Office of the
Comptroller of the Currency

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Bank Accounting Advisory Series

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Message From the Chief Accountant

I am pleased to present the Office of the Chief Accountant's September 2013 edition of the *Bank Accounting Advisory Series* (BAAS). The BAAS expresses the office's current views on accounting topics relevant to national banks and federal savings associations (collectively, banks). We hope that you find this publication useful.

The following questions have been added or revised in this edition:

NEW	Topic 2A	**Troubled Debt Restructurings**	Question 39
	Topic 2G	**Acquired Loans**	Question 9
	Topic 4	**Allowance for Loan and Lease Losses**	Question 53
	Topic 5A	**Other Real Estate Owned**	Questions 35-36
	Topic 9A	**Transfers of Financial Assets and Servicing**	Questions 15-17
	Topic 11D	**Fair Value Accounting**	Question 9

UPDATE	Topic 1A	**Investments in Debt and Equity Securities**	Questions 4 and 14
	Topic 2A	**Troubled Debt Restructurings**	Questions 4-5, 25, 32 and 38
	Topic 2B	**Nonaccrual Loans**	Question 3
	Topic 2G	**Acquired Loans**	Questions 5 and 8
	Topic 3A	**Lease Classification and Accounting**	Question 9
	Topic 4	**Allowance for Loan and Lease Losses**	Question 29
	Topic 5A	**Other Real Estate Owned**	Questions 4 and 6
	Topic 8A	**Sales of Stock**	Question 1
	Topic 9A	**Transfers of Financial Assets and Servicing**	Questions 3 and 8
	Topic 10C	**Push-Down Accounting**	Questions 1 and 11

This edition also incorporates FASB Accounting Standards Updates that have become effective through September 2013. As part of our annual review process, some additional existing entries have been fine-tuned.

On July 9, 2013, the OCC approved a new regulatory capital rule. The new rule becomes effective January 1, 2014, for advanced approaches banks and January 1, 2015, for all other banks. This edition of the BAAS does not include any new or revised questions to reflect changes in the new regulatory capital rule.

Banks and others are reminded that the BAAS does not represent official rules or regulations of the OCC. Rather, the BAAS represents the OCC's Office of the Chief Accountant's interpretations of generally accepted accounting principles and regulatory guidance based on the facts and circumstances presented. Nevertheless, banks that deviate from these stated interpretations may be required to justify those departures to the OCC.

Kathy Murphy
Office of the Comptroller of the Currency
Chief Accountant

Contents

Message From the Chief Accountant i

Topic 1 **Investment Securities** 1

1A. Investments in Debt and Equity Securities 1

1B. Other-Than-Temporary Impairment 10

Topic 2 **Loans** 21

2A. Troubled Debt Restructurings 21

2B. Nonaccrual Loans 44

2C. Commitments 60

2D. Origination Fees and Costs (Including Premiums and Discounts) 66

2E. Loans Held for Sale 71

2F. Loan Recoveries 82

2G. Acquired Loans 85

Topic 3 **Leases** 92

3A. Lease Classification and Accounting 92

3B. Sale-Leaseback Transactions 96

3C. Lease Cancellations 99

Topic 4 **Allowance for Loan and Lease Losses** 100

Topic 5 **OREO and Other Assets** 128

5A. Other Real Estate Owned 128

5B. Life Insurance and Related Deferred Compensation 144

5C. Miscellaneous Other Assets 148

Topic 6 **Liabilities** 153

6A. Contingencies 153

Topic 7 **Income Taxes** 156

7A. Deferred Taxes 156

7B. Tax Sharing Arrangements 162

7C. Marginal Income Tax Rates 164

Topic 8 **Capital** 166
8A. Sales of Stock 166
8B. Quasi-Reorganizations 167
8C. Employee Stock Options 168

Topic 9 **Income and Expense Recognition** 169
9A. Transfers of Financial Assets and Servicing 169
9B. Credit Card Affinity Agreements 178
9C. Organization Costs 179

Topic 10 **Acquisitions, Corporate Reorganizations, and Consolidations** 181
10A. Acquisitions 181
10B. Intangible Assets 189
10C. Push-Down Accounting 195
10D. Corporate Reorganizations 201
10E. Related-Party Transactions (Other Than Reorganizations) 203

Topic 11 **Miscellaneous Accounting** 207
11A. Asset Disposition Plans 207
11B. Hedging Activities 208
11C. Financial Statement Presentation 209
11D. Fair Value Accounting 210

Appendixes 216
Appendix A. Commonly Used Acronyms 216
Appendix B. Commonly Used Pre-Codification References 218
Appendix C. Commonly Used FASB Codification References 223

Topic 1 Investment Securities

1A. Investments in Debt and Equity Securities

Facts Under ASC 320, banks must classify their investment securities in one of three categories: HTM, AFS, or trading. Securities categorized as HTM are reported at amortized cost, while AFS and trading securities are reported at fair value. Banks include the net unrealized holding gains and losses on AFS securities in AOCI, net of applicable taxes, rather than as part of the bank's net income (loss). Banks do not include, however, the net unrealized holding gains and losses attributable to AFS debt securities in their calculation of Tier 1 capital. Net unrealized holding gains and losses on trading securities are reported immediately in net income.

Question 1

Should the net unrealized holding gains and losses on AFS debt securities be included in the calculation of a bank's lending limit?

Staff Response

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

Question 2

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 AFS investments denominated in a foreign currency should be excluded from net income and reported in AOCI. 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.

The gain or loss attributable to changes in foreign currency exchange rates, however, would be recognized in income, if the investment is categorized as HTM. Banks should follow the accounting guidance provided in ASC 830 for such investments.

Question 3

What is the appropriate accounting for transfers between investment categories?

Staff Response

In accordance with ASC 320-10-35, transfers between investment categories are accounted for as follows:

- *HTM to AFS*—The unrealized holding gain or loss at the date of the transfer shall be recognized in AOCI, net of applicable taxes.
- *AFS to HTM*—The unrealized holding gain or loss at the date of transfer shall continue to be reported in AOCI 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 the related premium or discount (see question 4).
- *All transfers to the trading category*—The unrealized gain or loss at the date of transfer, net of applicable taxes, shall be recognized in earnings immediately.
- *All transfers from the trading category*—The unrealized gain or loss at the date of transfer will have already been recognized in earnings and shall not be reversed.

UPDATE

Facts A bank purchased a $100 million bond on December 31, 20X1, at par. The bond matures on December 31, 20X6. Initially, the bond was classified as AFS. On December 31, 20X2, the bank decides it intends to hold the bond until maturity and transfers the security to the HTM portfolio. The fair value of the security on the date of transfer is $92 million. There has been no other than temporary impairment recognized to date, including credit-related impairment.

Question 4

How should the bank account for the transfer?

Staff Response

In accordance with ASC 320-10-35-10, at the date of transfer, the bank should record the security at its fair value, $92 million, which becomes the security's amortized cost. The $8 million unrealized holding loss on the date of transfer is not recognized in net income but remains in AOCI. In addition, an unaccreted discount of $8 million offsets the security's face amount of $100 million, so the security is reported at its fair value ($92 million) when transferred.

Under ASC 320-10-35-16, the $8 million discount is accreted to interest income over the remaining life of the security. In accordance with ASC 320-10-35-10d, the unrealized loss amount in AOCI is amortized simultaneously against interest income. Those entries offset or mitigate each other.

For regulatory capital purposes, the unamortized AOCI related to the security is treated in the same manner as an AFS debt security.

Question 5

Do any restrictions exist on the types of securities that may be placed in the HTM category?

Staff Response

Generally, there are few restrictions on how bank management chooses to allocate the securities in their portfolio among the investment categories. ASC 320 requires that a security, such as an IO strip, not be accounted for as HTM, 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 HTM. 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. Use of this feature, however, 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 HTM securities as collateral for a loan. A bank may also pledge HTM securities in a repurchase agreement if the agreement is not effectively a sale in accordance with ASC 860.

Question 6

How should banks account for investments in mutual funds under ASC 320?

Staff Response

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

Question 7

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, in the call report. If mutual fund investments classified as AFS are sold, the component in AOCI should be adjusted to remove any previously included amounts applicable to them.

Question 8

When may a bank sell HTM securities and not "taint" the portfolio?

Staff Response

ASC 320 establishes the following "safe harbors" under which HTM 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 industry-wide 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

What are the ramifications of selling debt securities that have been classified as HTM 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 HTM portfolio must be transferred to the AFS category. In addition, future purchases of securities must be classified as AFS. Consistent with the views of the Securities and Exchange Commission, the prohibition from using HTM will apply for a two-year period.

Because AFS securities are carried at fair value in the financial statements, the transfer of tainted HTM securities would result in an unrealized holding gain or loss, net of applicable taxes, at the date of transfer. The unrealized holding gain or loss should be included in AOCI, a separate component of stockholders' equity. Amounts included in AOCI, however, are excluded in the determination of the bank's regulatory capital.

In addition, ASC 320 requires certain disclosures for sales or transfers of securities out of the HTM category. Specifically, the amortized cost, realized or unrealized gain or loss, and circumstances leading to the sale or transfer of HTM securities must be disclosed in the bank's financial statements. For call report purposes, the amortized cost of securities sold or transferred from the HTM category should be included on Schedule RC-B, Memoranda.

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

Question 10

Would this sale of securities from the HTM 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 HTM portfolio taint the portfolio. Sales for liquidity reasons are excluded from the ASC 320 safe harbor exceptions. As a result, the HTM 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 HTM portion of the investment portfolio. The bank sold the securities because it no longer benefits from the tax-free status of the municipal securities, and the individual shareholders do not need the tax-exempt income.

Question 11

Does the sale of these securities taint the entire HTM portfolio?

Staff Response

Yes, selling securities from the HTM portfolio because of a change in tax status of the bank to Subchapter S is not one of the safe harbor exceptions included in ASC 320. Although ASC 320 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 HTM 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 ASC 320.

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

Question 12

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

Staff Response

The trust preferred securities should be classified and reported as securities on the bank's financial statements, including call reports. The legal means for acquiring the security is not relevant for the accounting treatment. The financial statement classification is governed by GAAP, not the legal authority under which the assets are purchased. The trust preferred securities are debt securities subject to the accounting requirements of ASC 320.

Facts In 20X1 Bank A purchased $10 million of the 30-year capital securities of the Trust of Bank B (trust preferred securities). These securities have a fixed distribution (interest) rate, quarterly payment dates, and a fixed maturity date. In accordance with ASC 320, Bank A has classified these assets as AFS debt securities.

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

During 20X4, Bank B began experiencing financial difficulties. Accordingly, in June 20X4, Bank B announced that the interest payment on the debentures and the Trust's distribution payment on the capital securities scheduled for July 31 would be deferred. These payments will be deferred for the last two quarters of 20X4. Resumption of payments in 20X5 is dependent upon Bank B returning to profitable operations. Further, the capital securities are publicly traded and selling at a discount in excess of 25 percent of par value.

Question 13

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

Staff Response

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

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

For the first criteria, both the 20X4 third and fourth quarter distribution (interest) payments will not be made because of the financial condition and operating losses of Bank B. Payments may resume in 20X5 but only if Bank B becomes profitable. Accordingly, there is no assurance that Bank A will receive these or future payments.

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

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

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

UPDATE

Question 14

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

Staff Response

The issue of whether the impairment in the trust preferred securities should be considered OTTI must be addressed. If, upon evaluation, the impairment of the securities is determined to be other-than-temporary, an impairment loss must be recognized. The impact of the write-down on net income will depend on several factors. See Topic 1B. Other-Than-Temporary Impairment for further discussion of OTTI.

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

Question 15

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

Staff Response

Under normal circumstances, the sale of any HTM investment would call into question a bank's intent to hold its remaining HTM investments to maturity. ASC 320-10-25 indicates that events that are isolated, nonrecurring, and unusual for the reporting enterprise that could not be reasonably anticipated, however, may cause an enterprise to sell or transfer an HTM security without necessarily calling into question its intent to hold other HTM debt securities to maturity. ASC 320-10-25 specifically states that extremely remote disaster scenarios should not be anticipated by an entity in deciding whether it has the positive intent and ability to hold a debt security to maturity. Accordingly, in this situation the sale of any HTM investment security would not necessarily call into question the bank's intent to hold its remaining HTM investment securities until maturity.

Facts A bank uses the cost method to account for its interest in Company A, a credit card payment intermediary. Company A restructures its legal form by converting from a mutual company to a stock company (demutualization). The bank receives restricted stock and may also receive cash in the future. Pending litigation related to Company A will affect the value realized of the restricted stock. Each mutual company owner has a proportional obligation for the litigation based on the member by-laws. It is determined that at the date of the restructuring the member by-laws were modified such that each mutual company owner's (including the bank's) proportional share is subject to ASC 460.

Question 16

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

Staff Response

No. Although GAAP does not directly address this specific type of transaction, ASC 325-20-30 provides guidance for certain nonmonetary exchanges of cost method investments. In accordance with that standard, the bank should record the stock received at the bank's historical cost, which may be zero.

The OCA staff notes that nonmonetary transactions within the scope of ASC 845 generally are recorded at fair value. This transaction, however, is not within the scope of that standard, because the transfer does not meet the definition of an exchange. Reciprocal transfers of nonmonetary assets are considered exchanges only if the transferor has no substantial continuing involvement in the transferred asset, such that the usual risk and rewards of ownership of the asset are transferred. The pending litigation constitutes substantial continuing involvement; therefore, the transfer does not meet the definition of an exchange.

ASC 325-30 provides guidance on the accounting for the demutualization of a mutual insurance company. Stock received in a demutualization within the scope of that standard should be recognized at fair value. The scope of ASC 325-30 is limited,

however, to the demutualization of mutual insurance companies and should not be applied to this transaction by analogy. As such, in the absence of guidance within GAAP specific to this particular transaction, the staff believes it is most appropriate to account for this transaction in accordance with ASC 325-20-30 at historical cost (as discussed previously).

Question 17

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

Staff Response

A bank should record, in accordance with ASC 460, the fair value of its proportionate share of all pending litigation as of the day the guarantee exists. In the event that, at the inception of the guarantee, the bank must recognize a liability under ASC 450 for the related contingent loss, the liability to be initially recognized for that guarantee must be the greater of the amount that satisfies the fair-value objective as discussed in ASC 460 or the contingent liability amount required to be recognized by ASC 450.

Question 18

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

Staff Response

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

Question 19

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

Staff Response

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

Facts A few months later, Company A has an IPO. Approximately one-fourth of the restricted stock is redeemed for cash, which results in significant gains for the existing stockholders. In certain instances the cash was distributed to the holding company rather than the bank. In addition, some of the IPO proceeds are retained in an escrow account to cover the pending litigation. The bank has considered the escrow account in recalculating its ASC 460 liability. The bank also retains its remaining restricted stock.

Question 20

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

Staff Response

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

Question 21

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

Staff Response

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

1B. Other-Than-Temporary Impairment

Question 1

What is OTTI?

Staff Response

An investment is impaired if the fair value is less than the amortized cost. ASC 320 requires institutions to determine whether the investment is other-than-temporarily impaired. OTTI may occur when the investor does not expect to recover the entire cost basis of the security. As a holder of an investment in a debt or equity security for which changes in fair value are not regularly recognized in earnings (such as securities classified as AFS and HTM), the bank must determine whether to recognize a loss in earnings when the investment is impaired.

Question 2

Does other-than-temporary mean permanent?

Staff Response

No. The staff believes that the FASB consciously chose the phrase "other-than-temporary" because FASB did not intend that the test be "permanent impairment," as has been used elsewhere in the accounting literature. Specific facts and circumstances

dictate whether OTTI recognition is appropriate. Therefore, this determination should be made on a case-by-case basis. The staff believes that "other-than-temporary" should be viewed differently than the absolute assurance that "permanent" impairment implies. This response is consistent with ASC 320-10-S99.

Question 3

What factors indicate that impairment may be other-than-temporary for an equity security classified as AFS?

Staff Response

- ASC 320-10-S99 and AICPA Statement on Auditing Standards No. 92, "Auditing Derivative Instruments, Hedging Activities and Investments in Debt Securities" provide criteria that is helpful in making the OTTI assessment. There are several factors to consider that, individually or in combination, may indicate an OTTI of an AFS equity security has occurred, including length of time and extent to which fair value has been less than cost.
- Financial condition, industry environment, and near-term prospects of the issuer.
- Downgrades of the security by rating agencies.
- Intent and ability of the bank to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.

Question 4

What factors indicate that impairment may be other-than-temporary for a debt security classified as AFS or HTM?

Staff Response

In certain cases, the OTTI determination for a debt security will be straightforward. For example, impairment would generally be considered other than temporary if the

- investor has the intent to sell,
- investor more likely than not will be required to sell prior to the anticipated recovery, or
- issuer of the security defaults.

Outside of these situations, management must evaluate impairment based on the specific facts and circumstances surrounding the security. The following are examples of factors that should be considered for debt securities, as described in ASC 320. This list is not meant to be all inclusive. Some factors are

- the length of time and the extent to which the fair value has been less than the amortized cost basis.

- adverse conditions specifically related to the security, an industry, or a geographic area (for example, changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, in the financial condition of the underlying loan obligors).
- the historical and implied volatility of the fair value of the security.
- the payment structure of the debt security (for example, nontraditional loan terms) and the likelihood of the issuer being able to make payments that increase in the future.
- failure of the issuer of the security to make scheduled interest or principal payments.
- any changes to the rating of the security by a rating agency.
- recoveries or additional declines in fair value subsequent to the balance sheet date.

Question 5

What additional expectations exist for bank management in the assessment and documentation of OTTI?

Staff Response

Banks should consider the following when evaluating and documenting whether impairment is other-than-temporary:

- Banks should apply a systematic methodology for identifying and evaluating fair value declines below cost that includes the documentation of all factors considered.
- Once a security is in an unrealized loss position, banks must consider all available evidence relating to the realizable value of the security and assess whether the decline in value is other-than-temporary.
- The longer the security has been impaired and the greater the decline in value, the more robust the documentation should be to support a conclusion of only temporary impairment and not OTTI.
- Banks should not infer that securities with declines of less than one year are not other-than-temporarily impaired or that declines of greater than one year are automatically other-than-temporarily impaired. An other-than-temporary decline could occur within a very short time, and/or a decline in excess of a year might still be temporary.
- An investor's intent to hold an equity security indefinitely would not, by itself, permit an investor to avoid recognizing OTTI.
- A market price recovery that cannot reasonably be expected to occur within an acceptable forecast period should not be included in the assessment of recoverability.

- In the case of an equity security for which an entity asserted its intent to hold until recovery or a debt security an entity did not intend to sell, facts and circumstances surrounding the sale of a security at a loss should be considered in determining whether the hold-to-recovery assertion remains valid for other securities in the portfolio. That is, the bank's previous assertion is not automatically invalidated.

Question 6

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

Staff Response

Yes. ASC 320-10-35-33 states that an investor should recognize an impairment loss when the impairment is deemed other-than-temporary even if a decision to sell the security has not been made.

Facts A bank holds an equity security whose fair value is less than amortized cost. Bank management has determined, based on facts and circumstances, that the decline in fair value is other-than-temporary.

Question 7

How should the bank record OTTI for the equity security?

Staff Response

The bank recognizes a loss in earnings equal to the entire difference between the security's cost basis and its fair value at the balance sheet date. The fair value of the security becomes the new amortized cost basis, and net income is not adjusted for subsequent recoveries in fair value of the instrument.

Facts Using the same facts as for question 7, assume the asset is a debt security rather than an equity security.

Question 8

How should the bank record OTTI for the debt security?

Staff Response

It depends. If the bank intends to sell the debt security or if it is more likely than not the bank will be required to sell the debt security before recovery of its amortized cost basis, the bank should recognize a loss in earnings for the entire difference between the security's amortized cost basis and its fair value at the balance sheet date.

If the bank does not intend to sell the debt security and it is not likely that the bank will be required to sell the security before recovery of its amortized cost basis, the bank shall separate the decline in value into the following two components:

- The amount representing the credit loss (also referred to as the credit component).
- The amount related to all other factors (also referred to as the noncredit component).

The amount of OTTI related to the credit component shall be recognized in earnings. The amount of the OTTI related to the noncredit component shall be recognized in AOCI, net of applicable taxes.

The previous amortized cost basis less the OTTI impairment recognized in earnings shall become the new amortized cost basis of the investment. Subsequent recoveries in fair value of the debt security will not be reflected in net income. The amortized cost basis of the impaired debt security, however, will be adjusted for accretion and amortization as described in question 15 included in this topic.

Question 9

How should a bank calculate the credit component of the OTTI for a debt security?

Staff Response

ASC 320-10-35-33D states that one way to estimate the credit component of the OTTI would be to consider the impairment methodology described in ASC 310-10-35. In general, ASC 310-10-35 measures impairment as the excess of the asset's recorded balance over the present value of expected future cash flows discounted at the asset's effective interest rate. Other methodologies may be used if they represent reasonable measurements of credit impairment.

Question 10

Beneficial interests in securitized financial assets that are not of high credit quality are accounted for in accordance with ASC 325-40. What is meant by securitized financial assets that are "not of high credit quality"?

Staff Response

The SEC staff has concluded that securitized financial assets that are "not of high credit quality" are those securitized financial assets rated below AA. The OCA staff does not object to the SEC staff's interpretation; however, banks should be alert to updated guidance in light of recent regulatory reform efforts,

ASC 325-40 provides examples of the securities that are of "high credit quality," which specifically include: securities that are guaranteed by the U.S. government, its agencies, or other creditworthy guarantors, and loans or securities that are collateralized to ensure that the possibility of credit loss is remote. As such, it appears the standard only intended assets to be deemed "of high quality" when the likelihood

of loss was remote. Based on review of the rating definitions, an AA rating is defined as "the obligor's capacity to meet its financial commitment on the obligation is very strong," which appears to be consistent with the intent of the standard when using the "high credit quality" terminology.

Also, the rating definition for an investment-grade rating of BBB is that of an "obligation that exhibits adequate protection parameters but that under adverse economic conditions or changing circumstances is likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation." The SEC staff's position is that an investment-grade rating of BBB is not consistent with the intent of the standard when using "high credit quality" terminology.

Question 11

Is there a different OTTI measurement for beneficial interests in securitized financial assets that meet the scope of ASC 325-40 and thus are "not of high credit quality" and can be contractually prepaid or settled so that the investor does not recover substantially all of the recorded investment?

Staff Response

No. Institutions with beneficial interests in securitized financial assets within the scope of ASC 325-40 should apply the OTTI measurement framework prescribed in ASC 320-10-35-18.

Question 12

If OTTI measurements now follow the requirements of ASC 320-10-35, why is there still a need for ASC 325-40?

Staff Response

ASC 325-40 is needed because guidance on interest income recognition remains applicable.

Question 13

When evaluating market prices, is it a valid argument that markets are performing irrationally and need time to recover before assessing fair value and OTTI?

Staff Response

No. Bank management is required to account for certain securities at fair value and assess OTTI on a quarterly basis for call report purposes. Bank management must estimate fair value by using observable market data to the extent available or otherwise make assumptions that a market participant would use in assessing fair value as required by ASC 820-10.

As explained in ASC 820-10, fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In other words, fair value is the price that would be received to sell an asset (exit price) as opposed to the price that would be paid

to purchase an asset (entry price). This exit price should be based on the price that would be received in the bank's principal market for selling that asset. The principal market is the market the bank has historically sold into with the greatest volume. If the bank does not have a principal market for selling that asset, the exit price should assume the asset is sold into the most advantageous market. The most advantageous market is the market in which the bank would receive the most value, considering the transaction costs in the respective markets. Additional guidance is provided in ASC 820-10-35-51 to assist in the determination of fair value when markets are inactive, when the level of activity has declined, and when transactions are not orderly. These concepts are discussed further in Topic 11D.

Question 14

How is OTTI reflected in a bank's financial statements and call reports?

Staff Response

In the income statement, banks must present the total amount of OTTI that has been recorded during the period, the portion of the loss recognized in AOCI, and the portion of loss recognized in earnings. As an example, the following presentation may be made:

Total OTTI losses	$ XXX
Portion of loss recognized in AOCI	(XX)
Net impairment loss recognized in earnings	$ XXX

Additionally, when reporting the total amount of AOCI, the bank must disclose the amount related to AFS securities and the total amount related to HTM securities.

Question 15

After an OTTI loss has been recorded for a debt security, the security has a new cost basis. How is the debt security accounted for in subsequent periods?

Staff Response

The subsequent accounting for a debt security with OTTI depends on whether it is classified as HTM or AFS.

For HTM securities, the amount of OTTI recorded in AOCI should be accreted from AOCI to the amortized cost of the security. This transaction does not affect net income. Accretion of amount in AOCI will continue until the security is sold, matures, or suffers additional OTTI.

For AFS securities, subsequent increases or decreases in fair value will be reflected in AOCI, as long as the decreases are not further OTTI losses. The difference between the new cost basis of the AFS debt security and the cash flows expected to be collected will be accreted into interest income as long as the security is not placed on nonaccrual. (See question 16.)

Question 16

When should a bank place a debt security on nonaccrual status and therefore not accrete or amortize the discount or reduced premium created through the OTTI write-down?

Staff Response

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

Facts A bank owned a corporate debt security of ABC Corp. and carried the investment in its AFS portfolio. ABC Corp. filed for bankruptcy, at which time the bank recorded OTTI through earnings to write down the value of the security to $0, because the bank determined that the full decline in fair value was related to credit. Several years later, ABC Corp. emerged from bankruptcy and issued new debt to its prior bondholders.

Question 17

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

Staff Response

Guidance regarding a creditor's accounting for a modification or exchange of debt instruments is addressed in ASC 310-20-35, which requires that the restructured debt be accounted for as new debt if the following two criteria are met:

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

ASC 310-20-35 provides that a modification is considered more than minor if the present value of the cash flows of the new debt is at least 10 percent different from the present value of the remaining cash flows of the original debt.

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

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

Question 18

If the reissued bond distributed by ABC Corp. qualifies as new debt under ASC 320-10-35, how should the bank account for the exchange?

Staff Response

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

Facts A bank holds a debt security that has an amortized cost basis of $100 and is currently trading in the active market at $70. The bank determined that the debt security is other-than-temporary impaired in accordance with GAAP, as of the reporting date. The fair value as of the reporting date is the market quote of $70. The bank holds approximately 25 percent of the entire debt security issuance. The sale of the bank's holdings would affect the market pricing on the debt securities, because of the market's inability to readily absorb the volume of securities being traded.

Question 19

Based on liquidity, may the bank consider the volume of securities being held in the determination of fair value?

Staff Response

No. Consistent with ASC 820-10, the best evidence of fair value is quoted market prices in an active market. Although the sale of the bank's holdings could affect the market pricing, an adjustment of fair value or a reserve for liquidity against a security is not permitted under GAAP when the security trades in an active market.

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

Question 20

How should banks holding municipal bonds from issuers in the areas of a major hurricane (a category 4 storm such as Hurricanes Katrina and Rita) on which fair value is less than the amortized cost, assess these bonds for OTTI to prepare their quarterly call reports?

Staff Response

Under GAAP, when the fair value of a municipal bond has declined below its amortized cost, the bank holding the bond must assess whether the decline represents an "other-than-temporary" impairment and, if so, write the cost basis of the municipal bond down to fair value. When making the OTTI assessment, banks should apply relevant OTTI guidance, including ASC 320-10-35.

In this regard, if a bank decided prior to the end of the quarter that it would sell a municipal bond after quarter-end and management did not expect the fair value of the

bond, which is less than its amortized cost, to recover prior to the expected time of sale, a write-down for OTTI should be recognized in earnings in the bank's quarterly financial statements. Otherwise, management should consider all information available prior to filing this report when assessing hurricane-affected municipal bonds for OTTI. If the bank determined the impairment on the bond was other-than-temporary, but it did not intend to sell the bond and it was not likely it would be required to sell the bond, the portion of the decrease in value attributed to credit loss should be recognized in earnings, and the change related to all other factors (i.e., the non-credit component) should be recognized in AOCI, net of applicable taxes.

In each subsequent reporting period, banks should continue to assess whether any declines in fair value below amortized cost of these municipal bonds are other-than-temporary.

Question 21

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

Staff Response

Measuring and recording OTTI is based on the specific facts and circumstances. Consistent with OTTI guidance, the staff believes that banks should review their securities portfolios at each reporting date and determine if write-downs are required in the current period. For example, if the bank determines that the cause of the decline in a security's value is a result of a ratings downgrade attributable to significant credit problems with the issuer, generally that decline would be considered other than temporary, and that loss should be recorded in the current period.

Question 22

There are securities in the market that mirror a debt instrument but have no maturity date, such as FNMA and FHLMC perpetual preferred stock issues. Are there any special OTTI considerations for these types of securities (i.e., equity securities)?

Staff Response

One important consideration in an OTTI analysis is the existence of a maturity date. Because equity securities do not have a maturity date, bank management must determine the period over which they expect the fair value to recover and they must have the ability and intent to hold the equity securities for a reasonable period of time to allow for the forecasted recovery of fair value. These time frames are typically of a shorter duration. Recently the SEC stated that because of the challenges with assessing OTTI for perpetual preferred securities, it would not object to "applying an impairment model (including an anticipated recovery period) similar to a debt security." This treatment may only be applied if there has been no evidence of deterioration in credit of the issuer. Note that this does *not* affect the balance sheet classification of the securities.

Because any market depreciation represents an unrealized loss on a marketable equity security, the unrealized loss is required to be deducted from Tier 1 capital. In addition, the OTTI write-down also affects earnings.

Question 23

How does one determine whether a fair value adjustment to an IO strip represents OTTI?

Staff Response

Institutions should follow the guidance in ASC 320-10-35-18 to determine whether fair value adjustments incurred on an IO strip are considered to be other than temporary. If the timing and amount of cash flows is not sufficient to recover the cost basis of the IO, OTTI is considered to have occurred and the IO strip should be written down to fair value.

Topic 2 Loans

2A. Troubled Debt Restructurings

Question 1

What is a TDR?

Staff Response

Under GAAP, a modification of a loan's terms constitutes a TDR if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. The concession could either stem from an agreement between the creditor and the debtor or be imposed by law or a court. This guidance is included in ASC 310-40.

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

If a modification meets the definition of a TDR in accordance with ASC 310-40-35, the specific accounting set forth in ASC 310-10-35 must be followed. Banks should have policies and procedures in place to evaluate loan modifications for the TDR designation.

With the exception of loans accounted for at fair value under the fair-value option, the TDR accounting rules apply to all types of restructured loans held for investment, including retail loans. Loans held for investment in a portfolio do not include loans accounted for as held for sale in accordance with ASC 310.

Question 2

What are some examples of modifications that may represent TDRs?

Staff Response

ASC 310-40-15-9 provides the following examples of modifications that may represent TDRs:

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

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

Question 3

How should a bank evaluate TDR loans for impairment?

Staff Response

Loans whose terms have been modified in TDR transactions should be evaluated for impairment in accordance with ASC 310-10-35. This includes loans that were originally not subject to that standard prior to the restructuring, such as individual loans that were included in a large group of smaller-balance, homogeneous loans collectively evaluated for impairment (i.e., retail loans).

A loan is impaired when, based on current information and events, it is probable that an institution will be unable to collect all amounts due, according to the original contractual terms of the loan agreement. Usually, a commercial restructured troubled loan that had been individually evaluated under ASC 310-10-35 would already have been identified as impaired, because the borrower's financial difficulties existed before the formal restructuring.

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

UPDATE

Facts Borrower A cannot service his $100,000 loan from the bank because of his financial difficulties. On June 1, the loan is restructured, with interest of 5 percent payable annually for the first two years and a final payment of $105,000 (principal plus interest at 5 percent) required at the end of the third year. The 5 percent interest rate is below the current market rate of 12 percent for new customers meeting the bank's underwriting criteria. Borrower A is expected to make two interest-only payments of $5,000 each and, due to continued poor performance, a final payment of $95,000.

The present value of the expected payments under the restructured terms, discounted at 10 percent (the original effective interest rate), is approximately $80,000. The loan is neither collateral dependent nor has an observable market price.

UPDATE

Question 4

How should a bank account for this restructuring?

Staff Response

This modification of terms should be accounted for as a TDR in accordance with ASC 310-40. Given the facts and circumstances, impairment should be measured in accordance with ASC 310-10-35 based on the present value of the expected future cash flows discounted at the effective interest rate of the original loan. In this example, the measure of impairment is the difference of approximately $20,000 between the present value of the expected payments (approximately $80,000) of the restructured loan, discounted at the loan's original effective interest rate, and the recorded investment ($100,000) in the loan.

UPDATE

Facts Consider the same facts as question 4, 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 interest rate of 12 percent, is $83,200.

