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Bank Accounting Advisory Series

BANK ACCOUNTING ADVISORY SERIES

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Administrator of National Banks

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This Bank Accounting Advisory Series expresses the Bank Accounting Division staff's current views on a wide variety of accounting topics of interest to national banks. Topics included in this first publication are set forth in the accompanying index. This series will be updated on a regular basis to address emerging accounting issues.

Although some of the statements herein are taken from regulations, interpretive rulings, or banking issuances of the Comptroller of the Currency (OCC), these advisories are not official rules or regulations of the OCC. Rather, they represent interpretations by the Bank Accounting Division of generally accepted accounting principles and bank regulatory accounting.

Nevertheless, national banks that deviate from these stated interpretations may be required to justify such departures to the OCC. The series is being issued to inform the banking community of the Division's views and rationale on a wide variety of accounting interests. Additional releases will be issued in the future on emerging accounting issues.

BANK ACCOUNTING ADVISORY SERIES

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TOPIC 1: PURCHASE ACCOUNTING

1A. INTANGIBLE ASSETS

Question 1:

Accounting Principles Board Opinion No. 17 (APB 17) allows for amortization of intangible assets over their useful life up to 40 years. Is a 40 year amortization period acceptable for national banks?

Staff Response:

No. Intangible assets should be amortized over their estimated useful lives. However, the amortization period may not exceed 10 years for core deposit intangibles and 15 years for other intangible assets, including goodwill. Although these amortization periods are substantially shorter than provided for in APB 17, the staff believes the maximums are appropriate in light of changes in the banking industry. The industry faces numerous uncertainties such as deregulation, widely fluctuating interest rates, and competition from nonbanking entities. Uncertainties such as these not only substantially shorten the useful lives of the intangibles acquired, but also make it extremely difficult to measure the period benefited.

Question 2:

What method should be used to amortize intangible assets?

Staff Response:

Identifiable intangible assets should be amortized in a manner that best corresponds to the benefit expected to be received from the asset. If the benefits are expected to decline over the life of the asset, or the value of the asset was calculated using assumptions of increased earnings in the earlier years, an accelerated method of amortization should be used. Therefore, the amortization of core deposit intangibles and mortgage servicing rights would normally require use of an accelerated method. Otherwise, the straight-line method would be appropriate.

The unidentifiable intangible asset (goodwill) would generally be amortized using the straight-line method. An exception would be those cases where the fair value of liabilities assumed exceeds the fair value of the identifiable assets acquired. Such cases would be accounted for in accordance with Statement of Financial Accounting Standards No. 72.

Facts:

Bank A acquires Bank B in a purchase transaction prior to April 15, 1985. Bank B is combined into Bank A. Intangible assets (core deposit intangible, goodwill, etc.) resulting from the acquisition are recorded on the Statement of Condition of Bank A and are included in the determination of capital ratios to the extent permitted.

Subsequent to April 15, 1985 Bank C acquires Bank A in a purchase transaction and Bank A is combined into Bank C.

Question 3:

Can the intangible assets resulting from the first acquisition be included in the determination of capital ratios for Bank C?

Staff Response:

No. The acquisition of Bank A by Bank C is recorded based on the fair market value of Bank A's assets and liabilities on the date of its acquisition by Bank C. This includes any identifiable intangible assets, such as a core deposit intangible, and the unidentifiable intangible asset (goodwill). The intangible assets resulting from the first acquisition (Bank B by Bank A) are no longer relevant because the acquisition by Bank C creates a new basis of accounting for the assets and liabilities of Bank A.

Accordingly, the intangible assets recorded on the financial statements of Bank C after the acquisition of Bank A result only from the latter acquisition. Intangible assets other than purchased mortgage servicing rights do not qualify for inclusion in the capital ratio computation since this acquisition occurred after April 15, 1985.

1B. PUSH-DOWN PURCHASE ACCOUNTING

Question 1:

What is "push-down purchase accounting?"

Staff Response:

The term "push-down purchase accounting" typically involves a situation where a bank holding company acquires a bank and accounts for the acquisition under the "purchase method" of accounting. Following the purchase method, the bank holding company records the acquisition by allocating the purchase price to the assets acquired and liabilities assumed based on their fair values. Hence, these assets and liabilities are assigned a new basis of accounting.

Under a literal application of push-down purchase accounting, the new basis of accounting (both assets and liabilities) is "pushed-down" from the bank holding company to the acquired bank. It is reflected on the bank's books. Additionally, the bank holding company's purchase price becomes the beginning shareholder's equity amount (capital stock and surplus) of the acquired bank. Also, the undivided profits account is adjusted to zero. Hence, push-down accounting establishes this new basis of accounting on the books of the acquired subsidiary bank.

Generally accepted accounting principles are primarily concerned with consolidated financial statement presentation. They offer only limited guidance with respect to the use of push-down accounting for a purchase acquisition. The majority of such guidance is contained in Accounting Principles Board Opinion No. 16 (APB 16), AICPA Accounting Interpretations to this Opinion, and SEC Staff Accounting Bulletins.

Question 2:

What is the regulatory policy with respect to "push-down" accounting?

Staff Response:

Push-down accounting is <u>required</u> for financial reporting purposes if an arms-length purchase accounting transaction results in a change in control of at least 95 percent of the voting stock of the bank. However, it is not required if the bank has an outstanding issue of publicly traded debt or preferred stock. Push-down accounting is also required if the bank's financial statements are presented on a push-down basis in reports filed with the Securities and Exchange Commission.

Push-down accounting may also be used when a change in control of at least 80 percent, but less than 95 percent, has occurred. However, approval by the bank's outside CPA and the OCC is required in these situations. As of September 30, 1989, the Call Report Instructions contain a glossary entry ("Business Combinations") describing the regulatory policy with respect to push-down accounting.

Facts:

Previous OCC policy for push-down accounting followed a legal entity format. That is, a new basis of accounting was adopted at the bank level only when the acquired assets and liabilities were transferred to another legal entity. If the acquired bank's legal structure was left intact, push-down accounting was generally not allowed.

Accordingly, push-down accounting has not been applied to a number of banks that previously had an arms-length transaction that resulted in a change of control of at least 95 percent of their voting stock.

Question 3:

Should these new push-down accounting requirements be retroactively applied to a bank which was not previously required to apply push-down accounting?

Staff Response:

No. The revised policy with respect to push-down accounting applies only to transactions occurring after September 30, 1989. Therefore, the bank would continue with its recorded amounts.

However, if the acquired bank is subsequently merged into another legal entity of its parent, the bank must adopt the new basis of accounting at that time. Accordingly, the acquired bank's assets and liabilities would be recorded at their fair value at the time of the original acquisition, adjusted for subsequent asset dispositions and amortization.

Facts:

Holding Company A acquires 75 percent of the stock of Bank B in a tender offer. As a result of its newly gained voting control, Holding Company A effects an interim bank merger. The assets and liabilities of Bank B are merged into newly formed Bank C, a wholly owned subsidiary of the holding company.

The minority shareholders of Bank B are paid cash for their stock. The holding company now owns 100 percent of the acquired bank's net assets. The bank does not have any outstanding issues of publicly traded debt or preferred stock.

Question 4:

Should push-down purchase accounting be applied when the substantial change in control has been effected through a series of acquisitions as in this example?

Staff Response:

Yes. It is required where 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. As long as a 95 percent change of control has taken place, push-down accounting is required.

In this respect, push-down accounting may be allowed (if approved) when the change of control involves at least 80 percent of the voting stock. However, push-down accounting is not allowed until a change of control involving at least 80 percent of the voting stock has occurred. Therefore, in this case, push-down accounting would have been required after the interim bank merger (second acquisition transaction). But it would <u>not</u> have been allowed after the tender offer (first acquisition transaction) since only 75 percent of the bank was acquired.

Facts:

Purchase acquisitions may involve the issuance of debt securities. The Securities and Exchange Commission, in Staff Accounting Bulletin 73 (SAB 73), describes situations where, in filing with the Commission, parent company acquisition <u>debt</u> must be "pushed-down" to the target entity. These 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 5:

Does the OCC require the push-down of parent company debt to the financial statements of an acquired national bank?

Staff Response:

We believe that the circumstances described in SAB 73 would rarely, if ever, occur in the acquisition of a national bank. This is because national banks are generally not permitted to assume or guarantee the parent company's debt. Nor are national banks permitted to pledge their assets as collateral. Therefore, it is unlikely that the parent company's acquisition debt would be pushed down to the acquired bank level.

However, if one of the situations described in SAB 73 does occur, the debt should be recorded on the financial statements of the acquired bank. The offsetting entry would reduce the acquired bank's capital accounts.

1C. PURCHASE ACCOUNTING ADJUSTMENTS

Facts:

Bank A acquires Bank B in a transaction to be accounted for by the purchase method in accordance with Accounting Principles Board Opinion No. 16.

Question 1:

Are there circumstances where it is appropriate for Bank A (purchasing bank) to adjust the allowance for loan and lease losses of an acquired bank (Bank B) to reflect a different estimate of collectibility?

Staff Response:

This question arises when Bank A is assigning its acquisition cost to the acquired assets of Bank B. Typically, no adjustment is allowed. Additions to the allowance are generally made through provisions for loan and lease losses, not as purchase accounting adjustments. Therefore, except as discussed below, purchase accounting adjustments reflecting different estimates of collectibility are generally not considered appropriate.

Estimation of probable loan and lease losses involves judgment. Accordingly, management of different banks may differ in their systematic approaches to this evaluation. Nevertheless, the staff believes that the collectibility estimates by each bank's management of Bank B's loan portfolio should not be materially different. Therefore, a purchase accounting adjustment to reflect a different estimate of collectibility of Bank B's loan portfolio is inappropriate.

The only time a purchase accounting adjustment may be appropriate is when Bank A has demonstrably different plans regarding the ultimate recovery of the acquired loans than those of Bank B. For example, Bank A may plan to sell certain loans Bank B had intended to hold to maturity. Such loans would be reported as assets held for sale and valued at the lower of cost or market value.

The staff is not suggesting that acquired loans be recorded at an amount that reflects an unreasonable estimate of collectibility. If Bank B's financial statements as of the acquisition date are not fairly stated because of an unreasonable allowance for loan losses, that allowance should not serve as a basis for recording the acquired loan. Rather, Bank B's preacquisition financial statements should be restated to reflect an appropriate allowance.

Facts:

Bank A purchases loans from the FDIC. The loans are performing in accordance with their contractual terms. Payments of principal and interest are current.

Question 2:

Can Bank A use its estimate of losses in the acquired loan portfolio to record an allowance for loan and lease losses at the acquisition date for the loans acquired?

Staff Response:

No. The purchase price, which could involve a premium or discount, takes into account both interest rate exposure and credit risk. Therefore, an allowance is not required. Any subsequent allowance should be established through a charge to operations.

However, if Bank A can determine the amount of the allowance applicable to the acquired loans on the previous owner's books, the staff will not object to inclusion of an appropriate allowance amount. The allowance amount, however, cannot exceed the applicable amount on the previous owner's books.

1D. ACCOUNTING FOR THE ACQUISITION OF FAILED INSTITUTIONS

Facts:

Bank A acquires Bank B from the FDIC in a Total Asset Purchase and Assumption (TAPA) transaction. Bank A submits a negative bid of $5 million (i.e. the FDIC pays Bank A $5 million to acquire Bank B).

Question 1:

How should this acquisition be accounted for?

Staff Response:

The acquisition should be accounted for as a purchase business combination. Accordingly, the assets received and liabilities assumed are recorded at their fair market value. The assistance received from the FDIC in the form of the negative bid (i.e. the $5 million) represents an acquired asset. Any difference between the fair value of the assets acquired and liabilities assumed would either be goodwill (if liabilities exceed assets) or negative goodwill (if assets exceed liabilities).

