 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 were valued at zero, the remaining loan balance of $100,000 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 $21,000 is established through a provision for loan and lease losses. This represents the difference between the recorded balance ($100,000) and the present value of the expected future payments ($79,000), discounted at 10 percent (the original loan interest rate).

Question 6: (September 2001)

Assume that the preferred stock has a determinable fair value of $6,000. How would a bank account for the transaction?

Staff Response:

The recorded value of the loan ($100,000) would be reduced by the fair value of the preferred stock received ($6,000). The remaining loan balance ($94,000) would be compared with the present value of the future payments of $79,000, and an allowance of $15,000 would be recorded.

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 7:

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 8:

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 9:

Can Note A be returned to accrual status immediately or is a six-month period of performance required?

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.

Question 10: (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 11:

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 12: (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 13:

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 14: (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 14, 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 15: (September 2001)

When appropriate reserves, 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 percent.

Note A carries a 9 percent 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 percent, with the difference between the contractual rate of 9 percent and the payment rate of 5 percent capitalized. The capitalized interest and all principal are due at maturity.

Additionally, interest on the capitalized interest compounds at the 9 percent rate to maturity.

Question 16:

If the borrower makes the interest payments at 5 percent 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. The staff believes that this response is consistent with Appendix B of AICPA Practice Bulletin No. 6.

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 17:

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 18:

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 8.

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 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:

Bank A purchases a loan with a face value of $100,000. The loan is on nonaccrual status. Because of the risk involved and other factors, the loan is purchased at a substantial discount of $50,000.

Question 5:

Can Bank A accrete the discount to income consistent with Accounting Principles Board Opinion No. 21?

Staff Response:

Accretion of discount may be appropriate when the loan is on a nonaccrual basis. AICPA Practice Bulletin 6, "Amortization of Discounts on Certain Acquired Loans," (PB 6) permits accretion of discount on certain acquired loans when it is not probable that all contractual principal and interest will be collected.

Accretion of the discount is appropriate if the sum of the acquisition amount of the loan and the discount to be accreted does not exceed the undiscounted future cash collections that are both reasonably estimable and probable. A loan on nonaccrual status on the date acquired is presumed to fail this requirement. However, this presumption may be overcome if other factors indicate that collection of the acquisition amount plus the discount is probable, and the amounts and timing of collections can be estimated reasonably.

Considerations in assessing collectibility include:

- The financial condition of the borrower.
- Substantial borrower equity in the underlying collateral.
- Historical cash flows from the acquired loan.
- The prospect of near-term cash flows.
- Other repayment sources (i.e., irrevocable letters of credit, personal guarantees, and takeout commitments, etc.).
- Cash flows expected to be generated by the assets underlying the loan.

In the example, the collectibility of the acquisition amount of $50,000 should be assessed. If the borrower can be reasonably expected to make periodic payments totaling $75,000, Bank A could accrete $25,000 of the discount to income. Discount accretion should be taken over the period that the payments are probable of collection using the interest method. However, the amounts and timing of collections must be reasonably estimable and probable. Otherwise, payments should be applied to reduce the acquisition amount of the loan.

Facts:

Continuing with the example, Bank A pays $50,000 for a loan with a face value of $100,000. 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 6:

Upon refinancing the loan, may Bank A 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. Additionally, Bank A must assess the appropriateness of accreting the discount in accordance with the requirements of PB 6. When the borrower has demonstrated the ability to perform, the loan can be returned to accrual status. At that time, if previously precluded from doing so, the bank would also begin to accrete the discount to income.

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 7:

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 8:

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 percent. An appropriate allowance has been recorded under SFAS 114.

Question 9:

Can Loan A remain on accrual status?

Staff Response:

Neither Loans 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 10:

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 11:

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 11, except that the developer has personally guaranteed both notes and provides a significant source of outside cash flow.

Question 12:

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 13:

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 14:

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 15: (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 borrowers' 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 16: (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 17:

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 percent 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 percent of the loan (the guaranteed portion) on accrual status and classify the remaining 10 percent as nonaccrual. Interest income would also be recognized accordingly.

Question 18:

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 a nonaccrual status.

Question 19:

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 so deteriorated that it did not expect full repayment of contractual principal and interest. As a result of the bank's credit evaluation, a charge-off of principal was recorded.