Question 5

How should a bank account for this restructuring?

Staff Response

ASC 310-40-40 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 ($83,200 in this example). In question 4, which involves a modification of terms, the impairment is recorded through a valuation allowance, whereas here a loss of $16,800 (i.e., the $100,000 recorded investment in the old loan less the $83,200 fair value of the new loan), to the extent it is not offset against valuation allowance, is recognized in earnings.

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

Question 6

Must a loss be recorded on the permanent loan financings?

Staff Response

Yes. The bank is granting a concession it would not have allowed otherwise, because of the developer's financial condition. Therefore, this transaction is a TDR. 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 ALLL.

Facts Assume that the real estate developer described in question 6 has not yet defaulted on the construction loan. He is in technical compliance with the loan terms. Because of the general problems within the local real estate market and specific ones affecting this developer, however, the bank agrees to give the home buyers permanent financing at below-market rates.

Question 7

Must a loss be recorded on these permanent loan financings?

Staff Response

Yes. Even though the loan is not in default, the staff believes that the concession was granted because of the developer's financial difficulties. ASC 310-40-15-20 states that a creditor may conclude that a debtor is experiencing financial difficulty even though he is not currently in payment default.

Therefore, this restructuring would be accounted for as an exchange of assets under the provisions of ASC 310-40. 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 8

How should the bank account for this transaction?

Staff Response

Securities (either equity or debt) received in exchange for cancellation or reduction of a troubled loan should be recorded at fair value. The recorded amount of the debt ($100,000) is reduced by the fair value of the preferred stock received. Any

impairment in the remaining recorded balance of the restructured loan would be measured according to the requirements of ASC 310. In this case, if the securities have a fair value of $1,000, the remaining loan balance of $99,000 would be compared with the present value of the expected future payments, discounted at the effective interest rate in the original loan agreement. An allowance of $20,000 is established through a provision for loan and lease losses. This represents the difference between the recorded balance ($99,000) and the present value of the expected future payments ($79,000), discounted at 10 percent (the original effective interest rate).

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 9

May 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 TDR as defined by ASC 310-40. 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. 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 is 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 10

What constitutes a period of satisfactory performance by the borrower?

Staff Response

ASC 942-310-35 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 11.

Neither ASC 942-310-35 nor regulatory policy, however, specify a particular period of performance. This will depend on the individual facts and circumstances of each case. Generally, we believe this period would be at least six months for a monthly amortizing loan.

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

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

Question 11

The previous response indicates that performance is required before a formally restructured loan may be returned to accrual status. When may 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. In rare situations, however, 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. 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 12

Given that evidence of performance under the restructured terms will likely be relied upon to determine whether to place a TDR on accrual status, may 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 13

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, ASC 310-40 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 14

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 ASC 310-40 would apply. It is not necessary to forgive debt for ASC 310-40 to apply, as long as some other concession is made.

Question 15

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. Because the restructured loans are supported by the same source of repayment, however, 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 15, 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 16

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

Staff Response

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

Facts A bank negotiates a TDR 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 0 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 17

If the borrower makes the interest payments at 5 percent as scheduled, may 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.
- whether similar loan terms can be obtained from other lenders.

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

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

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

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

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

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

Question 18

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. The bank protects its collateral position, however, 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 19

May 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 9.

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

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

Question 20

Should the debt modification be reported as a TDR because only the interest rate was reduced?

Staff Response

ASC 310-40 states that a restructuring of a debt is a TDR if a creditor, for economic or legal reasons related to the debtor's financial difficulties, grants a concession that it would not otherwise consider. This may include a reduction of the stated interest rate for the remaining original life of the debt. No single characteristic or factor taken alone, however, determines whether a modification is a TDR.

The following factors, although not all inclusive, may indicate the debtor is experiencing financial difficulties:

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

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

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

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

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

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

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

Question 21

Should this restructuring be accounted for as a TDR?

Staff Response

Yes. ASC 310-40 states that the restructuring of a debt is a TDR if a creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession that it would not otherwise consider. The company was experiencing financial difficulties, as demonstrated by the default on the interest payments. Further, while there was no forgiveness of interest or principal, a concession was granted by extending the maturity date and agreeing to capitalize interest on Note B.

Question 22

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

Staff Response

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

The parent paid $10 million (plus interest and fees) to bring all past-due amounts current and has demonstrated the intent and ability to continue to support the power company by its commitment to inject $4 million capital into the company in 2005 and 2006. The parent also indicated that additional financial support would be provided, as necessary. This capital injection and future support is sufficient to meet all required payments on Note A. Further, the previous actions of the parent sufficiently demonstrate its intent to support the borrowing. In addition, after the $10 million payment by the parent, the collateral value exceeds all current outstanding balances by approximately $13 million and exceeds the balance of Note A by approximately $53 million. Based on these factors, the collection of all principal and interest is deemed reasonably assured for Note A. Accordingly, accrual status is appropriate for Note A.

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

The credit line is restructured into a new revolving line of credit of the same amount at an interest rate of prime plus 3 percent. The rate and terms are considered to be at market terms and do not involve a concession. Further, the line of credit is considered to be both fully collectible and fully secured.

The term loan is restructured into two new term loans, Loan X and Loan Y.

Loan X matures in three years and has an interest rate of the prime rate plus 3 percent. It requires periodic principal payments during the second and third years and a balloon payment at maturity. The repayment structure is not uncommon for this type of loan and is considered to be at market terms. Repayment capacity and collateral are considered sufficient to assure repayment of the loan.

The second loan, Loan Y, provides for a below-market interest rate. It also matures in three years but does not require principal or interest payments until maturity. The terms of this loan are considered concessionary, because of the below market interest rate and the repayment terms. Accordingly, the restructuring of the original term loan is considered a TDR. Further, given that the borrower's repayment capacity and collateral are considered inadequate to repay any portion of this loan, the loan is deemed uncollectible and should be charged off.

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

Question 23

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

Staff Response

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

Consistent with the previous question 10, the revolving line of credit and Loan X may be returned to accrual status when there has been a period of satisfactory payment performance by the borrower. In this situation, however, Loan X does not require principal payments during the first year. Accordingly, consideration should be given to whether the borrower can continue making the required payments of principal and interest after the first year.

Question 24

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

Staff Response

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

UPDATE

Question 25

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

Staff Response

Recoveries related to Loan Y would not be recorded until the recorded loans (the revolving line and Loan X) are either paid off or returned to accrual status. Until then, any payments received for Loan Y would be applied to the revolving line of credit and Loan X.

Question 26

What is the impact on the ALLL determination under ASC 310-10-35 for TDR loans?

Staff Response

ASC 310-40 requires all TDRs, both retail and commercial transactions, to be evaluated for impairment in accordance with ASC 310-10-35. Given the financial difficulties of these borrowers, material impairment (i.e., additional ALLL provisions) is possible.

When measuring impairment on an individual basis under ASC 310-10-35, a bank must choose one of the following methods:

- The present value of expected future cash flows discounted at the loan's effective interest rate (i.e., the contractual interest rate adjusted for any net deferred loan fees or costs, premium, or discount existing at the origination or acquisition of the loan);
- The loan's observable market price; or
- The fair value of the collateral, if the loan is collateral dependent.

ASC 310-10-35 requires that if a loan's contractual interest rate varies based on subsequent changes in an independent factor, such as an index or rate (for example, the prime rate, the LIBOR, or the U.S. Treasury bill rate weekly average), the loan's effective interest rate may be calculated based on the factor as it changes over the life of the loan or be fixed at the rate in effect at the date the loan meets the impairment criterion. This method used shall be applied consistently for such loans. Further, projections of future changes in the factor should not be considered when determining the effective interest rate or estimate of expected future cash flows.

For most retail loan TDRs, the present value of expected future cash flows or the fair value of collateral methods (if the loan is collateral dependent) will be used to calculate impairment, because an observable market price for a loan is usually not available. If impairment is measured using an estimate of the expected future cash flows, the interest rate used to discount the cash flows (i.e., present value) is based on the original effective interest rate on the loan and not the rate specified in the restructuring agreement. If the present value of the modified terms is less than the recorded investment in the loan, bank management must include the difference in their ALLL analysis.

For practical reasons and as allowed in ASC 310-10-35, pools of smaller-balance homogeneous TDRs (generally retail loans) could be reviewed on a pooled basis. Some impaired loans have risk characteristics unique to an individual borrower, and the bank should apply one of the three measurement methods noted above on a loan-by-loan basis. Some impaired loans, however, may have risk characteristics in common with other impaired loans. A bank may aggregate those loans and may use historical statistics, such as average recovery period and average amount recovered, along with a composite, effective interest rate to measure impairment of those loans. In certain circumstances, grouping retail TDR loans together to measure impairment may help banks arrive at the best estimate of expected future cash flows.

Question 27

Can a TDR to be collateral dependent immediately following the loan modification (on day 1)?

Staff Response

Yes, a TDR can be collateral dependent at the time of or immediately after the loan modification. A loan is collateral dependent if repayment of the loan is expected to be provided solely by the underlying collateral and there are no other available and reliable sources of repayment. A modified loan requiring only a nominal monthly payment from the borrower with no support that the borrower can repay the recorded loan balance may result in a loan that ultimately is repaid only through the liquidation of the underlying collateral. Management judgment of a borrower's specific facts and circumstances is required to determine if this is the case.

If the facts and circumstances indicate that the borrower does not have the ability to repay the modified loan or if the terms of the loan are based on future, uncertain events, the loan may be deemed collateral dependent at the time of modification. As the critical terms of the modified loan (such as repayment of the recorded loan balance) extend over longer periods of time, there is more uncertainty in estimating the timing and amount of cash flows associated with the loan and if the borrower does not have the current capacity to repay the recorded loan balance, the likelihood of the loan being collateral dependent increases.

If the TDR is determined to be collateral dependent, the amount of confirmed loss (i.e., the amount deemed uncollectible) should be charged against the ALLL in a timely manner.

Question 28

Is it possible to have a group of originated loans or acquired loans that were not impaired at acquisition in which the entire pool is deemed to be collateral dependent at the time of TDR modification?

Staff Response

It is possible to have a pool of impaired residential mortgage loans that is collateral dependent at the time of TDR modification. As each new TDR is underwritten and executed, the loan must be reviewed for collateral dependency. If the impaired loan is determined to be collateral dependent at the time of the modification, the loan may be placed in a pool of other collateral-dependent loans that share similar risk characteristics. In that case, the pool of loans may be collateral dependent. If the collateral-dependent determination is not made at the time of the modification on a loan-by-loan basis or the loan pools do not sufficiently segment collateral dependent loans from those that are not collateral dependent, it is not appropriate to deem the entire pool of loans as collateral dependent. The loan pool must be further segmented to properly account for the collateral-dependent loans separately from other loans in the pool that are not collateral dependent.

Question 29

How is the ALLL amount for TDRs established under ASC 310-10-35?

Staff Response

If the ASC 310-10-35 measurement of a TDR is less than the recorded investment in the loan, impairment is typically recognized by adjusting the existing ALLL for the difference with a corresponding charge to "Provision for loan and lease losses."

Question 30

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

Staff Response

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

Facts In 2005, a 2/28 hybrid ARM loan is made to a borrower with an initial rate of 5 percent and a scheduled reset to LIBOR plus 2 percent as of September 1, 2007. In August 2007, while the loan is still at the initial rate of 5 percent, the lender becomes aware that the borrower cannot make payments at the reset rate. As of August 2007, LIBOR is 6 percent, so the loan's interest rate is expected to increase to 8 percent. Because of the borrower's financial difficulty, the bank agrees to modify the terms of the loan at a fixed rate of 6 percent until maturity, which is below the current market rate for a loan in this risk category.

Question 31

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

Staff Response

No. The impairment analysis as required by ASC 310-10-35 should reflect the "concession" made (i.e., the lost interest), because this interest rate modification results in the loan being considered a TDR. The effective interest rate for calculating the present value of the modified terms is not the 5 percent initial rate. Instead, the effective interest rate should be a blend of the 5 percent rate over the term of the initial period and the scheduled 8 percent reset rate for the remaining 28 years of the loan. In addition, shortcut methods may be used for the original effective rate calculation that may not result in a material difference from the blended rate (e.g., a bank may decide to use the full reset rate of 8 percent).

With respect to the reset rate, ASC 310-10-35 does not allow projected changes in the independent factor, in this case LIBOR, to be considered in calculating the effective interest rate; thus, the 8 percent rate during the reset period is the current LIBOR, 6 percent, plus 2 percent.

UPDATE

Facts Bank X has a fixed-rate mortgage from Borrower A in its held-for-investment portfolio. Borrower A's mortgage is part of a portfolio of mortgages that are evaluated collectively for impairment and for which an ALLL has been established, even though no specific loan has been identified as impaired. Borrower A is having difficulty making payments. Bank X has determined that it is in the bank's best interest to modify Borrower A's loan by lowering the interest rate from 7 percent to 6 percent. The 6 percent rate is below the market interest rate the bank would typically charge a borrower with similar credit risk as Borrower A. The lower interest rate results in contractual payments of $603.40 per month. Because of Borrower A's financial difficulties and the interest-rate concession granted by Bank X, the loan is a TDR and subject to ASC 310-10-35 for impairment measurement. The terms of the original loan and the modified loan are as follows:

Original loan terms	Modified loan terms
Payment: $665.12	Payment: $603.40
Interest rate: 7%	Interest rate: 6%
Remaining term: 27 years	Remaining term: 27 years
Loan balance: $96,700	Loan balance: $96,700

One approach to develop the best estimate of expected future cash flows would be to incorporate default and prepayment assumptions that would be relevant to an aggregated pool of loans with risk characteristics similar to the restructured loan. In addition, the analysis may incorporate uncertainty about the timing and amount of borrower payments. Bank X incorporates these assumptions in its cash flow analysis and expects to receive approximately $580 per month for the remaining term of the loan. Present value of the expected future cash flows discounted at the original effective interest rate is approximately $84,300. For simplicity, recorded investment in the loan at the time of the TDR equals the loan balance of $96,700, and the treatment of any accrued interest receivable is not considered in this example.

Question 32

How is the impairment calculated?

Staff Response

The present value of the modified loan's expected cash flows discounted at the original effective interest rate is approximately $84,300, which is less than the recorded investment in the loan of $96,700. The difference of approximately $12,400 is the measurement of impairment at the time of the restructuring as required by ASC 310-10-35.

Facts A borrower has a first lien residential mortgage with Bank A and a second lien residential mortgage with Bank B. Bank A modified the borrower's first lien mortgage through a TDR. At the time the first lien mortgage is modified with Bank A, the borrower is current on his second lien mortgage with Bank B. Bank B has not modified the borrower's loan.

Question 33

How should Bank B account for the second lien mortgage under ASC 310-10 after the first lien mortgage was modified?

Staff Response

ASC 310-10-35 specifically scopes out large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment. Those loans may include but are not limited to credit card, residential mortgage, and consumer installment loans. As a result, residential mortgage loans are generally evaluated for impairment as part of a group of homogenous loans under ASC 450-20. The only time a residential mortgage loan is required to be analyzed for impairment under ASC 310-10-35 is when the residential mortgage loan is modified and classified as a TDR. In the scenario described above, Bank B will include the second lien mortgage loan in its allowance methodology under ASC 450-20; the second loan has not been modified and is therefore not a TDR subject to ASC 310-10-35.

In addition, while the borrower's first lien mortgage has been modified by Bank A, Bank B may not be aware of this action. When Bank B does become aware of a first lien modification, however, Bank B should recognize that the second lien mortgage loan borrower is facing financial difficulties and that the second lien mortgage has different risk characteristics than other second lien mortgage loans that have not had their first lien mortgage modified or are not suffering financial difficulties. Following the modification of the first lien mortgage, Bank B should consider segmenting the loan into a different ASC 450-20 group that reflects the increased risk associated with this loan. Alternatively, the bank may consider applying additional environmental or qualitative factors to this loan pool to reflect the different risk characteristics.

Facts A bank's short-term modification (i.e., 12 months or less) program delays payments for troubled borrowers. Because the modifications are short term, the bank concludes the delay in payment is insignificant.

Question 34

Is the bank's basis for concluding the delay in payments is insignificant appropriate?

Staff Response

No. It is not appropriate to conclude the delay in payments is insignificant simply because the modification is short term (i.e., 12 months or less). Rather, the bank

must collectively consider the following factors, which may indicate the delay is insignificant:

- The amount of the restructured payments subject to the delay is insignificant relative to the unpaid principal or collateral value of the debt and will result in an insignificant shortfall in the contractual amount due.
- The delay in timing of the restructuring payments period is insignificant relative to any one of the following:
  - The frequency of payments due under the debt
  - The debt's original contractual maturity
  - The debt's original expected duration

Facts A bank originated an SFR mortgage that is HFI. At origination, the borrower's income was the primary source of repayment and the underlying collateral was the secondary source of repayment. There is no other source of repayment.

The borrower files for Chapter 7 bankruptcy. The bankruptcy court discharges the borrower's obligation to the bank and the borrower does not reaffirm the debt. Accordingly, after the bankruptcy proceedings are completed, the bank's only recourse is to take possession of the collateral. Therefore, if the bank does not receive contractual mortgage payments, it can foreclose on the property, but the bank cannot pursue the borrower personally for any deficiencies. Even if the borrower has been making payments, the borrower's continued ability and willingness to make voluntary payments is uncertain.

Question 35

How should the bank report the discharged debt in the call report?

Staff Response

The discharged debt should be reported as a loan in the call report. The call report instructions glossary states that a loan is generally an extension of credit resulting from direct negotiations between a lender and a borrower. That definition is consistent with GAAP, which defines a loan as a contractual right to receive money on demand or on fixed or determinable dates and is recognized as an asset in the creditor's statement of financial position. The discharge of a secured debt does not eliminate the bank's contractual right to receive money on demand or on fixed or determinable dates; only the debtor's personal liability on the debt has been eliminated.

The discharged debt should not be reported as OREO because the bank does not have physical possession or legal title to the collateral (see Topic 5A, question 2).

Question 36

Is the loan a TDR?

Staff Response

Yes. A restructuring constitutes a TDR if a concession is granted for economic or legal reasons related to the borrower's financial difficulties. The bankruptcy filing indicates the borrower is experiencing financial distress (see question 20) and the release of the borrower's personal liability as ordered by the bankruptcy court is a concession.

ASC 310-40-15-6 states that a concession can be imposed by a law or court. Additionally, ASC 310-40-15-10 specifically states that TDRs consummated under reorganization, arrangement, or other provisions of the Federal Bankruptcy Act or other federal statutes are within the scope of 310-40. Therefore, the bankruptcy court's discharge of the borrower's debt is a concession for the purpose of determining whether the restructured loan is a TDR.

Question 37

How should the bank account for the TDR?

Staff Response

The restructured loan is collateral dependent. The bank should, therefore, establish an ALLL in accordance with ASC 310-10 and charge-off the excess of the loan's carrying amount over the fair value of the collateral as uncollectible and the bank should place the remaining balance on nonaccrual. The bankruptcy court "removed" the borrower (the primary source of repayment) from responsibility to continue to make payments called for by the original loan agreement. As such, the TDR is collateral dependent because repayment depends solely on the collateral.

UPDATE

Facts A bank modifies a secured loan in a TDR and measures impairment using the present value of the expected future cash flows discounted at the loan's original effective interest rate because the loan is not collateral dependent. The modified contractual terms require a balloon payment at maturity. The current collateral value is less than the scheduled balloon payment.

Question 38

Is it appropriate for the bank to presume the borrower will be able to repay or refinance at maturity?

Staff Response

No. When a contractual balloon payment is required at maturity under the modified terms of a TDR loan that is not collateral dependent, significant uncertainty may exist regarding the troubled borrower's ability to refinance or repay the debt at maturity. In accordance with ASC 310-10-35-26, when estimating expected future cash

UPDATE

flows for impairment measurement purposes, the bank should consider all available evidence, with greater weight given to evidence that can be verified objectively. When no sources of cash flows are reasonably expected to be available to support the assumption that the borrower will be able to repay or refinance the secured loan at maturity, an acceptable approach for estimating expected future cash flows can be to base the expected payment at maturity on the current fair value of the collateral, less estimated costs to sell.

The fair value of the collateral should be supported by a current appraisal or other similar timely evaluation. Using the fair value of the collateral, less selling costs, in lieu of the balloon payment due at maturity, does not suggest a 100 percent probability of default at renewal. Rather, using the fair value recognizes the value inherent in the collateral to satisfy repayment should refinancing efforts prove unsuccessful.

However, if the contractual balloon payment at maturity is lower than the fair value of the collateral, less estimated costs to sell, the balloon payment amount should be used as the final cash flow in the impairment analysis since there is no collateral deficiency.

NEW

Facts A bank modifies a loan to a borrower in a TDR. The bank incurs certain costs directly related to the modification, including appraisal costs. The bank charges the borrower a general fee for the modification and adds the fee to the modified loan balance.

Question 39

How should the bank account for these direct costs incurred in a TDR and for the modification fee charged to the borrower?

Staff Response

Consistent with ASC 310-40-25-1, OCC staff believes that the bank should expense the appraisal and other direct costs associated with the TDR when incurred. Likewise, consistent with ASC 310-20-35-12, the bank should apply the fee received in connection with the TDR to reduce the recorded investment in the loan. Thus, the bank should defer recognition of the fee income associated with the TDR.

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

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

Staff Response

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

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

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

Question 2

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

Staff Response

Loans should be evaluated individually. The borrower's total exposure must be considered, however, 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.

UPDATE

Facts The bank has placed a loan on nonaccrual and charged the loan down to the estimated collateral value. The remaining principal has been classified as substandard because of the borrower's historical nonperformance or an event of default (e.g., covenant violation, significant credit event) and questionable ability to meet future repayment terms.

Question 3

Because the collateral value is sufficient to cover the remaining recorded investment (after charge-off), may interest payments be recognized as income on a cash basis?

Staff Response

Initial cash-basis income recognition would not be appropriate without a credit analysis and documentation to support the borrower's repayment capacity. In determining the accounting for individual payments on a nonaccrual loan, the bank must evaluate the loan to determine whether doubt exists about the ultimate collectability of the recorded investment. If collectability of the recorded investment in the loan is in doubt, any payment received in a nonaccrual loan should be applied to reduce the recorded investment to the extent necessary to eliminate such doubt.

The overall creditworthiness of the borrower and the underlying collateral values should be considered when making this determination. For example, doubt about collectability of troubled loans often exists when regular payments have not been made or with an event of default, even when a loan is fully collateralized. In general, collateral values are not sufficient, by themselves, to eliminate the issue of ultimate collectability of the recorded investment in the loan, especially when there is not a high degree of confidence in the accuracy of the estimated collateral value. Without a credit analysis and documentation to support the borrower's capacity to repay, there should be sufficient collateral margin before the bank can conclude that doubt has been eliminated.

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

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

Staff Response

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

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

Question 5

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

Staff Response

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

Facts A bank has two loans to a real estate developer for two different projects. Loan A is secured by a fully leased office building. The collateral value exceeds the loan obligation. Loan B is secured by an apartment building with relatively few units leased to date. A collateral shortfall exists relative to the loan obligation. The obligors are separate corporations wholly owned by the developer. There is no cross-collateralization of the notes, however, 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 ASC 310-10-35.

Question 6

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

Staff Response

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

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

Question 7

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

Staff Response

The cross-collateral agreement alone should not stop interest accrual on Loan A. The bank has merely taken steps to improve its relative position with the borrower. Thus, to the extent that cross-collateralization does not change the repayment pattern of the notes or endanger Loan A's full repayment in due course, Loan A may 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. Because of current economic conditions, however, 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 ASC 310-10-35.

Question 8

May Loan A remain on accrual status?

Staff Response

Neither Loan A or C should be on accrual status. Senior and junior liens on the same property generally should be considered as one loan. Regardless of whether 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 the loan 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 that meet the shortfall on Project B and provides for the debt service shortfall on Loan B, ensuring its full contractual collectibility. The developer can and does use these funds to keep Loan B current.

Question 9

May 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 may 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. In this case, however, 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 ASC 310-10-35.

Question 10

May 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 Loans A and B, both loans should be placed on nonaccrual.

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

Question 11

Must both notes be placed on nonaccrual status?

Staff Response

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

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

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 Loan B has been recorded, according to ASC 310-10-35.

Question 12

May Loan A be maintained on accrual status?

Staff Response

Possibly. The assertion that cross-collateralization of the loans will not affect the orderly and contractual repayment of Loan A, however, 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 may remain on accrual status.

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

Question 13

May 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. Although the bank now fully expects to collect the original contractual obligation, including the amount previously charged off, the loan is not yet contractually current.

Question 14

May 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. Because of doubt about collectibility, however, certain interest payments were applied to reduce principal.

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

Question 15

May 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. In this situation, the staff believes the previously foregone interest should be recognized as interest income when received.

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

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

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

Question 16

Is this an acceptable treatment?

Staff Response

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

Facts A loan is guaranteed by the U.S. government (or a government-sponsored agency). The guarantee covers 90 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 17

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

Staff Response

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

Question 18

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

Staff Response

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

Facts A bank placed a loan on nonaccrual status, because the borrower's financial condition had deteriorated and the bank did not expect full repayment of contractual principal and interest. Accrued interest was reversed and, as a result of the bank's credit evaluation, a charge-off of principal was recorded. One year later the borrower's financial condition has improved greatly, however, and the bank expects to recover all amounts contractually due.

Question 19

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

Staff Response

No. The decision to place the loan on nonaccrual indicates that there was doubt about full collection of principal and interest. The charge-off was based on management's determination that recovery of the principal was not expected. The reversal of the interest was based on the determination that the accrued interest may not be collected. The determination of collectibility is an accounting estimate as defined by ASC 250-10. That standard requires changes in accounting estimates to be accounted for in the period of change and future periods when the change affects both. Accordingly, payments would be accounted for in accordance with GAAP, and recoveries recorded as received. This would apply to both principal and interest payments.

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

Question 20

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

Staff Response

No. The meaning of "in process of collection" requires that the timing and amount of repayment be reasonably certain. The definition entails more than initiating legal action or pursuing a well-reasoned plan for collection. The following factors do not in and of themselves meet the "in process of collection" definition:

- Commencement of collection efforts
- Plans to liquidate collateral
- Ongoing workouts
- Foreclosing on or repossessing collateral
- Restructuring or settlement

There must be evidence that collection in full of amounts due and unpaid will occur shortly.

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

Facts A bank has designated a loan of $200,000 in nonaccrual status, because payment in full of principal and interest was not expected. The bank had previously accrued late fees of $500 prior to the loan's designation in nonaccrual status.

Question 21

May the bank continue to accrue late fees on a loan that has been designated in nonaccrual status?

Staff Response

No. Loan fees, including late fees, should not be accrued on a loan designated in nonaccrual status. The loan was placed in nonaccrual, because the full payment of the principal and interest is not expected. The staff believes the uncertainty in the collectibility of principal and interest raises doubt as to the collectibility of all payments, including late fees. Therefore, the bank should not continue to accrue the late fees while the loan is in nonaccrual status.

Question 22

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

Staff Response

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

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

Question 23

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

Staff Response

Yes. If the contractual terms of the loan permit, the payment of delinquent property taxes becomes part of the recorded balance of the loan. The bank should consider the increase in the loan amount when evaluating the loan for impairment and any amounts deemed uncollectible should be promptly charged off. The staff believes the existence of delinquent property taxes, which could result in a lien attachment on underlying collateral of a collateral dependent loan, represents credit-related impairment and, therefore, should be included in the ALLL or charged off as appropriate. The accounting treatment for payment of real estate taxes on property held as OREO is discussed in Topic 5A: Real Estate, question 9.

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

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

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

Question 24

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

Staff Response

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

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

All modified loans must be evaluated to determine whether the modification meets the definition of a TDR, as discussed in Topic 2A, Troubled Debt Restructurings.

Question 25

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

Staff Response

Not necessarily. Unless the loan is both well secured and in the process of collection, banks shall not accrue interest on any commercial loan

- that is maintained on a cash basis because of deterioration in the financial condition of the borrower.
- for which payment in full of principal or interest is not expected.
- upon which principal or interest has been in default for a period of 90 days or more.

Accordingly, if interest or principal has been waived on a commercial loan, the loan generally should be placed on nonaccrual status.

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

Question 26

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

Staff Response

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

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

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

Question 27

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

Staff Response

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

Question 28

What is the accounting for a purchased loan that was classified by the previous owner as in nonaccrual status and for which cash flows cannot be reasonably estimated under ASC 310-30?

Staff Response

The guidance does not prohibit placing (or keeping) loans in nonaccrual status. At inception or thereafter, the bank may place a purchased loan in nonaccrual status, if the conditions in ASC 310-30-35 are met. Generally, this would require that the loan be placed in nonaccrual status when it is not possible to reach a reasonable expectation of the timing and amount of cash flows to be collected on the loan.

Facts A loan is classified as nonaccrual by Bank A, because the debtor was not meeting its obligations under the loan's contractual terms. That loan is sold to Bank B that determines the loan meets the requirements of purchased, impaired loans under ASC 310-30-35.

Question 29

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

Staff Response

Yes, if the bank can reasonably estimate cash flows, it should recognize an accretable yield and report the loan as an accruing loan (see ASC 310-30-35). This paragraph requires that the loan be placed in accrual status when the bank can reach a reasonable expectation about the timing and amount of cash flows to be collected on the loan. This response is consistent with the AICPA's Technical Questions and Answers, Section 2130.

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

Question 30

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

Staff Response

If the loan was within the scope of the ASC 310-30 when it was purchased, it is not accounted for as a new loan but is always accounted for in accordance with that standard, even if its performance improves. As discussed in question 29, however, the loan should be accruing income whenever the bank can reasonably estimate cash flows. Also, if the currently expected cash flows exceed the originally expected cash flows, ASC 310-30-35 requires that income be recognized using the updated cash-flow estimates, which may result in recognizing income at a higher yield than originally expected. This response is consistent with the AICPA's Technical Questions and Answers, Section 2130.

Facts A bank originated several loans to a financially struggling small business. The loans are cross-collateralized and have the same primary source of repayment. The entire relationship is classified as Substandard, and a portion was previously charged-off.

The small business also has a demand deposit account it uses to fund all of the business's operations. The demand deposit account is frequently in an overdraft position and accumulates significant unpaid overdraft fees. The bank converts these accrued but unpaid overdraft fees into a term interest only loan for 2 years. This overdraft term loan is also on nonaccrual status.

Subsequent to converting the unpaid overdraft balances into a term loan, the borrower's demand deposit account frequently is in an overdrawn position. The bank continues to accrue unpaid overdraft fees. Overdrafts fees on the borrower's demand deposit account incurred after the overdraft term loan was originated are not added to the loan balance.

Question 31

Is it appropriate for the bank to recognize overdraft fees on this overdrawn demand deposit account?

Staff Response

No. Accrual of overdraft fee income should cease when the borrower's loans were placed on nonaccrual. In addition, any accrued but unpaid overdraft fees should have been reversed when the lending relationship was placed on nonaccrual status (similar to accrued but unpaid interest). Overdraft accounts are reported as loans (see Topic 4, question 41). The overdrawn checking account (i.e., the loan) is inextricably linked with a lending relationship that is rated substandard/doubtful and on nonaccrual. Therefore, the bank should not accrue overdraft fee income unless the entire borrower relationship has been restored to accrual status. Overdraft fees may be recognized on a cash basis when the entire lending relationship is placed on cash-basis nonaccrual status.

Question 32

How should the bank account for the overdraft term loan?

Staff Response

As noted above, overdrawn accounts represent loans. When the bank restructured the overdrawn account and accrued, but unpaid, overdraft fees into a term loan, it granted a borrower experiencing financial distress a concession. Accordingly, the overdraft loan is a TDR (see Topic 2A). The overdraft term loan should only include actual overdrafts, not fees since any accrued but unpaid overdraft fees should have been reversed when the lending relationship was placed on nonaccrual status (see question 31).

2C. Commitments

Facts A bank has off-balance sheet financial instruments, such as commitments to extend credit, guarantees, and standby letters of credit that are subject to credit risk. These financial instruments are off-balance sheet in accordance with GAAP and are not considered to be derivatives under ASC 815-10-15. The bank evaluates and estimates the credit losses associated with these off-balance sheet instruments. In some instances the counterparty to the off-balance sheet instrument is also a borrower of the bank.

Question 1

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

Staff Response

In accordance with the AICPA "Audit and Accounting Guide for Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies" and the call report instructions, credit losses related to off-balance sheet financial instruments, such as standby letters of credit, should be accrued and reported separately as liabilities and not reported in the ALLL. This is the appropriate treatment even if the counterparty of the off-balance sheet financial instrument is also a borrower of the bank. GAAP stipulates, however, that the recognition of the provision for losses must meet the criteria set forth in ASC 450-20-25, which requires recognition of a loss if the loss is both probable and the amount reasonably estimable. The AICPA's guidance also notes that the methodology used for evaluating "loan losses" may be useful in evaluating and estimating credit losses for these off-balance sheet financial instruments.