Facts:

These acquisitions are generally made on the basis of a bid process. Prior to submitting a bid, the acquirer (Bank A) will estimate the fair value of the assets and liabilities being acquired. However, these estimates are often performed quickly and may differ from the actual fair values determined in a more detailed analysis following the acquisition.

Question 2:

When recording the acquisition, is it appropriate for Bank A (the acquirer) to revise the estimated values assigned to the assets and liabilities of Bank B, and record the transaction based on fair values determined in the more detailed analysis?

Staff Response:

Yes, not only is it appropriate, it is required. The staff realizes that the values assigned during the due diligence process are only estimates and need to be refined. Therefore, shortly after the acquisition has been consummated, Bank A must determine the fair values of the acquired assets and liabilities. This process should be completed as soon as possible after the acquisition. This means a good faith effort should be made to have all purchase accounting adjustments recorded by the next Call Report due date.

Statement of Financial Accounting Standards No. 38 permits the adjustment for preacquisition contingencies of purchased enterprises during an "allocation period." This allocation period should usually not exceed one year. Thus, there may be revaluation of specific assets and liabilities beyond the period set forth above.

However, there should be relatively few adjustments during the allocation period. This allocation period is provided so that a contingency, such as an unresolved litigation matter, can be included as a purchase accounting adjustment when the amount becomes known. It should not be used as a means of applying "hindsight" to the process of determining fair market values.

Question 3:

How should negative goodwill be recorded?

Staff Response:

Negative goodwill is recorded by proportionately reducing the value of the noncurrent assets acquired, including the noncurrent portion of the loan portfolio. Once the noncurrent assets have been reduced to zero, the remaining negative goodwill is recorded as a liability. Negative goodwill is included in Other Liabilities on the Call Report and should be amortized over the average life of the acquired long-term interest bearing assets.

Question 4:

Should the fair value of the loan portfolio be determined on a loan-by-loan basis or may it be determined for the loan portfolio as a whole?

Staff Response:

Determination of the fair value of the loan portfolio should be made on a loan-by-loan basis. And it should consider both interest rate and credit risk. An exception to this requirement is made for groups of <u>similar</u> consumer loans. The fair value of these loans may be determined on an aggregate basis. However, any fair value discount should be applied to all the loans in the pool on a pro rata basis. In this way each loan can be subsequently accounted for on an individual basis.

Question 5:

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

Staff Response:

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

The allowance on the acquired loans should be segregated from Bank A's existing allowance and used only to absorb losses on the acquired loans. However, for Call Report purposes, the allowance on the acquired loans may be combined with the regular allowance.

FACTS:

A loan with a contractual balance of $100,000 is acquired in a failed bank acquisition. Based on collectibility information available at the time of acquisition, management records this loan at $90,000, its fair value. The loan is current as to principal and interest payments. Further, there is no doubt that the principal and interest is collectible in full.

Question 6:

Since the loan is current and the recorded balance is considered to be collectible, may Bank A accrue income on this loan?

Staff Response:

Yes. Since the loan is current with respect to principal and interest payments, and the recorded balance is considered collectible, it would be appropriate to accrue interest. Further, because the loan is on an accrual status, accretion of the fair value discount is also appropriate.

Question 7:

Would the answer be the same if the loan was not contractually current with respect to principal and interest payments?

Staff Response:

No. Regulatory policy allows a nonaccrual asset to be restored to accrual status only when none of its principal or interest is due and unpaid, or when it became well secured and in the process of collection. Since the loan is past due according to its contractual terms, accrual of interest is not appropriate. Interest income may be recognized on a cash basis. Further, accretion of discount is not allowed on any loan which is not on an accrual status.

Question 8:

If the bank accepts a cash payment of $95,000 in full satisfaction of the borrower's loan, how should this be recorded?

Staff Response:

The bank should recognize a $5,000 gain on settlement of the loan. This gain should be reported as non-interest income.

Question 9:

Subsequent to recording this loan, Bank A charges it off. How should this charge off be recorded?

Staff Response:

The charge off should be recorded against the allowance on the acquired loans. Once this allowance is eliminated, the charge off should be applied against Bank A's regular allowance, which is not segregated. If needed, a provision for loan loss should then be recorded to restore Bank A's allowance to an adequate level.

In the responses to Questions 8 and 9, the staff did not suggest the fair value assigned to the loan at acquisition be revised. This is because all relevant credit information was available for estimating the loan's fair value at the date of acquisition. Only when such information is <u>not</u> available and subsequently becomes available, may a change to the purchase price allocation be made in the allocation period. Otherwise, subsequent loan activity is reflected in the appropriate subsequent period's financial statements.

TOPIC 2: LOANS

2A. TROUBLED DEBT RESTRUCTURINGS

Question 1:

Can the accounting provided by Statement of Financial Accounting Standards No. 15 (SFAS 15) be used if there has not been a legal restructuring of the loan with the borrower?

Staff Response:

No, there must be a formal agreement between the debtor and creditor for the loan to be accounted for as a troubled loan restructuring under SFAS 15.

Question 2:

The introduction to SFAS 15 indicates it does not cover accounting for the allowance for estimated uncollectible amounts. Nor does it prescribe or proscribe methods of accounting for uncollectible receivables. Does generally accepted accounting principles establish the accounting for estimating credit losses on restructured loans?

Staff Response:

Yes, Statement of Financial Accounting Standards No. 5 (SFAS 5) is the basis that requires banks to maintain an adequate allowance for loan and lease losses at all times. In addition, the AICPA Industry Audit Guide "Audits of Banks" requires that loans be charged off in the period that the loan, or a portion thereof, is determined to be uncollectible. These requirements apply to all loans, including restructured loans.

Therefore, for restructured loans, the collectibility of the loan must be analyzed in accordance with the new or restructured terms. If doubt as to the borrower being able to service the debt under the restructured terms exists, the bank should establish an appropriate reserve or charge off the loan (or a portion thereof).

Facts:

Restructurings often include payment terms extending so far into the future that determining the collectibility of the payments can not be reasonably evaluated. In this respect, it is not unusual for the payment period to extend beyond the useful life of the collateral securing the loan. As an example, a loan which is restructured to require payments over a 20-year period may be secured by a piece of equipment with a 5-year remaining life.

Question 3:

How should such a loan be accounted for?

Staff Response:

As previously noted, banks are required to maintain an adequate allowance for loan and lease losses. Further, they must charge off loans which are deemed to be uncollectible. Accordingly, when a restructured loan contains payment terms that are either unrealistic or extend so far into the future as to be unsupportable, the staff believes that the collateral must be considered as the source of repayment. Therefore, if the collateral value does not support the loan balance or it has a much shorter life than the restructured loan, a write-down of the loan is appropriate.

Facts:

Borrower A cannot service his $100,000 loan from the bank. The loan is secured and bears interest at 10 percent, which is the current market rate. A restructuring occurs with Borrower A transferring the security to a new borrower (Borrower B) not related to Borrower A. The bank accepts Borrower B as the new debtor. The restructured loan provides that Borrower B will make 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. On the basis of the concessionary interest rate, the fair value of this loan is $87,500.

Question 4:

Does a loss have to be recorded on this restructuring?

Staff Response:

Yes. SFAS 15 requires that the receipt of a loan from a new borrower be accounted for as an exchange of assets. Accordingly, the asset received (new loan) is recorded at its fair value ($87,500 in this example). The difference between the fair value of the new loan received and the recorded value of the loan satisfied is charged to the allowance for loan and lease losses.

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. In order 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 5:

Does a loss have to be recorded on the permanent loan financings?

Staff Response:

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

Facts:

Assume that the real estate developer in Question 5 has not yet defaulted on the construction loan. He is in technical compliance with the loan terms. However, due to the general problems within the local real estate market and specific problems affecting this developer, the bank agrees to give the home buyers permanent financing at below market rates.

Question 6:

Does a loss have to be recorded on these permanent loan financings?

Staff Response:

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

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

Facts:

A borrower owes the bank $100,000. The debt is restructured due to 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 $50,000 but with only a nominal market value. The remaining $50,000 of debt is restructured so that the bank will receive $75,000 ($45,000 principal and $30,000 interest) in combined principal and interest payments over the next five years.

Question 7:

How should the bank account for this transaction?

Staff Response:

Securities (either equity or debt) acquired in exchange for cancellation or reduction of a troubled loan should be recorded at the lower of the fair (generally market) value of the securities or the carrying amount of the debt satisfied. However, value should only be assigned to the securities in those circumstances where there is a demonstrated value for the securities. Due to the borrower's precarious financial condition, it may not be possible to determine such a value. Accordingly, a fair value of zero would not be unusual in such cases.

After the recorded amount of the debt ($100,000) is reduced by the demonstrable fair value of the preferred stock received, the remaining cost is compared to the total future payments (principal and interest) to be received. A loss is recorded for the amount by which the adjusted cost exceeds the expected future payments.

In this case, if the securities were valued at zero, the loan balance of $100,000 would be compared to the expected future payments of $75,000. A loss of $25,000 would be recorded. However, as previously discussed, a credit evaluation should be performed based on the restructured loan terms to determine if there is a need for any charge offs or additional loan loss provisions.

Question 8:

Assume that the preferred stock has a determinable fair value of $30,000. How would the transaction be counted for?

Staff Response:

The recorded value of the loan ($100,000) would be reduced by the fair value of the preferred stock received ($30,000). The remaining loan balance ($70,000) would then be compared to the expected future principal and interest payments of $75,000. In this case, the future payments exceed the recorded value of the loan. Therefore, no loss due to the restructuring would be recorded. Again, a credit evaluation should be performed based on the restructured loan terms to determine the collectibility of the remaining loan balance.

Facts:

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

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

Question 9:

How should the bank account for this restructuring?

Staff Response:

In essence, the bank has received the security (zero coupon bond) as satisfaction of the loan. Because repayment of the loan is expected only from the proceeds of the security, the bank has effectively obtained control of the collateral even though actual repossession has not occurred. Therefore, the restructuring should be accounted for as if the bank had taken possession of the collateral.

Accordingly, the loan should be removed from the books of the bank and the security should be recorded in the investment account at its fair value ($40,000). The $60,000 difference is charged to the allowance for loan and lease losses. Effectively, an insubstance foreclosure has occurred. This conclusion is consistent with Financial Accounting Standards Board (FASB) Emerging Issues Task Force Consensus No. 87-18.

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:

If a payment is made on these loans, can a portion of the payment be applied to interest income?

Staff Response:

No. Interest income should not be recognized. The AICPA Industry Audit Guide "Audits of Banks" requires that when the ultimate collectibility of principal, wholly or partially, is in doubt, payments received on a nonaccrual loan be applied to reduce principal to the extent necessary to eliminate such doubt.

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

Facts:

Assume the same facts as Question 1 except cash flow projections support the borrower's repayment of the operating loan in the upcoming year. However, doubtful exposure continues on the equipment loan, due to the borrower's inability to service the loan and insufficient collateral values.

Question 2:

Can the bank accrue interest on the operating loan while the equipment loan remains on nonaccrual status?

Staff Response:

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

In this situation, projections indicate that the borrower will only be able to service one of the loans for one year. Therefore, on a long-term basis, doubt still exists with respect to the total borrower exposure. Accordingly, interest recognition is generally not appropriate.

Facts:

The bank has a loan on nonaccrual, and a portion of the principal has been charged off. The remaining principal on the bank's books has been classified as substandard. This classification is due to the borrower's historical nonperformance and questionable ability to meet future repayment terms. Collateral values covering the remaining principal balance are adequate.

Question 3:

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

Staff Response:

In determining the accounting for individual payments, the bank must evaluate the loan to determine whether doubt exists as to the ultimate collectibility of principal. Consideration should be given to the overall creditworthiness of the borrower as well as the underlying collateral values. For example, in dealing with troubled loans, doubt as to collectibility often exists on loans when payments have not been made on a regular basis, even when fully collateralized.

Therefore, if the debtor remains unable to meet the contractual payment terms, doubt as to collectibility probably continues to exist. Accordingly, payments received should generally be applied to reduce the principal balance until the doubt is removed. Collateral values are not sufficient, by themselves, to eliminate the issue of ultimate collectibility of principal.

