2011 ACCOUNTING/AUDITING ROUNDTABLE
Reference Materials
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Accounting for Financial Instruments
Summary of Decisions Reached to Date During Redeliberations
As of September 7, 2011

The Summary of Decisions Reached to Date is provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Accounting Standards Update.

Initial Measurement of Financial Instruments

The initial measurement principle would depend upon the subsequent measurement of a financial instrument. Financial instruments subsequently measured at fair value with all changes in fair value recognized in net income (FV-NI) would be initially measured at fair value. Financial instruments subsequently measured at fair value with fair value changes recognized in other comprehensive income (FV-OCI) or subsequently measured at amortized cost would be initially measured at transaction price.

Entities that follow specialized industry guidance in Topic 946 on investment companies would continue to initially measure their financial instruments at transaction price.

In certain circumstances, an entity would be required to evaluate whether the consideration given or received at recognition for a financial instrument that is not otherwise required to be initially measured at fair value indicates that an element other than the financial instrument is included in the transaction.

Subsequent Measurement of Financial Instruments

The classification and measurement of financial instruments would be based on both the characteristics of the financial instrument and the entity's business strategy for the instrument. The characteristics of the instrument criterion would be similar for both financial assets and financial liabilities, but a different business strategy criterion would apply to financial assets than to financial liabilities.

Characteristics of the Financial Instrument

A financial instrument that does not meet the following criterion would be measured at FV-NI:

It is a *debt instrument* held or issued that has all of the following characteristics:

a. It is not a financial derivative instrument subject to the guidance in Topic 815 on derivatives and hedging.

b. An amount is transferred to the debtor (issuer) at inception that will be returned to the creditor (investor) at maturity or other settlement, which is the principal amount of the contract adjusted by any discount or premium at acquisition.

c. The debt instrument cannot contractually be prepaid or otherwise settled in such a way that the investor would not recover substantially all of its initial investment, other than through its own choice.

Trade receivables and payables generally would meet the criterion above. A financial instrument that meets the criterion above then would be classified and measured on the basis of an entity's business strategy.

The classification and measurement of specific types of financial instruments are outlined below.

Derivatives

Derivatives would be measured at FV-NI except derivatives designated as the hedging instrument in a cash flow hedge or a hedge of a net investment in a foreign operation.

Hybrid Financial Instruments

Bifurcation and separate accounting for embedded derivative features in both hybrid financial assets and hybrid financial liabilities would be retained as currently required under Subtopic 815-15 on embedded derivatives. Therefore, bifurcated embedded derivatives would be measured at FV-NI. An entity would apply the classification and measurement model separately to the host contract, which would require classification and measurement based on both the characteristics of the contract and the entity's business strategy for the contract.

From the issuer's perspective, convertible debt instruments that qualify for the exception in paragraph 815-10-15-74(a) and that do not require separation under paragraph 470-20-25-12 would be measured at amortized cost in their entirety. This decision would not affect the classification and measurement of convertible debt instruments that require bifurcation under current U.S. GAAP.

Equity Securities

Equity securities would be measured at FV-NI.

Nonpublic entities would be provided a practicability exception to fair value measurement for investments in nonmarketable equity securities. The practicability exception would permit nonmarketable equity securities to be measured at cost less any impairment plus upward adjustments in fair value when information about a change in price is observable.

A nonpublic entity would use observable price changes in orderly transactions for the identical or a similar financial asset with the same issuer as an input for adjusting the carrying value of a nonmarketable equity security. When information about a change in price is observable, a nonpublic entity would be required to adjust the carrying value of a nonmarketable equity security upward or downward.

(The Board's decisions on equity securities do not apply to instruments that can only be redeemed for a certain amount or that are measured according to the equity method of accounting.)