Question 2

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

Staff Response

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

Question 3

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

Staff Response

As noted in question 1, ASC 450-20-25 requires recognition of a loss when the loss is both probable and the amount reasonably estimable. When the bank is obligated to fund the commitment and does not expect the counterparty to repay the resulting loan, the requirements of ASC 450-20-25 are met. In this situation, the bank must recognize the loss and record a liability to a separate liability account for the expected obligation. The bank cannot wait until the counterparty actually exercises the commitment to record the loss.

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

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

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

Question 4

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

Staff Response

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

ASC 450-20-25 requires recognition of a loss contingency when the loss is both probable and the amount reasonably estimable. In this situation, the bank may conclude that it has a loss contingency, because it typically funds these commitments

and does not expect all of these amounts to be repaid. Accordingly, the requirements of ASC 450-20-25 are met. As noted in question 1, these ASC 450-20 loss contingencies associated with off-balance sheet financial instruments are required to be reported separately as other liabilities and are not included in the ALLL.

Question 5

When would a loan commitment be recorded as a derivative in accordance with ASC 815-10-15?

Staff Response

ASC 815-10-15 defines a derivative as a financial instrument or other contract with the following characteristics:

- It has one or more underlyings and one or more notional amounts.
- It requires little or no initial net investment.
- Its terms require or permit net settlement or the equivalent thereof.

Loan commitments typically satisfy the first two characteristics; however, certain loan commitments may meet the net settlement provisions required by the last characteristic and others may not.

ASC 815-10 provides additional guidance for accounting for loan commitments as derivatives. It states that, notwithstanding the derivative characteristics just noted, potential lenders shall account for loan commitments related to the origination of mortgage loans that will be HFS as derivatives.

ASC 815-10-15-69 also provides scope exceptions for commitments to originate mortgage loans that will be held for investment and for commitments to originate other types of loans (i.e., other-than-mortgage loans). Therefore, loan commitments not related to the origination of mortgage loans that will be HFS are not subject to ASC 815-10 and are not accounted for as derivatives. Rather, these commitments should be reported as “unused commitments” in the call report.

Question 6

What is the accounting for commitments to originate mortgage loans?

Staff Response

Commitments to originate mortgage loans that will be HFS are derivatives under ASC 815-10. They must be accounted for at fair value on the balance sheet by the issuer, with changes in fair value recorded in current period earnings. Commitments to originate mortgage loans that will be held for investment are not accounted for as derivatives and therefore are not recorded at fair value, unless the bank has elected to apply the fair-value option.

The initial fair value of a derivative loan commitment should be determined in accordance with ASC 820-10. See Topic 11D. Fair Value Accounting for a discussion of ASC 820.

Question 7

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

Staff Response

Subsequent changes in the fair value of a derivative loan commitment should be recognized in the financial statements and call reports (e.g., changes in fair value attributable to changes in market interest rates) in earnings in the periods in which the changes occur.

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

Question 8

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

Staff Response

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

Based on the guidance in ASC 815-10-S99-1, the expected future cash flows related to the associated servicing of loans should be considered in recognizing derivative loan commitments. This is consistent with ASC 860-50 and ASC 825-10-25; however, ASC 815-10-S99-1 also indicates that no other internally developed intangible assets (such as customer relationship intangible assets) should be recognized as part of derivative loan commitments.

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

Question 9

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

Staff Response

No. In general, the staff does not believe it is appropriate for a bank to use a single pull-through rate in estimating the fair values of all its derivative loan commitments.

Numerous factors, including (but not limited to) the following, cause pull-through rates to vary:

- The origination channel
- The purpose of the mortgage (purchase versus refinancing)
- The stage of completion of the underlying application and underwriting process
- The time remaining until the expiration of the derivative loan commitment

As such, a bank should have sufficient granularity (i.e., stratification) in its pull-through rate assumptions to ensure that it appropriately considers the probabilities that its derivative loan commitments will result in originated loans.

Question 10

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

Staff Response

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

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

Question 11

How should the bank account for this hedging strategy?

Staff Response

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

Best-efforts loan sale agreements must be evaluated under ASC 815-10-15 to determine whether the agreements meet the definition of a derivative (refer to the characteristics of a derivative in question 5). Best-efforts loan sales agreements that meet the definition of a derivative should also be reported at fair value on the balance sheet with changes in fair value included in earnings.

Question 12

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

Staff Response

Regardless of whether the bank intends to hold the mortgage loans to be purchased under the agreement for investment or resale, the bank must evaluate the characteristics of the loan purchase agreement to determine whether the agreement meets the definition of a derivative under ASC 815-10-15 (refer to the characteristics of a derivative in question 5). Loan purchase agreements that meet the ASC 815-10-15 definition of a derivative should be reported at fair value on the balance sheet.

Question 13

When must banks recognize the change in fair value for commitments to purchase securities?

Staff Response

Banks must recognize the change in fair value of a commitment to purchase a security when the commitment meets the ASC 815-10-15 definition of a derivative. This also pertains when the bank has elected to account for the commitment at fair value under the ASC 825-10-25 fair value option. Commitments to purchase securities are accounted for as derivatives when the contracts allow for net settlement or when the securities to be purchased are readily convertible to cash. For the securities to be considered readily convertible to cash, quoted prices must be available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price. Commitments to purchase securities that do not meet the accounting definition of a derivative are accounted for only at fair value when the bank has elected the fair value option or meets the criteria below.

For those commitments to purchase debt securities that are not accounted for at fair value, the bank should consider the guidance in ASC 815-10-35-5. This guidance

states that changes in the fair value of forward contracts to purchase securities that will be accounted for as trading should be recognized in earnings as they occur. Changes in the fair value of forward contracts to purchase securities that will be accounted for as AFS should be recognized in other comprehensive income unless the decline is considered other than temporary (in which case the loss would be recognized in income). Additionally, changes in the fair value of forward contracts to purchase securities that will be accounted for as HTM should not be recognized unless the decline is considered other-than-temporary.

2D. Origination Fees and Costs (Including Premiums and Discounts)

Question 1

Does a bank have to apply ASC 310-20 if it does not charge loan origination fees?

Staff Response

Yes. ASC 310-20-25 requires that both net fees and costs be deferred and amortized. The fact that the failure to adopt ASC 310-20-25 would lower income and lead to a "conservative" presentation does not relieve the bank of its obligation to comply with GAAP.

Question 2

May a bank use average costs per loan to determine the amount to be deferred under ASC 310-20-25?

Staff Response

ASC 310-20-25 provides for deferral of costs on a loan-by-loan basis. The use of averages is acceptable, however, 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

May 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 ASC 310-20-25-23, additional costs incurred or committed to purchase loans should be

expensed. Furthermore, only certain direct loan origination costs should be deferred under ASC 310-20-25-2. 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

ASC 310-20-35-2 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

ASC 310-20-35 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 re-pricing 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 re-prices periodically.

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

Question 5

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

Staff Response

Credit card fees and related origination costs should be deferred and amortized over the period that the cardholder is entitled to use the card. This is consistent with ASC 310-20-35-5. Normally, the customer is entitled to use the credit card for a period of one to three years. In some cases the actual period of repayment on advances from the card may exceed that period. The amortization period is deemed to be the period that the cardholder may use the card, however, 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. All remaining fee income was deferred, however, 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

May 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 may be offset against the deferred fee income. ASC 310-20-35 requires fees and direct costs of originating a loan commitment to be offset similar to loan origination fees and costs. Legal fees to recover or prevent potential losses, however, are not direct costs of origination under ASC 310-20-25 and should be expensed as incurred.

Question 7

How should premiums and discounts on securities be accounted for?

Staff Response

Premiums and discounts generally should be accounted for as adjustments to the yield of the security. ASC 310-20-35-18 generally requires institutions to follow the "interest method" when amortizing a premium or accreting a discount on a security. A premium must be amortized, and a discount must be accreted from the date of purchase to the maturity date, not an earlier call date.

Question 8

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

Staff Response

Yes. ASC 310-20-35-26 permits expected maturity dates to be used only for holdings of similar debt securities for which prepayments are probable and the timing and amount of the prepayments can be reasonably estimated. In practice, MBSs and CMOs generally meet those conditions. For MBSs, CMOs, and other mortgage related securities that meet the conditions of ASC 310-20-35-26, banks should consider estimates of prepayments in determining the appropriate amortization period for the premium or discount.

Facts A bank purchased a CMO tranche, classified as HTM, 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 ASC 310-20-35-26.

Question 9

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

Staff Response

The bank should calculate a new effective yield on the investment to reflect the actual prepayment results and anticipated future prepayments. The net investment in the CMO should be adjusted to the amount that would have existed had the new amortization rate (effective yield) been applied since acquisition of the CMO. The investment should be adjusted to the new balance with a corresponding charge or credit to the current period's interest income. This method is commonly referred to as the "retroactive" method. The "prospective" method, which amortizes the adjustment into the yield over the remaining life of the security, is not consistent with ASC 310-20-35-26.

Question 10

A 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 ASC 310-20-55 for capitalization, they would be capitalized. All other lending-related costs should be expensed as incurred.

Facts In accordance with ASC 310-20-25-16, a bank capitalized net, direct, origination costs relating to credit card accounts. Subsequently, the bank identifies specific credit card accounts and transfers the receivable balances (but not account relationships) to a revolving credit card securitization trust, which is consolidated by the bank in accordance with ASC 810. The trust issues certificates to third-party investors. The identified credit card accounts are assigned to the trust such that if there are future balances and future collections of fees and finance charges, those balances and collections will be transferred or remitted to the trust. The bank is limited in its ability to remove specific accounts from the trust.

Question 11

How should the deferred origination costs be accounted for at the time of the first transfer?

Staff Response

Because the trust is consolidated under ASC 810-10, the credit card fees and costs should be accounted for under ASC 310-20. The bank has transferred the receivable balances but not the relationship that allows the customer to borrow funds. ASC 310-20-35 requires that credit card fees (and expenses) be deferred and recognized over the period that the cardholder is entitled to use the card. In this context, ASC 310-20-25 considers the origination fees to be loan commitment fees and requires amortization over the period that the cardholder may use the card.

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

Question 12

How should the bank account for its investment in the loans HFS?

Staff Response

The net fees or net costs related to these loans HFS are reported as part of the recorded investment in the loans, the same as they would be for any other loans. Accordingly, the recorded investment in the loans should be $99,000,000 ($100,000,000 less the net fees and costs of $1,000,000). On loans HFS, the loan origination fees and direct loan origination costs are not amortized, however. Consistent with ASC 310-20-25, these fees and costs are deferred until the loan is sold.

Question 13

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

Staff Response

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

Question 14

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

Staff Response

The deferred loan fees are recognized through the ALLL resulting in a reduction of the charge-off. This is because the recorded investment in a loan includes principal, accrued interest, net deferred loan fees or cost, and unamortized premium or discount. Consistent with ASC 310-20-35-2, the deferred loan fees are accreted into income as a yield adjustment over the life of the loan. At the time a loan is charged off, the unamortized deferred loan fees would effectively reduce the recorded investment in the loan and therefore the amount of the charge-off.

2E. Loans Held for Sale

Question 1

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

Staff Response

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

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

Question 2

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

Staff Response

Loans not covered by this guidance include mortgage loans HFS that are subject to ASC 948 and other loans originated with the intent to sell, including syndicated credits and other loans, or portions of other loans, originated with the intent to sell.

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

Question 3

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

Staff Response

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

Question 4

Should the bank also write down the portion of the loan remaining in the loan portfolio?

Staff Response

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

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

Question 5

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

Staff Response

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

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

Question 6

At what point should such loans be transferred to HFS?

Staff Response

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

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

Question 7

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

Staff Response

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

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

Question 8

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

Staff Response

In accordance with ASC 310-20-30-3, the premium is part of the recorded investment in the loan. The bank should compare the loan's recorded investment with its fair value to determine the amount of the write-off. This difference is then recorded as a credit loss, and the loan is written down by that amount, resulting in a new cost basis at the time of the transfer to HFS.

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

Question 9

When should these loans be reported as HFS?

Staff Response

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

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

Question 10

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

Staff Response

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

Question 11

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

Staff Response

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

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

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

Question 12

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

Staff Response

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

Question 13

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

Staff Response

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

Facts At origination (or purchase), a bank intends to sell a portion of a loan and, therefore, designates that portion as HFS. The bank is not successful in selling it.

Question 14

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

Staff Response

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

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

Question 15

Is the unsold portion considered HFS?

Staff Response

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

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

Question 16

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

Staff Response

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

Question 17

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

Staff Response

ASC 310-20 provides accounting guidance for loan origination fees and costs. The net fees or costs are part of the recorded investment in a loan. Under ASC 310-20, the loan origination fees and costs are deferred until the loan is sold (rather than amortized). Therefore, if a loan is transferred to the HFS account, amortization of deferred net origination fees or costs ceases. When the loan is sold, the difference between the sales price and the recorded investment in the loan is the gain or loss on the sale of the loan.

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

Question 18

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

Staff Response

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

Question 19

If a bank sells loans from its permanent loan portfolio that were not previously designated as HFS, are there any "tainting" provisions similar to the treatment for HTM securities under ASC 320-10-25-6?

Staff Response

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

Question 20

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

Staff Response

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

Question 21

Does the response in the previous question apply to the ASC 450-20-60 portion of the ALLL attributed to a group of loans that included loans transferred to the HFS account?

Staff Response

Yes. As noted in the previous question, if the portion of the ALLL attributable to the transferred loan can be determined, the loan transferred to HFS should be recorded net of the ALLL amount. For loans that were evaluated as a group under ASC 450-20-60, the ALLL amount or percentage provided for the group or segment that the loans were evaluated with would normally be used to determine the amount of ALLL to be attributable to the loan or loans.

Question 22

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

Staff Response

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

Question 23

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

Staff Response

The valuation allowance is established when the fair value is below cost for an individual loan or a group of loans. ASC 948-310-35-3 notes that either the aggregate or individual loan basis may be used in determining the lower of cost or fair value for each type of loan.

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

Question 24

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

Staff Response

At a minimum, ASC 948-310-35-3 requires that separate determinations be made for residential and commercial mortgage loans. There is no requirement in GAAP to further disaggregate different types of residential mortgage loans to determine the lower of cost or fair value. It may be reasonable to base such categorization on how management analyzes the portfolio for business purposes, or in a manner similar to that used for mortgage servicing rights stratification.

Question 25

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

Staff Response

This is only appropriate when bank management has the positive intent and ability to hold the loans for the foreseeable future or until maturity and no longer has the intent to sell. The loan must be transferred to the HFI category at the lower of cost or fair value when the bank decides not to sell the loan. This is consistent with the mortgage loan HFI treatment in ASC 948-310-30-4, which states that transfers to a long-term-investment classification shall be transferred at the lower of cost or fair value on the transfer date. The bank must document that management now has the positive intent and ability to hold the loans for the foreseeable future or until maturity. Such documentation should include management's definition of foreseeable future as it relates to the type of loans transferred to the held-to-investment category, which must be consistent for homogenous loans. Additionally, the documentation should include consideration of budgets that support the bank's ability to hold these loans into the foreseeable future.

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

Question 26

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

Staff Response

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

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

Question 27

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

Staff Response

No. ASC 815-10-15-69 states that commitments to originate loans (other than those of mortgage loans that will be HFS) are not subject to ASC 815 and are not accounted for as derivatives with a fair value adjustment.

Question 28

How should this loan commitment be accounted for?

Staff Response

As noted previously, this commitment is not subject to ASC 815 derivative, fair value accounting. This commitment would be accounted for at fair value only if the bank had elected the fair-value option under ASC 825-10-10. Although not recorded at fair value with gains and losses recognized in income, the bank may need to recognize a loss related to this commitment. The determination and consideration of any such loss (i.e., whether market and/or credit changes must be considered) depends on the bank's intent to either sell or hold the loan after origination.

Loan commitments that a bank intends to hold for investment should be evaluated for possible credit impairment in accordance with ASC 450-20-25. Similar to the accounting for loans held for investment, losses on commitments for these loans should be based on credit-related losses, not market-related losses. Loan commitments, or portions of loan commitments, that the company intends to sell should not be considered held for investment.

The Center for Audit Quality (CAQ), a nonprofit trade group comprised primarily of auditors of public companies, released three issue papers referred to as white papers. These papers were intended to help auditors address certain accounting issues that relate to a distressed market environment. They are not authoritative but summarize

existing authoritative guidance and provide some consensus views of the CAQ-member auditors.

The intent is to assist auditors in understanding the application of existing GAAP in the context of illiquid market conditions. One of these papers, titled "Accounting for Underwriting and Loan Commitments," presents two acceptable alternatives for accounting for loan commitments that relate to loans a bank intends to hold for sale (syndicate).

> *Alternative A*—Consistent with ASC 310-10-35-48, the bank would account for these loan commitments at the lower of cost or fair value. The bank would recognize a loss and record a liability to the extent that the terms of the committed loans are below current market terms.
>
> *Alternative B*—The bank would account for these loan commitments under ASC 450-20-25. If it is probable the bank the loan will be funded under the existing terms of the commitment, the bank would immediately recognize a loss and record a liability, because the commitment terms are below the current market terms. It is, therefore, probable a loss has been incurred.

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

Question 29

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

Staff Response

OCC Advisory Letter 99-4 (AL 99-4) states, "Agent banks should clearly define their hold level before syndication efforts begin." Generally there is no prohibition in GAAP for a bank changing its intent to sell. To comply with AL 99-4, however, sufficient documentation of the bank's reasons for changing its intent should be completed in a timely manner. This would include the bank's rationale for the change. It would also contain the bank's analysis from a credit- and interest-rate-risk perspective of how the intent change is consistent with the bank's overall risk management policies and procedures.

Question 30

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

Staff Response

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

Question 31

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

Staff Response

The answer again depends on whether the bank changed its intent. If the bank can demonstrate that during the commitment phase and once funded the loan is now held for investment, the bank will not recognize the further decline in the fair value of the loan (unless the fair-value option has been elected). Similar to the guidance in ASC 310-10-35-47, nonmortgage loans should be accounted for only as held for investment, if management has the intent and ability to hold for the foreseeable future or until maturity or payoff.

2F. Loan Recoveries

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

Question 1

Because the actuarial studies indicate death will result in three years, may 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. ASC 450-30-25-1 indicates that contingent gains are usually not booked, because doing so may result in revenue recognition prior to its realization. Because the bank can currently realize the cash surrender value of the policy, however, a loan loss recovery of $250,000 should be recorded at the transfer date.

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

Question 2

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

Staff Response

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

Facts A bank made a $500,000 unsecured loan to a corporation that is 100 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 precluded from disposing of the property.

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

Question 3

May 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. Because $500,000 of the loan has been previously charged off, only the $400,000 amount would be included in the recorded loan amount. Recovery of the previously charged-off portion is not appropriate, until it is converted into cash or cash equivalents. Further, because of the financial condition of the borrower and the uncertainty of loan collectibility, income on the loan should not be accrued.

Facts A bank sells loan receivables with a contractual balance of $100,000 for $5,000 to an independent third party. The receivables had been previously charged off through the ALLL four months prior and therefore have a current book value of $0.

Question 4

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

Staff Response

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

Facts A loan secured by business assets defaulted in year three (2008) of the loan term, and the uncollectible amount of the loan was charged off. After unsuccessfully attempting to recover its investment from guarantors and other businesses operated by the borrower, the bank began legal proceedings to recover its investment. The circuit court's judgment favored the bank; however, the borrower pursued an appeal. After the appellate court upheld the circuit court decision, the case progressed to the state supreme court. Following the appellate court's ruling, the borrower was required to obtain bond insurance to stay the judgment. The court's final judgment, which was issued in December 2010, ordered the borrower to pay the outstanding loan balance plus accrued interest totaling $5.2 million. The insurance company was notified, and the insurer paid the bank during January 2011.

Question 5

In what period should the bank record its recovery of $5.2 million?

Staff Response

The bank should record a receivable and a recovery as of December 2010, because the judicial process was complete and the payment was guaranteed by the insurance company. Receipt of the $5.2 million in January 2011 was a subsequent event that confirmed the recovery had been realized and that payment was assured.

At December 2010, the recovery from the insurance company represents a contingent gain. In accordance with ASC 450-30-25, gain contingencies usually should not be reflected in the financial statements, because to do so might result in the recognition of revenue prior to its realization. If realization of payment is assured, however, the recovery may be recognized. In accordance with ASC 855-10-25, banks should recognize in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the balance sheet date.

In this situation, the borrower obtained the bond insurance and, therefore, realization of payment was assured in December 2010. Situations in which the lender has insurance on a loan that subsequently defaults are discussed in Topic 5A, question 30.

2G. Acquired Loans

Facts Bank A acquires Bank B in a transaction accounted for under the acquisition method in accordance with ASC 805. The loan portfolio acquired includes both performing and impaired loans.

Question 1

How should the bank account for the acquired loans?

Staff Response

ASC 805 does not allow an acquirer to carry over the acquiree's previous ALLL. Rather, the acquired loans are recorded at fair value as of the acquisition date. Any credit impairment and cash-flow uncertainty is considered in the fair-value measurements. Fair values should be measured in accordance with ASC 820-10 (see Topic 11D), which states that fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date.

There are three methods to account for acquired loans. The bank may elect the fair-value option for any acquired loan. If the fair-value option is not elected, the bank should account for the acquired loans in accordance with ASC 310-20 or 310-30, as appropriate. Purchased loans with evidence of credit deterioration since origination should be accounted for in accordance with ASC 310-30, which requires income recognition based on expected cash flows. Loans within the scope of ASC 310-30 are commonly referred to as purchased credit impaired (PCI) loans. All other loans acquired (i.e., loans outside the scope of ASC 310-30) should recognize interest income in accordance with ASC 310-20, which requires income recognition based on contractual cash flows, absent an election for these loans under the ASC 310-30 model, described as follows.

In December 2009, the AICPA issued a public letter to the SEC confirming that the SEC staff did not object to the application of ASC 310-30 accounting for interest income recognition on purchased loans that do not fall within the scope of ASC 310-

30. If an entity makes this election, it must be disclosed in the financial statements, and ASC 310-30 must be applied consistently and in its entirety. As such, the OCA staff does not object to an accounting policy election that recognizes interest income based on expected cash flows under the ASC 310-30 model for all acquired loans.

Credit deterioration on any loan incurred subsequent to the acquisition date should be recognized in the ALLL through the provision.

Question 2

Should the fair value of the loan portfolio acquired in a business combination be determined on a loan-by-loan basis or may it be determined for the entire loan portfolio?

Staff Response

The fair value of the loan portfolio should be determined on a loan-by-loan basis as of the acquisition date. As discussed in question 1, the fair value of the loans should be measured in accordance with ASC 820-10. The staff believes it is acceptable in practice to determine the fair value of a loan pool consisting of loans with similar risk characteristics and then allocate a fair value to the loans within the pool on a pro rata basis.

Facts A bank acquires a loan in a business combination. At the time of the acquisition, relevant credit information is reviewed and the loan is recorded at fair value. The loan subsequently becomes uncollectible, however, and is charged off.

Question 3

How should this subsequent charge-off be recorded?

Staff Response

It depends. If the loan is within the scope of ASC 310-30, the bank should revise the cash flows it expects to collect and compare that amount with the carrying value of the loan. The excess of the carrying amount over cash flows expected to be collected is recorded against the nonaccretable amount. Any charge-off that is not accounted for within the nonaccretable amount should be recorded against the ALLL. If the loan is accounted for in accordance with ASC 310-20, the charge-off is recorded against the ALLL, which should have been previously established for credit deterioration incurred subsequent to the acquisition date. If needed, a provision for loan loss should be recorded to restore the bank's allowance to an adequate level.

It is not appropriate to revise the fair value assigned to the loan at acquisition, 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 measurement period. Otherwise, subsequent loan activity is reflected in the

appropriate subsequent period's financial statements.

Facts The bank acquires a portfolio of short-term loans from another bank in a transaction accounted for as a business combination. The bank records the acquired loans at fair value, which is substantially less than the acquired loans' contractual amount outstanding. The bank attributes the loans' discounted fair values to market dislocation (rather than credit deterioration). The bank has concluded that it is probable all contractual cash flows will be collected in accordance with the loan agreement. This conclusion is based on the bank's intent to refinance, rather than actually collect, most of the loans at maturity.

Question 4

Are the acquired loans within the scope of ASC 310-30?

Staff Response

Yes. Based on the fact pattern described previously, the staff presumes that the acquired loans are within the scope of ASC 310-30. First, the substantial discount recognized by the bank, despite the relatively short-term nature of the loans, strongly suggests the acquired loans have experienced credit deterioration since origination. Second, the bank has not demonstrated it can actually collect all contractually required payments receivable, as required by the standard.

The bank may overcome the staff's presumption with clear documentation supporting the borrower's ability to actually repay the loan at maturity. This documentation should be prepared as part of the ASC 310-30 scope analysis. Support for such a determination may include recent financial statements indicating the borrower has sufficient liquid assets to meet the obligation, or documentation showing the borrower has the ability to refinance with another institution at maturity, if necessary. The documentation should also address the differences in the valuation applied to the acquired loans and the dislocation in the market.

Even if the bank determines the acquired loans are not specifically within the scope of ASC 310-30, the staff would not object to the bank electing to account for the acquired loans in accordance with ASC 310-30. As noted in question 1, if an entity makes this election, the election must be disclosed in the financial statements, and ASC 310-30 must be applied consistently and in its entirety.

UPDATE

Facts A bank purchases a failed bank in an FDIC-assisted acquisition. The bank elects to account for all of the acquired loans in accordance with ASC 310-30 (see question 1).

UPDATE

Question 5

Can the bank aggregate PCI loans with loans that are not individually within the scope of ASC 310-30 but are accounted for using an expected cash flow approach through a policy election?

Staff Response

No. ASC 310-30 allows for aggregation of loans acquired in the same fiscal quarter that have common risk characteristics, which is defined as loans with similar credit risk or risk ratings and one or more predominant risk characteristics. For a loan to be eligible for aggregation in a common pool, a determination should first be made as to whether the loan meets the scope criteria in ASC 310-30-15-2. PCI loans individually within the scope of ASC 310-30 do not share similar credit risk characteristics with loans that do not individually meet the scope of ASC 310-30 but are accounted for using an expected cash flows approach through a policy election (see question 1).

Facts A bank purchases another bank and elects to account for all the acquired loans in accordance with ASC 310-30 (see questions 1 and 5). The bank aggregates or pools the acquired loans solely by collateral type.

Question 6

Is it appropriate for the bank to aggregate loans solely by collateral type?

Staff Response

No. The common risk factors by which loans are aggregated into pools include: (1) similar credit risk or risk ratings, and (2) one or more predominant risk characteristics. The determination of similar credit risk and which or how many predominant risk characteristics should be used to aggregate acquired loans into pools requires significant judgment. The institution must document the decisions reached and the basis for those decisions.

Similar Credit Risk or Risk Ratings

Metrics that can be considered for determining similar credit risk or risk rating include:

- Past-due status
- Risk grading
- Relative amount of fair value discount attributed to credit
- Other factors as supported by the acquiring institution

Whatever metric is used, the acquiring institution must document why that metric was selected and why it is appropriate for its population of acquired loans.

This analysis should be performed uniquely for each asset purchase or business combination.

With regard to using these metrics, pools should be differentiated based on where changes in the metrics correspond to significant changes in expected credit losses. For instance, it is generally inappropriate to pool criticized and classified loans with "pass" rated credits.

One or More Predominant Risk Characteristics

Metrics that can be used for determining similar predominant risk characteristics include:

- Collateral type
- Geography
- Industry
- Fixed/Variable Rate
- Loan size
- Other factors as supported by the acquiring institution

The acquiring institution must document its analysis of which, and how many, metrics are used to determine predominant risk characteristics. This analysis should be performed uniquely for each asset purchase or business combination.

Collateral type is a common, and often reasonable, metric selected as the predominant risk characteristic. Commercial loans, however, should be analyzed carefully, as the risks in this collateral type can be quite diverse, and further differentiation within the commercial collateral type may be required. Judgment must be exercised in the determination of which and how many characteristics should be considered.

Facts A bank acquires another bank and elects to pool certain PCI loans. Upon acquisition, the bank determined that one of the acquired PCI loan pools had an accretable yield of 6.5%. At a subsequent financial reporting date, the bank estimates a decline in the cash flows expected to be collected on this pool. The decline in cash flows reduces the pool's remaining period prospective effective yield to 6.0%. The bank determines the reduction in the yield is solely the result of a change in the index on variable rate loans included in the pool.

Question 7

Should the bank recognize credit impairment for the current quarter?

Staff Response

No. Decreases in expected cash flows and the accretable yield resulting from changes in a variable interest rate index are not considered credit impairment under ASC

310-30 as this portion of the reduced cash flow is the result of the declining interest rate spread. Rather, decreases in cash flows expected to be collected resulting directly from a change in the contractual interest rate should be recognized prospectively as a change in estimate by reducing all the cash flows expected to be collected at acquisition and the accretable yield. It is important to note, however, that if any portion of a decline in the expected cash flows resulted from a credit event, the bank must recognize impairment for the reduced cash flows not related to the change in the variable rate index.

UPDATE

Question 8

If a bank restructures a PCI loan after acquisition, is it subject to TDR accounting?

Staff Response

It depends on whether the restructured PCI loan is accounted for individually or within a pool of loans with similar risk characteristics. PCI loans may be accounted for individually or within a pool. Accounting for PCI loans within a pool requires loans to share common risk characteristics, to be treated as one unit of account and to be maintained within a closed pool.

A loan accounted for individually under ASC 310-30 (i.e., not accounted for in a closed pool of loans under ASC 310-30 with other loans that share common risk characteristics) is subject to the TDR accounting requirements (ASC 310-40) when restructured after acquisition (see question 9).

As explained in ASC 310-40-15-11d and ASC 310-30-40-1, modifications of loans accounted for within a pool with similar risk characteristics in accordance with ASC 310-30 are not subject to the TDR guidance in ASC 310-40. Rather, the revised estimated future cash flows of the individually modified loan are included in the estimated future cash flows of the pool.

NEW

Question 9

For PCI loans subject to TDR accounting, when does a modification of an individual PCI loan constitute a TDR?

Staff Response

ASC 310-40-15-13 states that a creditor has granted a concession when, as a result of the restructuring, it does not expect to collect all amounts due. However, ASC 310-40 is not specific on how to apply this concept to an individual PCI loan. In accordance with ASC 310-30-35-10[a], a PCI loan is impaired if it is probable that the creditor is unable to collect all cash flows expected at acquisition plus additional cash flows expected to be collected arising from changes in estimate after acquisition. Therefore, in determining whether the modification of the individual loan is a TDR, the post-modification expected cash flows should be evaluated against the cash flow estimate at acquisition plus any increase in expected cash flows since acquisition (hereinafter referred to as pre-modification expected cash flows). The creditor should consider all aspects of the restructuring in determining whether it has granted a concession

NEW

and is a TDR. If the modification results in a decrease in expected cash flows when compared to the pre-modification expected cash flows, without any other changes to the agreement to consider, then the creditor has granted a concession that would result in a TDR.

Topic 3 Leases

3A. Lease Classification and Accounting

Question 1

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

Staff Response

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

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

Question 2

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

Staff Response

In accordance with ASC 840-10-25, the bank must meet the following criteria for capital lease recognition:

- First, according to paragraph ASC 840-10-25-1, *at least one* of the following must be met:
  - The lease transfers ownership of the property to the lessee.
  - The lease contains a bargain purchase option.
  - The lease term equals or exceeds 75 percent of the economic life of the property.
  - The present value of the minimum lease payments equals or exceeds 90 percent of the fair value of the property at the inception of the lease.
- In addition, according to paragraph ASC 840-10-25-42, *both* of the following must be met:
  - Collectibility of payments is reasonably predictable.
  - There are no important uncertainties surrounding the amount of unreimbursable cost yet to be incurred by the lessor.

Question 3

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

Staff Response

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

Question 4

How is a capital lease recorded on the balance sheet?

Staff Response

The sum of the minimum lease payments (as defined in ASC 840-30-30-6) plus the unguaranteed residual value accruing to the benefit of the lessor is recorded in loans and lease financing receivables (net of unearned income).