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

Question 20: (September 2001)

Can the bank reverse the charge-off and rebook the loan?

Staff Response:

No. This charge-off was based on a determination that the principal was not expected to be recovered. Accounting Principles Board Opinion No. 20 (APB 20) cites collectibility determinations as an example of an accounting estimate. APB 20 further requires that changes in accounting estimates be accounted for on a prospective basis. Accordingly, payments would be accounted for in accordance with GAAP, and recoveries recorded as received.

Previous regulatory accounting policy allowed for rebooking charged-off loans in certain limited circumstances. However, with the adoption of GAAP, rebooking of the loan is not appropriate.

2C. 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:

Bank A 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 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 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:

How should the bank's recovery of the entire $60,000 judgment be recorded?

Staff Response:

The $60,000 judgment represents a recovery of both a 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 percent 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 unable to dispose 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.

2D. LOAN COMMITMENTS

Question 1: (September 2001)

Should a bank record a provision for losses on standby letters of credit to the ALLL or to a separate liability account?

Staff Response:

In accordance with GAAP, credit losses related to off-balance-sheet instruments, such as standby letters of credit, should be accrued and reported separately as liabilities if the criteria set forth in Statement of Financial Accounting Standards No. 5 (SFAS 5) are met. These criteria require recognition of a loss if the loss is both probable and the amount reasonably estimatable.

Question 2: (September 2001)

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

Staff Response:

Yes. The accounting requirement set forth in Question 1 results from the AICPA's Audit and Accounting Guide for Banks and Savings Institutions. This requirement has been incorporated into the call report instructions. Previously, the ALLL often included a component for this off-balance-sheet credit exposure. 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, as had been previously allowed. From a risk-based capital perspective, this is not a policy change, but rather a continuation of previous requirements.

Facts:

Bank A has issued a firm commitment to lend money to Company X. It is likely the company will exercise the commitment. Because of the troubled financial condition of Company X, the bank concludes that it will be required to fund the commitment, even though Company X will be unable to repay the loan.

Question 3: (September 2001)

How should the bank account for the loss on this off-balance sheet loan commitment?

Staff Response:

As noted in Question 1, SFAS 5 requires recognition of a loss when the loss is both probable and the amount reasonably estimatable. In this situation, the bank concludes that it has incurred a loss because it must fund the commitment and does not expect Company X to repay the resulting loan. Accordingly, the requirements of SFAS 5 are met. Bank A must recognize the loss and record a liability to a separate liability account for the expected obligation. The bank cannot wait until Company X actually exercises the commitment to record the loss.

2E. ALLOWANCE FOR LOAN AND LEASE LOSSES (subject to revision)

The AICPA currently is developing a Statement of Position that will address accounting for the allowance for loan and lease losses (ALLL). It is expected to provide guidance on how banks should determine the ALLL in accordance with the various pronouncements of the FASB. This section will be revised, as necessary, upon release of that document.

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:

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 3:

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. Commercials 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.

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 4:

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 5:

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. However, the bank should continue to review and refine its estimate of the possible effect of a base closing on it and its borrowers.

Question 6:

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 probably will be adversely affected. The bank should begin to evaluate the likelihood of default on individual credits and its exposure to that loss credits. For example, 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 previously criticized loans, 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. 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 uncriticized credits cannot be estimated yet, it can be measured for pools of similar loans. Those pools should encompass all uncriticized loans 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 7:

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 significant, previously criticized, and loans deteriorate. Additional provisions should be made to the ALLL, when necessary, and a loan charged off when it is no longer a bankable asset.

As significant, previously uncriticized, loans affected by the base closing deteriorate, their risk ratings should be adjusted and attempts made to estimate probable loss. If probable loss cannot be estimated on individual loans, they should be provided for in the pool of similarily criticized loans.

As the actual effect of the base closing becomes easier to measure, the bank should continue to adjust the loss rates it applies to pools of loans, both criticized and uncriticized. In time, the bank can identify most of its borrowers that may be affected and have risk rated and provided appropriately for their loans. Estimates of probable losses on individual loans and pools of loans will 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 8:

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.

Facts:

A bank evaluates a real estate loan for inherent 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 percent 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 9:

How should the bank determine the amount of loss inherent on the loan?