An Entity's Business Strategy

Financial Assets

An entity would classify financial assets that meet the characteristics of the financial instrument criterion based on the business activity the entity uses to manage those financial assets rather than on the entity's intent for an individual financial asset. An entity would be permitted to manage identical or similar assets through different business activities. An entity would be required to classify all financial assets into one of three categories as follows:

Amortized Cost Category

The business activity for these financial assets must meet *all* of the following conditions:

1. Financial assets issued or acquired for which an entity's business strategy, at origination or acquisition of the instrument, is to manage the instruments through customer financing or lending activities. These activities primarily focus on the collection of substantially all of the contractual cash flows from the borrower.
2. Financial assets for which the holder of the instrument has the ability to manage credit risk by negotiating any potential adjustment of contractual cash flows with the counterparty in the event of a potential credit loss. Sales or settlements would be limited to circumstances that would minimize losses due to deteriorating credit, or to exit a particular market for risk management purposes.
3. Financial assets that are not held for sale at acquisition.

FV-OCI Category

The business activity for these financial assets must meet *all* of the following conditions:

1. Financial assets issued or acquired in a business activity for which an entity's business strategy, at origination or acquisition of the assets, is to invest the cash of the entity *either* to:

a. Maximize total return by collecting contractual cash flows or selling the asset; *or* to

b. Manage the interest rate or liquidity risk of the entity by either holding or selling the asset.

2. Financial assets that are not held for sale at acquisition or issuance.

FV-NI Category

The business activity for these financial assets must meet *either* of the following conditions:

1. Financial assets that are held for sale at acquisition; *or*

2. Financial assets that are actively managed and monitored internally on a fair value basis and do not qualify for the FV-OCI category.

Financial Assets Subsequently Identified for Sale and Tainting

An entity may have financial assets that qualify for the amortized cost category at initial recognition that it subsequently identifies for sale. In such circumstances, an entity should continue to classify and measure the financial assets at amortized cost (less impairment) and recognize resulting gains, if any, only when the sale is complete. Impairment of a financial asset subsequently identified for sale should be recognized in net income in an amount equal to the entire difference between the asset's amortized cost basis and its fair value.

An entity may anticipate that a portion of a pool of similar financial assets will be sold while the other portion will continue to be managed through its customer financing (lending) activities. However, individual assets that will be subsequently sold are not specifically identified for sale at initial recognition. In these circumstances, an entity must classify and measure all financial assets into one of the three categories according to the defined business activities. An entity would not be prevented from managing the same or similar financial assets through different business activities.

The Board will consider at a future meeting presentation or disclosure alternatives for financial assets originally classified in the category measured at amortized cost that the entity subsequently sells. Such subsequent sales would not taint an entity's financial assets classified at amortized cost.

Recognition of realized gains and losses

For financial assets classified as FV-OCI, realized gains and losses from sales or settlements would be recognized in net income.

Financial Liabilities

An entity would measure financial liabilities that meet the characteristics of the instrument criterion at amortized cost unless *either* of the following conditions is met:

1. Financial liabilities for which an entity's business strategy at acquisition, issuance, or inception, is to subsequently transact at fair value.
2. Financial liabilities that are short sales.

Financial liabilities that meet either of the conditions above would be classified as FV-NI.

In circumstances in which financial assets will be used to settle nonrecourse financial liabilities, an entity should measure the financial liabilities consistently with the measure of the related financial assets, taking into account the same factors in determining each amount. For example, if both the assets and the liabilities are measured at amortized cost and the reported amount of the assets is reduced by a credit impairment, the reported amount of the nonrecourse liabilities should include the same reduction.

Loan Commitments, Revolving Lines of Credit, and Standby Letters of Credit

Loan commitments, revolving lines of credit, and standby letters of credit would not be required to meet the characteristics of the instrument criterion. An entity would classify loan commitments, revolving lines of credit, and standby letters of credit as FV-NI if its business strategy for the underlying loans is to hold them for sale.

For all other loan commitments, revolving lines of credit, and standby letters of credit, an entity would recognize any fees received in accordance with existing guidance in Subtopic 310-20. Under that guidance, if the likelihood is that exercise of the commitment is remote, any commitment fees received would be recognized as fee income over the commitment period. If the likelihood is that exercise is not remote, any commitment fees received would be deferred and recognized over the life of the funded loan as an adjustment of yield.