Question 5

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

Staff Response

ASC 840-10-20 defines estimated residual value as the estimated fair value of the leased property at the end of the lease. In this context, the statement defines fair value as the price at which the property could be sold in an arm's length transaction between unrelated parties. The guidance for determining the fair value of leased property included in ASC 840-10-55 differs in certain aspects from that included in ASC 820-10, which specifically scopes out accounting principles that address fair-value measurements for purposes of lease classification or measurement under ASC 840. ASC 820-10 requires that lessors' capitalized leases be accounted for under ASC 840-30.

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

Question 6

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

Staff Response

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

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

Question 7

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

Staff Response

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

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

Question 8

How should the residual value of this property be determined?

Staff Response

The residual value is the price at which the property could be sold in an arms-length transaction at the termination of the lease. The present value of future lease payments

may be used in determining residual value only when they are required by a lease or other legal agreement. It is not appropriate, under ASC 840-10, to use the present value of the expected future lease payments for periods that are not covered by the lease or other legal agreement.

UPDATE

Facts The bank (lessor) has a portfolio of automobile leases. To classify these leases, it calculates whether the minimum-lease-payments criterion is satisfied. The bank purchased an insurance policy that guarantees the required minimum residual value on a portfolio basis. That is, the guarantee is for a portfolio of leased automobiles that are subject to separate leases but not for any individual lease.

The minimum-lease-payments percentage (present value of the minimum lease payments divided by fair value of the individual leased automobile at the lease inception), without including the effects of the insurance contract, is 95 percent on half of the automobiles in the portfolio and 85 percent on the other half. If the insurance contract covered each individual automobile, the bank would receive a payment from the insurance company on those automobiles for which the minimum lease payment was only 85 percent. In this case, however, the insurance contract has been written to guarantee only 9 percent of the residual value of the portfolio as a whole. Therefore, the bank may not be entitled to any payment from the insurance company.

Question 9

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

Staff Response

No. ASC 840 requires that the determination of the lease classification be performed on a lease-by-lease basis. The residual value guarantees of a portfolio of leased assets may preclude a lessor from determining the amount of the guaranteed residual value of any individual leased asset within the portfolio at the inception of the lease. Accordingly, the guarantee from the insurance contract should not be included in the minimum lease payments in accordance with ASC 840-30-S99-1 (SEC Staff Announcement: Lessor Consideration of Third-Party Value Guarantee).

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

Question 10

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

Staff Response

ASC 840 requires that the calculation of the minimum lease payments be performed at the inception of the lease. Therefore, this guarantee would not be included in the calculation. Any previously issued financial statements should be revised accordingly, if material.

Question 11

May a methodology consistent with ASC 310-10-35 be used to measure impairment for direct financing leases?

Staff Response

Yes. While direct financing leases are excluded from ASC 310-10-35, bank management may use a methodology consistent with ASC 310-10-35. Direct financing leases have many similar characteristics to loans. The methodology for estimating impairment contained in ASC 310-10-35 is consistent with the guidance that applies to long-lived assets in ASC 360-10-35.

3B. Sale-Leaseback Transactions

ASC 840-40 requires that sale-leaseback transactions involving real estate qualify as sales under the provisions of ASC 360-20. If a transaction does not qualify as a sale, it would be accounted for as financing or using the deposit method. Accordingly, in the following examples, it is assumed that the transactions qualify for sales recognition under ASC 840-40.

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

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

ASC 840-40-25 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), because 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 because 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 and leaseback. The bank's ability to pay future dividends has decreased, however, 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 short term (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 based on 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.

ASC 840-40-25 requires that the resulting gains (from the increase to fair value) be deferred and amortized over the minimum lease term. In a related-party lease, however, the stated lease term often does not represent the intent of the parties. This is 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 believes the gains resulting from related-party, sale-leaseback transactions should 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 because 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 that, as in question 3, would be deferred and amortized over the remaining useful life of the building. Capital has not been reduced, because a dividend is not involved, and the building was actually sold to the holding company for cash. The deferral of the gain, however, results in no immediate increase to capital.

Question 5

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

Staff Response

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

Question 6

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

Staff Response

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

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

3C. Lease Cancellations

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

Question 1

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

Staff Response

ASC 420-10 provides guidance on how to account for costs associated with exit or disposal activities. ASC 420-10 requires the bank to recognize a liability on the date that the bank closes the branch for the lease costs that will be incurred without economic benefit.

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

Question 2

How should the loss be determined?

Staff Response

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

Question 3

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

Staff Response

No. The decision to stop using leased equipment has the same economic effect as abandoning a branch site. The leased equipment has no substantial future use or benefit. Consequently, the remaining lease payments, reduced by any estimated sublease rental that could reasonably be obtained, should be recognized as a loss. This conclusion is consistent with ASC 420-10.

Topic 4 Allowance for Loan and Lease Losses

Question 1

Regulatory guidance included in the *Comptroller's Handbook* booklet "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 booklet does not introduce a new concept to estimate the ALLL. Rather, it describes the use of concepts developed in ASC 450, a process that bankers, accountants, and examiners have performed for years.

"Inherent losses" are losses that meet the criteria in ASC 450 for recognition of a charge to income. This requires a conclusion that an asset has probably been impaired. Proper accounting recognition of 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

What are "estimated credit losses?"

Staff Response

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

ASC 450-20-25 requires the accrual of a loss contingency when information available prior to the issuance of the financial statements indicates it is probable that an asset has been impaired at the date of the financial statements, and the amount of loss can

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

Under ASC 310-10-35, an individual loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. It is implicit in these conditions that it must be probable that one or more future events ("confirming event") will occur confirming the fact of the loss.

Question 3

How should a bank identify loans to be individually evaluated for impairment under ASC 310-10?

Staff Response

Determining loan impairment is a multi-step process. First, the bank must set the criteria for determining loans to be reviewed for impairment under ASC 310-10-35. Second, based on those criteria, the bank would identify the loans to be individually evaluated for impairment. Finally, the selected loans are reviewed for impairment.

ASC 310-10-35-14 identifies the following sources of information that is useful in identifying loans for individual evaluation for impairment:

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

Question 4

What documentation should a bank maintain to support its measurement of impairment on an individually impaired loan under ASC 310-10?

Staff Response

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

For example, for collateral-dependent loans for which a bank must use the fair value of collateral method, the institution should document

- how fair value was determined including the use of appraisals.
- valuation assumptions.
- calculations.
- the supporting rationale for adjustments to appraised values, if any.
- the determination of costs to sell, if applicable.
- quality, expertise, and independence of the appraisal.

This is consistent with the 2001 Policy Statement, which discusses the supporting documentation needed.

Question 5

Are large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment within the scope of ASC 310-10-35?

Staff Response

Generally, no. Large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment are not included in the scope of ASC 310-10-35. Such groups of loans may include, but are not limited to, "smaller" commercial loans, credit card loans, residential mortgages, and consumer installment loans. ASC 310-10-35 would apply, however, if the terms of any of these loans were modified in a troubled debt restructuring, as defined by ASC 310-40-15. Otherwise, the relevant accounting guidance for these groups of smaller-balance homogeneous loans is contained in ASC 450-20.

Question 6

May "larger" versus "smaller" balance loans be quantified to identify loans that should be evaluated for impairment under ASC 310-10?

Staff Response

A single-size test for all loans is impractical because a loan that may be relatively

large for one bank may be relatively small for another. Deciding whether to individually evaluate a loan is subjective and requires a bank to consider the individual facts and circumstances, along with its normal review procedures in making that judgment. In addition, the bank should appropriately document the method and process for identifying loans to be evaluated under ASC 310-10.

Question 7

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

Staff Response

There are valid reasons to review a loan individually rather than in a pool of loans. Loans should be evaluated separately when sufficient information exists to make a reasonable estimate of the inherent loss. Individual loan review is generally applicable for large or otherwise significant (i.e., classified doubtful) credits, loans to companies in a deteriorating industry, or a combination of the above. In such situations, substantial information on the credit should be available, and a separate review is appropriate. If an individually analyzed loan is determined to be impaired, it should be specifically allocated for, in accordance with ASC 310-10-35, and not as part of the pool.

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

Question 8

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 a potential loss. Further, in substandard loans, inherent loss generally cannot be identified on a loan-by-loan basis.

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

Question 9

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 from 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. External events, such as changes in the local or national economy, however, may also signal problems for a pool of loans before one can see change in delinquency rates.

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

Question 10

May banks project or forecast changes in facts and circumstances that arise after the balance sheet date, when estimating the amount of loss under ASC 450-20 in a group of loans with similar risk characteristics at the balance sheet date?

Staff Response

No. ASC 450-20-25 only allows the recognition of estimated losses at the measurement date based on the facts and circumstances present at the date. In developing loss measurements for groups of loans with similar risk characteristics, a bank should consider the impact of current qualitative or environmental factors that exist as of the balance sheet date. It should also document how those factors were used in the analysis and how they affect the loss measurements. For any adjustments to the historical loss rate reflecting current environmental factors, a bank should support and reasonably document the amount of its adjustments and how the adjustments reflect current information, events, circumstances, and conditions. Questions 11 through 16 illustrate this concept.

Facts A bank evaluates a real estate loan for estimated credit loss. The loan was made during a recent boom period for the real estate industry. Both the general real estate market and the loan, however, 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. It is not possible at this time, however, to determine whether local real estate properties will experience additional declines in value.

Question 11

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

Staff Response

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

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

Question 12

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 continual basis, the bank should review the concentrations of credit risk arising from its loans to businesses and individuals associated with or dependent upon the military 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. A concentration of credit centered on the military base, however, is relevant to the assessment of the bank's capital adequacy.

Question 13

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

Staff Response

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

Question 14

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

Staff Response

A loss event has now occurred that probably will result in the bank subsequently charging off loans to a number of its borrowers. The bank's loan review system should identify those significant, individual borrowers that should be evaluated for impairment under ASC 310-10-35. This standard requires that loan impairment be measured based on the present value of the expected future cash flows discounted at the loan's effective interest rate.

As a practical expedient, however, ASC 310-10-35-22 allows the use of the loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. In reviewing the loan portfolio, the bank should address issues, such as the effect of the closing on

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

For loans previously identified as impaired, an increased provision to the ALLL may be warranted, depending on whether the base closing affects the bank's estimate of the probable loss on these credits. For loans reviewed under ASC 450-20, the bank should begin to adjust the historical loss rates as its estimates of probable loss increase for smaller criticized loans in a pool of similar loans, especially those credits that are currently performing and not criticized but that are likely to be affected adversely by the base closing. The bank should review and monitor such credits. Although the amount of probable loss on those individual credits cannot be estimated yet, it can be measured for pools of similar loans. Those pools should encompass all loans not identified as individually impaired that are expected to be affected by the base closing, including loans in the commercial, real estate, and consumer portfolios. The more homogeneous are the pools, the easier it will be to analyze and adjust the historical loss rates. The ALLL should reflect the probable increased exposure to loss arising from loans to this group of borrowers.

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

Question 15

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

Facts Assume the same facts as in question 12, except that six months after the military base closes, state government officials announce the former base site will be converted into a new minimum security prison. Conversion of the site will begin in three months, and the prison will open in 12 months.

Question 16

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

Staff Response

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

- Will the business opportunities provided by the new facility improve repayment prospects?
- What will be the effect of the new facility on local employment?
- What will be its effect on the demand for residential and commercial real estate?

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

Question 17

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

Staff Response

Pool analysis is used because there is generally insufficient information to reach loan-by-loan conclusions about the exposure to loss on substandard loans. Accordingly, adequate measurement of the inherent loss may require a pool analysis. As noted in question 8, 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. The assertion that individually analyzed substandard loans require a level of allowances that is significantly below the historical loss rate for pools of similar loans, however, must be supported clearly by the nature of the collateral or other circumstances that distinguish the loan from similarly classified credits.

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

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

Question 18

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

Staff Response

Given the definition, a substandard loan that is individually evaluated for impairment under ASC 310-10-35 (and that is not the remaining recorded investment in a loan that has been partially charged off) would not automatically meet the definition of

impaired. If a substandard loan is significantly past due or is in nonaccrual status, however, the borrower's performance and condition provide evidence that the loan is impaired. That is, it is probable the bank will be unable to collect all amounts due according to the contractual terms of the loan agreement. An individually evaluated substandard loan that is determined to be impaired must have its allowance measured in accordance with ASC 310-10-35.

For substandard loans that are not determined to be impaired in accordance with ASC 310-10-35, experience has shown that there are probable incurred losses associated with a group of substandard loans that must be provided for in the ALLL under ASC 450. Many banks maintain records of their historical loss experience for loans that fall into the regulatory substandard category. A group analysis based on historical experience, adjusted for qualitative or environmental factors, is useful for such loans.

For groups of loans with similar risk characteristics that include both loans classified substandard (and not determined to be impaired) and loans that are not adversely classified, the bank should separately track and analyze the substandard loans in the group. This analysis will aid in determining whether the volume and severity of these adversely classified loans differ from such loans during the period over which the bank's historical loss experience was developed. This will aid in determining the qualitative adjustment necessary for the group of loans under ASC 450.

Question 19

Assume a substandard credit has its ALLL allocation measured in accordance with ASC 310-10-35. Does a percentage relationship between the allocation amount and loan balance suggest the assignment of nonaccrual status and/or doubtful classification?

Staff Response

There is no allocation percentage that would automatically require a doubtful classification and/or nonaccrual status for a substandard loan. Specific allocations for individual substandard loans measured in accordance with ASC 310-10-35, however, raise some difficult questions. First, doesn't a bank's estimate of the amount of allowance necessary for the loan present prima facie evidence that there is doubt about its collectibility? Further, if there is doubt about its collectibility, shouldn't the loan be classified doubtful and put on nonaccrual? While the response to the nonaccrual issue is straightforward, the classification issue is more difficult. With respect to the nonaccrual issue, the call report instructions require that a bank not accrue interest on any loan for which payment in full of principal or interest is not expected. If a loan has been determined to be impaired, doubt of collectibility in accordance with its contractual terms therefore exists. This requires the loan to be placed on nonaccrual in accordance with the call report instructions.

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

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

Loans are classified 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 or guarantees, for example, is necessary. Exposure to loss on a large, unsecured substandard loan may be substantially greater than on a similarly sized substandard loan that is secured by real estate.

Question 20

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, and seasoning of loans. The staff has not identified any particular form of migration analysis as being the best, or most appropriate, for all banks.

Question 21

If a bank concludes that an individual loan specifically identified for evaluation is *not* impaired under ASC 310-10-35, should that loan be included in the assessment of the ALLL under ASC 450-20-25?

Staff Response

Yes, that loan should be evaluated under ASC 450-20-25. If the specific characteristics of the individually evaluated loan that is not impaired indicate that it is probable that there would be an incurred loss in a group of loans with those characteristics, the loan should be included in the assessment of the ALLL for that group of loans under ASC 450-20-25. Banks should measure estimated credit losses under ASC 310-10-35 only for loans individually evaluated and determined to be impaired.

Under ASC 450-20-25 a loss is recognized if characteristics of a loan indicate that it is probable that a group of similar loans includes some estimated credit losses even though the loss cannot be identified to a specific loan. Such a loss would be

recognized if it is probable that the loss has been incurred at the date of the financial statements and the amount of loss can be reasonably estimated. This response is consistent with ASC 310-10-35-35.

Question 22

If a bank assesses an individual loan under ASC 310-10-35 and determines that it is impaired, but it measures the amount of impairment as zero, should that loan be included in the assessment of the ALLL under ASC 450-20-25?

Staff Response

No. For an impaired loan, no additional loss recognition is appropriate under ASC 450-20-25 even if the measurement of impairment under ASC 310-10-35 results in no allowance. An example would be when the recorded investment in the impaired loan has been written down to a level where no allowance is required. This response is consistent with ASC 310-10-35-35.

Before concluding that an impaired ASC 310-10-35 loan needs no associated loss allowance, however, the bank should determine and document that its measurement process is appropriate and that it considered all available and relevant information. For example, for a collateral-dependent loan, the following factors should be considered in the measurement of impairment under the fair value of collateral method:

- Volatility of the fair value of the collateral
- Timing and reliability of the appraisal or other valuation
- Timing of the bank's or third party's inspection of the collateral
- Confidence in the bank's lien on the collateral
- Historical losses on similar loans
- Other factors as appropriate for the loan type

This response is consistent with the "Policy Statement on the Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions" (2001 Policy Statement), Question 3, and ASC 310-10-S99-4.

Question 23

Is the practice of "layering" the ALLL appropriate?

Staff Response

No. Layering is the inappropriate practice of recording in the ALLL more than one amount for the same estimated credit loss. When measuring and documenting estimated credit losses, banks should take steps to prevent the layering of loan loss allowances. For example, it is inappropriate to include a loan in one loan category,

determine that the best estimate of loss for that particular loan category, and then include the same loan in another loan category, which receives an additional ALLL amount.

Another example of inappropriate layering occurs when an allowance has been measured for a loan under ASC 310-10-35, but the loan is then included in a group of loans with similar risk characteristics for which an ALLL is estimated under ASC 450-20-25. The allowance provided for an individually impaired loan under ASC 310-10-35 should not be supplemented by an additional allowance under ASC 450-20-25. Inappropriate layering occurs when a bank includes a loan in two different pools of loans (i.e., ASC 310-10-35 and ASC 450-20-25) to provide an allowance. When measuring and documenting estimated credit losses, banks should take steps to prevent the layering of loan loss allowances. This is consistent with the 2001 Policy Statement, Appendix B.

Question 24

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 un-criticized loans?

Staff Response

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

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

Migration analysis is often applied to pools of past-due or classified loans, because, as their classification indicates, a loss event has probably already occurred.

Question 25

Is it appropriate to estimate an ALLL for pass loans?

Staff Response

Yes. In determining an appropriate level for the ALLL, a bank must analyze the entire loan and lease portfolio for probable losses that have been incurred that can be reasonably estimated. A loan designated pass generally would not be impaired if individually evaluated. If, however, the specific characteristics of such a loan indicate that it is probable that there would be an estimated credit loss in a group of loans with similar characteristics, then the loan should be included in the assessment of the ALLL for that group of loans under ASC 450-20-25.

Under ASC 450-20-25, the determination of estimated credit losses may be considered for individual loans or relative to groups of loans with similar characteristics. This determination should be made on a group basis, even though the loans that are uncollectible in the group may not be individually identifiable. Accordingly, the ALLL for a group of loans with similar risk characteristics, which includes loans designated as pass, should be measured under ASC 450-20-25.

Question 26

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

Staff Response

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

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

Question 27

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

Staff Response

As noted in the 2006 Policy Statement, banks should support adjustments to historical loss rates and explain how the adjustments reflect current information, events, circumstances, and conditions in the loss measurements. Management should maintain reasonable documentation to support factors that affected the analysis and the impact of those factors on the loss measurement. Support and documentation include the following:

- Descriptions of each factor
- Management's analysis of how each factor has changed over time
- Which loan groups' loss rates have been adjusted
- The amount by which loss estimates have been adjusted for changes in conditions
- An explanation of how management estimated the impact
- Other available data that supports the reasonableness of the adjustments

Examples of underlying supporting evidence could include, but are not limited to, relevant articles from newspapers and other publications that describe economic events affecting a particular geographic area, economic reports and data, and notes from discussions with borrowers.

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

Question 28

If a bank measures impairment based on the present value of expected future cash flows for ASC 310-10-35 purposes, what factors should be considered when estimating the cash flows?

Staff Response

The bank should consider all available information reflecting past events and current conditions when developing its estimate of expected future cash flows. All available information would include a best estimate of future cash flows, taking into account existing "environmental" factors (e.g., existing industry, geographical, economic, and political factors) that are relevant to the collectibility of that loan. This response is consistent with ASC 310-10-35-27.

UPDATE

Facts To measure impairment on an individually impaired collateral dependent loan, a bank uses the most recent appraised value of the collateral (less costs to sell, if applicable), and then compares it to the recorded investment in the loan reflecting any previous direct write-down of the investment.

Question 29

Should the bank use the most recent appraised value (less costs to sell, if applicable) to measure impairment on an individually impaired collateral dependent loan?

Staff Response

Depending on the facts and circumstances including how recent the appraisal is, the most recent appraised value may differ from the fair value of the collateral as of the

UPDATE

balance sheet date.

The bank should measure impairment on the impaired collateral dependent loan based on the fair value of the collateral (adjusted for costs to sell if the loan repayment depends on sale of the collateral). Although the bank should consider the appraised value of the collateral as the starting point for determining its fair value, the bank should also consider other factors and events (e.g., changes in market conditions or property use) subsequent to the appraisal date that may affect the fair value of the collateral as of the balance sheet date.

Facts Some banks remove loans that become adversely classified from a group of "pass" loans with similar risk characteristics to evaluate the loans individually under ASC 310-10-35 (if deemed impaired) or collectively in a group of adversely classified loans with similar risk characteristics under ASC 450-20.

Question 30

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

Staff Response

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

Question 31

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

Staff Response

Yes, the ALLL may include an amount labeled as unallocated as long as it reflects estimated loan losses determined in accordance with GAAP and is properly supported. The term "unallocated" is not defined in GAAP but has various meanings in practice. For example, some banks refer to the portion of the ALLL based on qualitative or environmental factors as unallocated, while others consider those adjustments to be an element of the allocated ALLL under ASC 450-20. Still others believe unallocated refers to any ALLL amounts that are not attributable to or were not measured on any particular groups of loans.

Economic developments that surface between the time management estimates credit losses and the date of the financial statements, as well as certain other factors such as natural disasters that occur before the date of the financial statements, are examples

of environmental factors that may cause losses that apply to the portfolio as a whole. Such factors are difficult to attribute to individual impaired loans or to specific groups of loans and, as a consequence, result in an unallocated amount.

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

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

Question 32

Is there a specific period of time that should be used when developing the historical loss experience for groups of loans to estimate the ASC 450-20 portions of the ALLL?

Staff Response

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

A bank should maintain supporting documentation for the techniques used to develop its loss rates. Such documentation includes evidence of the average and range of historical loss rates (including gross charge-offs and recoveries) by common risk characteristics (e.g., type of loan, loan grade, and past-due status) over the historical period used. At larger banks, this information is often segmented further by originating branch office or geographic area. A bank's supporting documentation should include an analysis of how the current conditions compare with those conditions during the period used in the historical loss rates for each group of loans assessed under ASC 450-20. A bank should review the range of historical losses over the period used, rather than relying solely on the average historical loss rate, and should identify the appropriate historical loss rate from within that range to use

in estimating credit losses for the groups of loans. This ensures that the appropriate historical experience is captured and is relevant to the bank's current portfolio.

Question 33

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

Staff Response

As noted in the 2006 Policy Statement, historical loss experience provides a reasonable starting point for the bank's analysis. Historical losses, or even recent trends in losses, however, are not by themselves a sufficient basis to determine the appropriate level for the ALLL. Because the bank's historical loss experience is minimal, any ASC 450-20 allowances that exceed the historical loss experience should be based on qualitative or environmental factors. Management should consider such factors as

- changes in lending policies.
- changes in the trend and volume of past-due and adversely classified loans.
- changes in local and national economic conditions.
- effects of changes in loan concentrations.

This will ensure that the ALLL reflects estimated credit losses in the current portfolio.

Question 34

How should guarantor payments and proceeds anticipated from conversion of collateral be handled when measuring impairment under ASC 310-10-35 using the present value of expected cash-flows method?

Staff Response

All expected cash flows should be included when measuring the amount of impairment for an individually evaluated credit. Per ASC 310-10-35-26, estimated cash flows should be based on reasonable and supportable assumptions and projections considering all available evidence. Anticipated payments directly from the borrower serve as the primary component in the discounted cash-flow model. In addition, any anticipated repayment from a guarantor or through collateral conversion (reduced by estimated selling costs) should be captured in the expected cash-flow analysis.

Question 35

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 the 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. This trend must be considered, however, when determining the adequacy of the ALLL.

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

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

Question 36

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

Staff Response

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

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

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

Question 37

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

Staff Response

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

Question 38

Must bank management review the appropriateness of the ALLL quarterly?

Staff Response

The appropriateness of the ALLL must be reviewed at least quarterly. Otherwise, management may not be able to determine the accuracy of the bank's call reports. Significant loans analyzed individually should be monitored regularly, however, 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 adjust for internal and external events that might indicate problems in a particular credit or group of credits.

Question 39

Do materially excessive allowances also pose a problem?

Staff Response

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

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

Question 40

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

Staff Response

The staff believes that an ALLL established in accordance with the 2006 Policy Statement and the 2001 Policy Statement falls within the range of acceptable estimates determined in accordance with GAAP. When the reported amount of a bank's ALLL is not appropriate, the bank will be required to adjust its ALLL by an amount sufficient to bring the ALLL reported on its call report to an appropriate level as of the evaluation date. This adjustment should be reflected in the current period provision or through the restatement of prior period provisions, as appropriate.

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

Question 41

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

Staff Response

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

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

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

Question 42

How should the bank account for uncollectible overdraft protection fees?

Staff Response

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

Question 43

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

Staff Response

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

Question 44

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

Staff Response

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

Question 45

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

Staff Response

As noted in question 5, large groups of smaller-balance homogeneous loans, such as credit card loans, that are collectively evaluated for impairment are not included in the scope of ASC 310-10, and the guidance for groups of smaller-balance homogeneous loans contained in ASC 450-20 is applied. If, however, the smaller-

balance loan has been modified in a troubled debt restructuring as defined by ASC 310-40, impairment should be assessed in accordance with ASC 310-10-35. Banks should determine whether the credit card workout program qualifies as troubled debt restructurings.

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

An appropriate allowance should be established and maintained for each program. Generally, the ALLL allocation should equal the estimated loss in each program based on historical experience adjusted for current conditions and trends. These adjustments should take into account changes in economic conditions, volume and mix of the accounts, terms and conditions of each program, and collection history.

Question 46

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

Staff Response

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

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

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

Question 47

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

Staff Response

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

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

In particular, for commercial loans whose terms have been modified in a TDR that provides for a reduction of either interest or principal (referred to as a modification of terms), banks should measure the impairment loss on the restructured loan in accordance with ASC 310-10-35. In this regard, a credit analysis should be performed in conjunction with the restructuring to determine the loan's collectibility and estimated impairment. The amount of this impairment should be included in the ALLL. As additional information becomes available indicating a specific commercial loan, including a TDR loan, will not be repaid, an appropriate charge-off should be recorded.

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

Question 48

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

Staff Response

No. This entire loss should be recorded through the ALLL. While a portion of the loss includes apparently fraudulent actions on the part of Customer A, the activity occurred within the bank's legitimate lending function. Even though the credit limit was $100,000, the bank ultimately loaned the borrower $200,000. Because the losses

relate to the bank's actions for Customer A's credit, it is considered a credit loss and charged against the ALLL.

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

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

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

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

Operational Loss—Losses that arise outside of a relationship between a creditor and a borrower (i.e., the bank does not have the legal ability to collect from a borrower) are considered operational losses. If these losses are "probable" and "reasonably estimable" as defined in ASC 450-20, an expense should be accrued and an "other liability" recorded. Once the actual losses are confirmed, they should be charged against the other liability.

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

Question 49

Should these losses be charged against the ALLL?

Staff Response

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

Facts A borrower questions a bank's processing of their payments and the posting methods of those payments to the account. Upon further examination, the bank discovers errors in the payment posting process to the customer's account that were to the bank's benefit. The borrower threatens to sue the bank. To avoid a costly lawsuit, the bank settles with the borrower. As part of the settlement, the bank forgives the full outstanding balance of the borrower's loan. At the time of settlement, the loan is in good standing, and there are no known issues regarding the collectibility of the loan.

Question 50

Does the settlement represent an operating or a credit loss?

Staff Response

The settlement is an operating loss that should be recorded as an "other noninterest expense," because the bank settled with the borrower in lieu of incurring litigation-related expenses. Credit losses arise from the borrower's failure to pay according to the terms of the loan agreement. (See question 48 for further discussion.) In this situation, the borrower was paying in accordance with the contractual terms, and there were no indications the borrower would not be able to continue such payments.

Additionally, the bank should determine whether the error was an isolated event or part of a more pervasive issue that warrants recognition of a loss contingency (see Topic 6A: Contingencies for further discussion).

Facts At origination, the bank requires a borrower to obtain PMI on an SFR mortgage, and names the bank as loss payee. The cost of the PMI is included in the borrower's monthly payment to the bank, similar to property taxes and insurance. The PMI covers losses incurred on the loan regardless of who owns the loan (e.g., if the loan is sold, any PMI benefits belong to the new owner of the loan).

Question 51

Should the borrower-paid individual PMI affect the bank's ALLL?

Staff Response

Yes. Individual loan PMI should be considered in a manner similar to guarantors. This means the bank must assess the insurer's willingness and ability to repay the loan in the event of the borrower's default. The bank must analyze, for example, the insurer's history and timeliness for paying claims and the insurer's current financial condition. If evidence suggests the bank may not be able to fully recover claims submitted to the insurer, the bank should make adjustments to reflect that evidence when determining an appropriate ALLL. For further discussion of accounting for mortgage insurance receivables, see Topic 5A, questions 29-30.

Question 52

Would the Staff Response to question 51 be different if the bank obtained mortgage insurance on a pool of loans, rather than borrower-paid PMI, and a loan would no longer be covered under the bank's insurance policy if sold to another institution?

Staff Response

Yes. Although the bank may contemplate the cost of mortgage insurance on a pool of loans when originating a particular loan and price the loan accordingly, the insurance contract is between the bank and the insurer. Because the insurance policy would not cover the individual loans if removed from the pool in a subsequent sale, the bank should not consider the existence of pool mortgage insurance when determining its ALLL. Rather, the bank should account for the pool mortgage insurance it holds as other insurance policies (see Topic 5A, questions 29-30 and Topic 5C, question 7 for additional discussion on the accounting for insurance recoveries).

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Facts A bank does not require escrow of real estate taxes or hazard insurance premiums on certain residential mortgage loans it originates. When these taxes and insurance premiums are not escrowed, the borrower is required by the loan agreement to pay taxes and insurance on or before the due date. A borrower's failure to pay taxes or insurance premiums by the due date is an event of default under the loan agreement. A number of borrowers did not pay their property taxes or insurance premiums, and the bank advanced those payments on behalf of the borrowers to protect its interest in the collateral securing the mortgage, as provided for in the mortgage note. Since property taxes and insurance are typically due annually, advances for taxes and insurance should generally be repaid within 12 months to the bank. However, for a number of borrowers, the advanced amount is added to the loan balance and each borrower's monthly payment is adjusted to amortize the advance over the remaining term of the loans (on average over 240 months). Aside from the nonpayment of taxes and insurance, these borrowers are less than 30 days past due. However, many of the loans have been past due 60 days or more multiple times in the past two years.

Question 53

What is the appropriate accounting for advances of real estate taxes and hazard insurance capitalized into loan balances with extended payment terms?

Staff Response

Once there is evidence borrowers have failed to make the required payments of taxes and insurance, the bank should evaluate its interest income recognition and the ALLL to ensure neither interest income nor provision for loan and lease losses is materially misstated and the ALLL remains appropriate. This evaluation should consider whether repayment in full of principal, interest, and advances on taxes or insurance is expected to be collected. If full collection of principal (including

NEW

capitalized advances) and interest is not expected, or if it is not expected that the borrower will be able to meet all future obligations to pay taxes and hazard insurance, the loan should be placed on nonaccrual or subject to an alternative method to ensure income is not materially overstated. The measurement of impairment on these loans and the resulting ALLL (as well as any regulatory classification when appropriate) will be based on the recorded investments in the loans after capitalization of the advances (see Topic 2B question 23 for discussion of capitalization of advances). The extended repayment terms of the bank's advances of taxes and insurance should also be evaluated to determine whether any of the modifications are TDRs.

Topic 5 OREO and Other Assets

5A. Other Real Estate Owned

Question 1

How should banks account for their investment in OREO property?

Staff Response

Detailed accounting guidance for OREO is provided in the call report instructions. These instructions require that OREO and its sales be accounted for in accordance with GAAP. In this respect, ASC 310 and ASC 360 provide general guidance for the recording of OREO. Sales of OREO are accounted for in accordance with ASC 360-20-40. ASC 970-340 provides guidance on the accounting for costs during the development and construction period, and ASC 835-20 provides guidance on capitalization of interest costs.

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

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

ASC 820-10 provides guidance on measuring the fair value of OREO property. Although the fair value of the property normally will be based on an appraisal (or other evaluation), the valuation should be consistent with the price that a market participant will pay to purchase the property at the measurement date. Circumstances may exist that indicate that the appraised value is not an accurate measurement of the property's current fair value. Examples of such circumstances include changed economic conditions since the last appraisal, stale appraisals, or imprecision and subjectivity in the appraisal process (i.e., actual sales for less than the appraised amount).