Staff Response:

First, the loan may be an impaired loan under the definition in SFAS 114. However, the implications of SFAS 114 will not be considered in this response.

The bank should base the adequacy of the ALLL for this loan 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.

Question 10:

Can 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 common practice 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.

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

Question 11:

Can a bank review substandard loans individually, 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 reserves 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.

Question 12:

How does this removal of the loan from the pool affect the calculation of the historical loss rate?

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 counting 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 13:

Assume a substandard credit has a specific allocation. 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 require automatically a doubtful classification and/or nonaccrual status for a substandard loan. However, specific allocations for individual substandard loans in the ALLL raise some difficult questions. First, doesn’t a bank's estimate of the amount of reserve 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? The answer to both questions is, "not necessarily."

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. Based on the individual facts and circumstances, it must be decided whether these borderline substandard/doubtful credits should remain in accrual status.

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., are 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 14:

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.

Question 15:

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.

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 16:

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 17:

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 18:

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 19:

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

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

adequate, management does not have a sound basis for determining an adequate level for the ALLL on an ongoing basis if its evaluation process is deficient.

Question 20:

Must bank management analyze the adequacy of the ALLL quarterly?

Staff Response:

The adequacy 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 21: (September 2001)

Do materially excessive reserves also pose a problem?

Staff Response:

The risk of error or imprecision is inherent in the entire allocation process. Accordingly, as noted in EITF 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.

TOPIC 3: SALES AND SERVICING OF ASSETS

3A. SALES OF ASSETS FOR RISK-BASED CAPITAL PURPOSES

In November 2001 the banking agencies issued a new rule on residual interests and direct credit substitutes. This rule is generally effective January 1, 2002. Any transactions settled on or after that date are subject to the final rule. However, banking organizations that have settled transactions before January 1, 2002 that result in increased capital requirements under the rule may delay the application of the rule to those transactions until December 31, 2002. Further, banking organizations may elect early adoption, as of November 29, 2001, of any provision of the final rule.

The following guidance applies to institutions and transactions when capital is being calculated under previously existing rules. Accordingly, it will generally be appropriate for preparation of the December 31, 2001 call reports.

Question 1: (September 2001)

For risk-based capital purposes, must capital be held for loans if they are sold with recourse, but the contractual terms limit the seller's risk of loss (amount of recourse)?

Staff Response:

Yes. For risk-based capital purposes, capital must be held against all sales with recourse. This is true even if the contractual terms limit the seller's risk to a set amount or a percentage of the *assets* sold. However, depending on the amount of recourse, the bank may be able to use the "low level" recourse rules. Under those rules, the bank would hold only capital that is based on the maximum amount of recourse for which it is contractually liable, not to exceed 8 percent of the assets sold.

Question 2: (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 percent and 90 percent basis. 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:

Bank A transfers credit card loans with a par value of $1,000,000 to third parties for $1,150,000. The agreement requires a subsequent adjustment to the sales price based on loan performance. Accordingly, the sales price may be reduced, based on future performance, to an amount as low as $1,100,000. The $50,000 amount subject to rebate is placed in an escrow account. When the adjustment period has expired, any monies remaining in the account are dispersed to Bank A. However, since the risk of loss from a price adjustment is considered to be minimal, for accounting purposes a gain of $150,000 has been recognized.

Question 3: (September 2001)

Must risk-based capital be held against this credit card loan transfer, in which the sales price is subject to future reduction, if the underlying loans are sold entirely for cash, the risk of loss is minimal, and the amount subject to refund is placed in an escrow account?

Staff Response:

In accordance with the call report Instructions, recourse exists if *any* amount of risk of loss is retained, even if it is immaterial. Therefore, this transaction creates recourse. However, capital may not need to be held against the full amount of these loans when the transaction qualifies as a sale under GAAP and the amount subject to refund is contractually limited. In such case, the low level recourse rules may apply.

Under the low level recourse rules, the bank would only be required to hold risk-based capital of $50,000, the maximum amount of recourse for which the bank is contractually liable. The low level recourse rules apply when a bank's maximum recourse contractual liability is *less* than the normal (8 percent) capital charge of a recourse transaction. These rules allow the bank to hold capital equal to that maximum contractual recourse liability in those cases. In this respect, the low level rules are used only when they result in a smaller capital charge than the regular risk-based capital rules. As an example, if this agreement provided for $100,000 of maximum recourse, the low level rules would not apply because the normal recourse capital charge would be $80,000.