Reclassifications

An entity would be required to classify its financial instruments upon initial recognition and would not be permitted to subsequently change that decision.

Impairment and Interest Income Recognition

Nonmarketable Equity Securities Accounted for Under the Practicability Exception

For a nonmarketable equity security accounted for under the practicability exception, an entity would apply a single-step approach in which an entity assesses qualitative factors (that is, impairment indicators) to determine whether it is more likely than not the fair value of a nonmarketable equity security is less than its carrying amount (that is, an impairment exists). If an impairment exists, an impairment loss would be recognized in earnings equal to the entire difference between the investment's carrying value and its fair value.

Financial Assets That are Debt Instruments

Impairment for financial assets that are debt instruments would follow a "three-bucket" approach in which an allowance balance is established capturing three different phases of deterioration in credit quality. Generally, the "three-bucket" approach can be described as follows:

> **Bucket 1:** In the context of portfolios, financial assets evaluated individually or collectively for impairment that do not meet the criteria for Bucket 2 or 3 (this would include loans that have suffered changes in credit loss expectations as a result of macroeconomic events that are not specific to either a group of loans or a specific loan).
>
> **Bucket 2:** Debt instruments affected by the occurrence of events that indicate a direct relationship to possible future defaults, however the specific debt instruments in danger of default have not yet been identified.
>
> **Bucket 3:** Debt instruments for which information is available that specifically identifies that credit losses are expected to, or have, occurred on individual debt instruments.

The allowance balance for debt instruments in Buckets 2 and 3 would be an estimate of remaining lifetime expected losses.

The approach to classifying and transferring financial assets between the buckets would be based on credit risk management systems, recognizing that credit risk management is a holistic process that includes evaluating all available information.

A "relative credit risk" model would underpin the classification and transfer of financial assets between the three buckets. The overall objective of the "relative credit risk" model is to reflect the deterioration or improvement in the credit quality of financial assets, thus making the maximum use of credit risk management practices. Under this approach, all originated and purchased financial assets would initially start in Bucket 1 and would move into Bucket 2 and Bucket 3 as credit loss expectations deteriorate, affecting the uncertainty in collectability of cash flows.

The Boards also discussed the measurement of expected loss on financial assets in Bucket 1. The Boards agreed to keep the calculation of the impairment allowance for Bucket 1 operationally simple and explore an allowance calculation that would incorporate either 12 or 24 months' worth of expected losses. The calculation of 12 months' worth of expected losses in Bucket 1 would be based on an *annual* rather than an *annualized* loss rate (that is, looking to the losses that are expected to occur in the next 12 months, as opposed to calculating the lifetime losses and dividing by the number of years remaining). The same logic would apply to a calculation based on 24 months.

The Boards will discuss the following at a future meeting:

1. Applying the relative credit risk model to loans acquired at a discount because of credit losses.
2. Approaches to measuring the expected loss on financial assets in Bucket 1that would calculate the allowance using 12 or 24 months' worth of losses expected to occur.

Below is a summary of decisions reached on impairment issues prior to development of the "three-bucket" approach. These issues may be reconsidered by the Boards at future meetings, if deemed necessary.

Uncollectibility

A financial asset is considered uncollectible if the entity has no reasonable expectation of recovery. Therefore, an entity would write off a financial asset or part of a financial asset in the period in which the entity has no reasonable expectation of recovery of the financial asset (or part of the financial asset).

A *write-off* would be defined as "a direct reduction of the amortized cost of a financial asset resulting from uncollectibility."

Estimating Expected Losses

An entity should use the best available and supportable information at the date of estimation (historical, current, and forecasted) to estimate expected losses. Expected losses should be estimated with the objective of an expected value. An expected value identifies possible outcomes (or a representative sample of the possible outcomes), estimates the likelihood of each outcome, and calculates a probability-weighted average.

