Current Accounting Issues Telephone Seminar

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Current Accounting Issues

- Allowance for Loan and Lease Losses
- Troubled Debt Restructurings
- Foreclosed Real Estate
- Impairment of Securities
- Transfers of Financial Assets

Allowance for Loan and Lease Losses

- Each institution must maintain an allowance for loan and lease losses (ALLL) at a level that is appropriate and determined in accordance with GAAP, its stated policies and procedures, management's best judgment, and relevant supervisory guidance
- Applicable GAAP standards for the ALLL
  - FAS 114, *Accounting by Creditors for Impairment of a Loan*, as amended (1993)
  - FAS 5, *Accounting for Contingencies*, as amended (1975)
  - Follow an "incurred loss" rather than an "expected loss" model

Allowance for Loan and Lease Losses

- Supervisory guidance includes ALLL policy statements issued in 2006 and 2001
  - http://www.fdic.gov/news/news/financial/2006/fil06105.html
  - http://www.fdic.gov/news/news/financial/2001/fil0163.html
- An ALLL that is at an appropriate level in accordance with GAAP covers estimated credit losses on individually evaluated loans that are impaired (FAS 114) and estimated credit losses inherent in the remainder of the portfolio (FAS 5)
- Estimated credit losses means an estimate of the amount of loans it is probable the bank will be unable to collect given current facts and circumstances

Allowance for Loan and Lease Losses

  - Represents net charge-offs likely to be realized for a loan or group of loans as of the ALLL evaluation date
- An “unallocated” loan loss allowance is appropriate when it reflects an estimate of probable losses, determined in accordance with GAAP, and is properly supported
- Process for determining an appropriate ALLL level should be based on a comprehensive, well-documented and consistently applied analysis of the loan portfolio
  - Analysis should take into account management’s current judgments about portfolio credit quality, including all significant qualitative factors that affect collectibility

Allowance for Loan and Lease Losses

- Evaluating individual loans secured by real estate for impairment under FAS 114
  - A loan is not impaired solely because the fair value of the collateral is less than the loan’s recorded investment
    - A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement
    - This determination does not consider collateral protection

Allowance for Loan and Lease Losses

- An impaired real estate loan is not collateral dependent solely because the fair value of the collateral is less than the loan's recorded investment
  - A loan is collateral dependent if repayment is expected to be provided solely by the underlying collateral
  - If there are other available and reliable sources of repayment besides the collateral, the loan would not be collateral dependent
  - Measure impairment on an individually impaired loan that is not collateral dependent based on the present value of the expected future cash flows discounted at the loan's effective interest rate

Allowance for Loan and Lease Losses

- If an individually impaired loan is collateral dependent, banking agencies' regulatory reporting policies require impairment to be measured based on the fair value of the collateral (less costs to sell, if appropriate), regardless of whether foreclosure is probable
  - Factors to be considered when estimating fair value include, but are not limited to
    - Timing and reliability of appraisal or other valuation
    - Timing of most recent inspection of collateral
    - Volatility of the fair value of the collateral
    - Confidence in the bank's lien on the collateral
    - Historical losses on similar loans

Allowance for Loan and Lease Losses

- If the measure of the impaired loan is less than its recorded investment, recognize the impairment by creating a FAS 114 allowance for the loan or adjusting the loan's existing FAS 114 allowance
- If the measure of the impaired loan is greater than its recorded investment, the amount of impairment is zero
  - In this situation, it is not likely that a charge-off would be realized on the loan given facts and circumstances as of the ALLL evaluation date
  - No FAS 114 allowance should be established
  - No additional loss recognition is appropriate for the impaired loan under FAS 5

Allowance for Loan and Lease Losses

- Before management concludes that no allowance is needed, it should determine and document that its measurement process was appropriate and that all available and relevant information was considered
- The bank’s estimate of fair value (less costs to sell) is subject to review by examiners
- If management’s measurement process was not appropriate or its assumptions, valuations, and judgments were not reasonable and properly supported, examiners should reestimate fair value (less costs to sell) using assumptions, valuations, and judgments that they can support

Allowance for Loan and Lease Losses

- When there are concerns and uncertainty about the effect of possible future events on the collectibility of the loan portfolio, e.g., further declines in the value of real estate collateral after the ALLL evaluation date
  - Address these concerns by ensuring that equity capital (and hence regulatory capital) is maintained at an appropriately high level that will support the risks to which the bank is exposed, including in the loan portfolio
  - Do not arbitrarily increase the ALLL in excess of amounts that can be supported under GAAP