Facts:

Bank A sells a portfolio of automobile receivables to a trust. The trust will issue senior and subordinated trust certificates for sale to investors. However, the bank will retain a one percent interest in the receivables through subordinated certificates.

Question 4: (September 2001)

Will retention of this one percent interest using subordinated trust certificates mean the asset securitization will be treated as a recourse transaction for risk-based capital purposes?

Staff Response:

In retaining the subordinated trust certificates, the bank provides a form of a credit enhancement to the senior certificate holders. As noted in question 2, the call report Instructions consider this recourse if any risk is retained, even if it is immaterial. However, low level recourse rules will apply to the recorded value of the one percent interest.

Facts:

A bank sells a group of consumer loans (i.e., credit card receivables or automobile loans) through a trust arrangement at par. The transaction meets the criteria as a sale under generally accepted accounting principles (SFAS 140). The bank has no recourse obligation to the trust for the loans sold other than for breach of customary seller's representations and warranties.

The contractual interest rate on the consumer loans is substantially higher than the rate provided to the purchaser of the trust units. The bank services the loans and charges the trust a normal servicing fee. The differences between the contractual interest rate on the consumer loans and that paid to the trust holders is sufficient to pay the bank's servicing fee and to fund a spread account that is used to absorb credit losses.

The spread account is funded through this interest rate differential. All credit losses are charged to the spread account. In the event the spread account balance is insufficient to absorb the credit losses, such excess losses are charged to the trust unit holders account.

Upon termination of the trust, the remaining balance in the spread account reverts to the bank. The bank has no additional liability for the trust. In accordance with GAAP, the bank records an asset (an IO strip receivable) for the estimated present value of the spread account funds that will revert to the bank.

Question 5: (September 2001)

Must capital be held against these assets (either the loans or the IO strip receivable) for risk-based capital purposes?

Staff Response:

The banks recording of an asset for its residual interest in the spread account creates an asset subject to risk of loss. Accordingly, the recourse rules (including low level recourse, if appropriate) would apply.

Facts:

The bank securitized credit card receivables through a master trust. Sometime thereafter, the loans in the trust began to experience adverse performance caused primarily by credit quality problems. If not corrected, those problems could jeopardize the investment grade ratings of the securities issued by the trust. To resolve that problem, the bank transfers replacement receivables to the trust at a discount of approximately 4 percent. This will create an over-collateralization in the trust for the benefit of the trust investors.

Question 6: (September 2001)

Must the bank hold risk-based capital against the assets in this securitization?

Staff Response:

Yes. This type of transaction is evidence of implicit recourse being provided to the trust. The practice of selling replacement receivables to the trust at a discount indicates the retention of risk of loss in the asset securitization. Accordingly, the bank must hold risk-based capital against the assets securitized.

Facts:

The 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 7: (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. It differs, however, from the previous two examples in that the bank 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.

Facts:

A bank securitizes credit card receivables and services the accounts. The difference between the amount of interest received from the borrowers and the amount paid to the investors provides for both a contractually specified servicing fee (recorded as a servicing asset under SFAS 140) and an excess portion (recorded by the bank on its financial statements as an IO strip under SFAS 140). Credit losses are paid from the excess portion, and the remainder is distributed monthly to the bank. The use of a spread account is required only if certain specific performance levels are not met. If required, this spread account would be funded from the excess portion. Any funds remaining in the spread account would be returned to the bank if performance levels increased to a level that no longer required the account.

Question 8: (September 2001)

What is the regulatory distinction between the spread account and an IO strip?

Staff Response:

There is no distinction for regulatory capital purposes between the spread account and the IO strip if they are each used as a credit enhancement or subject to risk of loss based on the performance of the securitized assets (in this case, credit card receivables).

Question 9: (September 2001)

Assuming that the low level recourse rules apply, must the bank hold capital in excess of the amount in the spread account to conform to low level recourse rules?