Facts As part of the foreclosure process, certain states have mandatory redemption periods after a title passes in a sheriff's sale whereby the borrower can reclaim title by fully satisfying the debt. During the redemption period, the borrower may occupy the property, thus maintaining physical possession of the collateral. Additionally, the borrower may secure other financing to pay off the debt in full. Generally, a bank does not have the ability to enter the property until the redemption period has expired. Therefore, the bank has foreclosed on the property and has obtained title, but does not have physical possession during the redemption period. The length of the redemption period varies by state, but generally ranges from three months to one year. During the redemption period the bank is able to sell the collateral; but, the collateral remains subject to the redemption period.

Question 2

Should the bank reclassify the loan to OREO at the time of foreclosure if the collateral is subject to a redemption period?

Staff Response

Yes. The bank should reclassify the loan to OREO after the physical possession of the property or taking legal title of the property, whichever comes first. In this case, the bank should transfer the loan to OREO once it obtains title at the time of the sheriff's sale. Acceptance of property in satisfaction of debt is a TDR as defined in ASC 310-40 (see Topic 2A).

Consistent with ASC 310-40, property received at the time of restructure is recorded at its fair value less estimated costs to sell. Reclassification to OREO is required even in the absence of physical possession. The borrower redeems the property only if funds are obtained to extinguish the outstanding bank debt in full, such as through financing provided by another institution or disposal of the property through a borrower initiated sale. The bank will continue to report OREO if the property is not redeemed within the statutory timeframe. In the event of redemption, the bank will report the sale of OREO for the amount of the proceeds received.

While the accounting treatment supports carrying the balance as OREO at the sheriff's sale date, bank regulations that limit the holding period for OREO would not begin until the redemption period expires.

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

Question 3

At what value should the OREO be recorded?

Staff Response

Upon receipt of the real estate, the property should be recorded at $165,000 in accordance with ASC 310 and 360. This represents the fair value of $180,000 less the $15,000 cost to sell the property. Because of safety and soundness concerns, however, the fair value determined in the appraisal should be scrutinized closely. Because the appraisal indicates that the borrower has equity in the property, the bank should address the issue of why the borrower would risk losing the property in foreclosure. If concern exists about the accuracy of the appraisal, further analysis should be performed. If, however, the appraisal properly supports the fair value, the $15,000 increase in value is recorded at the time of foreclosure. This increase in value may be reported as noninterest income unless there had been a prior charge-off, in which case a recovery to the ALLL would be appropriate.

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

UPDATE

Question 4

How should the OREO be accounted for?

Staff Response

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

Subsequent to the acquisition date, the OREO is carried at the lower of cost ($175,000) or fair value less cost to sell. When the fair value declines to $170,000, the fair value less cost to sell would be $155,000. This represents a $20,000 decline in value, which is recorded through a valuation allowance with a charge to net gains (losses) on sales of other real estate owned under noninterest income.

Question 5

If two years later the fair value of the property is $195,000, how should the increase in value be accounted for?

Staff Response

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

UPDATE

Question 6

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

Staff Response

No. A direct write-off establishes a new cost basis for the property. Because the bank did not establish a valuation allowance at the time the property was initially written down, a new cost basis was established. Reversing the previous write-down and rebooking the charged-off asset is not in accordance with GAAP. However, subsequent to the direct write-off, the bank may establish a valuation allowance for any additional fair value decline rather than record an additional direct write-off.

Question 7

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

ASC 970-340-25-8 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 may be capitalized, up to the fair value of the property. Such costs incurred at other times, however, must be expensed as incurred. In this respect, ASC 970-340-25-8 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 8

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. The resultant carrying value of the OREO, however, 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 9

The bank pays delinquent real estate taxes on a property to avoid lien attachment by the taxing authority. How should the bank account for the tax payment?

Staff Response

As noted in Topic 2B: Nonaccrual Loans, question 23, delinquent real estate taxes should have been considered when assessing loan impairment prior to transferring the property to OREO. If the delinquent real estate taxes are not paid prior to or at the time of transfer to OREO, this amount should be recorded as a liability (see Topic 5A: Real Estate, question 7). Real estate taxes incurred after the property becomes OREO are considered holding costs and expensed as incurred. Additionally, other such costs paid by the bank during, or in anticipation of, foreclosure should be expensed. These costs include items for which the bank may contractually be able to obtain reimbursement from the borrower, such as credit life insurance or property insurance premiums. 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 10

The bank purchases the real estate tax lien certificate on the property rather than pay the delinquent real estate taxes. Would the response change if the bank purchased the real estate tax lien certificate rather than pay the delinquent real estate taxes?

Staff Response

No. The substance of this transaction when the bank purchases the tax lien certificates on property on which it has a lien or has foreclosed is the same as if the bank were paying the property taxes on the property directly. Accordingly, the guidance in question 9 would apply.

Question 11

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

Staff Response

In accordance with ASC 360-20-40-5, 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.

See questions 12 and 13 for further discussion.

Question 12

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

Staff Response

The down payment requirement of ASC 360-20-55 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 13

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

ASC 360-20-40 provides four other methods for accounting for sales of real estate:

- The installment method
- The cost-recovery method
- The reduced-profit method
- 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. Depending on the circumstances, however, 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.

Furthermore, the installment 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 following:

- The size of the down payment
- Loan-to-value ratios
- Projected cash flows from the property
- Recourse provisions
- Guarantees

Because 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 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.

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.

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 14

Does this transaction qualify as a sale under the full accrual method of ASC 360-20-40?

Staff Response

No. ASC 360-20-40 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. The loan must be on normal terms, however, and at 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 principal balance is due at that time.

Question 15

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

Staff Response

No. ASC 360-20 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. ASC 360-20-55 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 16

Have the minimum initial investment requirements of ASC 360-20-55 been met at the end of the first year?

Staff Response

Yes. The minimum initial investment requirements of ASC 360-20-55 have been met. This results because ASC 360-20-55 allows the inclusion of both principal and interest payments in determining whether the down payment is adequate when the deposit method is used. Therefore, the $26,000 received by the bank during the first year exceeds 20 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 17

Must the bank adjust its recorded investment in the OREO?

Staff Response

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

Question 18

Assume the appraised value is the same as in question 17, 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 of the current year, 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, ASC 360-20-55 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 19

May 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. Should the loan experience delinquency problems, however, the nonaccrual rules would apply.

Question 20

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

Staff Response

Yes. ASC 360-20-55-12 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 may change to the full accrual method of accounting.

Question 21

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

Staff Response

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

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

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

Question 22

How should this sales transaction be accounted for?

Staff Response

This sale qualifies for sales treatment under the full accrual method of accounting. Because of the bank's exposure with respect to note B, however, the bank has retained continuing involvement in the property in that it has retained certain risks of ownership. ASC 360-20 establishes the accounting when a portion of the risk is retained.

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

Question 23

When would this portion of the gain be recognized?

Staff Response

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

Facts A bank forecloses on a construction loan on a house that is unfinished. The recorded balance of the loan is $120,000. The "as is" appraised value of the house is $100,000, and the estimated disposal costs are $10,000. The "when completed" appraised value of the house is $150,000, and the estimated disposal costs are $15,000. The estimated cost to complete construction of the house is $40,000.

Question 24

At what value should the OREO be recorded?

Staff Response

The OREO should be recorded at $90,000 in accordance with ASC 310 and 360. This amount represents the current "as is" fair value of $100,000 less the $10,000 estimated costs to sell the property.

Question 25

May the bank capitalize the costs incurred to complete the construction of the house?

Staff Response

Costs incurred to complete the construction may be capitalized; however, the recorded balance of the OREO should not exceed the "when completed" fair value less estimated costs to sell. The bank should monitor the estimated cost to complete construction to ensure that the estimated cost does not exceed original estimates. The recorded balance of the OREO should never exceed fair value less estimated costs to sell.

Facts A bank acquired a commercial building upon the default of its borrower. The property was placed into OREO at $5,000,000. This amount represents the property's fair value (less disposal costs) at the time the bank took possession. Subsequently, a tenant who was paying an above-market rent rate terminated its lease by paying the bank an early termination penalty fee of $500,000.

Question 26

How should this $500,000 fee be recorded?

Staff Response

The $500,000 fee should be included in the bank's other noninterest income. The loss of this tenant may be an indication of impairment in the value of the property. Therefore, the bank should update its appraisal to determine whether the estimated fair value of the building has become further impaired by the departure of the tenant. Any decline in fair value should be recorded in an OREO valuation account, if the decline is temporary, or as a direct write-down of the OREO balance.

Facts A bank sells a parcel of OREO property in a transaction that meets the four criteria (listed in question 11) set forth in ASC 360-20-40-5 for use of the full accrual method of accounting. The bank, however, provides the purchaser/borrower with a mortgage loan at a preferential rate (i.e., below-market rate) of interest.

Question 27

Would the granting of a preferential interest rate preclude use of the full accrual method of accounting?

Staff Response

No. As noted, this transaction meets the four criteria set forth in ASC 360-20-40-5 for use of the full accrual method of accounting. Accordingly, the transaction qualifies for use of the full accrual method. The preferential rate of interest does not affect that determination. As discussed in question 28, however, the sales price, amount of gain (or loss), and future recording of interest income would be affected.

Question 28

How would the sales price, gain (or loss) on the transaction, and future interest income be determined?

Staff Response

The loan should be discounted and recorded at its fair value, using a market rate of interest. This discount would also reduce both the effective sales price of the property and any gain (or increase the loss). The difference between the fair value and the contractual or face value of the loan is deferred-interest income and is recognized into income as a yield adjustment over the life of the loan.

Facts A bank originates a mortgage loan and contemporaneously obtains lender-paid mortgage insurance as part of the underwriting. Subsequently, the borrower defaults on the loan and the bank forecloses. The bank pays the premium for the insurance, and the cost is a factor in determining the loan's interest rate. The mortgage insurance does not meet the scope of a credit derivative under ASC 815-10-20.

Question 29

At what amount should the OREO property be recorded?

Staff Response

Upon receipt of the real estate, OREO should be recorded at the fair value of the asset less the estimated costs to sell, and the loan account reduced for the remaining balance of the loan (see question 1). The receivable related to the mortgage insurance should not be included in determining the fair value less costs to sell of the mortgage loan nor recorded as part of OREO. It is recorded as a separate asset.

Question 30

Should the bank record a mortgage insurance receivable?

Staff Response

The bank should evaluate the probability that the mortgage insurance claim will be paid. ASC 450-30-25 states that contingencies that might result in gains usually are not reflected in the accounts, because to do so might be to recognize revenue prior to its realization. If realization of the mortgage insurance claim is assured, however, then a receivable may be recognized. Determining if the realization of the mortgage insurance claim is assured requires the bank to assess the mortgage insurance company's intent and ability to pay the claim. This includes assessing the mortgage insurance company's creditworthiness, propensity for litigating claims, and history of paying claims. The bank should not recognize a receivable for the mortgage insurance claim if there are concerns about the mortgage insurance company's creditworthiness and history of litigating claims, or if the loans in question are subject to any uncertainty because of litigation.

Facts A bank sells the SBA-guaranteed portion of a loan. The borrower subsequently defaults on the loan. To facilitate foreclosure proceedings, the bank repurchases the guaranteed portion of the defaulted loan.

Question 31

At what amount should the purchase of the defaulted SBA loan be recorded?

Staff Response

The purchased loan should be recorded at its fair value. While the repurchased loan is "guaranteed" by the SBA, the fair value may be less than par because of the time value of money and the length of time it takes to get a liquidation plan accepted by the SBA. This difference would be recorded as a loan loss against the ALLL.

Question 32

At what amount should a foreclosed SBA loan be recorded in OREO?

Staff Response

The OREO should be recorded at fair value less estimated costs to sell when the loan is foreclosed or the bank receives physical possession of the property. The amount that the bank anticipates receiving from the SBA should be recorded as a receivable if the bank believes it is probable that its SBA claim will be paid.

Facts A bank has a nonaccrual SBA loan that is on the books for $150,000 secured by property with a fair value of $125,000. The bank estimates the cost to sell this property to be $12,500. The SBA guarantee is for 75 percent of any loss. The SBA will probably pay the guaranteed amount when the property is sold.

Question 33

What would the accounting entries be for this loan when it is transferred to OREO?

Staff Response

The OREO property is initially recorded at $112,500 (fair value of $125,000 less cost to sell of $12,500). The estimated loss before the SBA guarantee is the recorded value of the loan ($150,000) less the fair value of the OREO ($112,500), including the costs to sell, or $37,500. Because the SBA guarantees 75 percent of the loss, the value of the SBA guarantee is expected to be $28,125. The value of the SBA guarantee reduces the total loss to $9,375.

The entry to record the transaction would be:

Entry	Debit	Credit
OREO	$112,500	
ALLL (Charge-Off)	$ 9,375	
SBA Receivable	$ 28,125	
Loans		$150,000

Facts A bank transfers OREO originally acquired through a deed in lieu of foreclosure to a wholly-owned community development corporation subsidiary specializing in LIHTC projects. The community development corporation converts the OREO into a LIHTC project. The transfer meets the legal definition of a 'disposal'; therefore, subsequent to the transfer, the LIHTC project is not subject to the OREO regulatory holding period limitation. Further, the held for sale criteria in ASC 360-10-45 are not met subsequent to the transfer date.

Question 34

Prior to the transfer date, the bank reports the foreclosed property as OREO held for sale at LOCOM. Subsequent to the transfer date, should the bank continue to report the property as OREO held for sale at LOCOM when converted into a LIHTC project by the wholly-owned community development corporation subsidiary?

Staff Response

No. The call report instruction's glossary entry for "Foreclosed Assets" continues to incorporate accounting concepts included in AICPA Statement of Position 92-3, "Accounting for Foreclosed Assets," (SOP 92-3) which was rescinded and replaced with ASC 360. The most notable provision in the SOP 92-3 not present in ASC 360 was a *rebuttable* presumption that real estate acquired through foreclosure is held for sale. SOP 92-3 included this rebuttable presumption because: (1) most banks and thrifts do not intend to hold foreclosed assets for the production of income and (2) bank regulations require banks to sell foreclosed assets within prescribed timeframes.

The rebuttable presumption that the LIHTC project should be reported as OREO at LOCOM is overcome because the property is no longer subject to the regulatory holding period limitation and the LIHTC project does not meet the held for sale criteria in ASC 360-10-45. Therefore, subsequent to the transfer date, the subsidiary accounts for the LIHTC project as held for use and reports it in call report Schedule RC Item 9, Direct and indirect investments in real estate ventures.

NEW

Facts A bank finances the sale of an OREO property. The buyer pledges collateral (in addition to the OREO property) to the bank as security related to the financing. The bank is attempting to use full accrual method to account for the sale.

Question 35

Should the value of the collateral be included in the initial investment calculation for purposes of determining whether the full accrual method may be used?

Staff Response

No, a pledge of additional collateral for the buyer's debt does not qualify as a down payment for purposes of achieving the minimum initial investment percentage

required for profit recognition under the full accrual method. The buyer's equity in any additional pledged collateral should not be included as part of the initial investment in determining the initial investment percentage. The guidance provided in ASC 360-20-40-10 identifies specific items that qualify as a part of the initial investment.

Facts A bank sells an OREO property to a third party buyer for $800,000, and provides a loan of $800,000 at market terms to the buyer, thus financing 100 percent of the sale. Costs to sell equal $65,000. Before the sale, carrying value of the property equals the appraised value (less costs to sell) of $1,000,000. The disposition qualifies for sale accounting.

Question 36

How should the bank account for the transaction?

Staff Response

NEW

Per ASC 360-10-35-43 and call report instructions, the OREO property should be measured and carried at the lower of its carrying amount or fair value less costs to sell. The contract sales price on market terms is a better indication of the current fair value of the asset than the appraised value. Therefore, prior to the sale, the bank should recognize a loss of $265,000 (i.e., the difference between the carrying value of $1,000,000 and fair value $800,000 less costs to sell $65,000) and increase the valuation allowance for the OREO by $265,000 once the sales price is known. If the disposition qualifies for sale, given that there is no profit from the sale, the bank does not need to assess the adequacy of initial investment for profit recognition purpose.

In accordance with call report instructions, when payment in full of the loan's principal or interest is not expected, the loan should be placed on nonaccrual status. When doubt exists as to the collectability of the remaining recorded investment of the loan on nonaccrual status, any payments received should be applied to reduce the recorded investment to the extent necessary to eliminate such doubt. This is consistent with ASC 360-20-40-31, which states "if recovery of the cost of the property is not reasonably assured, the cost recovery method shall be used." Call report instructions further indicate "while the cost recovery method is used, the loan to the buyer should be on nonaccrual status."

5B. Life Insurance and Related Deferred Compensation

Facts A bank has purchased split-dollar life insurance policies on the life of several key officers. These are cash value policies wherein both the bank and the officer's family are beneficiaries. The bank's benefit is limited to a refund of the gross premiums paid. All other benefits are designated for the officer's beneficiaries.

Question 1

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

Staff Response

Consistent with ASC 325-30 the bank should record the amount that it could realize under the insurance policy (i.e., its portion of the cash surrender value) as of the date of the financial statements as an "other asset." Further, consistent with ASC 715-60 the bank should recognize a liability for future benefits. Based on the substantive agreement with the employee, the liability would be determined in accordance with ASC 715-60 (if a post-retirement benefit plan exists) or ASC 710-10 (if the arrangement is an individual, deferred-compensation contract).

Facts Bank A has purchased "key-man" life insurance policies on the life of several key officers. These are cash value policies. They differ from the policies discussed in question 1, however, in that the bank is the sole beneficiary.

Question 2

How should these "key-man" life insurance policies be accounted for?

Staff Response

Consistent with ASC 325-30, the bank should record the amount that it could realize under the insurance policy (i.e., the cash surrender value) as of the date of the financial statements as an "other asset." The change in cash surrender value during the period is an adjustment of the premium paid in determining the expense (other noninterest expense) or income (other noninterest income) to be recognized for the period.

Facts A bank enters into deferred compensation agreements with each of its three executive officers.

Question 3

Which accounting pronouncements provide guidance on the accounting for such transactions?

Staff Response

ASC 715-30 applies to deferred-compensation contracts with individual employees when those contracts, taken together, are equivalent to a post-retirement income plan, and ASC 715-60 applies when the equivalent is a post-retirement health or welfare benefit plan. Other deferred compensation contracts should be accounted for in accordance with ASC 710-10.

Question 4

Are the deferred-compensation agreements with the three executive officers equivalent to a post-retirement income plan or a post-retirement health or welfare benefit plan?

Staff Response

The determination of whether deferred-compensation contracts, taken together, are equivalent to a post-retirement plan should be based on facts and circumstances. Consideration should be given to the number of employees covered and the commonality of terms of the contracts. ASC 715-10-15-5 states that an employer's practice of providing post-retirement benefits to selected employees under individual contracts with specific terms determined on an individual basis does not constitute a post-retirement benefit plan. In this situation, the bank's deferred compensation agreements with only three employees do not constitute a plan. Accordingly, these contracts would be accounted for in accordance with ASC 710-10.

Facts A bank purchases a single-premium policy to provide funds for a deferred-compensation agreement with a bank executive. The agreement states that the bank executive is entitled to receive deferred compensation based on the "excess earnings" of this insurance policy. The compensation agreement provides for a base earnings amount on the initial investment in the policy to be computed using a defined index. All earnings over this base amount (the "excess earnings") accrue to the benefit of the employee, during both employment and retirement years. Payment is made to the employee, however, during his or her retirement years.

The deferred-compensation agreement provides for a "primary" and "secondary" benefit. The earnings on the policy that accumulate for the employee's benefit prior to retirement are paid out in 10 equal installments upon retirement and is the "primary benefit." The "secondary benefit" is the earnings that accrue for the employee's benefit after retirement. These amounts are paid each year in addition to the primary benefit. The secondary benefit will continue to accrue and be paid to the employee throughout his or her life.

Question 5

How should the bank account for the costs associated with this deferred compensation agreement?

Staff Response

These benefits should be accounted for in accordance with ASC 710-10. The present value of the expected future benefits to be paid to the employee from the deferred-compensation plan should be based on the terms of the individual contract. It should be accrued in a systematic and rational manner over the required service periods to the date the employee is fully eligible for the benefits.

The future payment amount is not guaranteed but is based on the expected performance of the insurance policy. That fact does not release the bank from the requirement that it recognize the compensation expense over the employee's expected service period. The estimate of the expected future benefits should be reviewed periodically, however, and revised, if needed. Any resulting changes should be accounted for prospectively, as a change in accounting estimate.

Question 6

What discount rate should be used in determining the present value of the expected future benefit payments to be made to the employee?

Staff Response

ASC 710-10 does not specify how to select the discount rate to measure the present value of the expected future benefit payments to be made to an employee. Therefore, other relevant accounting literature must be considered in determining an appropriate discount rate. The staff believes the bank's incremental borrowing rate and the current rate of return on high-quality, fixed-income debt securities to be acceptable discount rates by which to measure a deferred-compensation-agreement obligation. The bank must select and consistently apply a discount rate policy that conforms to relevant accounting literature.

Facts A bank purchased a BOLI policy with a face value of $250,000 as key-person life insurance on its chairman approximately 20 years ago. The chairman recently retired and purchased the policy from the bank for its current surrender cash value of $147,308.

Question 7

How should this transaction be recorded?

Staff Response

The bank should estimate the fair value of the BOLI policy based on the net present value of cash flows using the expected premium payments, death benefit, and expected mortality. The difference between the estimated fair value and the $147,308 paid for the policy would be reported as gain on sale with an offsetting employee compensation expense (i.e., retirement bonus) amount. The cash surrender value would be removed from the books, because the bank is no longer entitled to it. This would not affect earnings or capital, because the gain on sale and employee compensation expense would offset each other.

5C. Miscellaneous Other Assets

Facts Various federal, state, and local laws require the removal or containment of dangerous asbestos or other 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. In certain jurisdictions, however, the property owners must clean up the property, regardless of cost. Further, sometimes a company must clean up property that it does not currently own. For banks, this liability may extend not only to bank premises but also to OREO.

Question 1

Should asbestos and toxic waste treatment costs incurred for cleanup be capitalized or expensed?

Staff Response

Cleanup costs for asbestos may be capitalized only up to the fair value of the property. Cleanup 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 ASC 410-30.

Generally, environmental contamination (toxic waste) treatment costs should be charged to expense. When recoverable, however, 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; or
- The costs are incurred in preparing for sale a property currently held for sale.

This opinion is consistent with ASC 410-30-35-18.

Question 2

How should a bank account for the costs associated with the development of software for internal use?

Staff Response

ASC 350-40, with respect to the accounting for costs associated with the development of software for internal use, requires the capitalization of certain costs associated with obtaining or developing internal-use software. Specifically, the software development process is separated into three stages:

- Preliminary project stage

- Application development stage
- 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.

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 3

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 ASC 835-30.

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 4

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

Staff Response

ASC 360-10 requires that the equipment be accounted for as held for use as long as the equipment is still being used. As a result of entering into this contract, the bank should revise the estimated useful life of the equipment to reflect the shortened

useful life. Once the bank has stopped using the old data processing equipment, the equipment should be accounted for at the lower of amortized cost or fair value less cost to sell.

Facts When a property tax bill becomes delinquent, the taxing authority places a tax lien on the property. In many states, the taxing authority is authorized to sell tax liens by issuing tax lien certificates. A tax lien certificate transfers to a third party the taxing authority's right to collect delinquent property taxes and the right to foreclose on the property. A tax lien has a superior priority status that supersedes any existing non-tax liens, including first mortgages, and accrues interest and fees.

Question 5

How should a bank report the acquisition of a tax lien certificate in the call report?

Staff Response

Tax lien certificates should be reported in "Other assets" in Schedule RC and Schedule RC-F. The staff does not believe a tax lien certificate meets the definition of a loan provided in the call report instructions, because an interest in a tax obligation does not result from direct negotiations between the holder of the certificate and the property owner, or between the taxing authority and the property owner.

Question 6

Should a bank accrue interest on a tax lien certificate?

Staff Response

Accrual status should be determined in accordance with call report instructions and the bank's nonaccrual policy. Delinquency should be calculated from the date the taxes were due the taxing authority. At the time a bank purchases a tax lien certificate, the property owner's tax obligation generally meets the criteria for nonaccrual status set forth in the call report instructions; therefore, tax lien certificate income should generally be recognized on a cash basis. As a consequence, tax lien certificates should be reported in the past due and nonaccrual schedule of the call report (Schedule RC-N) in the item for "Debt securities and other assets" in nonaccrual status. When income is recognized on a tax lien certificate, it should be reported as "Other noninterest income" in Schedule RI and Schedule RI-E.

Facts A bank obtains an insurance policy to indemnify itself against litigation defense expenses incurred. As legal costs are incurred, the bank files insurance claims with the insurer for reimbursement. The bank recognizes an insurance claim receivable in other assets for the amount of total claims submitted because the insurer has historically paid in full all claims filed. The insurer subsequently denies a portion of the bank's claims. The bank sues the insurer to recover the denied claims.

Question 7

How should the bank account for the disputed insurance claims receivable asset?

Staff Response

The bank should recognize a full valuation allowance against the insurance claim receivable because it is subject to litigation and, therefore, collection of the receivable is presumed not probable.

Insurance recoveries are contingencies accounted for in accordance with ASC 450-30. In accordance with that standard, a contingency that might result in a gain should not be reflected in the financial statements because to do so might recognize revenue before realization. Although 450-30 does not elaborate more precisely as to when a gain contingency should be recognized, Emerging Issues Task Force Issue 01-10, *Accounting for the Terrorist Attacks of September 11, 2011* (EITF 01-10) addresses some interpretative issues. The OCA staff finds that the task force's consensus opinion should be applied to gain contingencies not specifically covered by other authoritative accounting standards.

EITF 01-10 distinguishes between the recognition of (a) a contingency related to the recovery of a loss recognized in the financial statements where the recovery is less than or equal to the amount of the loss recognized (i.e., a loss recovery) and (b) a recovery of a loss not yet recognized in the financial statements or an amount recovered in excess of the loss recognized in the financial statements (i.e., a gain contingency). The task force concluded that the recognition criteria for a loss contingency (i.e., probable and estimable) should also be applied to recoveries, but that a gain contingency should not be recognized until resolved.

Type of Contingency	Description	Recognition Criteria
(1) Loss recovery	Related to recovery of a loss when the recovery is less than or equal to the amount of the loss recognized in the financial statements	Recognize if collection is probable and estimable
(2) Gain contingency	Recovery of a loss not yet recognized in the financial statements or an amount in excess of the loss recognized in the financial statements	Recognize when resolved

ASC 450-20-S99, states "there is a rebuttable presumption that no asset should be recognized for a claim for recovery from a party that is asserting that it is not liable to indemnify the registrant." Said another way, there is a presumption that recovery of claims subject to litigation is not probable. The SEC staff's position is consistent with ASC 410-30-35, which applies to potential recoveries of amounts expended for environmental remediation, stating: "If a claim is the subject of litigation, a rebuttable presumption exists that the recovery is not probable."

The OCA staff finds the nature of the insurance claims in this case to be consistent with a contingent loss recovery. As such, the claim should be recognized to the extent recovery is probable. Because the insurance claim is subject to litigation, there is a presumption that recovery of the claim is not probable. Unless the rebuttable presumption can be overcome, the bank should recognize a valuation allowance against the full amount of the insurance claim receivable.

Question 8

How can the bank overcome the rebuttable presumption that the recovery of the claims is not probable?

Staff Response

First the bank should obtain a written opinion from competent and independent legal counsel that explicitly states that the bank will probably prevail in its litigation against the insurer. The opinion letter should provide support for the assertion, such as examples of existing legal precedent. If the bank cannot rebut the presumption, a valuation allowance against the full amount of the insurance claim receivable must be recorded.

It also important to note that even if the bank rebuts the presumption, it must demonstrate the insurer has the financial capacity to pay the obligation. This includes an evaluation of the financial condition of the insurer and the insurer's ability to pay the insurance claim receivable amount in full. If the bank cannot demonstrate the insurer has the financial capacity to pay the full amount of the insurance claim receivable, the bank must establish a valuation allowance for the portion of the insurance claim receivable the bank does not expect to collect.

Topic 6 Liabilities

6A. Contingencies

Facts A legal action was brought against a bank. The court issued a judgment against the bank, and the bank has appealed. The bank has not provided any provision (liability) for the possible loss resulting from this litigation.

Question 1

Should the bank provide a provision for this loss because a judgment has been awarded against it?

Staff Response

ASC 450-20-25 requires 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 counsel 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 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 cause a bank to incur losses of $2 million ($1,900,000 in loan losses and $100,000 in legal fees). The bank filed a claim with its fidelity bond carrier for payment of the total amount of coverage under the bond, aggregating $2 million. The losses have reduced bank capital below a level that the regulators find acceptable.

Question 2

Should the bank record a receivable for the $2 million when the claim is filed with the insurer?

Staff Response

No. It is usually inappropriate for a fidelity claim to be recognized before a written settlement offer has been received from the insurer. The staff believes that the potential recovery of the loss from anticipated insurance proceeds is a contingent asset. ASC 450-30 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.

Facts A bank originates mortgage loans that are sold in the secondary market. The sales agreements include the normal "reps and warranties" clause that requires the bank to repurchase any loan that has incomplete documentation or has an early payment default (e.g., during the first 90 days after the sale).

Question 4

How should the bank account for this recourse?

Staff Response

The requirement to repurchase loans with incomplete documentation or early payment default represents a recourse obligation. ASC 860-10 requires the bank to recognize a liability at the time of the sale in the amount of the fair value of the recourse obligation. If it is not practicable to estimate the fair value, the bank should

recognize no gain on the sale. This recourse obligation is recorded as an Other liability rather than as part of the ALLL, because these loans have been sold by the bank and are no longer part of its loan portfolio.

Subsequently, the bank should assess whether there has been a change in probable and reasonably estimable losses related to its recourse obligation. The bank should adjust its Other liability amount to the extent that probable and reasonably estimable losses related to its recourse obligations (based on historical experience adjusted for current trends) are different from the carrying amount of the related liability.

Topic 7 Income Taxes

7A. Deferred Taxes

Facts Banks must report income tax amounts, including DTAs, in the call report in accordance with ASC 740.

The amount of certain DTAs that national banks may include in regulatory capital, however, is limited to the lesser of either

- the amount of DTAs 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
- 10 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 DTAs 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-R, item 9.b, "Disallowed deferred tax assets."

Question 1

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

The regulatory capital limit applies only to "deferred tax assets that are dependent upon future taxable income." How are DTAs determined?

Staff Response

A bank's DTAs that depend upon future taxable income are those DTAs 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 DTAs 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 NOL (carryback potential).

Question 3

May a bank use existing forecasts of future taxable income that it prepared for its budget to estimate realizable amounts under ASC 740-10-25 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 ASC 740-10-25, 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

A bank's income projections are prepared typically each fiscal year. When applying the regulatory capital limit at an interim quarter-end report date, may a bank use the income projections for its fiscal year to approximate its income for the one-year period following the report date?

Staff Response

Yes. A bank may use its fiscal-year income projections when applying the proposed capital limit at an interim quarter-end report date, provided that those projections are not expected to differ significantly from the estimate of future taxable income for the one-year period following the quarter-end report date.

Question 5

In determining the regulatory capital limit, is there a specific method a bank must follow to estimate the amount of DTAs 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. Whatever method the bank chooses, however, 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).

The OCC recognizes, however, 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

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

How does the valuation allowance that may be required under ASC 740-10-30 relate to the regulatory capital limit?

Staff Response

The required valuation allowance (if any) under ASC 740-10-30 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 ASC 740-10-30 valuation allowance.

A bank should determine the amount of DTAs for reporting on its call report in accordance with ASC 740-10-30 and ASC 740-10-25. Under ASC 740-10-30, a bank calculates DTAs by multiplying its deductible temporary differences by the applicable tax rate (the rate expected to apply during the period in which the deferred tax assets will be realized). Under ASC 740-10-25, a bank may only recognize the benefit of a tax position if that tax position is "more likely than not" to be sustainable, assuming the taxing authority has full knowledge of the position and all relevant facts.

If necessary, a bank should record a valuation allowance to reduce the amount of DTAs 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 DTAs (i.e., DTAs net of any valuation allowance and net of DTLs) on Schedule RC-F, item 2. This net DTA amount is the starting point for applying the regulatory capital limit.

Question 8

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 in determining 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 exists. 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, which permanently reduces operating expenses.
- a significant improvement in the quality of the loan portfolio.

Examples of negative evidence include

- a history of operating losses or tax credit carryforwards expiring unused.
- an expectation that operating losses will continue in early future years and that positive income will not be realized until the more distant future.
- unsettled circumstances that if unfavorably resolved would continuously affect future operations and profit levels adversely in future years.