Facts:

The bank affects a troubled debt restructuring with Borrower A. Prior to the restructuring, the bank had placed Borrower A's loan on nonaccrual status. The restructured terms include a concessionary interest rate and extended repayment terms. As a result, Borrower A is expected to be able to service the restructured debt. The debt is disclosed as a restructured trouble debt in accordance with SFAS 15.

Question 4:

Since the restructured terms enable Borrower A to service the debt, can the loan be immediately removed from nonaccrual status and interest accrual resumed?

Staff Response:

No. The loan should continue as a nonaccrual loan until the borrower has demonstrated the ability to comply with the restructured loan terms. For example, on a monthly amortizing loan, regular monthly payments for a six-month period may be sufficient to demonstrate ability to comply with the new terms, provided the borrower's creditworthiness does not deteriorate.

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 5:

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

Staff Response:

No. The Glossary instruction to the Call Report states that a nonaccrual asset may be restored to accrual status only when none of its principal and interest is due and unpaid. Additionally, these instructions preclude the accrual of interest for any asset for which full payment of interest or principal is not expected. Therefore, accrual of interest on the loan would not be appropriate.

Facts:

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

Question 6:

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

Staff Response:

No. Accretion of discount is not appropriate in circumstances where the loan is on a nonaccrual basis. The Instructions to the Call Report specifically state that discounts should not be accreted for loans on nonaccrual status. Discount accretion is allowed only when the loan has been brought fully current in accordance with its contractual loan terms.

Facts:

Same facts as in Question 6, except that the borrower's business experiences major improvement. He is able to bring the loan current. Further, the note is now well-secured and the borrower has adequate cash flow to service the debt. The loan is placed on accrual status.

Question 7:

Must the bank accrete the discount?

Staff Response:

Yes. Again, accrual of interest and accretion of discount are not mutually exclusive. Both represent interest income. Thus, if the criteria for accrual have been met, the discount must also be accreted to income.

Facts:

Continuing with the examples, Bank A purchases a loan with a face value of $100,000 for $50,000. The loan is on nonaccrual status. The bank then renegotiates the loan with the borrower. The new loan has a face value of $125,000 with the borrower receiving $25,000 of new funds. In return, the borrower pledges additional collateral. The collateral value is sufficient to support the face amount of the new loan.

Question 8:

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

Staff Response:

No, it is not appropriate to recognize any gain on this refinancing. Further, the loan should remain on nonaccrual status until the borrower has demonstrated his ability to comply with the new loan terms. When the borrower has demonstrated this ability, the loan can be returned to accrual status. At that time the bank would also begin to accrete the discount to income.

2C. REBOOKING LOANS

Facts:

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

Question 1:

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

Staff Response:

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

2D. LOAN SPLITTING

Facts:

A $10 million loan is secured by income producing real estate. Cash flows are sufficient to service only a $6 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 $6 million and carries a current market rate of interest. Note B is for $4 million and carries a below-market rate of interest. The bank charges off all of Note B, but does not forgive it.

Question 1:

Can the bank return Note A to accrual status?

Staff Response:

Yes, but only if the following conditions are met:

1. The restructuring qualifies as a troubled debt restructuring (TDR) as defined by SFAS 15. In this case, the transaction is a TDR because the bank granted a concession it would not normally consider, a below market rate of interest on Note B.

2. The partial loan charge off is supported by a good faith credit evaluation of the loan(s). And, it should be recorded before or at the time of the restructuring. Under SFAS 5, a partial charge off may be recorded only if the bank has performed a credit analysis and determined that a portion of the loan is uncollectible. SFAS 15 prohibits writing down a loan at the time of restructuring <u>merely to achieve a market rate of interest</u>.

3. The ultimate collectibility of the recorded loan amount, wholly or partially, is not in doubt. If such doubt exists, the loan should not be placed back on accrual status.

4. There is a period of satisfactory payment performance by the borrower <u>before</u> the loan (Note A) is returned to accrual status.

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

Question 2:

Can Note A be returned to accrual status immediately, or must there be a six-month period of performance?

Staff Response:

AICPA Practice Bulletin No. 5, "Income Recognition on Losses to Financially Troubled Countries (PB 5)," requires some period of performance in the case of loans to troubled countries. The staff believe this guidance should apply to domestic loans as well. Accordingly, the bank may not return Note A to accrual status immediately after restructuring.

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

Question 3:

Can six-month historical cash flow statements indicating the ability to perform on Note A suffice for the required performance period?

Staff Response:

Generally, no. Cash flow statements by themselves are not usually sufficient to evaluate future performance. Typically, there must be a period of actual repayment performance to demonstrate the ability to pay.

Question 4:

Should Note A be shown as a restructured loan for Call Report purposes and disclosed as a TDR in public financial statements?

Staff Response:

Yes. Because the restructuring is a TDR as defined by SFAS 15, the bank is required to report the loan balance as a restructured loan in the Call Report. In the quarter of the restructuring, the loan would appear in Schedule RC-N (Memo Item No. 1, Restructured loans and leases).

If the loan is subsequently restored to accrual status, it would drop off of Schedule RC-N and be shown on Schedule RC-C (Memo Item No. 2, Maturity and repricing data for loans and leases)--providing it did not become 30 days or more past due. If the interest yield computed under SFAS 15 was equal to a current interest rate on a loan with similar risk, the loan would drop off of Schedule RC-C.

For public financial statement purposes, the bank should disclose the information called for by paragraph 40 of SFAS 15 for the year of restructuring and each subsequent year until maturity.

Question 5:

Must Note A be shown as a restructured loan for Call Report purposes and disclosed as a TDR for public financial statements until it is paid off, even if the amortization period is 10 years?

Staff Response:

Generally, yes. SFAS 15 and Call Report instructions require continuing disclosure as a TDR over the term of the restructured loan. However, there is a possible exception to this continuing disclosure requirement. Specifically, SFAS 15 states:

> "A receivable whose terms have been modified need not be included in the disclosure if, subsequent to restructuring, its effective interest rate has been equal to or greater than the rate that the creditor was willing to accept for a new receivable with comparable risk."

In other words, in a year subsequent to the TDR, the required disclosure may be dropped. But, this is possible only if the interest yield under SFAS 15 is greater than or equal to a current interest rate on a loan with similar risk.

A similar exception to the continuing disclosure requirement is provided in the Call Report instructions to both Schedules RC-C and RC-N.

Question 6:

If the bank receives payments on both Note A and Note B, how should it record the payments?

Staff Response:

Under SFAS 15, loan payments are not designated between individual notes. Likewise, separate interest yields are not computed on a note-by-note basis. Rather, total payments to be received under the restructured terms are compared to the recorded investment in the loan at the time of the restructuring.

In this case, the recorded investment in the loan is $6 million. This assumes the bank charged off the $4 million portion before or at the time of the restructuring. If the payments exceed $6 million, an effective interest yield is computed based on this excess. This interest yield is then recognized over the term of the restructured loan.

Accordingly, it is inappropriate under SFAS 15 for the bank to "apply" payments to Note A or Note B. Rather, the bank applies all payments to the recorded loan balance to reflect a level yield, if any, under the restructured terms. Designation as a Note A or Note B payment is irrelevant for this purpose. Furthermore, disclosure as a TDR would continue over the term of the restructured loan as described in the response to Question 5.

Question 7:

What if there is no interest rate concession on Note B? How would that affect the accrual status and TDR disclosure for Note A?

Staff Response:

If the bank grants no interest rate concession on Note B nor any other concession, the restructuring would not qualify as a TDR. SFAS 15 and disclosure as a TDR would not apply.

In substance, the bank has merely charged down its $10 million loan by $4 million, leaving a $6 million recorded loan balance. The remaining balance should be accounted for and reported as a nonaccrual loan. Merely partially charging off a loan is not 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 regarding the ultimate collectibility of the recorded loan balance ($6 million). When that doubt is removed, payments should be booked as loan loss recoveries until the full contractual principal is again recorded on the bank's books. At that point, payments may begin to be recorded as interest income.

Question 8:

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

Staff Response:

Clearly, forgiving debt is a form of concession to the borrower. Therefore, a restructuring including the forgiveness of debt would qualify as a TDR, and SFAS 15 would apply. Of course, if the bank provides some other concession, it is not necessary to forgive debt for SFAS 15 to apply.

Question 9:

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

Staff Response:

Since the borrower was granted a concessionary rate on Note B, the restructuring would qualify as a TDR. SFAS 15 would apply. This is the case whether or not Note B is charged off.

The difference here is that $10 million is the recorded investment in the loan for SFAS 15 purposes. In the base case, the recorded investment in the loan was only $6 million--the charge off was recorded before or at the time of the TDR. Without the charge off, the new interest yield under SFAS 15 will be lower. Other than that, the answers to Questions 1 through 5 apply.

TOPIC 3: SALE OF LOANS

3A. LOANS WITH RECOURSE

Question 1:

May a sale of loans, other than pools of residential mortgage loans, be recorded if the loans are sold with recourse, but the contractual terms limit the seller's risk of loss (amount of recourse)?

Staff Response:

No. A sale is not recorded and the entire proceeds are reported as a borrowing. This results because the Instructions to the Call Report require the transaction to be recorded as a borrowing if there is recourse. This is true even if the contractual terms limit the seller's risk to a set amount or a percentage of the assets sold.

Sales treatment is allowed if the seller's risk is limited, on a pro rata basis, to a fixed percentage of any losses that might be incurred. This assumes that there are no other provisions resulting in retention of risk, either directly or indirectly, by the seller. However, sales treatment is limited to the percentage of principal for which the seller is not at risk.

For example, assume $100,000 of assets are sold with a recourse provision requiring the seller and buyer to proportionately share in losses incurred on a 10 percent and 90 percent basis. The seller is not liable for any other retention of risk. Under these circumstances a sale is reported for $90,000 of assets. The remaining $10,000 is recorded as a borrowing.

3B. LOAN STRIPS

Facts:

Sales of loans under committed facilities, or "loan strips" as they are commonly called, refer to transactions in which a bank sells short-term loans under a long-term loan commitment. In the typical situation, a bank enters into a long-term credit agreement (i.e., five years) with a borrower. In order to provide the borrower with the lowest interest rate, the long-term commitment is fulfilled with a series of short-term loans (i.e., 90-days).

These short-term loans are essentially "roll-overs" of the original loan. However, the lender may cease to provide funds if any of the covenants under the long-term commitment are not satisfied. Subsequent to the funding of the short-term loan, the lender then "sells" the loan to another party.

Question 1:

Should the subsequent "sale" of the short-term loan to another party be accounted for as a sale or a financing?

Staff Response:

In a "loan strip" transaction, the Instructions to the Call Report require that the "sale" of the short-term loan be reported as a financing. The long-term commitment to provide an additional loan is, in effect, a significant obligation for future performance. Therefore, the "sale" of the short-term loan under a committed borrowing facility is a liability.

This results because there is a probable future sacrifice to transfer assets (i.e., which would effect repayment of principal) based upon the long term commitment with the borrower. The staff believes that, in essence, buyers of loan strips look to the originating bank for repayment. The likelihood and ability of the seller to perform are the motivating factors for investors investing in loan strips.

3C: CONSUMER LOAN POOLS

Facts:

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

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

Other than a nominal secured loan from the selling bank, the escrow account is funded through this interest rate differential. All credit losses are charged to the escrow account. In the event the escrow account balance is insufficient to absorb the credit losses, such excess losses are charged to the trust unit holders account (including the Bank) on a pro-rata basis.

Upon termination to the Trust, the balance in the unused escrow account reverts to the bank. The bank has no additional liability with respect to the Trust.

Question 1:

Should this transaction be reported as a sale or a borrowing?

Staff Response:

Two conditions are required to account for the transaction as a sale. First, the transaction must meet the criteria as a sale under generally accepted accounting principles (i.e., Statement of Financial Accounting Standards No. 77). Second, there cannot be any potential loss to the selling bank with respect to loans (or portions thereof) owned by the purchaser.