Staff Response:

Generally, yes. In accordance with GAAP (SFAS 140), an IO strip has been recorded as an asset on the bank's financial statements. This IO strip includes both the present value of the excess portion expected to be paid to the bank monthly and any expected residual from the spread account. For risk-based capital purposes, the bank is "at risk" for the entire amount of the recorded IO strip, not only the portion related to any spread account amount. Accordingly, under the low level recourse rules, the bank would hold capital equal to the full recorded amount of the IO strip, not the spread account balance alone.

Question 10: (September 2001)

For leverage capital purposes, how is this transfer of assets treated?

Staff Response:

The leverage capital ratio is generally based on the bank's assets as recorded on the Consolidated Report of Condition (balance sheet). Accordingly, it would affect the bank's leverage capital ratio to the extent that an IO strip or other asset has been recorded on the bank's balance sheet. Assets considered sold under GAAP are not included on the balance sheet or in the leverage ratio computation.

Question 11: (September 2001)

Assume that the specified performance levels are not met and funding of the spread account is required. Is the funding of the spread account considered to be recourse?

Staff Response:

The bank would be required to hold capital against future collections that were expected to revert to the bank and, therefore, included in the IO strip receivable. Accordingly, recourse from the funding of the spread account results from the risk of loss of the IO strip receivable.

3B. SALES AND SERVICING OF ASSETS - GAAP ISSUES

Facts:

Bank A originates $1,000,000 of mortgage loans that will yield 8.5 percent interest income. The bank transfers (sells) the principal plus the right to receive interest at 6.5 percent 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 one percent, 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 percent), including servicing, is $1,100,000. The fair value of the servicing is $44,000 and 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: (September 2001)

How should this sale of assets be accounted for?

Staff Response:

This sale of assets is accounted for in accordance with SFAS 140. Accordingly, Bank A should allocate the previous carrying amount between the assets sold (the loans) and the assets retained (i.e., servicing asset and IO strip) based on their relative fair value at the date of transfer. Cost would be allocated as follows:

	Fair Value (FV)	% of Total FV	Allocated Carrying Amount
Assets sold	$1,000,000	91%	$ 910,000
Servicing asset	44,000	4%	40,000
IO strip	56,000	5%	50,000
Total Fair Value	$1,100,000	100%	$1,000,000

The bank would record a gain of $90,000 (sales price of $1,000,000 less allocated carrying amount of $910,000). The retained assets (servicing asset and IO strip) would be recorded at their allocated carrying amount of $90,000.

Question 2: (September 2001)

How should the servicing asset be accounted for on an ongoing basis?

Staff Response:

The servicing asset should be amortized in proportion to and over the period of the net servicing income. However, it should be evaluated and measured for impairment, based on current fair value, on a regular (at least quarterly) basis.

Question 3: (September 2001)

How should the IO strip be accounted for on an on going 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:

Bank A 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:

Bank A 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 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:

- There is a decline in the fair value of the IO strip below the investor's carrying amount, and
- There is a decrease in 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, servicing assets purchased and all servicing liabilities are initially measured at fair value. Servicing assets retained from a sale or securitization are initially valued based on the relative fair value of all the assets sold and retained.

Specifically, the Statement notes that a servicing asset results when the benefits of (revenues from) servicing are expected to provide more than Aadequate 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: (September 2001)

For purposes of this determination, how is Aadequate compensation" defined in SFAS 140?

Staff Response:

SFAS 140 defines "adequate compensation" as Athe 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's 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 the Statement'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 where 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.

TOPIC 4: LOAN ORIGINATION

4A. LOAN ORIGINATION FEES AND COSTS

Question 1: (September 2001)

Does a bank have to apply 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 borrower 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, insubstance, 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 fee entitles the cardholder to use the card. This is consistent with the FASB Implementation Guide for SFAS 91. Normally, the fee entitles the customer to use the credit card for one year. In some cases the actual period of repayment on advances from the card may exceed the one-year 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 2001)

How should the premiums and discounts resulting from the purchase of collateralized mortgage obligations (CMOs) be accounted for?

Staff Response:

Statement of Financial Accounting Standards No. 91 (SFAS 91) generally requires the amortization of premiums and discounts on securities over their contractual life. However, an exception exists for CMOs. Estimated prepayments should be considered when a bank holds a large number of similar loans for which prepayments are probable and subject to reasonable estimation. Therefore, when mortgages that secure the CMO are subject to such estimation, amortization of the premiums or discounts should give consideration to these prepayments.