The weight given to the potential effects of negative and positive evidence should be commensurate with the extent to which it can be verified objectively. For example, a history of operating losses would likely carry more weight than a bank's assessment that the quality of its loan portfolio has improved.

Facts A bank has been in existence for five years. Although it has had profitable quarters from time to time, it has never shown positive annual income. Its cumulative losses exceed $2,000,000. In the latest fiscal year, its best year ever, the bank lost $150,000. The bank's total assets have been growing steadily, and management believes it will reduce costs and begin earning positive operating income in the coming year.

Management estimates the bank will show taxable income of $200,000 next year. Management bases its estimate on several factors, including an improved loan portfolio and a higher net interest margin, which it believes will result from decreases in market interest rates.

Question 9

How should the bank account for its DTAs?

Staff Response

The bank should record a valuation allowance for the full amount of its DTAs. 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 DTA.

The recent history of operating losses provides objective evidence of the bank's inability to generate profits. Such evidence should be given more weight than less quantifiable data that depend on subjective data (i.e., future interest rate forecasts).

Facts A bank has a net unrealized holding gain on AFS debt securities of $1,000,000. Its composite tax rate is 40 percent, so it has recorded a $400,000 DTL relating to the unrealized gain. The bank also has gross DTAs of $4,000,000 and other DTLs of $300,000. Taxes paid for the current year and prior two years that could potentially be recovered through loss carrybacks total $2,000,000. Its Tier 1 capital before deducting disallowed DTAs is $5,000,000. The bank does not have servicing assets or purchased credit card relationships. The bank has a strong record of earnings and expects continued profitability in the future. Therefore, it has not recorded a valuation allowance.

Question 10

Net unrealized holding gains and losses on AFS securities (ASC 320 gains and losses) are excluded from regulatory capital. When calculating the deferred tax limitation, should the bank also exclude from this calculation the tax effect of gains and losses on available-for-sales securities?

Staff Response

For regulatory capital purposes, the OCC allows banks to establish their own policy on the inclusion of gains and losses on AFS securities in their computation of the deferred tax limitation. The bank, however, must consistently apply the method that it chooses.

The decision on how to treat the ASC 320 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 effect on the bank's regulatory capital.

	Scenario 1	Scenario 2
	Eliminate ASC 320 tax effects	Include ASC 320 tax effects
Gross DTA	$4,000,000	$4,000,000
Carryback potential	2,000,000	2,000,000
DTL	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 of one year's future taxable income exceeds 10 percent of Tier 1 capital.

This situation, which included a net unrealized holding gain on the AFS securities, resulted in higher regulatory capital under scenario 2. If, however, a net unrealized holding loss occurred on these securities, scenario 1 would have produced the most favorable regulatory capital result.

Question 11

Under the regulatory capital limit, DTAs that depend upon future taxable income are limited to the amount of DTAs 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 ASC 740-10-30?

Staff Response

No. The one-year limit applies only when determining the amount of DTAs 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. ASC 740 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

When determining a bank's carryback potential under ASC 740-10 and the regulatory capital limit, how should a bank consider taxes paid in prior years at effective rates different from the applicable tax rate used to record DTAs?

Staff Response

In determining its carryback potential to apply ASC 740-10 and the capital limitation, banks should consider the actual amount of taxes it could potentially recover through the carryback of NOL.

7B. Tax Sharing Arrangements

Facts The bank is a member of a consolidated group subject to a tax sharing agreement with its parent holding company. During the current year, the bank incurs a loss that would result in a tax benefit on a separate entity basis. The consolidated group previously has carried back its losses, however, 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

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 on Income Tax Allocation in a Holding Company Structure" (November 1998) prohibits banks from paying their DTL 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. The tax sharing agreement between the subsidiary bank and the holding company, however, 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. Some subsidiaries filing as separate entities, however, 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 that it can carryback as a separate entity. A mortgage banking subsidiary of the bank, however, 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. At the bank level, however, the reporting entity includes its mortgage banking subsidiary and any other subsidiaries that the bank may own. Payment of taxes to and refunds from the holding company would be based on the consolidated tax position of the bank and its subsidiaries. The mortgage banking subsidiary would pay taxes to the bank, not to the holding company. This applies the separate entity concept to each subsidiary level.

7C. Marginal Income Tax Rates

Facts The bank is a subsidiary of a holding company that files a consolidated return. Because of their common ownership, the affiliated companies are entitled to only one surtax exemption. Current IRS regulations permit the arbitrary allocation of the surtax exemption to any member of a group under common control, even if a consolidated return is not filed. As a result, the holding company, which was operating at a loss, allocated the entire surtax exemption to itself.

Question 1

For regulatory purposes, what is the proper allocation of the surtax exemption among subsidiaries when determining the amount of tax payments to be forwarded to the holding company?

Staff Response

The one surtax exemption should be allocated among the affiliates in an equitable and consistent manner. Additionally, the surtax exemption should be allocated to profitable entities, because 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. 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. Those instructions, however, also allow adjustments to allocate additional amounts among the subsidiary banks, provided the allocation is equitable and applied consistently. An adjustment for the consolidated groups' incremental tax rate, properly applied, would satisfy that requirement.

Topic 8 Capital

8A. Sales of Stock

UPDATE

Facts Bank A has a stock offering. The purchasers finance the stock purchase by obtaining unsecured loans from an unaffiliated bank, Bank B. Several years later, Bank A acquires Bank B. Accordingly, the loans to Bank A shareholders are now owned by Bank A.

Question 1

After the acquisition of Bank B by Bank A, should the loans funded by Bank B and used to purchase the stock of Bank A in the prior transaction continue to be classified as an asset or as a deduction from the stockholders' equity of Bank A?

Staff Response

The loans provided by Bank B to purchasers of Bank A capital stock should be recorded as an asset of Bank A after the acquisition because prior to the acquisition the stock issuer (Bank A) and the stock purchasers' loan provider (Bank B) were unrelated. In this situation, it was not the intent of Bank A to finance the sale of its own stock and the loan was not made in contemplation of the acquisition. The funds provided by Bank B at the time of the transaction were not used to purchase stock of Bank B.

Facts A bank has a successful common stock offering. The bank incurs certain costs directly related to the securities offering for legal, accounting, and printing expenses.

Question 2

How should these expenses that are directly related to the stock offering be accounted for?

Staff Response

Expenses that are directly related to a successful stock offering are accounted for as a reduction of the amount of the offering. Accordingly, they would be included as a reduction of the surplus account and not charged to current operations through the income statement. This response is consistent with AICPA Technical Questions and Answers, Section 4110.

Question 3

How should these expenses be accounted for if the stock offering is not successful (i.e., no stock is sold)?

Staff Response

Expenses that are related to an unsuccessful stock offering are charged to current operations through the income statement.

8B. Quasi-Reorganizations

Question 1

What is a quasi-reorganization?

Staff Response

As defined in ASC 852-20, 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. 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 GAAP, 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

As part of the revaluation of its assets and liabilities to their current fair values, may 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. The use of fair value, however, 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

May 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, GAAP does 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. 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.

8C. Employee Stock Options

Facts ASC 718 requires entities to recognize compensation expense in an amount equal to the fair value of the share-based payments. This compensation will generally be recognized over the period that the employee must provide services to the entity.

Question 1

If bank holding company stock is issued rather than bank stock, must the compensation expense be recorded (pushed down) in the financial statements of the bank?

Staff Response

Yes. ASC 718-10-15 requires that share-based payments awarded to an employee of an entity (bank) by a related party as compensation for services provided be accounted for as a share-based payment of that entity (bank), unless the transaction is clearly for a purpose other than compensation. In this respect, ASC 718-10-15 notes that the substance of such a transaction is that the issuer of the shares (the holding company) made a capital contribution to the reporting entity (the bank).

Topic 9 Income and Expense Recognition

9A. Transfers of Financial Assets and Servicing

Facts A bank originates $1,000,000 of mortgage loans that yields 8.5 percent interest. The bank transfers the loans to another entity for par ($1,000,000). The bank continues to service the loans. The contract states that the bank will receive a servicing fee of 1 percent and receives a beneficial interest (interest-only). The remaining interest income not sold is considered to be an IO strip under ASC 860-20. 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 the fair value of the IO strip is $56,000. The fair value of the principal and interest sold is its sales price of $1,000,000. This transfer meets the conditions set forth in ASC 860-10-40-5 for sale accounting treatment.

Question 1

How should this transaction be accounted for?

Staff Response

The bank should derecognize all the assets sold and recognize any assets obtained or liabilities assumed in the sale, including, but not limited to, cash, servicing assets/liabilities, and beneficial interests, at their respective fair values. In accordance with ASC 860-50, the servicing is considered a separate identifiable asset—not a retained interest in the principal amount of the financial instruments sold—and should be recognized at fair value. The bank should remove loans in the amount of $1,000,000 from the balance sheet and record cash of $1,000,000, a servicing asset of $44,000, an IO strip of $56,000, and a resulting gain of $100,000.

Question 2

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

Staff Response

In accordance with ASC 860-50-35, the subsequent accounting for servicing assets is based on the bank's accounting policy election. Separately, for each class of servicing assets, the bank may elect either

- the amortization method under which the servicing assets are amortized in proportion to and over the period of estimated net servicing income and assessed for impairment based on fair value at each reporting date, or
- the fair value measurement method under which the servicing assets are reported at fair value at each reporting date with changes in fair value reported in earnings when the changes occur.

If the bank elects the fair value measurement method for a class of servicing asset, that election cannot be changed.

UPDATE

Question 3

How should the IO strip be accounted for on an ongoing basis?

Staff Response

ASC 860-20-35-2 requires that the IO strip and any other financial asset that can contractually be prepaid or otherwise settled so that the holder would not recover substantially all of its recorded investment be accounted for similar to an investment in debt securities classified as AFS or trading under ASC 320-10. Accordingly, the IO strip should continue to be measured at its fair value after initial recognition.

In addition, the IO strip, if classified as AFS, should be assessed for impairment consistent with the guidance in ASC 320-10-35 and ASC 325-40-35. See Topic 1B for additional guidance on identifying, measuring, and recognizing OTTI. When the IO strip is classified as a trading asset, all changes in fair value are recognized in earnings. Interest income of the IO strip should be measured and recognized in accordance with ASC 325-40-35.

Facts A 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 4

How should the sale of the account relationships be accounted for?

Staff Response

An account relationship is a separately identifiable asset from an underlying credit receivable and is accounted for as another intangible asset in accordance with ASC 350-30. This transaction is analogous to the sale of the mortgage servicing rights on loans owned by other parties, which are covered under ASC 860-50-40. Accordingly, a gain should be recognized based on the $25 million premium, because the transaction was settled in cash.

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. It will, however, continue to own the credit card relationship and make advances to the credit card customers. Any income received on new credit card advances accrues 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 5

How should this transaction be accounted for?

Staff Response

The proceeds from the sale of the future income stream on the credit card accounts should be accounted for as a borrowing, because the transfer of future gross income does not qualify as a sale. Accordingly, 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 ASC 470-10-35.

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 the six criteria, the sales proceeds generally would be reported as debt. The criteria, as listed in the standard, are as follows:

1. The transaction is purported as a sale.
2. The entity has significant continuing involvement in the generation of the cash flows due the investor (for example, active involvement in the generation of operating revenues of a product line, subsidiary, or a business segment).
3. The transaction is cancelable by either the entity or the investor through payment of a lump sum or other transfer of assets by the entity.
4. The purchaser's rate of return is implicitly or explicitly limited by the terms of the transaction.
5. Variations in the bank's revenue or income underlying the transaction have only a trifling impact on the purchaser's rate of return.
6. The purchaser has recourse to the bank relating to the payments due the purchaser.

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, because 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.

Facts Under ASC 860-50, a servicing asset results when the benefits of (revenues from) servicing are expected to provide more than "adequate compensation" to the servicer. If the benefits of servicing are not expected to compensate a servicer adequately for performing the servicing, the contract results in a servicing liability.

Question 6

How is "adequate compensation" defined in ASC 860?

Staff Response

The ASC glossary defines adequate compensation as "the amount of benefits of servicing that would fairly compensate a substitute servicer should one be required, which includes the profit that would be demanded in the marketplace." It goes on to say, "adequate compensation is determined by the marketplace; it does not vary according to the specific costs of the servicer."

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 $1,000,000 pool of loans, a portion of which is guaranteed by the SBA. The bank is transferring the SBA guaranteed portion of the loan pool.

Question 7

How should the transfer of the guaranteed portion of the loan pool be accounted for?

Staff Response

To be eligible for sales treatment in accordance with ASC 860-10-40-6A, transfers of a portion of a loan must first meet the definition of a participating interest, in addition to the other requirements for a sale under ASC 860-10-40. One of the criteria in the definition of a participating interest requires there be no recourse (other than standard representations and warranties) to, or subordination by, any participating interest holder. There is an exception to this general rule for recourse in the form of independent third-party guarantees, such as SBA loans. The independent third-party guarantee is considered a separate unit of account from the portion of the loan that is sold and does not influence the pro-rata distribution of cash flows required by a participating interest. As long as the other criteria for a participating interest are met, the guaranteed and unguaranteed portions of the SBA loan meet the definition of a participating interest. The bank would account for this transfer as a sale in accordance with ASC 860-20-40.

UPDATE

Facts A bank transfers a participation in an originated loan to a third party. The bank receives a premium on the transfer, which is subject to a provision that requires the seller to refund any premium received if the borrower fails to make any of the first three payments (90-day period).

UPDATE

Question 8

How should this transaction be accounted for?

Staff Response

The transfer of the loan participation would not initially be accounted for as a sale since the participation does not meet all the characteristics of a participating interest described in ASC 860-10-40-6A. In this case, the premium refund provision is considered to be recourse that is beyond standard representations and warranties and results in a disproportionate allocation of cash flows. During the 90-day recourse period, the transaction would not be eligible for sales treatment and therefore would be accounted for as a secured borrowing until the recourse provision expires. Any gain resulting from the premium received on the transfer should not be reflected as other noninterest income, nor should a servicing asset be recorded, until the provision expires, the participation meets the definition of participating interest, and the transfer meets all criteria for sale accounting.

Facts A bank formed a $1 billion pool of receivables from credit card accounts and transferred the receivables to a trust. The trust is consolidated by the bank in accordance with ASC 810-10. During a specified reinvestment period (i.e., 48 months), the trust will purchase additional credit card receivables generated by the selected accounts. During the revolving period, the investors' dollar investment remains constant, because principal payments, allocated to the investors' interest are reinvested in additional credit card receivables. The up-front transaction expenses of $5,000,000 consist of legal fees, accounting fees, rating agency fees, and underwriting fees.

Question 9

How should the bank account for the up-front transaction costs of the securitization?

Staff Response

Debt issuance costs, such as the fees described previously, are capitalized and amortized in accordance with the terms of the debt agreement. Because the trust is consolidated and, therefore, the trust's outstanding bonds are reported on the bank's balance sheet, all debt issuance costs should be capitalized and amortized accordingly.

Facts A bank issues GNMA mortgage-backed securities, which are securities backed by residential mortgage loans that are insured or guaranteed by the FHA, the VA, or the FmHA. This program allows, but does not require, the bank to buy back individual delinquent mortgage loans that meet certain criteria from the securitized loan pool, which the bank is servicing. At the servicer's (bank's) option and without GNMA's prior authorization, the servicer may repurchase such a delinquent loan for an amount equal to 100 percent of the remaining principal balance of the loan. The bank is not the primary beneficiary, as defined by ASC 810-10-20, of the VIE, into which the residential mortgages were transferred, and does not consolidate the VIE.

Question 10

Does the buy-back provision preclude the bank from recognizing the transfer as a sale?

Staff Response

No. In accordance with ASC 860-10-40-25, the bank's conditional or contingent buy-back option generally does not maintain the bank's effective control of the transferred loans, because the option might not be exercised or the conditions might not occur. Accordingly, the loans are removed from the bank's balance sheet.

Question 11

When individual loans later meet GNMA's specified delinquency criteria and are eligible for repurchase, how should the bank account for the loans?

Staff Response

When individual loans later meet the delinquency criteria and are eligible for repurchase, the issuer (bank), providing the issuer is also the servicer, is deemed to have gained effective control over the loans. Accordingly, under ASC 860-10-40, the loans may no longer be reported as sold. The loans must be brought back on the issuer/servicer's (bank's) books as an asset and initially recorded at fair value, regardless of whether the bank intends to exercise the buy-back option. An offsetting liability also would be recorded.

Question 12

Would the staff response to the two preceding questions change if the loans were not guaranteed or issued by an entity affiliated with the federal government?

Staff Response

No. The staff response would not change. The issuer of the security is permitted to treat the transaction as a sale for accounting purposes, because the conditional or contingent nature of the buy-back option means that the issuer does not maintain effective control over the loans.

Question 13

How should the assets and the related liability (see response to question 11) be reported on the call report (balance sheet)?

Staff Response

The loans should be reported as either loans held for sale or loans held for investment, based on the facts and circumstances, in accordance with GAAP. The loans should not be reported as Other assets. The offsetting liability should be reported as "Other borrowed money" on the call report.

Facts The bank enters into a contractual arrangement with a third party whereby it will provide funding to the mortgage company at the time of closing for mortgage loans originated by the third party, up to a specific funding amount. The interest received by the bank is at a fixed rate and not dependent on the rate paid by the borrower on the underlying mortgages. The third party provides the bank with a blank assignment on these loans and has entered into forward-purchase commitments with parties unrelated to the bank on each of the loans that the bank funds.

Question 14

Should this transaction be recorded by the bank as an individual purchase of each underlying mortgage?

Staff Response

No. The bank must evaluate the terms of the transaction to determine if it meets the requirements for a sale under ASC 860-10-40-5. Under this accounting principle, the third party must have surrendered control (i.e., no longer maintains control) of the financial asset for the transaction to qualify as a sale. The economic benefits provided by a financial asset (generally, the right to future cash flows) are derived from the contractual provisions that underlie that asset, and the entity that controls the benefits should recognize the benefits as its asset. The fact pattern above leads to the conclusion that the seller is maintaining control of the asset, as it will continue to receive the economic benefits from the contractual terms of the contract (mortgage servicing rights, coupon rate of interest) while paying the bank a fixed rate independent of any terms under the contractual arrangement. The mortgage company's control of the party to whom the loan is sold through its forward-sale commitment is also problematic in obtaining sales treatment. Both of these factors are consistent with the determination that this transaction is a secured financing and should be accounted for as such by the bank. These types of arrangements are traditionally referred to as warehouse facilities.

NEW

Question 15

A bank has transferred "last-in, first-out" (LIFO) and "first-in, first-out" (FIFO) loan participations. What is the proper accounting treatment for these types of loan participations transferred?

Staff Response

LIFO or FIFO participations transferred do not qualify for sale accounting as they do not meet the definition of a participating interest under ASC 860-10-40-6A which specifically requires cash flows to be divided proportionally among the participating interest holders. Therefore, LIFO or FIFO participations are accounted for as secured borrowings. For the transferor, the entire loan balance remains on the books and a liability is recorded to reflect the proceeds from the portion purchased by the participating bank(s). Assets and liabilities of the transferor bank are therefore higher than they would be if a sale were recognized for the transferred loan participations. As a result, the transferor bank must hold regulatory capital for the entire loan balance, including the amount transferred to the participant(s). The transferred loan participations should also be included in the transferor's loan balance for purposes of determining appropriate allowance for loan losses.

NEW

Facts A bank (transferor) plans to transfer mortgage servicing rights (MSRs) on previously sold mortgage loans to an unrelated entity for cash. The bank is preparing an MSR transfer accounting analysis to determine whether substantially all of the risks and rewards of the MSRs have been transferred to the purchaser to achieve sales accounting. The bank retains the responsibility for representations and warranties relating to underwriting standards on the serviced loans associated with the MSRs. Upon repurchase of the mortgage loans due to a breach of representations and warranties, the bank is obligated to repurchase the related MSRs at a specified fixed price based on the time elapsed since the original MSR transfer date. The MSR repurchase price may not be equivalent to fair value at the time of repurchase.

Question 16

In determining whether the MSR transfer qualifies for sale accounting, does the bank need to consider the potential required MSR repurchases related to loan representations and warranties as retention of risk as part of the protection provisions?

Staff Response

Yes. Depending on the facts and circumstances, the potential that the seller repurchases the MSR may or may not be considered a protection provision. When the MSR purchaser is being compensated at a "predetermined price," it may be considered a form of yield protection for the MSR purchaser in the MSR transfer accounting analysis.

NEW

In accordance with ASC 860-50-40, one quantitative test requires aggregating all the protection provisions (e.g., indemnifications and recourse obligations that protect the yield or value of the MSR to the MSR purchaser) retained by the transferor after the MSRs transfer date. To qualify for sale accounting under this test, such aggregate obligations need to be minor (10 percent or less) in relationship to the sales price (as adjusted), as determined for each unit of account. In the bank's facts and circumstances, the MSR repurchase is considered a protection provision because the seller may be required to pay a pre-determined fixed price greater than the actual fair value of the MSR at the time of the repurchase. The protection provision needs to be analyzed under ASC 860-50-40-4(1) because it may be more than minor on the MSR transfer date. If a bank pays fair value on the specific MSR at the repurchase date, recourse would be zero (i.e., there would be no protection provision). In contrast, since the bank pays a fixed amount for the repurchase of the MSR, the amount paid may be higher than the actual fair value of the MSR. In some instances, the MSR has a zero or negative fair value on the transfer date, but the purchaser is still compensated at a pre-determined amount if the MSR is repurchased by the transferor.

Facts A bank plans to transfer MSRs on previously sold mortgage loans to an unrelated entity for cash. The MSR sales contract transfers servicing of different underlying pools comprised of mortgage loans governed under different servicing contracts, with similar legal and servicing provisions except that one servicing contract has a different recourse provision on certain vintages of loans within the pools of loans sold. Since some loans in this servicing contract are subject to a different recourse provision retained by the seller, these underlying loan pools are dissimilar to those covered under other servicing contracts to be sold.

Question 17

What "unit of account" should be used to evaluate whether the MSR transfers qualify as sales under GAAP?

Staff Response

The OCC staff views the group of MSRs associated with each underlying loan pool under the servicing contract with different recourse as a separate unit of account. Each of these pools needs to be separately evaluated for the 10 percent test in MSR transfer accounting analysis and therefore should not be aggregated with the others.

When the MSRs related to the underlying loan pools share the same protection provision, then these homogenous pools may be aggregated for the 10 percent test in the MSR transfer accounting analysis. It is inappropriate to aggregate established units of account to achieve the desired sales result for the 10 percent test.

MSRs are not financial assets. The accounting model used to evaluate whether the transfer of an MSR asset qualifies for a sale is based on a risks and rewards approach. Although ASC 860-50-40-4 is not specific about how the 10 percent test needs to be completed, individual facts and circumstances need to be considered if it appears the

NEW

transaction was structured to meet the sales rules. To determine the appropriate level at which the sale accounting analysis should be performed, the bank should evaluate the risks retained or unique characteristics of underlying serviced loans associated with the MSRs governed under the contracts that are dissimilar because they have a specific recourse provision retained by the MSR transferor.

9B. Credit Card Affinity Agreements

Facts In 20XX, a bank entered into a 12-year contract with an affinity group for the exclusive right to offer credit cards to the group's members in return for a nonrefundable payment to the group of $50 million per year. The affinity group has a stable membership, and, therefore, the number of credit card customers is expected to remain relatively constant. Further, the services performed by the parties are constant throughout the life of the contract.

The contract also contains a royalty calculation provision that uses an escalating scale that bears no relationship to the expected earnings from the credit card portfolio or services performed under the contract. Under this escalating scale, the royalty provision provides for a $10 million amount in the first year and in excess of $100 million in the final year of the contract. Although the excess of the annual payment over the royalty amount is not refundable, it may be used to offset future royalties. The bank proposes to record a $10 million expense the first year and include the $40 million amount difference as a prepaid expense (other asset) on its balance sheet.

Question 1

Should the bank capitalize $40 million of the $50 million payment related to this affinity agreement as a prepaid asset because of the royalty calculation provision?

Staff Response

No. GAAP requires that the expense be determined in a systematic and rational manner to the periods in which the payments are expected to provide benefit. In this situation, the benefits of the relationship and the services of the affinity group are being provided consistently throughout the contract period. Further, the royalty calculation provision in the contract is not related to the expected earnings on the portfolio or the services performed by the affinity group.

Accordingly, an accounting method that recognizes expense on a periodic basis relative to the benefits received should be used. In this case, the periodic payments from the bank to the affinity group are the best measurement of that benefit. This accounting is consistent with ASC 450. ASC 840-20-25 also provides guidance that requires leases with accelerated payment structures to be accounted for by recognizing income or expense on a straight-line basis or another income recognition method that provides a systematic pattern consistent with the benefits derived.

9C. Organization Costs

Question 1

What are start-up activities and organization costs?

Staff Response

Start-up activities are defined broadly as those one-time activities related to opening a new facility, introducing a new product or service, conducting business in a new territory, conducting business with a new class of customer, or commencing a new operation. Start-up activities include activities related to organizing a new entity—such as a new bank—that are commonly referred to as organization costs.

Organization costs for a bank are the direct costs incurred to incorporate and charter the bank. Such costs include, but are not limited to, professional (e.g., legal, accounting, and consulting) fees and printing costs directly related to the chartering or incorporation process, filing fees paid to chartering authorities, and the cost of economic impact studies.

Question 2

What is the accounting for start-up activities, including organization costs?

Staff Response

Costs of start-up activities, including organization costs, should be expensed as incurred. Costs of acquiring or constructing premises and fixed assets and getting them ready for their intended use are capitalized as fixed assets. The costs of using such assets that are allocated to start-up activities (e.g., depreciation of computers), however, are considered start-up costs. For a new bank, pre-opening expenses such as salaries and employee benefits, rent, depreciation, supplies, directors' fees, training, travel, postage, and telephone are considered start-up costs.

Guidance on the accounting and reporting for start-up activities, including organization costs, is set forth in ASC 720-15 and the call report instructions glossary under "start-up activities."

Question 3

What is the accounting for the organization costs of forming a BHC?

Staff Response

Although BHC organization costs are sometimes paid by a bank owned by the BHC, those costs are the BHC's organization costs and should not be reported as expenses of the bank. Call report instructions require any unreimbursed BHC organization costs paid for by the bank on behalf of the BHC to be recorded as a cash dividend paid from the bank to the BHC. Similarly, if the BHC application is unsuccessful or abandoned, the costs are the responsibility of the BHC organizers. Therefore, unreimbursed amounts should be recorded as a dividend.

Facts Bank A would like to expand into a nearby state. Because of state law, a bank must have an existing charter in the state for more than five years to be able to conduct business. To achieve this, Bank A purchases and merges with Bank B's existing charter, which it acquired from Bank B's parent holding company for $300,000. Bank B is an independent third-party institution. Bank A does not acquire any other net assets of Bank B but now has the legal right to do business in that state. The transaction is not a business combination, because the charter in itself does not constitute a business.

Question 4

How should Bank A account for the $300,000 paid to acquire the charter with the sole purpose of achieving the right to do business in the state?

Staff Response

Although this cost may be consistent with the definition of an organization cost, because it was created in a third-party transaction, it is considered to be an intangible asset and is accounted for under ASC 350 rather than ASC 720-15. Accordingly, this cost may be capitalized.

Question 5

May the intangible asset noted be accounted for as goodwill?

Staff Response

No. The intangible is not considered to be goodwill. In accordance with ASC 350-30, assets acquired outside of a business combination do not give rise to goodwill. This asset would be considered to be an identifiable intangible asset. (See Topic 10B for further guidance on the appropriate accounting for intangible assets.)

Facts The start-up costs of forming a bank are sometimes paid by the organizing group (or founders or BHC) without reimbursement from the bank. This may occur because the organizing group or BHC wishes to contribute these funds to the bank, or because the shareholders or the OCC disallow reimbursement of certain costs.

Question 6

How should the bank account for these start-up costs that are paid by the organizers?

Staff Response

The bank must record these start-up costs as expenses of the bank, with a corresponding entry to surplus to reflect the capital contribution. This includes direct costs paid to third parties and services that are provided by the holding company, such as legal or accounting expertise. In the latter case, the holding company should estimate the cost of services provided, including salaries, and the bank should record these costs as start-up costs.

Topic 10 Acquisitions, Corporate Reorganizations, and Consolidations

10A. Acquisitions

Question 1

In general, what are the accounting principles for business combinations under ASC 805?

Staff Response

The accounting requirements in ASC 805 include, but are not limited to, the following:

- Banks are not allowed to carryover the acquired bank's ALLL in an acquisition. Instead, all acquired loans should initially be recorded at fair value without an ALLL.
- Other than the direct costs to issue debt and equity, transaction costs are expensed. These costs should not be capitalized as part of the acquisition cost.
- The bank will recognize and, with limited exceptions, measure the identifiable assets acquired, the liabilities assumed, and any NCI at fair value as of the acquisition date. Subsequent acquisitions of the remaining NIC are accounted for as part of equity with no impact on earnings.
- Any excess of the net assets acquired over the purchase price (formerly referred to as negative goodwill) should be recognized in earnings as a bargain purchase gain.
- The bank should recognize an indemnification asset, if the seller contractually indemnifies the bank for the outcome of a contingency or uncertainty related to all or part of a specific asset acquired or liability assumed in the business combination.
- The bank is required to recognize assets acquired and liabilities assumed arising from contingencies as of the acquisition date, if acquisition-date fair value can be determined during the measurement period.

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

Should those costs be capitalized by Bank A in the acquisition?

Staff Response

No. Under ASC 805, the acquiring bank is not allowed to record the transaction and restructuring costs of an acquisition as part of the purchase price. An acquiring bank may only capitalize the costs to issue debt and equity securities as part of the acquisition.

Accordingly, costs incurred to terminate Bank B's unfavorable contracts, including data processing contracts, should be expensed when incurred. This includes the cost to make Bank B's data processing system compatible with Bank A. In addition, costs incurred by the acquiring institution to modify, convert, or terminate its own data processing system should also be expensed as incurred.

Facts Bank A acquires Bank B from the FDIC in a 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 transaction be accounted for?

Staff Response

The transaction should be accounted for using the acquisition method of accounting. Accordingly, the assets acquired and liabilities assumed are generally recorded at fair value in accordance with ASC 820-10. The cash received from the FDIC (i.e., the $5 million) is recorded as an asset acquired in an acquisition. Any difference between the fair value of the net assets acquired and the purchase price should be recognized as goodwill (if purchase price exceeds the fair value of the net assets acquired) or as a gain from bargain purchase (if fair value of the net assets acquired exceeds the purchase price).

Question 4

Would the response to question 3 be different if the bank had entered into a loss-sharing agreement with the FDIC?

Staff Response

The transaction should still be accounted for under the acquisition method. The loss-sharing agreement between the bank and the FDIC should be accounted for as an indemnification asset or a derivative, either of which is recorded at fair value on the acquisition date. If recorded as an indemnification asset, when the bank experiences a change in the cash flows expected to be collected on an FDIC indemnification asset because of a change in the cash flows expected to be collected on the assets covered by the loss-sharing agreement, the bank should account for the change in the measurement of the indemnification asset on the same basis as the change in the

assets subject to indemnification. Any amortization of changes in the value of the indemnification asset should be limited to the lesser of the term of the indemnification agreement and the remaining life of the indemnified assets.

Facts FDIC-assisted acquisitions generally are made through an expedited bid process. Prior to submitting a bid, the acquirer (Bank A) will prepare a provisional amount for the fair value of the assets and liabilities being acquired. These provisional amounts are based on limited due diligence and incomplete information regarding the assets acquired and liabilities assumed by the bank.

Question 5

Is it appropriate, in recording the acquisition, for Bank A (the acquirer) to revise the provisional fair value amounts?

Staff Response

Yes, not only is it appropriate, it is required. At the acquisition date the acquirer generally will not have obtained all of the information necessary to measure the fair value of the assets acquired and liabilities assumed in the acquisition in accordance with ASC 820-10. The provisional estimates assigned during the initial due diligence process must be retrospectively adjusted during the measurement period (see question 6), when appropriate.

Question 6

What is the measurement period referred to in the staff response to question 5?

Staff Response

The measurement period is the period of time after the acquisition date, not to exceed 12 months, that is required to identify and measure the fair value of the identifiable assets acquired, liabilities assumed, and any NCI in the acquiree in a business combination. The measurement period ends as soon as the acquirer receives the information it was seeking about the facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable.

Question 7

What is the acquisition date for purposes of determining the purchase price of an acquisition and the assignment of fair values to the assets acquired and liabilities assumed?