Therefore, this transaction should be accounted for as a sale in conformity with the Call Report Instructions for "Sale of Assets." However, there may be other factors present in the transaction which may provide an element of recourse to the bank causing the transaction to be accounted for as a financing.

Question 2:

If a bank seeks the staff's review of a similar proposed transaction, what information does the staff require?

Staff Response:

Generally, the staff requests that the following be furnished:

- o A complete description of the transaction addressing, in particular, the mechanisms which preclude any potential loss to the bank.
- o A detailed accountant's report opining upon the transaction as meeting the sale criteria under generally accepted accounting principles.
- o If available, the selling document (i.e., prospectus) describing the transaction.
- o The basis for concluding the transaction is appropriately accounted for as a sale in accordance with the Call Report Instructions.

Question 3:

Assume that the loans in the Trust are effectively owned 80 percent by the purchaser and 20 percent by the selling bank. If the Trust agreement provides that the purchaser will receive 90 percent of all loan principal payments until the purchaser's interest is entirely paid, can the transfer of the 80 percent interest be recorded as a sale?

Staff Response:

No. The Call Report Instruction, "Sale of Assets," requires such payments be shared on a pro rata basis in order for the transaction to be accounted for as a sale. Additionally, in this instance, the effective maturity of the purchasers' interest in the loans differs from the loans' contractual maturity. Consequently, the Call Report Instructions would preclude "sales treatment" on this basis. This conclusion is consistent with FASB Emerging Issue Task Force Consensus No. 88-22.

Facts:

Assume the transaction involves credit card receivables. Ownership of the trust is divided between the purchaser and the bank on a 80 percent/20 percent basis. The agreement provides that for a period of one year, all principal payments will be used to buy new credit card charges or additional loans in order that the total dollar amount and ownership percentage in the pool will remain constant for one year.

At the end of this one year period, principal payments will be distributed during the "pay down period" to the purchaser and the bank based upon the 80 percent/20 percent ownership. Charged off loans will be similarly allocated except that the purchaser's share will first be charged to the escrow fund until it is exhausted. Only then will the purchaser absorb any losses on charged off loans.

Question 4:

Credit card loans are effectively open lines of credit, and the balances of the pooled loans may increase after the beginning of the "pay down" period. This may cause the actual ownership percentage to change during the pay down period (the bank's effective percentage will increase) while principal payment distribution allocations remain constant. Accordingly, can the transaction (for the 80 percent interest) be accounted for as a sale?

Staff Response:

Yes. The staff believes sale treatment is appropriate because risks of ownership are shared on a pro rata basis consistent with the Call Report Instructions.

The staff's conclusion relies on the fact that losses are shared on a pro rata basis, and the bank has no risk of loss for the portion of the loans sold. Although the purchaser will receive a greater portion of principal payments than his/her proportionate interest if the individual credit card balances increase, the purchaser's account will also incur proportionately larger charge off amounts should they occur. Hence, the staff concluded that the preference in repayment terms was offset sufficiently by the corresponding charge off method. Additionally, this conclusion is, in part, based upon the unique nature of credit card loans.

TOPIC 4: LOAN ORIGINATION AND SERVICING

4A. LOAN ORIGINATION FEES AND COSTS

Facts:

Statement of Financial Accounting Standards No. 91 (SFAS 91) requires that the cost of advertising and soliciting potential borrowers, when performed by the lender (bank), be charged to expense as incurred. However, some confusion has developed as to the appropriate accounting treatment for advertising and solicitation costs when these services are performed by independent third party contractors.

Question 1:

How should a national bank account for advertising and solicitation costs when the services are performed by independent contractors?

Staff Response:

National banks should expense, as incurred, all advertising and soliciting costs. The staff believes that the determination of whether these costs are capitalized or expensed should not depend on who performs the service. Consequently, all such costs must be expensed as incurred consistent with the Instructions to the Call Report.

Question 2:

SFAS 91 requires that loan origination fees and certain direct loan origination costs be deferred. The deferred amounts are then recognized over the life of the related loan as a yield adjustment. Must a bank apply SFAS 91 if it considers these amounts to be immaterial?

Staff Response:

A bank does not have to adopt SFAS 91 if the effect would not be material. However, the bank must document and maintain records to support their conclusion that the effect of not adopting SFAS 91 is immaterial. Also, the bank must review the assessment on a periodic basis and adopt SFAS 91 should the effect become material.

Question 3:

Does a bank have to apply SFAS 91 if it does not charge loan origination fees?

Staff Response:

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

Again, if the bank concludes that the costs are immaterial to its financial statements, those costs may be expensed currently. However, the bank must maintain documentation supporting their conclusion that the effect of not adopting SFAS 91 is not material.

Question 4:

Are deferred loan fees part of regulatory capital?

Staff Response:

No. Consistent with generally accepted accounting principles, deferred loan fees represent unearned income. They are recorded as a reduction of the loan balance. Therefore, they are not included as a component of regulatory capital.

Question 5:

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

Staff Response:

SFAS 91 provides for deferral of costs on a loan-by-loan basis. However, the use of averages is acceptable provided 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 6:

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

Staff Response:

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

Question 7:

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

Staff Response:

SFAS 91 was designed to recognize the effective interest over the life of the loan. In addition, accounting is usually based on the economic substance of a transaction when it differs from the legal form. Therefore, it is necessary to analyze the terms of the loan and the historical relationship between the borrower and the lender.

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

On the other hand, if the borrower prepares new loan documentation, performs a new credit review and does other functions typical of funding a new loan, the old loan has essentially been repaid at that date. In this case it is not uncommon for a fee to be charged on the refinancing. As a result, the net deferred fees from the original loan should be amortized over the contractual loan period to the balloon date. This results because the lender has, insubstance, granted a new loan to the borrower.

Question 8:

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 the fee entitles the cardholder to use the card. This is consistent with the FASB Implementation Guide for SFAS 91. Normally, the fee entitles the customer to the use of the credit card for one year. In some cases the actual period of repayment on advances from the card may exceed the one year period. However, the amortization period is deemed to be the period the cardholder can use the card; not the expected repayment period of the loan.

4B. MORTGAGE SERVICING RIGHTS AND FEES

Question 1:

Statement of Financial Accounting Standards No. 65 (SFAS 65) requires that banks that sell loans and retain the servicing recognize future income based on a current (normal) servicing fee rate. How is this current (normal) servicing fee rate determined?

Staff Response:

SFAS 65 defines the current (normal) servicing fee rate as "representative of servicing fee rates most commonly used in comparable servicing agreements covering similar types of mortgage loans." In this respect, conventional loans may require a different fee than government insured loans since the loans have different characteristics and risks.

In December 1987, the Financial Accounting Standards Board issued Technical Bulletin No. 87-3. One of the topics covered by this bulletin is the application of the definition of a normal servicing fee rate. The bulletin notes that federally sponsored secondary market makers, such as Government National Mortgage Association, Federal Home Loan Mortgage Corporation, and Federal National Mortgage Corporation, set minimum rates for transactions with them. The bulletin indicates that the servicing fee rates set by these agencies should be considered the normal servicing fee rate for a transaction with these agencies.

In private transactions, the seller/servicer should select a federally sponsored secondary market maker rate if the loans involved are comparable. If there is no appropriate federally sponsored agency rate, the servicer should consider the predominant rate used by major private sector secondary market makers for similar loans.

Additionally, some banks have argued that the normal fee should be based on the individual bank's servicing costs. However, the FASB Emerging Issues Task Force, in Issue No. 85-26, determined that a normal service fee developed as a function of the servicer's cost is not appropriate.

Facts:

A bank purchases mortgage loans, including the servicing right for those loans. A definitive plan for the sale of these loans exists when the loans are purchased. The servicing is to be retained by the bank. As required by SFAS 65, the purchase cost is allocated between the cost of the mortgages and the cost of the servicing rights. The subsequent sale of the mortgages under the definitive plan results in a gain.

Question 2:

Is it appropriate to recognize this gain at the time the mortgages are sold?

Staff Response:

No. Since the bank had a definitive plan (commitment) to sell these mortgages at the time of purchase, the purchase and eventual sale should be viewed as one transaction rather than as two independent transactions. The difference between the price paid to acquire the loans with servicing rights and the sales price without servicing rights is the cost of acquiring the servicing rights. Therefore, the excess of sales price over recorded amount of the mortgages sold is an adjustment of the cost of the servicing rights rather than current income. However, losses should be expensed.

Question 3:

A bank previously purchased mortgage servicing rights. The bank does not own the mortgages, but services them for others. The mortgages are prepaying at a faster rate than anticipated when the rights were purchased. Should the mortgage servicing rights intangible be written-down?

Staff Response:

The FASB Emerging Issues Task Force, in Issue No. 86-38, concluded that a write-down of the intangible asset is not necessary if the estimated future net servicing income on an undiscounted basis exceeds the carrying value. However, the subsequent amortization rate of the intangible should be adjusted based upon the revised prepayment estimates.

Facts:

The bank sold mortgage loans and retained the servicing. The future servicing fees exceed a normal servicing fee. Therefore, this excess servicing fee is included as part of the sales price of the mortgages and the bank recorded additional income on the sale of the mortgages. A receivable based on this excess servicing fee is included on the balance sheet. The excess servicing fee and the amount of the receivable is based on the expected life of the mortgages sold. However, the mortgages are prepaying at a faster rate than anticipated.

Question 4:

Should the receivable resulting from recording this excess servicing fee as mortgage sales income be written-down?

Staff Response:

The FASB Emerging Issues Task Force, in Issue No. 86-38, concluded that this receivable should be written-down to the present value of the estimated remaining future excess servicing fee income.

Facts:

Bank A originated mortgage loans aggregating $1,000,000. The bank sells the mortgage servicing rights to another bank for $10,000, but retains the loans as part of its investment portfolio.

Question 5:

Can Bank A recognize a gain on the sale of the mortgage servicing rights?

Staff Response:

No. The staff believes that the proceeds received from the sale of the servicing rights (in this case $10,000) should be deferred and amortized.

4C. SMALL BUSINESS ADMINISTRATION LOANS

Facts:

Many banks initiate Small Business Administration (SBA) loans and sell the guaranteed portion. The sale price is set to yield the buyer an interest rate slightly lower than the rate at which the bank issued the loan. As an example, a bank may write an SBA loan at an interest rate of prime +2.75 percent. The guaranteed portion is sold so as to yield the buyer prime +2 percent, resulting in a sales price in excess of face value. In addition, the bank retains servicing and charges a separate fee.

Question 1:

Can a bank record the premium on the sale of SBA loans as income at the time of sale?

Staff Response:

If a bank has charged a servicing fee sufficient to cover both direct and indirect servicing costs, it is appropriate to record the premium as additional sales proceeds at the time of sale. However, in many instances banks charge servicing fees that do not cover the bank's direct and indirect servicing costs. Usually this occurs in situations where the bank receives a large premium on the sale. In such cases, the premium is actually a prepaid servicing fee. Therefore, the premium would be deferred and amortized over the life of the loan.

In this respect, the Small Business Administration requires that a servicing fee of at least 1 percent be charged. However, this is a minimum fee, many banks will need to charge substantially higher fees to cover their costs. In this respect, it should be noted that the fees associated with SBA loans are much higher than those associated with mortgage loans because of the higher costs associated with servicing these loans.

Question 2:

How should the bank's recorded investment in a loan be allocated between the portion of the loan sold (the guaranteed portion) and the portion retained (the unguaranteed portion) for purposes of determining the gain or loss on the sale and the remaining recorded investment?

Staff Response:

Because of the difference in risk associated with the guaranteed and unguaranteed portions of SBA loans, the two portions have substantially different fair values and would command different rates of return (interest rate). Therefore, the recorded investment in the loan should be allocated between the portion sold and the portion retained based on the respective relative fair values on the date the loan was acquired. The sales date may be used in cases when it is not practicable to determine the fair values on the acquisition date.