Allowance for Loan and Lease Losses

- Changes in an institution’s ALLL level should be directionally consistent with changes in the factors, taken as a whole, that evidence credit losses, considering the characteristics of the institution’s loan portfolio
  - If declining credit quality trends relevant to an institution’s portfolio are evident, as is currently the case for many banks, the ALLL level as a percentage of loans should generally increase
  - If improving credit quality trends are evident, the ALLL level as a percentage of loans should generally decrease

Allowance for Loan and Lease Losses

- FAS 141(R), *Business Combinations,* takes effect in 2009
  - Under FAS 141(R), acquired loan portfolios must be recorded at fair value at the acquisition date
  - FAS 141(R) prohibits an acquiring institution from carrying over the acquired institution’s ALLL when it records the loans acquired in a merger or acquisition, which, in general, is the current accounting practice
  - An acquired institution that must apply push down accounting will have no ALLL as of its acquisition date
  - Establish an ALLL for acquired loans that reflects only those credit losses incurred after acquisition
  - Will complicate analyses of ALLL levels at institutions that have had significant mergers and acquisition

Troubled Debt Restructurings

- Applicable Accounting Standards
  - FAS 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, as amended (1977)
  - FAS 114, *Accounting by Creditors for Impairment of a Loan*, as amended (1993)
  - EITF 02-4, *Determining Whether a Debtor's Modification or Exchange of Debt Instruments Is within the Scope of FASB Statement No. 15*

Troubled Debt Restructurings

- A restructuring constitutes a “troubled debt restructuring” if the creditor for economic or legal reasons related to the debtor’s financial difficulties grants a concession to the debtor that it would not otherwise consider
- A troubled debt restructuring may include
  – A transfer from the borrower to the bank (including via foreclosure or repossession) of real estate or other assets,
  – A modification of the loan terms, or
  – A combination of the above

Troubled Debt Restructurings

- A modification of terms includes
  - Reduction of the contractual (stated) interest rate
  - Extension of the maturity date at a contractual interest rate lower than the current rate for new debt with similar risk
  - Reduction of the face amount of debt, i.e., forgiveness of a portion of principal
  - Reduction (forgiveness) of accrued interest
- Not all modifications of terms are troubled debt restructurings

Troubled Debt Restructurings

- Is a modification of terms a troubled debt restructuring?
  - Is the debtor experiencing financial difficulty?
    - NO – Not a troubled debt restructuring
    - YES – Go to next question
  - Has the creditor granted a concession?
    - NO – Not a troubled debt restructuring
    - YES – Modification is a troubled debt restructuring
  - Even if a loan is current, a modification of terms would be a troubled debt restructuring if the preceding conditions are met

Troubled Debt Restructurings

- Creditor's accounting for a troubled debt restructuring involving a modification of terms on a loan held for investment
  - Loan is considered impaired and FAS 114 must be applied
  - FAS 114 applies even if the loan – such as a 1-4 family residential mortgage – would not otherwise fall within the scope of FAS 114 because it would be part of a "large group of smaller-balance homogeneous loans that are collectively evaluated for impairment"

Troubled Debt Restructurings

- Impairment (i.e., the FAS 114 allowance) on a loan modified in a troubled debt restructuring should normally be measured based on present value of expected future cash flows discounted at loan's effective interest rate
  - Modifying terms of a real estate loan essentially acknowledges that there is an additional source of repayment other than underlying collateral; therefore, loan is not collateral dependent
- Effective interest rate is rate of return implicit in the original loan, i.e., original contractual interest rate adjusted for any net deferred loan origination fees or costs or any purchase premium or discount

Troubled Debt Restructurings

- Effective interest rate is not
  - The interest rate specified in the restructuring agreement
  - The starter, introductory, or teaser rate on the original loan, e.g., on a residential mortgage
    - For a restructured residential mortgage loan with a starter rate, original effective interest rate would be a blend of the starter rate and the fully indexed rate at the time of the modification (even if the modification occurs before the interest rate resets)

Troubled Debt Restructurings

- For a restructured residential mortgage loan, should a prepayment assumption be used when estimating expected future cash flows?
  - General view seems to be that no prepayment should be assumed when measuring impairment on an individual loan
- The amount of impairment on the restructured loan (i.e., the FAS 114 allowance) is the excess of the recorded investment in loan over the present value of expected future cash flows

Troubled Debt Restructurings

  - Recorded investment is loan balance adjusted for any unamortized premium or discount and unamortized loan fees or costs, less any previous charge-off, plus recorded accrued interest

– For impaired loans with common risk characteristics, FAS 114 permits a creditor to aggregate the loans and "use historical statistics, such as average recovery period and average amount recovered, along with a composite effective interest rate as a means of measuring impairment of those loans"

  - Under this approach, use of a prepayment assumption for estimating expected future cash flows appears acceptable