Staff Response

For an acquirer, ASC 805-10-25-6 defines the acquisition date as "the date on which it obtains control of the acquiree." Generally, control occurs when the acquirer legally transfers consideration, acquires the assets, and assumes the liabilities of the acquiree. This would normally be the consummation or closing date of the transaction.

Question 8

If equity securities are issued in the business combination, is their value also determined as of the acquisition date?

Staff Response

Yes. Under ASC 805-10-25, the fair value on the acquisition date is used in determining the value of the securities issued.

Facts Bank A acquires Bank B in a transaction accounted for under the acquisition method in accordance with ASC 805. The purchase price paid at acquisition exceeds the fair value of the net assets acquired. In addition to the amount paid at the time of the acquisition, the agreements provide for additional payments by Bank A to the former owners of Bank B, based upon the occurrence of certain future events.

Question 9

How should these additional payments be recorded? Should any portion of the contingent consideration be included in the purchase price at the date of acquisition?

Staff Response

The additional payments are considered contingent consideration, and Bank A should include the fair value of the contingent consideration on the acquisition date as part of the cost of acquiring the entity (i.e., the purchase price). If the fair value of the contingent consideration cannot be determined at the acquisition date, or during the measurement period (see question 6), the contingent consideration should not be included in the purchase price. If the fair value of contingent consideration can be determined during the measurement period, Bank A should classify the obligation as a liability or as equity at the date of acquisition in accordance with ASC 480-10.

Contingent consideration classified as a liability should be remeasured at each reporting date with changes in fair value recognized in earnings. Contingent consideration classified as equity should not be remeasured at each reporting date, and its subsequent settlement should be accounted for as an equity adjustment.

Question 10

In certain situations the fair value of the net assets acquired exceeds the purchase price of an institution. How should the excess (formerly referred to as negative goodwill) be recorded?

Staff Response

A transaction in which the fair value of the net assets acquired exceeds the purchase price is referred to as a bargain purchase. When a bargain purchase occurs, the acquirer must first review the fair value of the assets acquired, the liabilities assumed,

and the consideration transferred. If the fair-value amounts are appropriate, the acquirer should recognize any excess of the net assets acquired over the consideration transferred (i.e., the purchase price) in earnings as a gain from bargain purchase.

ASC 805-10 requires that the fair values of the acquired assets and liabilities be reassessed before any bargain purchase gain amounts are recognized in earnings.

Facts Bank A acquires 100 percent of Bank B, an unaffiliated entity. There is a contingent payment (earn-out) agreement between Bank A and the original shareholders of Bank B. Based on future performance, contingent payments (i.e., contingent consideration) to the shareholders will range from $0 to $50 million.

Question 11

How should the contingent consideration be accounted for?

Staff Response

Bank A should determine the fair value of the contingent consideration as of the acquisition date and include that amount in the purchase price of Bank B. Bank A must classify the contingency as a liability because the contingency will be paid in cash. Subsequent to the acquisition date, the liability should be reported at fair value with changes in fair value reflected in net income. The difference between the amount recorded as a liability and the settlement amount should be recognized in earnings.

Facts Bank A acquires 100 percent of Bank B, an unaffiliated entity. Bank B is involved in litigation with a third party. Bank A, following the acquisition of Bank B, may suffer a loss due this litigation. Bank A estimates that it may face a loss between $0 and $50 million at the acquisition date.

Question 12

How should the contingent payment associated with the litigation (i.e., the loss contingency) be accounted for?

Staff Response

If the fair value of the loss contingency as of acquisition date can be determined during the measurement period (see question 6), the contingent payment should be reported at fair value and included in the net assets acquired (i.e., as a liability assumed) in the business combination. Going forward the bank should account for the liability in accordance with ASC 450-20. When the loss contingency is resolved, any difference in the payment amount and the recorded amount of the liability should be recognized in earnings.

If Bank A cannot determine the acquisition-date fair value of the contingent payment during the measurement period, no liability should be recorded. Subsequent to the

measurement period, the bank should account for the loss contingency in accordance with ASC 450-20. Accordingly, the liability should be recognized and included in earnings, when payment is probable and the amount of the payment can be reasonably estimated.

Facts Bank A acquires Bank B in a transaction accounted for under the acquisition method in accordance with ASC 805.

Question 13

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 the 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. The capital accounts of the acquired entity are eliminated. If there is any NCI, the NCI is recorded at fair value as part of equity. 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 may be included in the calculation. Operations of the acquired bank would be included from the date of acquisition.

Because of concerns about the quality and composition of capital when a gain from bargain purchase is expected to result from a business combination and the related fair value estimates have not yet been validated, the OCC may impose certain conditions in their approvals of acquisitions to maintain and protect the safety and soundness of the acquiring institution. Conditions may include, but are not limited to, the acquiring institution excluding the gain from bargain purchase from its dividend-paying capacity calculation until the end of the period set forth in the conditional approval.

Question 14

In a business combination effected through the exchange of equity interests, is the surviving legal entity necessarily the acquiring entity for accounting purposes?

Staff Response

ASC 805-10-05-4 notes that the acquisition method requires identification of the acquiring entity and establishes criteria for making that determination. In that context, the entity that issues the equity interests is generally also the acquiring entity for accounting purposes. This, however, is not always the case. In certain circumstances,

the entity that is acquired for accounting purposes will issue the equity interests and be the surviving charter. These transactions are commonly referred to as reverse acquisitions.

Generally, the acquiring bank for accounting purposes is the larger entity; however, all of the facts and circumstances must be considered in making this determination.

Question 15

In addition to the relative size of the combining banks, what other factors should be considered in determining the surviving entity for accounting purposes?

Staff Response

The following factors should be considered in determining the surviving entity for accounting purposes:

- The relative voting rights of the shareholders of each entity in the combined entity—the owners of the surviving entity usually retain the largest voting rights in the combined entity.
- The existence of a large NCI that will have significant voting influence over the combined entity—the owners of the surviving entity usually hold the largest interest.
- The composition of the governing body (i.e., board of directors)—the owners of the surviving entity usually have the ability to make changes to the majority of the members of the board of directors.
- The composition of senior management—management of the surviving entity usually dominates the combined management.
- The terms of the exchange of equity interests and the values ascribed to the prices of the equity interests that are exchanged—the surviving entity usually pays a premium over the value of the equity interests of the other entity.

Facts Bank A is the legal survivor in a business combination with Bank B. Prior to the merger, however, Bank A has $150 million in assets, and Bank B has $220 million in assets. After the merger, Bank A's former shareholders will own 40 percent of the outstanding stock, and Bank B's former shareholders will own 60 percent of the outstanding stock of the combined entity.

Further, former Bank B shareholders will have four members on the board of directors, and former Bank A shareholders will have three members on the board.

Question 16

For accounting purposes, which bank is the acquiring bank?

Staff Response

Bank B is the acquiring bank. This determination is based on the relative size of the combining banks, as well as the resulting shareholder ownership and board membership percentages. In this situation, the determination is relatively clear-cut because Bank B provided approximately 60 percent of the assets, and its former owners received approximately 60 percent of the security interests and board membership. In practice, the determination will not always be this clear.

Question 17

How is this transaction accounted for?

Staff Response

Because Bank B is the acquiring bank for accounting purposes, its financial statements will be carried forward at historical cost. Further, for dividend limitation purposes under 12 USC 56 and 60(b), the retained net income of Bank B will be used. Bank A is accounted for as the acquired bank and its assets (including intangible assets) and liabilities are recorded at fair value. The purchase price for the acquisition is the fair value of the shares of stock owned by former Bank A shareholders. Goodwill is recorded for the difference between the purchase price and the fair value of the net assets acquired.

Facts Bank A previously acquired 20 percent of Bank B for $20 million. The current carrying value of Bank A's investment in Bank B is $22 million at March 31, 20XX. On March 31, 20XX, Bank A acquires an additional 50 percent of Bank B for $75 million. On March 31, 20XX, the fair value of Bank B's net identifiable assets and liabilities is $110 million and the fair value of the remaining 30 percent interest not held by Bank A is $45 million. The fair value of Bank A's initial 20 percent investment is $30 million.

Question 18

How should Bank A account for the subsequent acquisition of the 50 percent interest in Bank B?

Staff Response

ASC 805-10-25 refers to this type of transaction as a business combination in stages, or a step acquisition. Bank A should account for the subsequent purchase of the 50 percent interest using the acquisition method under ASC 805-10-25. The acquisition of the additional interest on March 31, 20XX, is the date Bank A obtains control of Bank B and is considered the acquisition date to apply ASC 805-10-25.

As the first step, Bank A should adjust the carrying amount of its initial investment to fair value or $30 million, with a corresponding gain of $8 million recognized in earnings. Then Bank A should record the full fair value of the acquired assets and liabilities, along with an NCI of $45 million. Finally, Bank A would record the full goodwill value of $40 million as shown in the following:

Purchase of additional 50 percent	$75 million
Fair value of initial 20 percent investment	$30 million
Fair value of 30 percent not held by Bank A	$45 million
Total fair value of Bank B	$150 million
Fair value of net identifiable assets and liabilities	$110 million
Goodwill	$40 million

The goodwill value represents the excess of the acquisition cost of Bank B, which includes the fair value of the NCI, over the fair value of its acquired net assets in their entirety.

Question 19

If Bank A subsequently acquires the remaining 30 percent of Bank B, should Bank A make any further adjustments to the reported carrying values?

Staff Response

Because Bank A had previously acquired control of Bank B, the acquisition of the remaining NCI should be accounted for as a capital transaction, pursuant to ASC 810-10. In this situation, Bank A controls Bank B and thus no gain or loss is recognized as a result of the purchase of the remaining 30 percent NCI. In addition, Bank A should not make any further adjustments to the acquired assets and liabilities of Bank B.

Instead, the NCI currently reported in Bank B is eliminated as an offset to the purchase price. Any difference between the purchase price and the carrying value of the NCI is recognized as part of Bank A's APIC.

10B. Intangible Assets

Question 1

In general, what are the accounting principles for recognizing goodwill and other intangible assets as part of a business combination?

Staff Response

ASC 805 and ASC 350 include, but are not limited to, the following recognition and measurement principles for goodwill and other intangibles:

- An intangible asset should be recognized as an asset separately from goodwill, if either of the following two criteria is met:
  - It is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of

whether the entity intends to do so; or

— It arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

In general, the excess of the consideration transferred and the fair value of any NCI in the acquiree over the fair value of the net identifiable assets acquired should be recognized as goodwill by the acquirer.

Subsequent to the acquisition date, as long as the acquirer maintains control, any changes in the level of ownership will be treated as capital transactions; there is no further change to the goodwill amount.

Goodwill and indefinite-lived, intangible assets should not be amortized; rather, they should be reviewed at least annually for impairment in accordance with ASC 350-20-35 (for goodwill) and ASC 350-30-35 (for indefinite-lived intangibles).

Other intangible assets (i.e., core deposit intangibles, purchased credit card relationships, etc.) that are not indefinite-lived should be amortized over their useful lives and assessed for impairment in accordance with ASC 360-10-35 (see question 3).

Question 2

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

Staff Response

An intangible asset that has a finite life (e.g., core deposit intangible and PCCR) should be amortized over its estimated useful life using a method that reflects the pattern in which the economic benefit of the asset is consumed. This will generally result in the use of an accelerated method of amortization. If a usage pattern cannot be reliably determined, institutions should use the straight-line method.

The staff believes the estimated useful lives of core deposit intangibles and PCCRs will generally not exceed 10 years. In unusual circumstances, however, a longer useful life and amortization period may be justified.

Question 3

Should discounted or undiscounted expected future cash flows be used in assessing an intangible asset with a finite life (e.g., a purchased credit card relationship) for impairment?

Staff Response

An intangible asset with a finite life should be assessed for impairment in accordance with ASC 360-10-35. An impairment loss shall be recognized if the carrying amount of the intangible asset is not recoverable. The carrying amount is not recoverable if it exceeds the sum of the undiscounted expected future cash flows from the intangible

asset. If the carrying amount of the asset is not recoverable, it is written down to its fair value (i.e., the sum of the discounted expected future cash flows from the intangible asset).

Facts Bank A acquires Bank B in a business combination accounted for using the acquisition method. 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 business combination accounted for using the acquisition method, and Bank A is combined into Bank C.

Question 4

Should 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 value of Bank A's assets and liabilities on that acquisition date. This includes any identifiable intangible assets, such as core deposit intangibles, and unidentifiable intangible assets (goodwill). The intangible assets resulting from the first acquisition (Bank B by Bank A) are no longer relevant, because the second acquisition creates a new basis of accounting for Bank A's assets and liabilities. Accordingly, the intangible assets recorded on the financial statements of Bank C, after the acquisition of Bank A, result only from that acquisition.

Question 5

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 may not be acquired or sold separately. In this respect, ASC 350-20 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" (see Topic 10C) and recorded at the bank level. It would be inconsistent with this policy to allow the goodwill to be sold to a parent holding company or other related party and not be included on the bank's financial statements.

Facts A bank pays a license fee to a third party to assist the bank in establishing a new factoring program for its customers. The fee is not subject to refund and represents a contract right. The agreement gives the bank territorial exclusivity for one year. There is also a monthly license fee that is expensed each month.

Question 6

How should the license fee be accounted for?

Staff Response

The license fee represents an intangible asset. The fee should be amortized over its useful life in accordance with ASC 350. ASC 350-30-35 lists pertinent factors to consider in estimating the useful life. One factor is contractual provisions that may limit the useful life. In this case, the contract provides for one year of territorial exclusivity. Once this period expires, the value of the license is diminished. Thus, a useful life of one year appears appropriate. If a longer life is considered appropriate, the value of the intangible asset should be reviewed for impairment in accordance with ASC 360-10-35.

Facts On December 31, Bank A acquired Bank B in a business transaction accounted for as a purchase transaction and recognized goodwill for the excess of the purchase price over the fair value of the identifiable assets acquired and liabilities assumed. Two years have now passed since the acquisition, and Bank A has experienced a loss of certain key personnel and increased competition related to the acquisition. As such, Bank A believes that the recorded value of its goodwill may have declined.

Question 7

How should goodwill be tested for impairment?

Staff Response

ASC 350-20-35 gives an entity the option to first assess qualitative factors to determine whether the existence of event or other circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstance, an entity determines it is not more likely than not that the fair value of the reporting unit is less than its carrying amount, then performing the two-step impairment test described below is unnecessary. If, however, an entity concludes otherwise, then it is required to perform the two-step impairment test at the reporting unit level to identify potential goodwill impairment and measure the amount of goodwill impairment loss to be recognized (if any).

An entity may assess qualitative factors to determine whether it is more likely than not (that is a likelihood of more than 50 percent) that the fair value of a reporting unit

is less than its carrying amount, including goodwill. An entity has the unconditional option to bypass the qualitative assessment for any reporting unit in any period and proceed directly to performing the first step of the two-step goodwill impairment test. An entity may resume performing the qualitative assessment in any subsequent period.

ASC 350-20-35-3C provides some examples (not-all-inclusive) of relevant events and circumstances in evaluating whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount.

In this example, the reporting entity is considered to be Bank A. While the reporting unit is typically at a level below an operating segment, Bank B's operations and financial information has been merged into Bank A, and the combined activities are managed as one unit.

Step 1—Perform a comparison of the carrying value of Bank A to its fair value. The carrying value used in this comparison includes the current goodwill value. If the fair value of the reporting entity exceeds the carrying value, no further evaluation is necessary. If the fair value of Bank A is less than the carrying value, step 2 is performed.

Step 2—Require Bank A to allocate the fair value determined in step 1 to the identifiable assets and liabilities, including any intangible assets, to determine an implied value of goodwill. If the implied fair value of goodwill is less than the carrying amount of goodwill, the difference is recognized as an impairment charge.

Question 8

Would the tests be performed any differently if Bank A had other assets that might have declined in value? For example, as a result of the increased competition, Bank A no longer intends to use some of the acquired premises for banking purposes and has decided to sell those assets.

Staff Response

In this case, the subsequent decision not to use some of the acquired premises for banking purposes results in a need to evaluate those assets for impairment. As a result, the acquired premises will be reclassified from banking premises carried at amortized cost to other real estate owned accounted for at lower of cost or fair value, less costs to sell. If the fair value less cost to sell is less than amortized cost, that loss should be recognized in earnings and the carrying value of the premises adjusted to the lower value, which becomes the new cost basis as other real estate owned.

In performing step 2 of the impairment test for goodwill, a bank may identify other long-lived assets that should be tested for impairment under ASC 360-10-35. ASC 350-20-35-31 requires that any impairment on other long-lived assets be recognized before testing goodwill for impairment. Any impairment of other long-lived assets that is identified should be recognized prior to the final impairment test under step 2 for goodwill.

Question 9

If the results of step 2 of the goodwill impairment test identify different values for other identifiable assets or liabilities, should those new amounts be recorded on the bank's balance sheet?

Staff Response

No, the results of step 2 of the impairment test for goodwill are only used for determining the *implied* value for goodwill. Other than the need to determine whether any long-lived assets should be tested for impairment, the recorded values of the assets and liabilities are not changed.

Facts On December 31, Bank A acquired Bank B in a transaction accounted for as a purchase transaction and recognized goodwill for the excess of the purchase price over the fair value of the identifiable assets acquired and liabilities assumed. Two years have now passed since the acquisition, and Bank A has not experienced any significant adverse factors related to the acquisition.

Question 10

Bank A manages Bank B as a reporting unit. Bank A has historically determined the fair value of the reporting unit annually. Is Bank A required to determine a new value of the reporting unit each year to test goodwill for potential impairment?

Staff Response

Not necessarily. If the latest valuation indicates that the fair value of the reporting unit substantially exceeds the carrying amount, Bank A may be able to carry forward the valuation for the next year. Bank A must also be able to conclude, however, that the assets and liabilities of that reporting unit have not changed significantly since the most recent fair-value determination, and that the likelihood that the fair value from a new appraisal would be less than the carrying value is remote. If there have been no significant changes to its operations, its competition, or other adverse conditions that would indicate that the previous fair value was no longer appropriate, Bank A is not required to obtain an updated fair value annually.

Question 11

Is Bank A allowed to consider a control premium, the excess amount a buyer is willing to pay to gain control of an entity, in its fair-value determination of the reporting unit?

Staff Response

It depends. The fair values used to test goodwill for impairment should be based on the principles of ASC 820-10. Acquiring banks may be willing to pay more for an equity investment that represents a controlling interest than for an investment in a similar number of equity securities that do not represent a controlling interest. As part of the determination of the fair value of the reporting unit, a bank may need

to consider the impact of the control premium based on the value of the reporting unit in the marketplace. Because it is being valued as a whole, the marketplace typically places additional value on the ability to gain control of an entity. Therefore, individual prices by themselves need not be the sole measurement basis for the fair value of a reporting unit.

10C. Push-Down Accounting

UPDATE

Question 1

What is push-down accounting?

Staff Response

Call report instructions describe push-down accounting as the establishment of a new accounting basis for a bank in its separate financial statements as a result of it becoming substantially wholly owned via a purchase transaction or series of purchase transactions. Push-down accounting typically applies when an investor (usually a BHC) acquires 80 percent to 100 percent (see question 2) of a bank in a business combination accounted for by the acquisition method, and the acquired bank retains its separate corporate existence.

The majority of push-down accounting guidance is contained in ASC 805-50-S99 and call report instructions.

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 business combination accounted for using the acquisition method results in a change in control of at least 95 percent of the voting stock of the bank. It is, however, 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 SEC.

Push-down accounting may also be used after a change in control of at least 80 percent, but less than 95 percent. Approval by the bank's outside accountant and the OCC, however, 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 noncontrolling shareholders of Bank B are paid cash for their stock. Holding Company A 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 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. Push-down accounting is not allowed, however, 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), because only 75 percent of the bank was acquired.

In addition, Holding Company A should have recorded the acquired assets and liabilities, including goodwill, at their full fair values at the acquisition date when control is obtained, under ASC 805-10-25-6. The subsequent acquisition of the NCI holders would have been accounted for as a capital transaction by the holding company, with no gain or loss recognized in earnings. Once the criteria for push-down accounting were met, the full amounts from the acquisition date would have been recorded at the bank level.

Facts Purchase acquisitions may involve the issuance of debt securities. In ASC 805-50-S99, the SEC 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 ASC 805-50-S99 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.

If that circumstance should occur, however, the debt should be recorded on the financial statements of the acquired bank. The offsetting entry would reduce the acquired bank's capital accounts.

Question 5

Question 1 refers to the acquisition of a bank by a parent and notes that it is typically a BHC. Does push-down accounting apply when the acquisition is made by an individual, group of individuals, or another type of entity?

Staff Response

Yes. Push-down accounting would apply whenever a new "control group" acquires at least 95 percent of a bank. Further, consistent with the guidance in question 2, push-down purchase accounting may be used after a change in control of at least 80 percent, but less than 95 percent has occurred. This could result from an acquisition by a corporation, partnership, voting trust, individual, or group of individuals acting together.

Facts Question 2 refers to the requirement for push-down accounting in an acquisition that results in a change of control of at least 95 percent of the voting stock of the bank. Assume that Holding Company A owns 100 percent of the voting stock of Bank A. Rather than a change in the ownership of Bank A stock, the change of control results from a change of ownership of at least 95 percent of the holding company stock.

Question 6

Does push-down accounting apply at the bank level when the change of ownership is of holding company stock?

Staff Response

Yes. Push-down accounting would be applied whenever there is a change of control of at least 95 percent of a bank's ownership. This change could result from either a direct or indirect change of ownership of the bank. Further, consistent with the guidance in question 2, push-down accounting may be used after a change in control of at least 80 percent, but less than 95 percent, has occurred.

Facts Four individuals acting together (the purchasing group) enter into an agreement to purchase 97 percent of the outstanding stock from shareholders of ABC Bancorporation (Bancorp). Bancorp is a one-bank holding company that owns 100 percent of the stock of ABC National Bank. Subsequently, but prior to consummation of the acquisition, the purchasing group brought in 17 additional investors. The four original individuals that constitute the purchasing group acquired 70 percent of the outstanding shares of Bancorp. The 17 additional investors acquired 27 percent of the outstanding shares. Preexisting shareholders continued to own 3 percent of the outstanding shares.

Question 7

Should push-down accounting be applied in this situation?

Staff Response

Yes. The four individuals who constituted the purchasing group negotiated for the purchase of 97 percent of Bancorp. The terms of the acquisition were dictated by the agreement between the four individuals and the selling shareholders. If the purchasing group had not brought in the additional investors, push-down accounting would be applied.

The fact that the purchasing group brought in additional investors between the time the acquisition agreement was executed and the date the acquisition was consummated would not affect the conclusion regarding the use of push-down accounting. This results because there is a new control group in place, and there has been a change of control of at least 95 percent.

Facts A 100 percent interest in Bank A, a credit card bank, is acquired by an unaffiliated entity, Holding Company B. The purchase price allocation includes both PCCR and goodwill.

After acquisition, the bank continues to originate credit card loans but immediately sells the loan balances at fair value to a nonbank finance subsidiary of the holding company. The bank maintains ownership of the account relationships and receives income from this ownership arrangement. The bank also continues to service the loans and receives a monthly servicing fee from the subsidiary. All of the related-party transactions and fees are at fair market amounts.

Question 8

Should the purchase adjustments, including the purchased credit card relationships and goodwill, resulting from the acquisition of Bank A be pushed down to the bank, because the bank has entered into an agreement to immediately sell off the receivable balances to a related party?

Staff Response

As noted in question 2, push-down accounting is required if an arms-length purchase accounting transaction results in a change of control of at least 95 percent of the voting stock of an acquired entity. In this situation there has been a 100 percent change of control. The acquired credit card business has been split, however, with portions of the business allocated to the bank and to the finance subsidiary. Accordingly, the net assets, including the purchased credit card relationships and goodwill, should be allocated to the bank and the finance subsidiary in a reasonable and rational manner. In this situation, the purchased credit card relationships would be allocated to the bank, because it owns the relationships. The goodwill should be allocated between the two entities based on the relative value to each.

Facts Corporation XYZ acquires 51 percent of Bank Holding Company, Inc. (BHC, Inc.). BHC, Inc. owns 100 percent of Bank A. Just prior to the acquisition, BHC, Inc. reincorporated to another state using a new legal entity to facilitate the change. In accordance with GAAP, XYZ accounted for the transaction using the acquisition method of accounting for the acquisition. BHC, Inc. files consolidated financial statements and "parent only" financial statements with the SEC. The bank's assets represent substantially all of BHC, Inc.'s consolidated assets.

Question 9

Is the application of push-down purchase accounting required for the bank?

Staff Response

No. Although ASC 805-10-25 requires BHC, Inc. to revalue its assets and liabilities, push-down accounting at the subsidiary bank is not permitted, because the change in control of 51 percent is less than 80 percent (see question 2). In addition, the bank's financial statements are not being presented separately in reports filed with the SEC. As noted in question 2, push-down accounting is required in a change in control of at least 95 percent of the voting stock of the bank, or if the bank's financial statements are presented on a push-down basis in reports filed with the SEC.

Question 10

May the bank elect to apply push-down accounting for financial reporting in the call report?

Staff Response

The bank may elect to apply push-down accounting for call report purposes, provided the bank's independent auditors and the OCC concur that the application is consistent with GAAP. As noted in question 2, the OCC would normally only consider such application for push-down accounting appropriate when the change of control is at least 80 percent. In unusual circumstances, however, such application may be appropriate when the change in control is less than 80 percent.

UPDATE

Facts An existing BHC acquired all of the stock of a bank in a transaction that was accounted for by the acquisition method and resulted in a bargain purchase gain. The acquired bank applies push-down accounting because of the 100 percent change in control.

Question 11

Should the bargain purchase gain amount be recorded on the bank's separate balance sheet as a part of equity capital?

Staff Response

Yes. Under push-down accounting, the bank restates its identifiable assets, liabilities, and any NCI to their respective fair values (with limited exceptions as specified in ASC 805) as of the acquisition date. The excess of the fair value of the net assets acquired over the purchase price paid by the BHC represents a bargain purchase gain. The bargain purchase gain amount should be reflected in the separate balance sheet of the bank as paid-in capital or on the call report as part of surplus. The bargain purchase gain should be reflected in the consolidated income statement of the BHC but not in the acquired bank's separate income statement.

Facts A newly formed BHC purchased a bank. As part of the purchase and sale agreement, the BHC entered into a contractual obligation to pay to the former owners of the acquired bank certain payments depending on the level of credit losses experienced by the acquired bank within the next three years. The payment is to be made in stock issued by the holding company.

Question 12

How should this contingent consideration, commonly referred to as an "earn out," be recorded in the purchase accounting adjustments?

Staff Response

The contractual agreement to pay the former owners of the acquired bank specified amounts based on the subsequent loan performance is a liability, because the agreement constitutes an obligation to pay the former owners, subject to the level of performance being obtained. Thus, the contingent consideration should be recorded as a liability at its fair value on day 1. The purchase price paid would include the fair value of the liability and will be reflected in the push-down accounting entries to the bank. Subsequent to the acquisition date, the liability should be reported at fair value with changes in fair value reflected in earnings. The final difference between the amount recorded as a liability and the settlement amount should be recognized in earnings.

10D. Corporate Reorganizations

Question 1

How should a bank account for transfers of an individual asset or group of assets that do not constitute a business between a bank and its parent holding company or other related party?

Staff Response

The transfer of assets that do not constitute a business 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 asset 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

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

Staff Response

Generally, no. A combination between two or more affiliated banks is accounted for in accordance with ASC 805-50. This requires that such combinations be accounted for at historical cost in a manner similar to pooling of interest accounting. The staff believes this accounting is appropriate when all or substantially all (90 percent or more) of net assets from a target entity that constitute a business are transferred to an affiliated entity.

If, however, the acquired net assets do not constitute a business or the transaction involves less than substantially all (90 percent) of the target bank's net assets that constitute a business, the reorganization of affiliated banks must be accounted for at fair value (see 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

What is the definition of a business as used in question 2?

Staff Response

ASC 805-10 defines a business as "an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors

or other owners, members, or participants." ASC 805-10-55 provides additional guidance that states a business consists of inputs and processes applied to those inputs that have the ability to create outputs. Although businesses usually have outputs, outputs are not required for an integrated set of activities and assets to qualify as a business.

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

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 among entities under common control, which is exempt from the general requirements of ASC 805-10. Furthermore, because this transfer of assets involves all of the target institution's assets, it is accounted for in accordance with ASC 805-50, 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 ASC 805-50, 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

In accordance with 12 USC 60(b), how should the retained net income amounts be determined when computing dividend limitations?

Staff Response

As the combined national bank's financial statements represent the combination of the financial statements of the two banks at historical cost, the retained net income (net income less dividends paid in each year) for both entities should be combined when computing the dividend limitations of 12 USC 60(b). Therefore, the prior two years of retained net income plus current year net income for both banks would be considered in the calculation.

10E. Related-Party Transactions (Other Than Reorganizations)

Facts The bank sold a previously charged-off loan to related parties (i.e., members of the board of directors and stockholders). The sale price of the loan was its face value of $800,000. An appraisal has determined that the fair value of the charged-off loan is $100,000.

Question 1

How should the sale of this charged-off loan be accounted for?

Staff Response

The fair value of the loan ($100,000) is credited to the ALLL 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 in the previous question, except that the fair value of the charged-off loan cannot be reasonably determined. How should this transaction be accounted for?

Staff Response

Inasmuch as it is not possible to determine if the charged-off loan has any value, it should be assumed the loan has only minimal value. Therefore, the entire purchase price ($800,000) is considered to be a capital contribution and is credited to capital surplus.

Facts The bank sold a previously charged-off loan to related parties, i.e., members of the board of directors and stockholders, at its face value of $800,000. It is not possible to determine if the charged off loan has any value. Further, because of a lending limit violation, the directors are liable legally to purchase the loan at its face value.

Question 3

How is this transaction accounted for?

Staff Response

This transaction is accounted for in the same way 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 percent 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

How should the bank record the purchase of the loans?

Staff Response

The purchased loans should be recorded at their fair value, which is presumed to be the net amount received by the seller (unrelated party). The excess of the purchase price over the fair value of the loans should be reported as a dividend.

In this case, the fee appears to significantly exceed a normal fee expected for an arms-length transaction for services of the type provided by the loan brokerage company. Further, it supports the presumption that the face amount of the loans is not their fair value. Therefore, in substance, they represent a dividend, with the fair value of the loans represented by the net proceeds received by the seller.

Facts A bank maintains escrow balances on deposits for loans serviced by certain mortgage banking affiliates of the bank's parent holding company. The bank retains income earned on such deposits.

The mortgage banking affiliates borrow funds from the bank, paying the market rate of interest. The interest rate does not recognize the benefit of the escrow funds deposited with the bank. Furthermore, no other arrangements exist to compensate the mortgage banking affiliates for the loss of the escrow account income.

Question 5

How should the bank account for the earnings from the use of the mortgage escrow balances?

Staff Response

Earnings from the bank's free use of the mortgage escrow balances provided by the mortgage banking affiliates should be credited to capital surplus as a contribution rather than recorded as income.

This response presumes that the mortgage banking affiliates can realize the benefit associated with the escrow balances. Earnings from escrow deposits provide a

significant source of income to a mortgage banking operation. This income source is a significant part of the inherent value of mortgage servicing rights and a key consideration when servicing is acquired. Further, servicers often recognize part of this inherent value by negotiating a reduced interest cost on their borrowings as a result of these deposits.

Differences between the terms that prevail in the marketplace and those entered into by related parties is accounted for as a capital transaction (i.e., capital contribution or dividend). This policy is based upon the need to maintain consistency in accounting policy for transactions between affiliated and nonaffiliated parties.

Facts A one-bank holding company has entered into deferred compensation agreements with its six executive officers, who are also officers and employees of the bank. When the officer terminates employment, he or she is entitled to receive the vested amount in cash. The amount is paid by the holding company. Dividends from the bank are the holding company's only source of funds.

Question 6

Should the compensation expense under the deferred compensation agreements be recorded on the books of the bank?

Staff Response

The compensation expense resulting from these deferred compensation agreements should be recorded on the book of the entity for which the officers-employees perform services. If the holding company is a shell with little activity of its own, the compensation likely relates to services performed for the bank.

In this situation, the holding company has the contractual obligation to pay the deferred compensation to the officer-employee. The holding company is incurring this obligation on behalf of the bank, however. Therefore, the bank should record the expense and a liability for reimbursement to the holding company. If the holding company does not require or forgives reimbursement from the bank, a capital contribution from the holding company is recorded by the bank.

Facts The bank has a $5,000,000 impaired loan to a borrower that is experiencing financial difficulty. The bank has the loan classified as substandard. The bank has established an allowance of $1,525,000 measured in accordance with ASC 310-10-35. Seven bank directors who are unrelated to the borrower signed personal guarantees on the loan. The borrower is not aware of the guarantee. The signing of the guarantees was intended to reduce the bank's ratio of classified loans to capital and to eliminate the need for the $1,525,000 allowance. The directors have substantial net worth.