The guaranteed portion will require a lower rate of return and, therefore, have a higher relative fair value than the unguaranteed portion of the SBA loans. This allocation of original costs will result in a lower gain (or greater loss) than if the cost of the loan has been allocated to each portion on a pro rata basis .

This conclusion is based on FASB Emerging Issues Task Force Consensus No. 88-11.

TOPIC 5: LEASES

5A. SALE AND LEASEBACK TRANSACTIONS

Facts:

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

Question 1:

How should this transaction be accounted for?

Staff Response:

Interpretive Ruling 7.6120 requires that a "dividend in kind" be recorded on the basis of the fair (appraised) value of the property. Therefore, the book value of the building is increased to its fair value. The fair value is then charged to undivided profits as a dividend. However, since the bank leases the premises back from the purchasing third party, an effective sale/leaseback has occurred.

Statement of Financial Accounting Standards No. 13 (SFAS 13) requires that the resulting gain from the increase from book value to fair value be deferred and amortized over the lease term. Involvement by the holding company is ignored (except for the dividend transaction) since the substance of the transaction is the same as if the bank had actually sold the building, leased it back, and distributed the sales proceeds by dividend to the holding company. In this example, capital has been reduced since the dividend is recorded on the basis of fair value, but the gain is deferred.

In April 1988, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 98 (SFAS 98). This Statement requires that sale/leaseback transactions involving real estate qualify as a sale under the provisions of Statement of Financial Accounting Standards No. 66 (SFAS 66) for sales treatment to be used. Otherwise, the transaction will be accounted for either as a financing or under the deposit method. Accordingly, in this and the following examples, it is assumed that the transaction qualifies for sales recognition under SFAS 98.

Question 2:

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

Staff Response:

The accounting for this transaction would be the same as in Question 1 except that the bank would also record the amount of the capital contribution. Therefore, total capital remains essentially the same as it was prior to the sale/leaseback. However, the bank's ability to pay future dividends has decreased because undivided profits have been reduced by the amount of the dividend, while 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 either be on a short-term basis (i.e., one or two years) or on a month-to-month basis. How should this transaction be accounted for?

Staff Response:

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

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

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

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

Question 4:

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

Staff Response:

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

Question 5:

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

Staff Response:

Since transactions between affiliates are required to be recorded at fair value (Interpretative Ruling 7.6120), a dividend would be recorded for the difference between the fair value of the property and the amount paid by the holding company. Again, because of the lease provisions, the resulting gain on the sale would be deferred and amortized over the remaining life of the building.

Question 6:

In some cases the sale/leaseback may be with a related party other than the holding company. As an example, it may be with a major shareholder or a partnership made up of major shareholders and/or board members. How should such transactions be accounted for?

Staff Response:

The accounting for related party transactions should be used in all situations where the same individual, individuals, or control group have significant influence over both entities (i.e., the bank and the purchaser). Such determination is made on a case-by-case basis. However, it would not always be necessary for the control group to have a voting majority (over 50 percent in each entity) to be considered as having significant influence. In a bank which has numerous shareholders, an individual with a 15 or 20 percent stock interest can be deemed to have significant influence.

However, a shareholder with 40 percent interest may not have such influence if another shareholder has a controlling interest. Therefore, judgment should be used in making this determination.

5B. LEASE CANCELLATIONS

Facts:

The bank has a remaining lease on a branch office site that exceeds one year. The lease is accounted for as an operating lease. The bank has decided to close the branch and abandon it without cancelling the related lease. The bank will be required to 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:

All costs and expenses directly associated with the decision to abandon the branch should be recognized as a loss during the period management decides to close the branch. These costs and expenses include all future payments contractually required by the existing lease.

Closing a branch site is similar to disposing of a business segment. Therefore, the costs and expenses incurred to close the branch should be accounted for in the same fashion.

Accounting Principles Board Opinion No. 30 (APB 30) requires that a loss on the abandonment of a business segment be recognized at the measurement date. The measurement date is when management commits itself to a formal plan to abandon the branch site.

AICPA Accounting Interpretation No. 1 to APB 30 provides additional guidance. It requires that gains and losses from events or transactions that resemble a business segment disposal be reported in current income using the principles of APB 30. Additionally, under Financial Accounting Standards Board Interpretation No. 27, the cash flows from the original lease should be considered in determining the loss on the abandonment. Finally, the FASB Emerging Issues Task Force, in Issue 88-10, supports this accounting.

Question 2:

How should the loss be determined?

Staff Response:

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

To discount the lease payments, SFAS 13 requires that the lessee (bank) use its incremental borrowing rate. However, if the bank knows the interest rate implicit in the lease, it should use the lower of the two rates.

Question 3:

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

Staff Response:

Yes. Anticipated future revenues from sublease income, proceeds from the disposal of any branch assets, and other future income would be considered in the calculation. A loss should be recognized at the measurement date based on the amount that the estimated costs and expenses exceed anticipated future revenues.

If the anticipated future revenues exceed those costs and expenses, a gain is expected. However, under APB 30, recognition of the gain is deferred until it is actually realized.

The lack of an existing sublease contract at the measurement date does not preclude anticipating future sublease income. If it is probable that the bank will sublease the branch site, future rental income should be considered.

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

Question 4:

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

Staff Response:

No. The decision to stop using leased equipment has the same economic impact as abandoning a branch site. The leased equipment has no substantial future use or benefit. Consequently, the remaining lease payments, reduced by any anticipated sublease income, should be recognized as a loss. This conclusion is consistent with FASB Emerging Issues Task Force Consensus No. 88-10.

TOPIC 6: INVESTMENT SECURITIES

6A. MUTUAL FUNDS

Question 1:

Banking Circular No. 220 states that mutual funds are to be accounted for consistent with Statement of Financial Accounting Standards No. 12 (SFAS 12). However, SFAS 12 deals primarily with marketable equity securities. Since national banks are only allowed to invest in mutual funds with portfolios of obligations of, or obligations guaranteed by, the U.S. government or its agencies, why is SFAS 12 considered the governing accounting requirement?

Staff Response:

If the underlying government securities are owned directly by the bank and it has the ability and intent to hold the securities to maturity, the assets are reported at amortized cost. However, by investing in a mutual fund, the bank gives up the ability to control whether the underlying securities are held to maturity. Therefore, the FASB Emerging Issues Task Force, in Issue No. 86-40, concluded that financial institutions (banks) should report their investments in mutual funds at the lower of cost or market value following SFAS 12.

Question 2:

Both the Banking Circular and SFAS 12 indicate that unrealized losses (that are considered temporary) should be reported in the shareholders' equity section net of the applicable income tax effect. Is it always appropriate to determine the tax effect on these unrealized losses?

Staff Response:

No. Based upon discussions with tax professionals, losses from most investments in mutual funds would be characterized as "capital losses" under the Internal Revenue Code. SFAS 12 allows the tax effecting of capital losses only when there is assurance beyond a reasonable doubt that the benefit will be realized by an offset of the loss against capital gains. Therefore, unless the bank currently has offsetting capital gains, the unrealized loss generally cannot be reduced by anticipated tax benefits.

Question 3:

If the aggregate market value of mutual fund holdings improves after the bank has established a valuation allowance in the stockholders' equity section, can the bank increase the carrying value of its investment?

Staff Response:

Yes. Any subsequent recoveries can be recognized and reported as an adjustment to the accumulated changes in the valuation allowance. However, the carrying value of a mutual fund holding cannot be increased above its original cost.

Question 4:

How should gains or losses be reported when the mutual fund interests are sold?

Staff Response:

Realized gains and losses should be included in the determination of net income for the period in which they occur. They should be recorded as "Other non-interest income" or "Other non-interest expense," as appropriate. The valuation allowance would be adjusted to remove any previously included amounts applicable to the mutual fund interest sold.

6B. COLLATERALIZED MORTGAGE OBLIGATIONS

Question 1:

How should the premiums and discounts resulting from the purchase of Collateralized Mortgage Obligations (CMOs) be accounted for?

Staff Response:

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

Question 2:

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

Staff Response:

A difference in the rate of prepayments on the mortgages backing a CMO should be accounted for in accordance with SFAS 91. The statement requires that the bank recalculate the effective yield on the investment to reflect the actual prepayment results and anticipated future payments. 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 <u>since acquisition</u> of the CMO. The corresponding charge or credit should be made to interest income.

6C. OPTIONS

Question 1:

What is an option contract?

Staff Response:

Options are contracts where, for payment of compensation, the buyer has acquired the right (or option) to sell to, or purchase from, another party some financial instrument at a stated price on a specified future date. For receipt of such compensation, the seller (writer) of the contract is obligated to purchase or sell the financial instrument at the option of the buyer of the contract. Such contracts may relate to purchases or sales of securities, money market instruments, or futures contracts.

Question 2:

How should national banks account for options?

Staff Response:

Current policy requires that purchased options be accounted for using the lower of cost or market value method. Fee income from short (i.e., written) options should be deferred until the contract expires, is exercised by the buyer, or is closed out by an offsetting contract. However, unrealized losses, which equal the excess of market declines over deferred fee income, on short positions should be accrued and charged against current operations. Gains should only be recognized to the extent that they offset previously recognized losses.

Facts:

The bank writes covered call options on 30-year Treasury bonds held in its investment portfolio. The bonds are accounted for at amortized cost. If the holder exercises the option, the bank must deliver the specified amount of Treasury bonds in the option contract in exchange for payment of the strike price.

Question 3:

Should the bank continue to account for the 30-year Treasury bonds at amortized cost?

Staff Response:

No. As the writer of a covered call option, the bank no longer has the ability or intent to hold the 30-year Treasury bonds until maturity. The AICPA Bank Audit Guide permits Treasury bonds and other debt securities to be carried at amortized cost only if they are held for investment. Therefore, the 30-year Treasury bonds should be reported as held for sale and accounted for at lower of cost or market value.

Question 4:

What are interest rate caps and floors?

Staff Response:

Interest rate caps are contracts whereby the writer, for a fee, agrees to pay a counterparty if a floating rate index goes above a specified level over a particular term. Interest rate floors, on the other hand, obligate the writer to pay the holder if a floating rate index goes below a specified level. In these cases, the seller (writer) of the contract has, for a fee, become obligated to pay the buyer (holder) of the cap (or floor) if unfavorable events occur.

Question 5:

How should national banks account for interest rate caps and floors?

Staff Response:

Interest rate caps and interest rate floors are considered the economic equivalent of options. Therefore, for the issuer, written caps and floors should be accounted for at the higher of proceeds or market value.

As such, fees or other compensation received from written caps and floors should be deferred and accounted for similar to fees received on written options. Obligations to pay under the cap or floor should be charged against the deferred fee. And, unrealized losses due to changes in market value that exceed the deferred fee should be recognized in current period income.

Question 6:

The staff response to Question 2 requires that options be accounted for by the lower of cost or market value method. May this valuation be done in the aggregate?

Staff Response:

Yes. Generally, changes in the market value of options with similar characteristics should be determined in the aggregate. Accordingly, unrealized losses on an option portfolio are offset against unrealized gains and only the net unrealized loss on the portfolio need be recorded. This response is based on SFASs 12 and 65.

6D. REPOs TO MATURITY

Question 1:

What is a repurchase agreement to maturity?

Staff Response:

A repurchase agreement is a transaction involving the sale of assets (typically securities) by a bank which agrees to repurchase the assets at a specified date or under specified circumstances. Generally, repurchase agreements are written for a short period of time and involve the sale of or collateralization by a U.S. government agency security. Such an agreement is similar to a secured borrowing and would be accounted for as such. However, long term repurchase agreements and repurchase agreements to maturity may be used as a method of permanently disposing of a security. This type of agreement should be accounted for as a sale of the asset.

Question 2:

Under what circumstances should repurchase agreements be considered as a sale of the underlying security?