However, other appropriate methods could be used to achieve the objective of an expected value. An example of a suitable method would be a loss rate method and the use of probabilities of default, loss given default, and exposure at default data. In performing this calculation, an entity must not ignore observations and possibilities that are known. (The Boards directed the staff to draft language that will be transparent to constituents to apply this objective.)

Expected losses should be measured as all shortfalls in cash flows (both principal and interest) on a discounted basis. That is, the measurement of expected losses should reflect the effect of discounting. A variety of techniques can be used to measure the discounted amount and that the unit of account need not be an individual loan.

Unwinding the Discounting of Expected Credit Losses

The effect of unwinding the discounting of expected credit losses should be included in the credit losses line item on the statement of comprehensive income.

(The Board will consider at a later date whether to require disclosure of the effect of unwinding on the allowance for credit losses, after considering any operational issues.)

Interest Income Recognition

Interest income should be determined by applying the effective interest rate to an amortized cost balance that is not reduced for credit impairment.

Purchased Financial Assets

An entity should account for credit impairment of purchased financial assets for which the entity has no explicit expectation of losses at the individual asset level, even when acquired as part of a portfolio, in the same way as for originated financial assets. Interest income for these financial assets would be recognized on the basis of contractual cash flows, thus aligning credit impairment accounting and interest income recognition for originated financial assets and purchased financial assets (those for which the entity has no explicit expectation of losses at the individual asset level at acquisition). (The Boards will determine the appropriate credit impairment accounting model for these financial assets during redeliberations).

For purchased financial assets for which the entity has an explicit expectation of loss at the individual financial asset level (that is, for financial assets that are purchased at a “deep discount”), interest income recognized should be based on expected collectible cash flows estimated at the date of acquisition (that is, the purchase price should be accreted to expected cash flows). A separate credit impairment expense would not be recognized at the date of acquisition as a result of limiting the recognition of interest income for these credit-deteriorated financial assets by basing interest income on expected cash flows as opposed to contractual cash flows,.

(The Boards' decisions are subject to future discussions on related issues, including determining what constitutes a "deep discount" to differentiate purchased portfolios of financial assets.)

Nonaccrual

In light of the decisions reached to date as described in this document, a nonaccrual principle would not be required.

Financial Statement Presentation of Financial Instruments

(Some of the following presentation requirements apply only to public entities. The Board will discuss at a future meeting presentation or disclosure requirements for nonpublic entities.)

Statement of Financial Position

An entity would be required to separately present financial assets and financial liabilities on the statement of financial position by classification and measurement category.

Financial Assets and Financial Liabilities Measured at Amortized Cost

A public entity would be required to present parenthetically on the face of the statement of financial position the fair value, measured consistently with the requirements in Topic 820, for financial assets and financial liabilities, except for demand deposit liabilities, that are measured at amortized cost. A public entity would be required to disclose a present value amount for demand deposit liabilities in the notes to the financial statements.

Receivables and payables due in less than a year would not be subject to the parenthetical disclosure of fair value.

All entities would be required to separately present cumulative credit losses on the face of the statement of financial position.

Financial Liabilities Measured at Fair Value

All entities would be required to present parenthetically on the face of the statement of financial position the amortized cost of an entity's own debt that is measured at fair value.

Statement of Comprehensive Income

Financial Assets

An entity would be required to present in net income an aggregate amount for realized and unrealized gains or losses for financial assets measured at fair value with all changes in fair value included in net income.

An entity would be required to separately present the following items in net income for both financial assets measured at fair value with changes in value recognized in other comprehensive income and financial assets measured at amortized cost:

1. Current-period interest income
2. Current-period credit losses
3. Realized gains and losses

Financial Liabilities

An entity would be required to present in net income an aggregate amount for realized and unrealized gains or losses for financial liabilities measured at fair value with all changes in fair value recognized in net income.