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 8: (September 2001)

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:

A difference in the rate of prepayments on the mortgages backing this CMO instrument should be accounted for according to SFAS 91. That statement requires that the bank recalculate the 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 corresponding charge or credit should be made to interest income.

Question 9: (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.

TOPIC 5: LEASES

5A. 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:

How should this transaction be accounted for?

Staff Response:

Interpretive Ruling 7.6120 requires that a "dividend in kind" be recorded on the basis of the fair (appraised) 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 dividend. However, an effective sale/leaseback has occurred in the bank's leasing of the premises back from the purchasing third party.

Statement of Financial Accounting Standards No. 13 (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:

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 must be recorded at fair value (Interpretative Ruling 7.6120), a 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 exert 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 percent in each entity) to be considered as exerting significant influence. In a bank that has numerous shareholders, an person possessing a 15 or 20 percent stock interest can be deemed to have significant influence.

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

5B. 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: (September 2001)

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

Staff Response:

All costs and expenses directly associated with the decision to abandon the branch should be recognized as a loss for the period in which management decides to close the branch. These costs and expenses include all future payments contractually required by the existing lease. This loss should be recorded when management commits to a formal plan to abandon the branch site.

Financial Accounting Standards Board Interpretation No. 27 (Interpt 27) and FASB Emerging Issues Task Force Consensus No. 88-10 support this accounting. Interpt 27 requires that the cash flows from the original lease be considered in determining the loss on the abandonment.

Question 2:

How should the loss be determined?

Staff Response:

The future lease payments required from the bank are discounted to their present value. This discounted value should be added to the other costs and expenses in determining the loss from closing the branch.

Question 3:

In the previous example, the bank had decided to abandon the branch. Would the response be different if the bank intended to sublease the branch premises or use them for other purposes?

Staff Response:

Yes. Anticipated future revenues from sublease income, proceeds from the disposal of any branch assets, and other future income would be considered in the calculation. A loss should be recognized at the measurement date based on the amount that the estimated costs and expenses exceed anticipated future revenues. Anticipated future revenues in excess of costs and expenses would result in a gain. However, under APB 30, its recognition is deferred until actually realized.

The lack of an existing sublease contract at the measurement date does not preclude anticipating future sublease income. Future rental income should be considered, if the bank probably will sublease the branch site.

This conclusion is based on APB 30 and FASB Interpretation 27. They require that anticipated future cash flows from the original lease and any subleases and the carrying amount of any related recorded assets or obligations be considered in determining the total loss or gain.

Question 4:

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 anticipated sublease income, should be recognized as a loss. This conclusion is consistent with FASB Emerging Issues Task Force Consensus No. 88-10.

TOPIC 6: INVESTMENT SECURITIES

6A. 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 percent 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 included 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:

1. 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.

2. 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).

3. All transfers to the trading category - The unrealized gain or loss at the date of transfer shall be recognized in earnings immediately.

4. 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:

Bank A 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, 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: (September 2001)

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 and each subsequent reporting date, the bank must evaluate whether the investment should be classified as "trading" or "available-for-sale." A mutual fund bought principally for sales of the investment in the near term should be classified as trading and marked to market through net income. Otherwise, it should be classified as available-for-sale and recorded at its fair value. Net unrealized holding gains and losses on available-for-sale investments 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.

TOPIC 7: OTHER ASSETS

7A. Real Estate

Question 1: (September 2001)

How should banks account for their investment in OREO property?

Staff Response:

Detailed accounting guidance has been removed from the OREO regulation and replaced with a reference to 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 No. 121 (SFAS 121) 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).

After foreclosure, OREO should be recorded at the fair value of the asset minus the estimated sales costs. Subsequent declines in the fair value of OREO are recorded as an addition to its valuation reserve. Changes in fair value must be determined on a property-by-property basis. A reserve allocated to one property may not be used to offset losses incurred on another property. Further, unallocated reserves are not acceptable. Subsequent increases in the fair value of a property may be used to reduce the reserve, but not below zero.