Staff Response:

Securities sold under agreement to repurchase should be recorded as sales (or purchases) when the repurchase agreement either matures at the same time as the underlying security or has a maturity date that exceeds 50 percent of the remaining maturity of the underlying security at the time the repurchase agreement is entered into.

Yield maintenance dollar repurchase agreements should also be reported as sales (or purchases) of securities. These are agreements that involve the sale and repurchase of securities with different contract interest rates, but the repurchased securities will provide the same yield as the sold securities. This transaction is reported as a sale because the repurchased assets are not substantially identical to the assets sold.

6E. SECURITY LENDING TRANSACTIONS

Question 1:

What is a security lending transaction?

Staff Response:

Some banks, in order to convert tax exempt income into taxable income at higher yields, enter into security lending transactions. This is accomplished by lending the tax-exempt security to a broker on a short-term basis and investing the proceeds in a higher yielding taxable security.

Question 2:

What conditions must be met for a security lending transaction to be accounted for as a loan of the security and not a sale?

Staff Response:

To be considered a loan of the security:

1. The loan term must be substantially shorter than the security's remaining maturity;
2. The identical security must be returned to the bank, and;
3. There must be a material monetary penalty to ensure return of the security.

It is important to note that the security returned must be "identical," and not "substantially identical."

The determination of whether the transaction is a sale or loan is based on a case-by-case analysis. However, one transaction that was accepted as a loan by the OCC had a loan term (including all renewals) not exceeding 50 percent of the security's remaining maturity.

6F. COUPON STRIPPING

Question 1:

How should a bank account for the sale of "stripped" securities?

Staff Response:

The original purchase price should be allocated between the principal portion and the coupons based upon the interest rate at the time the security was originally purchased by the institution, (i.e., the yield to maturity of the security at that time). Any gain or loss on the portion sold is based on that portion's cost basis and should be recognized during the period in which the sale occurs as "Other non-interest income" or "Other non-interest expense," as appropriate. The retained portion will be reported as "All other" on Schedule RC-B, Securities, to the Call Report.

TOPIC 7: OTHER ASSETS

7A. Real Estate

Fact:

Interpretive Ruling 7.3025 (IR 7.3025) includes three situations under which a sale of other real estate owned (OREO) is classified as a "covered transaction." One is the financing by the selling bank of all or a portion of the sales price on terms more favorable than those customarily required by the bank.

Question 1:

Since this ruling is not consistent with generally accepted accounting principles, how should the bank account for such a transaction?

Staff Response:

SFAS 66 requires that the accounting principles set forth in Accounting Principles Board Opinion No. 21 (APB 21) be followed when a bank has sold OREO and granted financing on terms more favorable than those customarily required by the bank. This opinion requires that the below market rate loan be discounted to achieve a market rate of interest. The discount is deferred and accreted as additional interest income over the life of the loan. Any gain or loss on the sale of the OREO is based upon the discounted value of the loan and any other consideration received.

For Call Report purposes, a bank should follow this accounting treatment. Furthermore, since both the loan amount and interest rate are recorded based upon current market rates, it is not necessary to include this sale as a covered transaction.

Question 2:

How should banks account for declines in the fair value of OREO?

Staff Response:

A valuation reserve should be established for any subsequent decline in the fair value of OREO which is considered temporary. The determination of changes in fair value must be made on a property by property basis. Subsequent increases in the fair value of the property may be used to reduce the reserve, but not below zero. Declines in value which are considered other than temporary should be recorded as a direct write down of the property.

Question 3:

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

Staff Response:

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

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

Question 4:

How should the revenues and expenses resulting from the operation of OREO be accounted for?

Staff Response:

The revenues and expenses from the operation of OREO should be included in the Statement of Income for the period in which they occur. The Instructions to the Call Report require that gross rentals from OREO be included in "Other noninterest income." The expenses of operating the property, including depreciation when appropriate, should be included in "Other noninterest expense."

Facts:

A loan is secured by a second lien on a piece of property. The bank forecloses on that property and agrees to assume the prior lien.

Question 5:

How should the bank account for the lien assumption?

Staff Response:

The investment in the OREO should be increased by the amount of the lien assumed, with a corresponding liability recorded. However, the resulting carrying value of the OREO can not exceed the fair value of the property. Any excess should be expensed. Further, interest payments on the prior lien must be expensed.

Question 6:

Is the treatment the same if the bank makes payments on a prior lien, but does not assume it?

Staff Response:

No. In this case, the bank should generally not record the liability. However, the principal portion of payments made to the prior lien holders may be capitalized to OREO as paid, provided that the carrying value of the OREO does not exceed its fair value. As with lien assumptions, interest payments must be expensed.

Question 7:

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

Staff Response:

No. While a tax delinquency effectively creates a prior lien, the accounting differs. IR 7.3025 requires that all costs of foreclosure be expensed as incurred. The staff believes that settling real estate tax delinquencies are costs incidental to foreclosure and must be expensed. Additionally, real estate taxes on property held as OREO are considered holding costs and expensed as incurred. An exception to this rule exists for property which is under construction. Generally accepted accounting principles allow for capitalization of property taxes during the development period of the property.

Question 8:

If a bank provides nonrecourse financing for the sale of OREO, will the sale be considered a covered transaction?

Staff Response:

It may, depending upon the fact situation. If the bank does not normally make real estate loans on a nonrecourse basis, the financing is considered to be "on terms more favorable than those customarily required by the bank." Thus, the sale would be considered a covered transaction. If the bank's loan policy does provide for nonrecourse lending <u>and</u> the the bank has a practice of making nonrecourse loans, this provision would not create a covered transaction.

Facts:

The bank sells a tract of OREO property. It receives a down payment of 10 percent and accepts a note receivable which includes interest at market rates.

Question 9:

Can this transaction be recorded as a sale and the bank record the resulting profit?

Staff Response:

To determine whether a bank-financed disposition of OREO qualifies as a sale, and if so, whether the indicated profit can be recognized immediately, a bank must consider not only IR 7.3025, but also SFAS 66.

The requirements of SFAS 66 are generally more restrictive than those of IR 7.3025. Accordingly, a disposition of OREO property that is not a covered transaction may not qualify for sales recognition using the full accrual method under SFAS 66. This results because SFAS 66 generally requires down payments larger than 10 percent and also requires a continuing investment (regular periodic payments) on the part of the buyer.

Question 10:

How is the down payment requirement determined under SFAS 66?

Staff Response:

The down payment requirement of SFAS 66, which must be met for the full accrual method to be used, 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 having 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.

An exception to the strict requirements of SFAS 66 is single-family residential property used as the buyer's primary residence. Only a 5 percent down payment is required. However, the requirements of IR 7.3025 would preclude immediate sale treatment in this case.

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 11:

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

Staff Response:

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

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

Facts:

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

Question 12:

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

Staff Response:

No. SFAS 66 establishes the requirements for recording the transaction under the full accrual method. It requires the buyer's continuing investment (annual 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. A method which defers profit recognition should be used.

Facts:

OREO property with a book value of $110,000 is sold for $120,000. The bank finances the sale and receives no cash down payment. The terms of the note require 120 monthly payments of $1,000 plus interest at market rates. SFAS 66 requires a minimum initial investment of 20 per cent 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 13:

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

Staff Response:

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

7B. INSUBSTANCE FORECLOSURE

Question 1:

What is an "insubstance foreclosure?"

Staff Response:

An "insubstance foreclosure" occurs when a bank effectively controls the collateral for a loan even though actual repossession or foreclosure has not taken place. In essence, the bank is the de facto owner of the collateral. As such, the bank is more exposed to the risks of ownership of the collateral and better positioned to benefit from recovery of its fair value than the borrower(s).

Question 2:

What guidance is available for identifying an insubstance foreclosure?

Staff Response:

The Securities and Exchange Commission's Financial Reporting Release No. 28 (FRR 28) is the primary source of accounting guidance regarding insubstance foreclosures. FRR 28 provides specific criteria for judging when an insubstance foreclosure has occurred:

> Collateral generally should be considered repossessed in substance and accounted for at its fair value when:
>
> - The debtor has little or no equity in the collateral, considering the current fair value of the collateral; <u>and</u>
>
> - Proceeds for repayment of the loan can be expected to come only from the operation or sale of the collateral; <u>and</u>
>
> - The debtor has either:
>
>   Formally or effectively abandoned control of the collateral to the creditor, <u>or</u>
>
>   Retained control of the collateral but, because of the current financial condition of the debtor, or the economic prospects for the debtor and/or the collateral in the foreseeable future, it is doubtful that the debtor will be able to rebuild equity in the collateral or otherwise repay the loan in the foreseeable future.

Question 3:

If an insubstance foreclosure occurs, how should a bank account for it?

Staff Response:

We believe that insubstance foreclosures occur infrequently. However, when one does occur, the bank should reclassify the loan as either other real estate owned or other assets. This classification depends on the nature of the collateral.

In addition, the bank should record the collateral at the lower of the recorded investment in the loan or the fair value of the collateral. Any write down required at the time of an insubstance foreclosure should be recorded as a charge to the bank's allowance for loan and lease losses. All subsequent write downs should be charged to current period earnings as a noninterest expense.

8A. COMPUTER SOFTWARE COSTS

Facts:

Banking Circular 203 (Rev) requires that national banks expense, as incurred, the cost of internally developed computer software developed for a bank's own use. However, in some cases a bank will develop software in circumstances where it can be argued who is responsible for the development. As an example, a bank develops a computer software system through the use of independent contract programmers. The bank maintains responsibility for the development and design of the complete project, and bears the financial burden of testing, perfecting and completing the program.

Question 1:

Can the cost of the contract programmers be capitalized?

Staff Response:

No. The bank should expense these costs as incurred. This is based upon the fact that the bank has the ultimate responsibility for the development of the software and assumes the risk for its completion. This position is consistent with Statement of Financial Accounting Standards No. 86, which does not allow capitalization prior to the determination of technological feasibility.

Question 2:

The bank purchases a completed, tested, and operational software package. The cost of the package qualifies for capitalization. However, the purchased software must be modified to operate on the bank's computer system. Can these modification costs be capitalized? Would the answer be different if the modification is being performed by employees of the firm that developed the software?

Staff Response:

Whether the modifications are performed by the firm that developed the software or by the bank, Bank Circular No. 203 (Rev) requires that modification and implementation costs of purchased software be expensed as incurred.

8B. DATA PROCESSING SERVICE CONTRACTS

Facts:

A bank decides to convert from its current in-house data processing arrangement to a third-party data processing servicer. The bank enters into a long-term contract (e.g., seven years) with the servicer. As part of the contract, the servicer agrees to purchase the bank's data processing equipment, paying the bank book value ($1,000,000), while fair value is significantly less ($400,000).

Question 1:

May the bank record the sale of its equipment at book value ($1,000,000), recognizing no loss on the sale?

Staff Response:

Generally, no. In most cases, the substance of this transaction is a borrowing by the bank from the servicer for the amount received in excess of the fair value of the equipment. There is a rebuttable presumption that the servicer will recoup this excess payment over the life of the service contract.

Therefore, the bank should record the sale of its equipment at fair value, recognizing the loss of $600,000 ($1,000,000 - $400,000). Furthermore, the bank should record a liability to the servicer for $600,000, and amortize this amount in accordance with the terms of the contract. In addition, interest expense should be recorded on the unamortized portion of this liability in accordance with APB 21.

Facts:

A bank decides to convert from its current in-house data processing arrangement to a third-party data processing servicer. The bank enters into a long-term contract (e.g., seven years) with the servicer. The bank will continue to own its data processing equipment, but anticipates that most of it will be replaced once conversion to the servicer occurs.

Question 2:

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

Staff Response:

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

TOPIC 9: INCOME TAXES

9A. DEFERRED TAXES

Facts:

The bank subsidiary of a bank holding company has deferred tax charges booked as an asset. The bank subsidiary does not have any net operating loss (NOL) carryback available on a separate entity basis. The holding company files a consolidated federal tax return and the consolidated group does have NOL carryback potential available. The holding company has offered to purchase the deferred tax charges from the bank subsidiary.