Question 7

How should the bank account for this transaction?

Staff Response

The impaired loan should remain classified substandard with an appropriate allowance. The allowance should be estimated without consideration of the guarantee by the bank's seven directors, because the guarantee was obtained subsequent to origination and independent from the contractual relationship between the borrower and the bank. Upon execution of the guarantee, accounting entries are not required, because the guarantee is considered a contingent capital contribution. If/when the directors perform on the guarantee, the amounts received by the bank should be recorded as a capital contribution and should not affect the accounting for the loan.

The economic substance of the guarantee by the seven directors is a contingent purchase of the note. The purchase of the note is contingent on the loan defaulting and the bank taking action to enforce the guarantee. To the extent the directors will be paying the bank a purchase price in excess of fair value, the excess represents a contingent capital contribution (see Topic 10E, question 1). The contingent capital contribution should not be recorded until it is realized.

Topic 11 Miscellaneous Accounting

11A. Asset Disposition Plans

Facts On January 10, 2011, a bank proposes and adopts an asset disposition plan that will result in the sale or disposition of all non-cash assets of the bank. The bank anticipates that the liquidation of the bank's assets will not be sufficient to satisfy all of the bank's liabilities. On the basis of a preliminary valuation of the loan portfolio, substantial losses are expected.

Question 1

What is the appropriate accounting for the bank at December 31, 2010?

Staff Response

The assets and liabilities of the bank at December 31, 2010 should be recorded at fair value. The results of operations for the period ended December 31, 2010, should include a charge for the decline in value. This is based on ASC 942-810-45-2, which requires that assets and liabilities of a liquidating bank be recorded at fair value.

Question 2

Does the fact that the decision to liquidate the bank was made 10 days after the year-end affect the accounting?

Staff Response

GAAP establishes two types of subsequent events. The first type provides additional evidence for conditions that existed on the balance sheet date. ASC 855-10-25 requires entities to recognize the effects of all "type one" events in the current period financial statements. The second type of event provides evidence on conditions that did not exist on the balance sheet date. These events do not result in adjustments to the financial statements.

The adoption of the asset disposition plan would be the first type of event for which inclusion of the effects in the December 31, 2010, financial statements would be required. The adoption of an asset disposition plan is the culmination of an undercapitalized position that existed prior to December 31, 2010.

11B. Hedging Activities

Facts A bank borrowed $30 million from the FHLB with interest due monthly at one-month LIBOR plus 15 basis points, and principal due at maturity in three years. At maturity, the bank expects the FHLB borrowing to be rolled over into a new borrowing with similar terms. The bank elected to use hedge accounting for this instrument. To hedge the risk associated with potential increasing interest rates, the bank purchased a five-year, interest-rate cap.

Question 1

Does the hedge using an interest-rate cap qualify for the short-cut method set forth in ASC 815-20-25?

Staff Response

No, the use of the shortcut method is only available to interest-rate swaps.

Question 2

Even though the shortcut method does not apply, should the bank still assume that the hedge is perfectly effective?

Staff Response

Possibly, provided the following four criteria outlined in ASC 815-20-25-129 have been met:

1. The critical terms of the hedging instrument (such as its notional amount, underlying, and maturity date) completely match the related terms of the hedged forecasted transaction (such as the notional amount, the variable that determines the variability in cash flows, and the expected date of the hedged transaction).
2. The strike price (or prices) of the hedging option (or combination of options) matches the specified level (or levels) beyond (or within) which the entity's exposure is being hedged.
3. The hedging instrument's inflows (outflows) at its maturity date completely offset the change in the hedged transaction's cash flows for the risk being hedged.
4. The hedging instrument can be exercised only on a single date, its contractual maturity date.

Question 3

If the interest rate cap meets the ASC 815-20-25-129 criteria and is assumed to be perfectly effective, should the bank perform and document an assessment of hedge effectiveness continually?

Staff Response

Yes, the bank should still perform and document an assessment of hedge effectiveness at least quarterly. This assessment should include

- verifying and documenting whether the critical terms of the hedging instrument and the forecasted transaction have changed during the period in review.
- determining that the forecasted transaction is still probable of occurring at the same time and location as originally projected.
- assessing whether there have been adverse developments regarding the risk of counterparty default. If there are no such changes in the critical terms or adverse developments regarding counterparty default, the bank may conclude that there is no ineffectiveness to be recorded.

11C. Financial Statement Presentation

Question 1

May banks have a fiscal year-end financial reporting period that differs from the calendar year-end financial reporting period required for call report reporting purposes?

Staff Response

Yes. Banks are not restricted in their choice of a fiscal year-end financial reporting period. For call report purposes, however, banks must report financial information at the end of each calendar quarter with December 31 as their year-end. Also, the 12 CFR 18 requires all national banks to disclose annual financial and other information to the public using a December 31 year-end date.

Facts A bank has publicly held stock and is registered under the Securities Exchange Act of 1934. Accordingly, in addition to filing call reports, the bank also files with the OCC Forms 10-K and 10-Q under the Securities Exchange Act.

During a regulatory examination, the OCC determined that certain adjustments were required for the bank's financial statements to be in accordance with GAAP. The bank disagreed and asked for a review by the OCC's Ombudsman. The Ombudsman's decision supported the position of the OCC examination staff, and the bank amended its call reports. The bank, however, did not amend its Securities Exchange Act filings filed with the OCC.

Question 2

Must the bank also amend its Forms 10-K and 10-Q filed with the OCC under the Securities Exchange Act to record the adjustments required by the OCC examination staff and the Ombudsman?

Staff Response

Yes. The general instructions to the call reports note that the instructions include reporting guidance that falls within the range of acceptable practice under GAAP. The

instructions also note that when the supervisory agency issues an interpretation of GAAP application to a specific transaction, the supervisory agency may require the bank to prepare its call reports in accordance with that interpretation.

Further, the Securities Exchange Act requires that financial statements included under the act be prepared in accordance with GAAP. Therefore, bank financial statements prepared in accordance with GAAP and included in filings under the Securities Exchange Act filed with the OCC must be prepared using the same accounting interpretations or guidance as was used in the call reports.

11D. Fair Value Accounting

Question 1

How does ASC 820-10 define fair value?

Staff Response

ASC 820-10 provides a comprehensive definition of fair value. ASC 820-10 states that "fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date" and further clarifies that fair value represents an exit price, not an entry price. In other words, fair value is the price that would be received to sell an asset as opposed to the price that would be paid to purchase an asset.

ASC 820-10-35 also clarifies that the exit price should be based on the price that would be received in the bank's principal market for selling that asset. The principal market is the market the bank has historically sold into with the greatest volume. If the bank does not have a principal market for selling that asset, the exit price should assume the asset is sold into the most advantageous market. The most advantageous market is the market in which the bank would receive the most value, considering the transaction costs in the respective markets.

Question 2

ASC 820-10 specifies that fair value represents the price that would be received in other than a forced or distressed sale. What does this mean?

Staff Response

When estimating the price that would be received to sell an asset, the bank should base its analysis on the price that would be received in an orderly transaction. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets. Sales that are not consistent with this time frame when the seller is experiencing financial difficulty might be considered forced sales and would not represent orderly transactions. Judgment must be used in determining whether specific observable transactions represent forced or non-orderly sales.

ASC 820-10-35-51E provides guidance in determining whether specific observable transactions represent forced or non-orderly sales. Factors to be considered in making this determination include, but are not limited to, lack of adequate exposure to the market to allow for customary marketing activities, or a seller near bankruptcy or receivership required to enter into a sales transaction for legal or regulatory purposes.

Question 3

Does GAAP provide guidance explaining how to estimate the exit price (fair value) of an asset as of the measurement date?

Staff Response

ASC 820-10-35 requires that banks look first to current quoted market prices, when available, in estimating fair value. The standard establishes a fair value hierarchy that prioritizes the use of inputs used in valuation techniques in the following three levels:

Level 1—Observable prices in active markets for identical assets and liabilities.

Level 2—Observable inputs other than quoted prices in active markets for identical assets and liabilities.

Level 3—Unobservable inputs (i.e., internally generated assumptions).

Banks must use quoted prices in active markets for the identical asset (Level 1) if they are available. When determining a value, the measurement method should maximize the use of observable inputs and minimize the use of unobservable inputs. If quoted prices are only available for similar (but not identical) assets or based on markets that are not active, those prices would be considered Level 2 inputs. The measurement of fair value for an asset with only Level 2 inputs available may include adjustments to the observable prices that are needed to arrive at the best estimate of the exit price for that particular asset. Banks should support the adjustments made to observable prices for similar assets or in markets that are not active, as further discussed in question 4.

Question 4

Is there any specific guidance for modeling fair value?

Staff Response

ASC 820-10-35 provides general, but not specific, guidance when models are used. When Level 1 inputs are not available, a bank generally needs to use a valuation technique. To the extent possible, banks should base the assumptions used in modeled valuations on observable, market-corroborated inputs. If observable market data cannot be gathered without unreasonable cost and effort, a bank should use assumptions that represent the bank's best estimate of the assumptions that it believes a market participant would use. In estimating these assumptions, banks should not ignore information about market participant assumptions that is reasonably available. Although internally generated assumptions may need to be used, the fair value

measurement objective remains the same: that is, an exit price from the perspective of a market participant. To the extent a bank needs to use valuation models that include unobservable inputs, ASC 820-10-35 requires the bank to factor into the fair-value measurement any adjustment for risks related to the valuation technique and inputs that a market participant would include in determining the price that a market participant would pay to acquire that asset.

Question 5

What guidance is available regarding when observable transactions should not be considered reflective of fair value or regarding what should go into valuation modeling?

Staff Response

ASC 820-10-35 provides guidance for institutions to evaluate if observable transactions have occurred as part of transactions that are not orderly or if the volume and level of activity in that market has significantly decreased. Even though activity levels may have declined and there may be transactions that are not orderly, the objective of providing a fair-value measurement does not change and should represent the price received to sell an asset or the amount paid to assume a liability in an exchange between willing market participants.

ASC 820-10-35-51A provides a listing of several factors that may indicate that the volume and level of activity in a given market has significantly declined. If the bank concludes that observable transactions have occurred in such a market, the quoted prices or observable transactions may not necessarily be representative of fair value, if the observable transactions were forced sales. The bank needs to further analyze these transactions and quoted prices and may be required to make significant adjustments or change the valuation technique used to measure fair value.

ASC 820-10-35-55 further explains that a transaction is not necessarily a forced transaction just because the volume or level of activity has declined. The bank must review the facts and circumstances of each transaction in the market to determine if the transaction is not orderly. Factors that indicate a transaction is not orderly include but are not limited to

- insufficient time to allow for marketing activities that are usual and customary in similar transactions.
- the seller is in bankruptcy or receivership.
- the transaction price is an outlier compared with other recent transactions.

If the transaction is determined to not be orderly, then little weight should be placed on the transaction price when estimating fair value. Otherwise, the transaction price should be considered in determining fair value.

Facts A bank chose to adopt the fair value option as of January 1, 2007 as permitted by the early adoption provisions in paragraph 30 of SFAS 159. The bank elected to apply the fair value option to selected existing AFS debt securities that had unrealized losses as of January 1, 2007. Prior to the date on which the fair value option was elected, the bank had the intent and ability to hold the selected securities until recovery and had appropriately determined that the unrealized losses were not other than temporary.

Question 6

Does the bank's fair value option election for the selected AFS securities result in the unrealized losses as of the adoption date being recognized as an adjustment to beginning retained earnings (retained earnings as of January 1, 2007)?

Staff Response

The Center for Audit Quality provides guidance on this issue in an Alert issued in April 2007 regarding ASC 825-10 early adoption. It notes that although ASC 825-10 allows for early adoption of the fair-value option to available-for-sale securities, including securities with unrealized losses, care should be exercised that the bank adopts ASC 825-10 in a manner consistent with the principles and objectives outlined in the statement.

The objective of using fair value accounting is not met if the bank elected the fair-value option for the designated securities so as to recognize the unrealized loss through retained earnings, with the intention of then selling those securities and not applying fair-value accounting going forward. In this case, the election of the fair-value option for those securities would not be considered substantive. The unrealized losses related to the securities would be recognized in income if the losses became other than temporary or if the securities were sold.

If the purpose behind the bank's election was to account for the selected securities at fair value on a going-forward basis, then the adoption would be considered substantive and the unrealized losses as of the adoption date would be recognized as an adjustment to the January 1, 2007, retained earnings balance.

Question 7

Is there a capital impact of applying the fair value option to selected or all AFS securities?

Staff Response

Yes. Any unrealized losses related to the AFS securities that are included in accumulated other comprehensive income as of the election date do not affect capital calculations, while any unrealized losses that are classified as an adjustment to the retained earnings as a result of applying the ASC 825-10 fair value option decrease

regulatory capital. Additionally, there could be greater volatility in regulatory capital because all future changes in fair value related to these assets are recognized through earnings each subsequent period.

Question 8

Does ASC 820-10 provide any guidance specific to fair valuing liabilities?

Staff Response

Yes. If a liability is reported at fair value, ASC 820-10-35 requires that the fair value be based on the price that would be paid to transfer that liability to a market participant with the same credit standing. The transfer price does not necessarily equal the price that would be paid to settle the liability. The transfer price concept also assumes that the nonperformance risk related to the liability does not change as a result of the transfer.

In many instances, there is not an active market with quoted prices for an identical liability that allows an entity to readily determine the transfer price of a liability. In those circumstances, another valuation technique consistent with ASC 820-10-35 is appropriate. One could use the quoted market price for the identical liability when it is traded as an asset or for a similar liability when traded as an asset. If either of these techniques is used, the quoted price may need to be adjusted for factors that are present in the asset that are not present in the liability, or vice versa. A present value technique may also be applied to determine the fair value of the liability. No matter which technique is used, the entity should maximize the use of observable inputs and minimize the use of unobservable inputs.

If a bank's own liability is reported at fair value, ASC 820-10-35 requires the bank to include in the fair-value measurement the effect that changes in the bank's own credit risk (credit standing) have on the fair value of the liability. As the bank's credit standing deteriorates, the fair value of the bank's own liabilities decreases, and a gain from the change in fair-value results. Conversely, the fair value of the bank's own liabilities increase as the bank's credit standing improves, which may result in a loss. For call report purposes, when a bank elects to account for its own liabilities at fair value, the bank should exclude from Tier 1 capital the cumulative change in the fair value of those liabilities included in retained earnings that is attributable to the bank's own creditworthiness.

NEW

Facts A bank, in its capacity as a market maker, holds a portfolio of credit derivatives in its trading book that are measured at fair value (categorized within Level 2) with changes in fair value recorded in earnings. The bank obtains bid and ask prices (e.g., broker quotes), on each derivative position on a daily basis in order to measure its fair value. Historically, to measure the fair value of the individual positions within the portfolio, the bank used the mid-point of the bid-ask spread (mid-market pricing convention), adjusted for appropriate valuation adjustments consistent with market participant assumptions. These included assumptions about risks, e.g., counterparty credit valuation adjustments, own credit valuation adjustments, and liquidity adjustments. In the recent quarter, the fair value of certain credit derivative positions in the entity's credit derivative portfolio began to move adversely as calculated in accordance with its documented policies using mid-market pricing convention (after considering appropriate valuation adjustments to the mid-market prices).

Question 9

Is it appropriate for the bank to measure the fair value of the individual positions using a different point within the bid-ask spread (e.g., a more advantageous point within the bid-ask spread) to achieve a desired reporting outcome?

Staff Response

No. It is inappropriate to change a valuation methodology that would result in a fair value estimate not representative of a derivative position's exit price by migrating from a mid-market pricing convention to using a price within the bid-ask spread that is more advantageous to the entity in order to offset the impact of adverse changes in market prices or otherwise mask losses.

An entity should determine the price within the bid-ask spread that is most representative of fair value, which is the price that would be received to sell the asset or paid to transfer the liability (i.e., an exit price), based on assumptions a market participant would use in a similar circumstance. However, when measuring the fair value of a derivative position that has a bid-ask spread, ASC 820-10 does not preclude the use of mid-market pricing or other pricing conventions as a practical expedient for measuring the fair value within the bid-ask spread. An institution should maintain documented policies for determining the point within the bid-ask spread that is most representative of fair value and consistently apply those policies.

An entity is expected to apply its valuation policies and techniques for measuring fair value consistently over time. Nevertheless, ASC 820-10 acknowledges that a change in valuation technique from one methodology to another that results in an equally or more representative measure of the fair value of a derivative position may be appropriate. However, it would be inappropriate for an entity to alter its valuation methodology or policies to achieve a desired financial reporting outcome.

Appendixes

Appendix A. Commonly Used Acronyms

Acronym or Term	Definition
AFS	available-for-sale
AICPA	American Institute of Certified Public Accountants
ALLL	allowance for loan and lease losses
AOCI	accumulated other comprehensive income
APB	Accounting Principles Board
APIC	additional paid-in capital
ARM	adjustable rate mortgage
ASC	Accounting Standards Codification
BAAS	Bank Accounting Advisory Series (OCC)
Banks	national banks and federal savings associations
BHC	bank holding company or thrift holding company
BOLI	bank-owned life insurance
call report	The combined Reports of Condition and Income: the "Report of Condition" encompasses Schedules RC and RC-A through RC-T, and the "Report of Income" encompasses Schedules RI, RI-A through RI-E.
CAQ	Center for Audit Quality
CFR	Code of Federal Regulations
CLN	credit-linked notes
CLO	collateralized loan obligation
CMO	collateralized mortgage obligation
DTA	deferred tax asset
DTL	deferred tax liability
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
FFIEC	Federal Financial Institutions Examination Council
FHA	Federal Housing Administration
FHLB	Federal Home Loan Bank
FHLMC	Federal Home Loan Mortgage Corporation ("Freddie Mac")
FIFO	first in, first out
FmHA	Farmers Home Administration
FNMA	Federal National Mortgage Association ("Fannie Mae")
GAAP	generally accepted accounting principles (United States)
GNMA	Government National Mortgage Association ("Ginnie Mae")
GSE	government-sponsored enterprise
HFI	held for investment
HFS	held for sale
HTM	held-to-maturity
IO	interest-only
IPO	initial public offering
IRS	Internal Revenue Service
LC	letter of credit

Acronym or Term	Definition
LIBOR	London interbank offered rate
LIFO	last in, first out
LIHTC	low income housing tax credit
LOCOM	lower of cost or fair value
MBS	mortgage-backed security
MSR	mortgage servicing right
NCI	noncontrolling interest
NOL	net operating loss
OCA	Office of the Chief Accountant (OCC)
OCC	Office of the Comptroller of the Currency
OREO	other real estate owned
OTTI	other-than-temporary impairment
PCCR	purchased credit card relationships
PCI	purchased credit impaired loans (i.e., loans within the scope of ASC 310-30)
PMI	private mortgage insurance
PP&E	property, plant, and equipment
provision	provision for loan and lease losses (call report)
RC	Call report schedule RC—Balance Sheet
RC-B	Call report schedule RC-B—Securities
RC-F	Call report schedule RC-F—Other Assets
RC-N	Call report schedule RC-N—Past Due and Nonaccrual Loans, Leases, and Other Assets
RC-R	Call report schedule RC-R—Regulatory Capital
RI	Call report schedule RI—Income Statement
RI-E	Call report schedule RI-E—Explanations
SBA	Small Business Administration
SEC	Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standards
SFR	single family residential
SPE	special purpose entity
SPV	special purpose vehicle
TDR	troubled debt restructuring
USC	United States Code
VA	Department of Veterans Affairs
VIE	variable interest entity

Appendix B. Commonly Used Pre-Codification References

Pre-Codification Reference		FASB Codification Reference
APB 12	Accounting Principles Opinion No. 12, Omnibus Opinion—1967	ASC 710-10
APB 21	Accounting Principles Opinion No. 21, Interest on Receivables and Payables	ASC 835-30
APB 29	Accounting Principles Opinion No. 29, Accounting for Nonmonetary Transactions	ASC 845
ARB 43 Chapter 7A	Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins	ASC 852-20
EITF 00-19	Emerging Issues Task Force Consensus No. 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock	ASC 815-40
EITF 01-07	Emerging Issues Task Force Consensus No. 01-7, Creditor's Accounting for a Modification or Exchange of Debt Instruments	ASC 310-20
EITF 06-04	Emerging Issues Task Force Consensus No. 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements	ASC 715-60
EITF 06-05	Emerging Issues Task Force Consensus No. 06-5, Accounting for Purchases of Life Insurance Determining the Amount That Could be Realized in Accordance with FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance	ASC 325-30
EITF 85-01	Emerging Issues Task Force Consensus No. 85-01, Classifying Notes Received for Capital Stock	ASC 310-10 ASC 505-10
EITF 85-13	Emerging Issues Task Force Consensus No. 85-13, Sale of Mortgage Servicing Rights on Mortgages Owned by Others	ASC 860-50-40
EITF 87-19	Emerging Issues Task Force Consensus No. 87-19, Substituted Debtors in a Troubled Debt Restructuring	ASC 310-40
EITF 88-18	Emerging Issues Task Force Consensus No. 88-18, Sale of Future Revenues	ASC 470-10-35
EITF 88-25	Emerging Issues Task Force Consensus No. 88-25, Ongoing Accounting and Reporting for a Newly Created Liquidating Bank	ASC 942-810-45

Pre-Codification Reference		FASB Codification Reference
EITF 89-13	Emerging Issues Task Force Consensus No. 89-13, Accounting for the Cost of Asbestos Removal	ASC 410-30
EITF 90-08	Emerging Issues Task Force Consensus No. 90-08, Capitalization of Costs to Treat Environmental Contamination	ASC 410-30-25
EITF 99-20	Emerging Issues Task Force Issue No. 99-20, Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets	ASC 325-40 ASC 320-10-35
EITF D-80	Emerging Issues Task Force Topic D-80, Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio	ASB 310-10-35
EITF 96-11	Emerging Issues Task Force Consensus No. 96-11, Accounting for Forward Contracts and Purchased Options to Acquire Securities Covered by FASB Statement No. 115	ASC 815-10
FIN 45	FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others—An Interpretation of FASB Statements No. 5, 57, 107 and Rescission of FASB Interpretation No. 34	ASC 460
FIN 46(R)	FASB Interpretation No. 46, Consolidation of Variable Interest Entities—An Interpretation of ARB No. 51	ASC 810-10
FIN 48	FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes—An Interpretation of FASB Statement No. 109	ASC 740-10-25
FSP FAS 115-1	FASB Staff Position No. FAS 115-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments	ASC 320-10
FSP FAS 157-4	FASB Staff Position No. FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly	ASC 820-10-35
FTB 85-4	FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance	ASC 325-30

Pre-Codification Reference		FASB Codification Reference
PB 5	AICPA Practice Bulletin 5, Income Recognition on Loans to Financially Troubled Countries	ASC 942-310-35
SAB 59	SEC Staff Accounting Bulletin No. 59 as codified in SAB Topic 5.M, Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities	ASC 320-10-S99
SAB 109	Staff Accounting Bulletin No. 109, Written Loan Commitments Recorded at Fair Value Through Earnings	ASC 815-10-S99
SFAS 5	Statement of Financial Accounting Standard No. 5, Accounting for Contingencies	ASC 450
SFAS 13	Statement of Financial Accounting Standard No. 13, Accounting for Leases	ASC 840-30
SFAS 15	Statement of Financial Accounting Standard No. 15, Accounting by Debtors and Creditors to Troubled Debt Restructurings	ASC 310-40
SFAS 52	Statement of Financial Accounting Standard No. 52, Foreign Currency Translation	ASC 830
SFAS 65	Statement of Financial Accounting Standard No. 65, Accounting for Certain Mortgage Banking Activities	ASC 310-10-35 ASC 948-10
SFAS 66	Statement of Financial Accounting Standard No. 66, Accounting for Sales of Real Estate	ASC 360-20
SFAS 67	Statement of Financial Accounting Standard No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects	ASC 970-340
SFAS 87	Statement of Financial Accounting Standard No. 87, Employers' Accounting for Pensions	ASC 715-30
SFAS 91	Statement of Financial Accounting Standard No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases	ASC 310-20
SFAS 98	Statement of Financial Accounting Standard No. 98, Accounting for Leases	ASC 840-40
SFAS 106	Statement of Financial Accounting Standard No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions	ASC 715-60 ASC 715-10
SFAS 109	Statement of Financial Accounting Standard No. 109, Accounting for Income Taxes	ASC 740
SFAS 114	Statement of Financial Accounting Standard No. 114, Accounting for Creditors for Impairment of a Loan	ASC 310-10-35 ASC 310-40-35

Pre-Codification Reference		FASB Codification Reference
SFAS 115	Statement of Financial Accounting Standard No. 115, Accounting for Certain Investments in Debt and Equity Securities	ASC 320
SFAS 118	Statement of Financial Accounting Standard No. 118, Accounting by Creditors for Impairment of a Loan	ASC 310
SFAS 123R	Statement of Financial Accounting Standard No. 123R, Accounting for Share-Based Payment	ASC 715-10-15
SFAS 133	Statement of Financial Accounting Standard No. 133, Accounting for Derivative Instruments and Hedging Activities	ASC 815-10-15 ASC 815-20-25
SFAS 140	Statement of Financial Accounting Standard No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (replaced SFAS 125)	ASC 860
SFAS 141R	Statement of Financial Accounting Standard No. 141R, Business Combinations	ASC 805
SFAS 144	Statement of Financial Accounting Standard No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets	ASC 360-10
SFAS 146	Statement of Financial Accounting Standard No. 146, Accounting for Costs Associated with Exit or Disposal Activities	ASC 420-10
SFAS 149	Statement of Financial Accounting Standard No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities	ASC 815-10
SFAS 150	Statement of Financial Accounting Standard No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity	ASC 480-10
SFAS 154	Statement of Financial Accounting Standard No. 154, Accounting Changes and Error Corrections	ASC 250-10
SFAS 157	Statement of Financial Accounting Standard No. 157, Fair Value Measurements	ASC 820-10
SFAS 159	Statement of Financial Accounting Standard No. 159, The Fair Value Option for Financial Assets and Financial Liabilities	ASC 825-10
SFAS 160	Statement of Financial Accounting Standard No. 160, Noncontrolling Interests in Consolidated Financial Statements	ASC 810-10

Pre-Codification Reference		FASB Codification Reference
SFAS 166	Statement of Financial Accounting Standard No. 166, Accounting for Transfers of Financial Assets (amended SFAS 140)	ASC 860-10
SFAS 167	Statement of Financial Accounting Standard No. 167, Amendments to FASB Interpretation No. 46R	ASC 810-10
SOP 01-6	AICPA Statement of Position 01-06, Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others	ASC 942-10 ASC 310-10
SOP 03-3	AICPA Statement of Position 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer	ASC 310-30
SOP 98-1	AICPA Statement of Position 98-01, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use	ASC 350-40
SOP 98-5	AICPA Statement of Position 98-05, Reporting on the Costs of Start-up Activities	ASC 720-15

Appendix C. Commonly Used FASB Codification References

FASB Codification Reference		Pre-Codification Reference
ASC 250-10	Accounting Standards Codification Topic 250-10, Accounting Changes and Error Correction—Overall	SFAS 154
ASC 310-10	Accounting Standards Codification Topic 310-10, Receivables—Overall	SFAS 65 SOP 01-6 SFAS 114
ASC 310-20	Accounting Standards Codification Topic 310-20, Receivables—Nonrefundable Fees and Other Costs	SFAS 91
ASC 310-30	Accounting Standards Codification Topic 310-30, Receivables—Loans and Debt Securities Acquired with Deteriorated Credit Quality	SOP 03-3
ASC 310-40	Accounting Standards Codification Topic 310-40, Receivables—Troubled Debt Restructurings by Creditors	SFAS 15 SFAS 114 EITF 87-19
ASC 320	Accounting Standards Codification Topic 320, Investments—Debt and Equity Securities	SFAS 115
ASC 320-10	Accounting Standards Codification Topic 320-10, Investments—Debt and Equity Securities—Overall	FSP FAS 115-1
ASC 320-10-S99	Accounting Standards Codification Topic 320-10-S99, Investments—Debt and Equity Securities—Overall—SEC Materials	SAB 59
ASC 325-30	Accounting Standards Codification Topic 325-30, Investments—Other—Investments in Insurance Contracts	FTB 85-4 EITF 06-5
ASC 325-40	Accounting Standards Codification Topic 325-40, Investments—Other—Beneficial Interests in Securitized Financial Assets	EITF 99-20 FSP FAS 115-1
ASC 350-20	Accounting Standards Codification Topic 350-20, Intangibles—Goodwill and Other—Goodwill	SFAS 142
ASC 360-20	Accounting Standards Codification Topic 360-20, Property, Plant, and Equipment—Real Estate Sales	SFAS 66
ASC 420-10	Accounting Standards Codification Topic 420-10, Exit or Disposal Cost Obligations—Overall	SFAS 146
ASC 450	Accounting Standards Codification Topic 450, Contingencies	SFAS 5
ASC 460	Accounting Standards Codification Topic 460, Guarantees	FIN 45

FASB Codification Reference		Pre-Codification Reference
ASC 470-10-35	Accounting Standards Codification Topic 470-10-35, Debt—Overall—Subsequent Measurement	EITF 88-18
ASC 480-10	Accounting Standards Codification Topic 480-10, Distinguishing Liabilities from Equity—Overall	SFAS 150
ASC 710-10	Accounting Standards Codification Topic 710-10, Compensation—General—Overall	APB 12
ASC 715	Accounting Standards Codification Topic 715, Compensation—Retirement Benefits	SFAS 106
ASC 715-10-15	Accounting Standards Codification Topic 715-10-15, Compensation—Retirement Benefits—Overall—Scope	SFAS 123R
ASC 715-30	Accounting Standards Codification Topic 715-30, Compensation—Retirement Benefits—Defined Benefit Plans—Pension	SFAS 87
ASC 715-60	Accounting Standards Codification Topic 715-60, Compensation—Retirement Benefits—Defined Benefit Plans—Other Postretirement	EITF 06-4
ASC 720-15	Accounting Standards Codification Topic 720-15, Other Expenses—Start-Up Costs	SOP 98-5
ASC 740	Accounting Standards Codification Topic 740, Income Taxes	SFAS 109
ASC 740-10-25	Accounting Standards Codification Topic 740-10-25, Income Taxes—Overall—Recognition	FIN 48
ASC 805	Accounting Standards Codification Topic 805, Business Combinations	SFAS 141R
ASC 810-10	Accounting Standards Codification Topic 810-10, Consolidation—Overall	FIN 46(R) SFAS 167 SFAS 160
ASC 815-10	Accounting Standards Codification Topic 815-10, Derivatives and Hedging—Overall	SFAS 149
ASC 815	Accounting Standards Codification Topic 815, Derivatives and Hedging	SFAS 133 EITF 00-19
ASC 820-10	Accounting Standards Codification Topic 820-10, Fair Value Measurements and Disclosures—Overall	SFAS 157
ASC 825-10	Accounting Standards Codification Topic 825-10, Financial Instruments—Overall	SFAS 159
ASC 830	Accounting Standards Codification Topic 830, Foreign Currency Matters	SFAS 52
ASC 835-30	Accounting Standards Codification Topic 835-30, Interest—Imputation of Interest	APB 21
ASC 840-30	Accounting Standards Codification Topic 840-30, Leases—Capital Leases	SFAS 13

FASB Codification Reference		Pre-Codification Reference
ASC 840-40	Accounting Standards Codification Topic 840-40, Leases—Sale-Leaseback Transactions	SFAS 98
ASC 845	Accounting Standards Codification Topic 845, Nonmonetary Transactions	APB 29
ASC 852-20	Accounting Standards Codification Topic 852-20, Reorganizations—Quasi-Reorganizations	ARB 43 Chapter 7A
ASC 860-10	Accounting Standards Codification Topic 860-10, Transfers and Servicing—Overall	SFAS 166
ASC 860-50-40	Accounting Standards Codification Topic 860-50-40, Transfers and Servicing—Servicing Assets and Liabilities—Derecognition	EITF 85-13
ASC 940-810-45	Accounting Standards Codification Topic 940-810-45, Financial Services—Brokers and Dealers—Consolidation—Other Presentation	EITF 88-25
ASC 942-310-35	Accounting Standards Codification Topic 942-310-35, Financial Services—Depository and Lending—Receivables—Recognition	PB 5
ASC 970-340	Accounting Standards Codification Topic 970-340, Real Estate—General—Other Assets and Deferred Costs	SFAS 67