Although the fair value of the property normally will be determined by an appraisal (or other evaluation), circumstances may justify a more conservative approach in establishing the reserve. Examples of such circumstances include changed economic conditions since the last appraisal, stale appraisals, or imprecision and subjectiveness in the appraisal process (i.e., actual sales for less than the appraised amount).

Question 2:

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

Staff Response:

No. Since the bank did not establish a reserve at the time the properties were initially charged down, an assessment is assumed to have been made that the decline represented a permanent impairment in value. If the bank determines subsequently that the decline was not permanent, this represents a change in estimate.

Accounting Principles Board Opinion No. 20 does not permit retroactive application of a change in estimate. Instead, this change should be given prospective treatment. Accordingly, increases in the appraised value would not be recorded until the property is actually sold and a sale recognized under SFAS 66.

Question 3: (September 2001)

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, including depreciation when appropriate, should be included in "Other noninterest expense."

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 4:

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 5:

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. Additionally, 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.

Question 6:

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 7:

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 percent to 25 percent 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 percent 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 8:

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 9:

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 10:

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 percent 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 11:

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. Therefore, the $26,000 received by the bank during the first year exceeds 20 percent 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 12:

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. The fair value definition in SFAS 15 points out that the best determination of fair value is a fair market transaction between a willing buyer and a willing seller. 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 13:

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 percent 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 percent 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 percent 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 percent of the gain or $15,000 is recognized at the time of sale. The remainder of the gain is deferred.

Question 14: (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 non-accrual rules would apply.

Question 15: (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 percent 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 16: (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.

COMPUTER COSTS

8A. 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.

8B. 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 APB 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:

Is the bank required to adjust the carrying amount of its data processing assets as a result of entering into this contract?

Staff Response:

Yes. By entering into the contract, the bank effectively has removed its data processing equipment from active, productive use. Such an abandonment requires the bank to reflect the equipment on its books at the lower of amortized cost or fair value. Therefore, when the contract is entered into, the bank should determine which equipment will be used productively, and which will be effectively abandoned. For the latter, an adjustment to fair value should be recorded if it is less than amortized cost. In addition, subsequent adjustments should be made as the equipment's fair value declines.

TOPIC 9: INCOME TAXES

9A. 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.

9B. 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 percent.

Under this rate structure, a consolidated group could have taxable income in excess of $10 million that would be taxed at 35 percent, and the taxable income of the banks within the consolidated group, measured on a separate entity basis, may be taxed at a 34 percent 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 percent. 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.

9C. 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 percent 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 banks' 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 percent of the Tier 1 capital portion of the limit?

Staff Response:

Yes. A bank should apply the 10 percent 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: (September 2001)

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 valuation allowance.

A bank should determine the amount of deferred tax assets for reporting on its call report in accordance with SFAS 109. 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).

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 proposed 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:

Bank A 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 Bank A account for its deferred tax assets?

Staff Response:

Bank A 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:

Bank A has a net unrealized holding gain on available-for-sale debt securities of $1,000,000. Its composite tax rate is 40 percent, 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. Bank A 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 Bank A 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 Bank A'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 percent 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.

TOPIC 10: CAPITAL

10A. QUASI-REORGANIZATION

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.

10B. 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.

TOPIC 11: MISCELLANEOUS ACCOUNTING

11A. RELATED PARTY TRANSFERS (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 proceeds ($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 percent 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 values, 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:

Bank A 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 Bank A account for the earnings from the use of the mortgage escrow balances?

Staff Response:

Earnings from Bank A'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.

11B. ORGANIZATION COSTS

Question 1:

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.

11C. ACCOUNTING FOR CONTINGENCIES

Facts:

A legal action was brought against bank A. 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 bank A 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 determinate 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 regulator’s find acceptable.

Question 2:

Should a 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 polices 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.

11D. LIFE INSURANCE COSTS

Facts:

Bank A 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:

How should these split-dollar life insurance policies be accounted for?

Staff Response:

Consistent with FASB Technical Bulletin No. 85-4, the bank should record the amount that it could realize under the insurance policy (i.e., its portion of the cost surrender value) as of the date of the financial statements as an "other asset." Further, the bank should determine whether a reportable obligation for post-retirement benefits has been incurred under Statement of Financial Accounting Standards No. 106.

11E. 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.