Question 1:

How should the bank subsidiary record the deferred tax charge transfer to the bank holding company?

Staff Response:

Deferred tax charges are not transferrable. Any assets received from the holding company in this transaction are to be recorded as a capital contribution. Further, Banking Circular No. 202 would require the bank subsidiary to write-off this deferred tax charge. This is because the subsidiary bank doesn't have any NOL carryback potential available on a separate entity basis. A bank that is a member of a consolidated group should generally determine its NOL carryback potential on a separate basis.

Facts:

Assume the deferred tax charges in Question 1 are supported by that amount of NOL carryback at the bank level. However, the NOL carryback potential of the consolidated group is less than that of the bank. Additionally, the parent holding company is not financially capable of reimbursing the bank for its deferred tax benefits.

Question 2:

Can the bank continue to carry on its books the entire deferred tax asset in the amount of its NOL carryback?

Staff Response:

No. Under Banking Circular No. 202, when a consolidated group's NOL carryback is less than the bank's (on a stand alone basis), the bank's deferred tax asset is limited to the group's NOL carryback. An exception is made if the parent is "financially capable" of refunding the tax benefits due to the bank as the underlying book-tax differences reverse. In this case, the bank may record a deferred tax asset up to the amount of the group's NOL carryback potential only.

Determining the parent's financial capability is a matter of judgment. However, in the case of a one-bank holding company, the parent is probably not financially capable, for this purpose, if its sole or primary source of income (i.e., financial strength) is its subsidiary bank.

9B. TAX SHARING ARRANGEMENTS

Facts:

The bank is a member of a consolidated group subject to a tax sharing agreement with its parent holding company. During the current year, the bank incurs a loss that would result in a tax benefit on a separate entity basis. However, the consolidated group has previously carried back its losses and recovered all available tax refunds from the IRS.

Question 1:
Should the bank record a tax receivable for the benefit of its current year loss?

Staff Response:

Yes. The bank should record the tax benefit for its current year tax loss and the holding company should refund this amount to the bank. The Instructions to the Call Report 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 does not have the financial capability to reimburse the bank, it should be recorded as a dividend.

The Instructions to the Call Report 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 on a quarterly basis.

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 Banking Circular No. 105 prohibits banks from paying their deferred tax liability to the holding company, it was not intended to restrict the payment of a bank's current tax liability. The Instructions to the Call Report allow a bank to remit the amount of current taxes that would have been calculated on a separate entity basis. However, the tax sharing agreement between the subsidiary bank and the holding company must contain a provision to reimburse the bank when it incurs taxable losses that it could carryback on a separate entity basis.

Such remittances may be made on a quarterly basis 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 which files a consolidated return. The consolidated group incurs a loss in the current year and carries the loss back to prior years, resulting in a refund of substantially all taxes previously paid to the IRS. Under the tax sharing agreement, the subsidiary banks that produced the loss will receive a pro rata share of the total tax refund from the IRS. However, on a separate entity basis, some subsidiaries 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 Instructions to the Call Report require that the individual bank subsidiaries compute and record the tax benefit of a loss on a separate entity basis. Additionally, they should receive that benefit as if they had filed for a refund on a separate entity basis.

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, it should be recorded as a dividend.

9C. SURTAX EXEMPTION

Facts:

The bank is a subsidiary of a holding company which files a consolidated return. Because of their common ownership, the affiliated companies are only entitled to 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:

Since only one surtax exemption is available for a consolidated group, the exemption should be allocated among the affiliates in an equitable and consistent manner. Additionally, the surtax exemption should be allocated to profitable entities, since it is only used to compute the tax liability.

A bank subsidiary of a holding company which files a consolidated return must report as current taxes and pay to its parent holding company the amount of taxes which would otherwise be payable had it filed a tax return on a separate entity basis. Accordingly, the determination of the subsidiary's current tax liability should encompass the allocation of the available surtax exemption. This accounting treatment is set forth in the Instructions to the Call Report and Banking Circular No. 105.

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 Instructions to the Call Report regardless of the number of subsidiaries involved.

9D. STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 96

Facts:

In December 1987, the Financial Accounting Standards Board (the Board) issued Statement of Financial Accounting Standards No. 96, "Accounting for Income Taxes (SFAS 96)." It changes the method of determining deferred income taxes from the deferred method under Accounting Principles Board Opinion No. 11, "Accounting for Income Taxes (APB 11)" to the liability method. Currently, the Board is considering requests to amend SFAS 96. Accordingly, it has delayed the required effective date until 1992. However, companies (bank) may elect to adopt SFAS 96 prior to 1992.

Question 1:

How should a bank report the effect of adopting SFAS 96 for Call Report purposes?

Staff Response:

The adoption of SFAS 96 represents a change in accounting principles. For the year in which SFAS 96 is first adopted for Call Report purposes the effect of applying SFAS 96 on the amount of deferred tax charges or credits at the beginning of the year should be reported in Schedule RI, item 11, "Extraordinary items and other adjustments," in accordance with the Instructions to the Call Report. It should be noted that SFAS 96 has an election, but not a requirement, that allows for the restatement of prior years financial statements.

Question 2:

Under the Tax Reform Act of 1986, banks are required to compute their regular tax liability and an alternative minimum tax (the AMT), and pay the higher of the two. SFAS 96 requires that the determination of a bank's deferred taxes reflect the requirements of alternative tax systems where they exist. How should the AMT calculation be computed for banks that are members of a consolidated group and have adopted SFAS 96?

Staff Response:

Under the Instructions to the Call Report, banks that are a member of a consolidated group should first compute their deferred taxes on a separate entity basis without regards to the AMT. The AMT should then be determined on a consolidated basis. If there is any excess of AMT over regular tax, that excess should be allocated to the subsidiary banks using an equitable method.

In subsequent years when the AMT credit carryforward is realized, the credit must be reallocated to the subsidiary banks based on the AMT previously allocated.

Question 3:

Early application of SFAS 96 has been encouraged by the FASB. Can members of a consolidated group follow different methods of determining their deferred taxes using either the existing deferred method (APB 11) or by early adoption of the liability method (SFAS 96)?

Staff Response:

No. Members of a consolidated group shall follow the same accounting principles for Call Reports when determining their deferred tax balances. Under the AICPA Bank Audit Guide, holding companies and their subsidiaries may apply accounting principles that differ when the subsidiaries are in different industries that have specialized accounting practices and acceptable alternatives exist. However, SFAS 96 applies equally to all industries and the decision to adopt SFAS 96 must be applied to all members of the consolidated group during the period of adoption.

The decision to adopt SFAS 96 supersedes the right to continue to use APB 11 in accounting for deferred taxes. In essence, APB 11 is only acceptable as long as the consolidated group has not elected to adopt SFAS 96.

TOPIC 10: CAPITAL

10A. QUASI-REORGANIZATION

Question 1:

What is a quasi-reorganization:

Staff Response:

A quasi-reorganization is an accounting procedure whereby an entity (bank), without undergoing a legal reorganization, revalues its assets and liabilities and reorganizes its equity capital. This allows for removal of a cumulative deficit in undivided profits. Chapter 7A of Accounting Research Bulletin No. 43, issued by the American Institute of Certified Public Accountants, describes a quasi-reorganization. It is based on the concept that an entity which has previously suffered losses but has corrected its problems should be allowed to present its financial statements on a "fresh start" basis. Banking Circular No. 236 (BC 236) describes the staff's views as to the circumstances necessary for a fresh start.

Under generally accepted accounting principles, an entity undergoing a quasi-reorganization must revalue all its assets and liabilities to their current fair value. The effective date of the readjustment of values should be as near as possible to the date on which the shareholders gave their approval to the reorganization. The tax benefits of loss carryforwards arising before the quasi-reorganization should be added to capital surplus when realized.

Question 2:

Can total capital increase as a result of the quasi-reorganization process and the revaluing of the net assets of the bank?

Staff Response:

No. While the individual elements that make up equity capital may increase or decrease, BC 236 does not permit an increase in total capital due to a quasi-reorganization. This is based upon the historic cost model and the conservative concept in accounting which generally precludes recognition of gains until realized. Additionally, since the revaluation procedure is similar to that employed in purchase accounting (see APB 16), the staff believes this method is similarly limited to the original cost amount -- shareholders' equity.

Question 3:

Is approval of the OCC needed if a bank intends to effect a quasi-reorganization?

Staff Response:

Yes. BC 236 outlines the procedures for a bank to request and obtain OCC's approval to consummate a quasi-reorganization. The quasi-reorganization must be approved by the appropriate district office of the OCC.

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 effect 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 as well as to financial statement presentation. Therefore, in applying 12 USC 56, only the undivided profits amount since the date of the quasi-reorganization would be considered. Losses prior to the date of the quasi-reorganization are ignored. However, prudent judgment should nevertheless be employed in determining the appropriateness of dividend payments in light of the bank's financial condition and anticipated future financial needs.

Facts:

Bank A has a deficit in undivided profits due to losses suffered during years 1981 through 1986. During 1985, two individuals acquired a majority interest in the bank's stock. Later, in 1988, the two individuals were bought out in a public offering.

There has also been a substantial change in management since 1985. The Chairman and Vice Chairman of the Board of Directors assumed their positions in 1985. A new president and a new chief executive officer were hired. And, other members of management were replaced. In spite of the change of ownership in 1988, this management team hired in 1985 continues. In 1988, after the public offering, the bank desires to consummate a quasi-reorganization.

Question 5:

Does the bank meet the criteria for a quasi-reorganization?

Staff Response:

No. BC 236 identifies the requirements for a bank to consummate a quasi-reorganization. Two of these requirements are a substantial change in ownership and an acceptable change in management from those at the time the losses occurred. These changes should occur simultaneously. If this is not practicable, they should occur within a short time of each other, normally within one year.

As previously noted, a quasi-reorganization is based on the concept of a "fresh start." Old owners and old management should not benefit from the quasi-reorganization. In this situation, management of the bank did not change in 1988 when ownership did.

TOPIC 11: MISCELLANEOUS ACCOUNTING

11A. TRANSFERS BETWEEN RELATED PARTIES

Facts:

Transfers of assets (loans, securities, etc.) between related parties may involve a number of forms. Examples are asset swaps between a bank and its holding company, the transfer of bank premises to the holding company as a dividend, or the transfer of bank premises to the bank as a capital contribution.

Question 1:

How should transfers of assets between a bank and its parent holding company or other related party be accounted for?

Staff Response:

The transfer of assets between a bank and a related party should be accounted for on the basis of the asset's fair value. This position is based on the necessity of maintaining consistency of accounting policy regarding transactions involving affiliated and nonaffiliated institutions.

For regulatory purposes, each bank reports as a separate legal and accounting entity. Therefore, it is necessary for each transaction to be recorded on the basis of its economic substance from the standpoint of the bank as a separate entity. Any resulting profit or loss on the transaction is based on the fair value of the assets involved. If a difference between the contract price and the fair value exists, the amount is recorded as either a dividend or capital contribution, as appropriate.

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 2:

How should the sale of this charged off loan be accounted for?

Staff Response:

The fair value of the loan ($100,000) is credited to the allowance for loan and lease losses as a recovery. The excess of the purchase price over the fair value of the loan ($800,000 - $100,000 = $700,000) is considered a capital contribution and is credited to the capital surplus account.

Question 3:

Assume the same facts as above, except that it is not possible to determine if the charged off loan has any value. How should this transaction be accounted for?

Staff Response:

Inasmuch as it is not possible to determine if the charged off loan has any value, it should be assumed the loan has only minimal value. Therefore, the entire proceeds ($800,000) is considered to be a capital contribution and is credited to capital surplus.

Question 4:

Assume the same facts as above, except that because of a lending limit violation, the directors are legally liable to purchase the loan at its face value of $800,000. How is this transaction accounted for?