Troubled Debt Restructurings

- Should a 1-4 family residential mortgage loan whose terms are modified in a troubled debt restructuring be placed in nonaccrual status?
  - If the mortgage was on nonaccrual prior to restructuring, it should remain on nonaccrual until the borrower has demonstrated a willingness and ability to make the restructured loan payments, generally for a period of at least six months

Troubled Debt Restructurings

- If mortgage was not on nonaccrual prior to restructuring and bank expects borrower to perform after restructuring, e.g., loan was current and monthly payment is not significantly larger than before restructuring, placement on nonaccrual not required
- If mortgage was not on nonaccrual prior to restructuring, but bank does not expect payment in full of both principal and interest under the modified terms, loan may be placed on nonaccrual
  - If loan is not placed on nonaccrual, bank must apply other alternative methods of evaluation to ensure that net income is not overstated

Foreclosed Real Estate

- Standards applicable to foreclosed assets
  - In general, governed by FAS 15; FAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*; and FAS 66, *Accounting for Sales of Real Estate*
  - Call Report instructions have retained certain provisions of AICPA SOP 92-3, *Accounting for Foreclosed Assets*, which has been rescinded
    - Provisions represent prevalent banking practice and are consistent with safe and sound banking practices and accounting objectives in the FDI Act
    - See Glossary entry for “Foreclosed Assets”
  - FDIC FIL-62-2008 (7/1/08) also provides guidance on other real estate
    - http://www.fdic.gov/news/news/financial/2008/fil08062.html

Foreclosed Real Estate

- At time of foreclosure
  - – The property's fair value (less cost to sell) becomes the "cost" basis of the foreclosed real estate
  - – Report the amount of any senior debt (principal and accrued interest) to which the foreclosed real estate is subject at foreclosure as "Other borrowed money"
  - – The amount, if any, by which recorded investment in the loan (plus any senior debt) exceeds the fair value (less cost to sell) of the property is a credit loss that must be charged to the ALLL
  - – Expense foreclosure costs

Foreclosed Real Estate

- After foreclosure
  - At each balance sheet date, report each foreclosed property at the lower of
    - Current fair value less cost to sell the asset or
    - The asset’s cost basis
  - If fair value less cost to sell is less than property’s cost basis, recognize deficiency as a valuation allowance against the asset and a charge to expense
  - Thereafter, increase or decrease the valuation allowance through charges or credits to expense for changes in the asset's fair value less cost to sell
  - Holding costs should be expensed as incurred

Foreclosed Real Estate

- Disposal of foreclosed real estate
  - Unless property is sold with no seller financing, primary accounting guidance for disposals of foreclosed real estate is FAS 66
  - Sales value under FAS 66 will differ from sales price of property if financing is provided at less than prevailing interest rates
  - FAS 66 establishes several methods to account for disposals of real estate
    - If the transaction generates a profit, each method specifies manner in which profit is to be recognized
    - Any loss on disposition of real estate must be recognized immediately

Foreclosed Real Estate

- Accounting methods under FAS 66
  - Each disposition and related financing must be evaluated to determine whether certain conditions have been met
  - Full accrual: Transaction is a sale, loan is recognized, and full profit is recognized in earnings at sale date
  - Installment method: Transaction is a sale, loan is recognized, but profit recognition occurs over time as loan payments are received
  - Cost recovery method: Transaction is a sale, loan is recognized, but entire profit is deferred until certain conditions are met

Foreclosed Real Estate

- Accounting methods under FAS 66
  - Reduced-profit method: Transaction is a sale, loan is recognized, but profit recognition occurs over time as loan payments are received (in different manner than installment method)
  - Deposit method: Transaction does not qualify as a sale, asset continues to be reported as foreclosed real estate, no profit or interest income is recognized, and payments received from the borrower are reported as a liability until certain conditions are met that enables another method to be used

Impairment of Securities

- Available-for-sale (AFS) and held-to-maturity (HTM) securities
  - Under FAS 115, an AFS or HTM security whose fair value is less than its cost basis is “impaired”
  - Evaluate each impaired security each quarter to determine whether impairment is temporary or other than temporary, considering such factors as
    - Probability of collecting all amounts due according to contractual terms of a debt security
    - Duration and severity of the impairment
    - Issuer’s financial condition and near-term prospects
    - Intent and ability to hold until anticipated recovery in fair value (which may be maturity for a debt security)

Impairment of Securities

- For beneficial interests in securitized financial assets, EITF 99-20 provides impairment guidance
  - Applies to interests that are not of "high credit quality," i.e., rated below AA at acquisition
  - May apply to interests that are later downgraded, depending on bank's accounting policy
  - If there has been an adverse change in estimated cash flows based on holder's best estimate of cash flows that a market participant would use in determining the current fair value of the beneficial interest, other-than-temporary impairment is considered to have occurred
    - Discount cash flows at current yield used to accrete discount on beneficial interest