Staff Response:

The entire proceeds from the directors should be credited to the allowance for loan and lease losses as a recovery. The staff believes that because the directors are legally liable to reimburse the bank for its losses, the transaction should be accounted for similarly to a bond claim.

Facts:

A bank holding company (BHC) owns a number of subsidiary banks. Each subsidiary bank has trust operations. The BHC proposes to consolidate the group's trust operations into one entity, newly formed Company A, which will be a subsidiary of the BHC. Company A will purchase the trust operations from each bank at their current appraised value. Each selling subsidiary bank will finance the sale to Company A for an amount equal to the appraised value. Collateral for the loan will be the trust operations sold and U.S. government securities totalling 130 percent of the loan amount. The trust operations have a nominal book value.

Question 5:

How should the sale to Company A be recorded by the selling banks?

Staff Response:

The sale should be recorded in the same manner as if the operations were sold to an independent third party. Income should be recognized for the difference between the selling price and the recorded book value. However, the outstanding principal amount of the affiliate loan should be reported as a deduction from shareholders' equity similar to a stock subscription receivable. The loan balance will continue to be reported in this manner until the loan is paid in full.

Question 6:

If a 10 percent cash down payment is received in connection with the sale, would the outstanding loan be reported differently?

Staff Response:

No. The staff believes that all notes of an affiliate received in connection with a transaction which increases shareholders' equity should be reported as a deduction from shareholders' equity. This opinion is based upon the predominant practice to record capital only when payment is received, or to offset the notes in the equity section. Since the result in the transaction would be an increase in shareholders' equity represented by notes, the staff concluded such increases should not be recognized until the funds are received.

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 (individuals related to the key management personnel of the bank). The related parties also own a voting interest in the holding company.

As a fee for introducing the unrelated parties to the bank, the loan brokerage company receives 20 to 30 percent of the face amount of the loans from the seller (unrelated party). The loans have contractual rates approximating market yields and have demonstrated good repayment histories.

Question 7:

How should the bank record the purchase of the loans?

Staff Response:

The purchased loans should be recorded at their fair values, which is presumed to be the net amount received by the seller (unrelated party). The excess of the purchase price over the fair value of the loans should be reported as a dividend.

In this case, the fee appears to 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 to the related party, with the fair value of the loans represented by the net proceeds received by the seller.

11B. ORGANIZATION COSTS

Question 1:

May a bank capitalize the organizational costs of forming a bank holding company?

Staff Response:

No. Although bank holding company fees and other related costs are sometimes paid by the sponsoring bank, they are organizational costs of the bank holding company. Accordingly, any unreimbursed costs paid on behalf of the holding company should be recorded as a cash dividend paid by the bank to the holding company. Similarly, if the bank holding company application is unsuccessful or abandoned, the costs are the responsibility of the organizers. Therefore, unreimbursed amounts should be recorded as a dividend.

11C. BONDING CLAIMS

Facts:

As a result of fraudulent acts by former officers, a bank recognized losses totalling $2 million ($1,900,000 in loan losses and $100,000 in legal fees). In connection with these losses, the bank filed a claim with its fidelity bond carrier seeking payment of the total amount of coverage under the bond aggregating $2 million.

The losses have reduced bank capital to a level below that required for regulatory purposes and the bank seeks to correct this deficiency.

Question 1:

May the bank record a receivable for the $2 million claim at the time it is filed with the insurer?

Staff Response:

No. The staff believes the potential recovery of the loss via insurance proceeds is a contingent gain. SFAS 5 indicates that contingent gains are usually not recorded. FASB Interpretation No. 14 indicates that gain contingencies may be recorded only if the contingent event is highly probable of occurring and the amount of gain may be estimated with a reasonable degree of accuracy.

These conditions generally are not met with respect to insurance claims since the insurance company normally does not initially formally acknowledge the validity of the claim nor the amount for which it is liable. Therefore, it generally can not be determined whether the insurance company will agree to honor the claim or for what amount.

Question 2:

Assume the same facts as above, 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 is highly probable of occurring and the amount of the gain may be estimated with a reasonable degree of accuracy. If management and counsel are able to conclude that these conditions have been met because of the settlement offer from the insurer, it would be appropriate to record the amount of the offer.

11D. LOSSES FROM LITIGATION

Facts:

A legal action was brought against Bank A. The court issued a judgment against the bank and it has appealed. The bank has not provided any provision (liability) for the possible loss resulting from this litigation.

Question 1:

Should Bank A provide a provision for this loss since a judgment has been awarded against the bank?

Staff Response:

Generally accepted accounting principles (SFAS 5) requires that a loss contingency be recorded when a loss is probable and the amount can be reasonably estimated. In making a determination of whether a loss is probable, it is necessary to assess the expected outcome of the bank's appeal. This is a legal determination which 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.

Based on the circumstances of the case and the opinion of legal council, a determination must be made as to whether a loss is probable and whether the amount can be reasonably estimated. Sound judgment must be exercised in reaching this determination. Further, if it can be determined 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 substantially reduced, the staff believes that a liability should generally be recorded for the amount of the judgment. This is based on the fact that a lower court has decided against the bank and no additional information is being provided to support the bank's position.

11E. ONE BANK HOLDING COMPANY FORMATIONS

Facts:

Holding Company A is organized for the purpose of issuing common stock to acquire all of the common stock of Bank A. Under the plan of reorganization, each share of common stock of Bank A will be exchanged for one share of common stock of the holding company. The holding company will not engage in any operations prior to consummation of the reorganization, and its only significant asset after the transaction will be its investment in the bank. The bank has furnished its shareholders with an annual report that includes financial statements that comply with generally accepted accounting principles.

Question 1:

Must financial statements, selected financial data, and a management discussion and analysis for Bank A be included in the proxy statement which seeks shareholder approval of the reorganization?

Staff Response:

The staff will not object to the omission of financial statements and other financial information in the proxy statement if all of the following conditions are met:

- There are no anticipated changes in the shareholders' relative equity ownership interest in the underlying bank assets, except for redemption of no more than a nominal number of shares of out of state shareholders or nonaffiliated persons who dissent;

- In the aggregate, only nominal borrowings are to be incurred for such purposes as organizing the holding company, to pay out of state shareholders or nonaffiliated persons who dissent, or to meet minimum capital requirements;

- No new classes of stock are authorized other than those corresponding to the stock of Bank A immediately prior to the reorganization;

- There are no plans or arrangements to issue any additional shares to acquire any business other than Bank A; and,

- No material adverse change has occurred in the financial condition of the bank since the latest fiscal year end included in the annual report to shareholders.

The bank should provide a letter to the staff requesting waiver of the financial disclosure requirement of the proxy statement. The letter should indicate that all of the above conditions have been met. Additionally, the proxy should include a statement that either an annual report was previously furnished to shareholders or is being delivered with the proxy. This annual report should contain financial statements for at least the latest fiscal year prepared in conformity with generally accepted accounting principles.

If financial statements have been previously furnished, the proxy should indicate that an additional copy of such report will be furnished upon request without charge to shareholders. The name and address of the person to whom the request should be made must be provided. One copy of such annual report should be furnished to the staff with the initial filing.

11F. LIFE INSURANCE COSTS

Facts:

Bank A has purchased split-dollar life insurance policies on the life of several key officers. These are cash value policies wherein both the bank and the officer's family are beneficiaries. Generally, the bank's benefit is limited to refund of the gross premiums paid, with all other benefits going to the officer's beneficiaries.

Question 1:

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

Staff Response:

The bank should record as an "Other asset" the lesser of the cash surrender value of the policy or the present value of the future expected refund of officer life insurance premiums paid. The present value should be computed over the estimated time period until refund of the premiums is expected. The present value calculation should use an interest rate consistent with that used in the policy to compute cash surrender value. The difference between the gross premium payments and the cash surrender value or present value of premiums paid should be expensed as salaries and employee benefits. This accounting is consistent with APB 21, which requires the discounting of long term receivables when there is no stated interest rate.

This response applies to split-dollar life insurance policies where the bank's benefits are limited to a refund of the gross premiums paid. Recently, we have become aware of variations in the contractual terms of these policies. In some cases the bank is entitled to a substantial portion of the increases in the cash surrender value. The accounting for these policies would vary based on the terms of the insurance contract.

11G. ASBESTOS AND TOXIC WASTE REMOVAL COSTS

Facts:

Various federal, state, and local laws require the removal or containment of dangerous asbestos or toxic waste from building and land sites. Such removal or containment of dangerous materials can be very expensive, often costing more than the value of the property. However, in certain jurisdictions the property owners may be required to "clean-up" the property, regardless of cost. With respect to banks, this liability may extend not only to bank premises, but also to other real estate owned.

Question 1:

Should asbestos and toxic waste treatment costs incurred be capitalized or expensed?

Staff Response:

Generally, these costs may be capitalized up to the fair value of the property. When the problem was known at the time the property was acquired, the rationale is that these costs are part of the cost of acquiring the property. With respect to costs incurred to "clean-up" waste on existing property, the rationale for capitalization is that they represent betterments or improvements. However, as noted above, in both cases the amount capitalized is limited to the fair value of the property.

With respect to asbestos removal, this opinion is consistent with FASB Emerging Issue Task Force Consensus No. 89-13. Our conclusion that toxic waste removal should be accounted for in the same manner is based on the similarities between the two issues.

11H. LIQUIDATING BANKS

Facts:

Bank A has a substantial amount of nonperforming assets which it will transfer (sell) to a newly formed bank (Bank B). In accordance with regulatory policy, this transfer must be made at fair value. The newly formed bank is known as a "liquidating bank." Its purpose is to manage the assets it receives and collect whatever cash can be obtained, either through loan repayments or dispositions of assets.

The common stock of the newly formed Bank B is distributed to the common shareholders of Bank A or its holding company. The majority of the funds required by Bank B to purchase the assets are raised through the public sale of senior debt. In addition, subordinated debt or preferred stock is generally purchased by the parent holding company of Bank A. However, in some cases this subordinated position may be purchased by Bank A itself. This subordinated position is usually required by the underwriters of the senior debt offering, as protection for the public senior debt holders.

Question 1:

Is the transfer of the nonperforming assets from Bank A to Bank B accounted for as a sale or a borrowing?

Staff Response:

The criteria which must be met for a national bank to account for transfers of assets as a sale is set forth in the Call Report Glossary entry "Sale of Assets." It should be noted that this regulatory requirement <u>does</u> differ from generally accepted accounting principles. It allows a transfer of loans, securities, receivables, or other assets to be accounted for as a sale only if the transferring institution (Bank A):

- retains <u>no</u> risk of loss from the assets transferred resulting from any cause, <u>and</u>
- has no obligation to any party for the repayment of principal or interest in the assets transferred.

Accordingly, Bank A would be considered to be at risk and the transaction would be recorded as a borrowing if it holds any security interest in Bank B. This would include senior debt, subordinated debt, preferred stock or common stock. In order for the transaction to be recorded as a sale, Bank A must retain no risks of loss or obligations to any party resulting from either the assets transferred or its relationship with Bank B.

Question 2:

Is sales treatment allowed if the security interest in Bank B is held by the parent holding company, or other shareholders of Bank A or its holding company?

Staff Response:

Yes. The Instructions to the Call Report address the risk of loss being retained by the selling bank and its subsidiaries. Other affiliates, such as a parent holding company, or bank or holding company shareholders are not prohibited from either purchasing a security interest in Bank B or assuming a portion of the risk of loss.

It is for this reason that liquidating bank transactions are generally structured with the parent holding company purchasing the preferred stock or subordinated debt, and the holding company shareholders receiving the common stock of the liquidating bank.

Question 3:

How should the ongoing financial statements of the liquidating bank (Bank B) be presented?

Staff Response:

The liquidating bank should report its assets and liabilities at their fair values at the date of the financial statements. Increases and decreases in these values should be recognized in the results of operations for each current period. This reporting is consistent with the accounting for companies in liquidation and is based on a consensus on FASB Emerging Issues Task Force Issue No. 88-25.