Impairment of Securities

- If impairment is other than temporary, cost basis of individual security must be written down to fair value through earnings, establishing a new cost basis for the security
- Given current market conditions, the longer a security remains impaired and recovery of fair value remains uncertain, particularly for equity securities (which have no maturity), the more evidence is needed to support a conclusion that the impairment continues to be only temporary and no write-down is needed

Impairment of Securities

- Banks should have policies and processes in place for the quarterly evaluation of impaired securities and determination of whether impairment is temporary or not
  - Evaluations should be made case-by-case based on individual facts and circumstances, which requires judgment
  - Policies and processes that are inadequate, nonexistent, or not followed are subject to examiner criticism

Impairment of Securities

- Banks should ensure they are properly reporting investments in “preferred” stocks with readily determinable fair values
  - Preferred stocks with a stated maturity date or that can be redeemed at the option of the investor are debt securities under FAS 115
    - Report in Call Report Schedule RC-B, item 6
  - Perpetual preferred stocks (even if they can be redeemed at the option of the issuer) are equity securities under FAS 115 and cannot be HTM
    - All Fannie Mae and Freddie Mac preferreds currently outstanding are perpetual
    - Report in Call Report Schedule RC-B, item 7

Impairment of Securities

- Regulatory capital treatment of net unrealized losses on AFS securities reported in Accumulated Other Comprehensive Income component of equity capital
  - Net unrealized losses on AFS debt securities excluded from regulatory capital
    - Other-than-temporary impairment losses reduce both earnings and regulatory capital
  - Net unrealized losses on AFS equity securities deducted from Tier 1 capital
    - Other-than-temporary impairment losses reduce earnings but will not affect regulatory capital if bank has no equity securities with unrealized gains

Impairment of Securities

- Examiners should factor unrealized losses (depreciation) on AFS and HTM securities into their evaluation of capital adequacy and earnings even when these losses are deemed to be temporary because of the risks posed by these depreciated securities
  - Banks with significant unrealized losses (not already deducted from regulatory capital) should maintain capital levels in excess of minimums in order for capital to be appropriate for the risk exposure in its securities

Transfers of Financial Assets

- On 9/15/08, FASB issued proposed amendments to
  – FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
  – FIN 46(R), *Consolidation of Variable Interest Entities*
  – Comment deadline is 11/14/08
- Amendments would take effect for fiscal years beginning after 11/15/09 (1/1/10 for calendar year banks)
- FASB also issued a proposed FASB Staff Position on 9/15/08 that would require additional disclosures by public companies about continuing involvement by transferors in transferred financial assets and any involvement with VIEs as soon as possible
  – Comment deadline is 10/15/08

Transfers of Financial Assets

- Proposed amendments would remove the concept of a qualifying special-purpose entity (QSPE) from both FAS 140 and FIN 46(R)
  - Would cause securitizations and structured transactions using what are now QSPEs to be subject to a consolidation analysis
- FIN 46(R) proposal would require an enterprise involved in a variable interest entity (VIE) used in a securitization or structured transaction to consider whether it is the primary beneficiary of the VIE primarily through a qualitative assessment of the VIE that focuses on control
  - Primary beneficiary must consolidate VIE

Transfers of Financial Assets

- If enterprise cannot determine if a primary beneficiary exists (or does not exist) through the qualitative assessment, it performs the current FIN 46(R) quantitative assessment of expected losses and residual returns to determine if it is the primary beneficiary
- With QSPEs removed, a significant volume of
  - New loan transfers that would qualify as sales under current accounting standards may instead remain on balance sheet as secured financings
  - Existing assets involved in securitizations and structured transactions that are currently off balance sheet may have to be put back on balance sheets as secured financings

Transfers of Financial Assets

- FAS 140 proposal would permit only an entire financial asset, a group of entire assets, or a “participating interest” in an individual financial asset to qualify for sale accounting
- Characteristics of a participating interest
  - – Cash flows received must be allocated in proportion to interests in asset
  - – No recourse, other than standard reps and warranties
  - – No subordination
  - – No right to pledge or exchange the entire asset
- Plain vanilla loan participations would likely as “participating interests”; LIFO participations would not

Transfers of Financial Assets

- In a 9/15/08 interagency press release, federal banking agencies stated that they
  - Are evaluating the potential impact that the FASB's proposals could have on banking organizations' financial statements, regulatory capital, and other regulatory requirements
  - Expect to engage in discussions with institutions to review and understand fully the implications of the proposed amendments
  - http://www.fdic.gov/news/news/press/2008/pr08081.html
- FASB's proposals can be accessed from its Exposure Documents Web page at http://www.fasb.org/draft/index.shtml