An entity would be required to separately present the following items in net income for financial liabilities measured at amortized cost:

1. Current-period interest expense
2. Realized gains and losses.

An entity would not be required to present the changes in the fair value of financial liabilities attributable to changes in the entity's own credit risk separately from other changes in fair value. (The Board noted that it might revisit this decision if the population of financial liabilities subsequently measured at fair value significantly increases as a result of future redeliberations on the fair value option for financial liabilities.

Fair Value Option for Financial Instruments

An unconditional fair value option would not be provided for either financial assets or financial liabilities. However, an entity would be permitted to measure a group of financial assets and financial liabilities at fair value with changes in fair value recognized in net income if both of the following conditions are met:

1. The entity manages the net exposure relating to those financial assets and financial liabilities (which may be derivative instruments); and
2. The entity provides information on that basis to the reporting entity's management.

An entity would only be permitted to elect that conditional fair value option for a group of financial assets and financial liabilities at recognition, and the election could not subsequently be changed.

An entity also would be able to elect at recognition to apply a conditional fair value option for both hybrid financial assets and hybrid financial liabilities to avoid bifurcation and separate accounting for an embedded derivative feature. An entity would be allowed to measure a hybrid financial asset or financial liability at fair value in its entirety after the entity has determined that an embedded derivative feature that would otherwise require bifurcation and separate accounting exists.

Disclosures

The Board is developing liquidity and interest rate risk disclosures related to an entity's involvement in financial instruments.

Scope

The proposed disclosures about liquidity risk would be required for all entities, but only *financial institutions* would provide disclosures about interest rate risk. *Financial institutions* includes banks, savings and loan associations, savings banks, credit unions, finance companies, and insurance entities as the term is described in paragraph 942-320-50-1 of the *FASB Accounting Standards Codification*®.

The disclosures for *financial institutions* would apply to reportable segments of entities, for example, reportable segments that engage in transactions that involve lending to or financing the activities of others. The term *reportable segment* is described in Section 280-10-50 of the Codification.

Qualitative Disclosures

For interest rate risk and liquidity risk arising from financial instruments, an entity would disclose all of the following:

1. The exposure to risks and how they arise
2. The entity's objectives, policies, and processes for managing the risks and the methods used to measure the risks
3. Any changes in (a) or (b) from the previous period and the reasons for the changes.

Quantitative Disclosures about Liquidity Risk

All entities would provide disclosure about their available liquid funds, which includes unencumbered cash and high-quality liquid assets, and borrowing availability such as lines of credit. This disclosure would include a discussion about the effect of regulatory, tax, legal, and other restrictions that could limit the transferability of funds among entities in the consolidated group, for example, between the parent and its subsidiaries.

Financial institutions would provide a tabular disclosure based on expected maturities of classes of financial assets and financial liabilities. The term *expected maturity* relates to contractual settlement of the instrument, rather than to when the entity expects to sell the instrument. Financial instruments that are measured at fair value with all changes in value included in net income, with the exception of derivatives, would not be placed in maturity buckets and would only show the total carrying amount. The table would include the entity's off-balance-sheet commitments, for example, loan commitments and lines of credit.

Nonfinancial entities would provide a tabular disclosure of their undiscounted cash obligations, including off-balance-sheet obligations.

Quantitative Disclosures about Interest Rate Risk

A financial institution would provide a tabular disclosure about when its classes of financial assets and financial liabilities would reprice (that is, when their interest rate would be reset). The table also would include the weighted-average yield and duration of the classes of financial assets and financial liabilities.

A depository institution would provide a tabular disclosure about its issuance of time deposits during the last four quarters. This disclosure would show the entity's average rate and average life for insured, uninsured, and brokered deposits.

A financial institution would provide a tabular disclosure of the effect of prospective, hypothetical interest rate shifts on the entity's interest-sensitive financial assets and liabilities. The table would present the effects of parallel shifts, flatteners, and steepeners of the yield curve. This disclosure would not incorporate the effects of certain assumptions such as a company's strategy related to assumed growth rate or change in asset mix.

Periods for Which Disclosure Would Be Required

The proposed disclosures would be required for interim and annual reporting periods, except for nonpublic, nonfinancial entities, which would be required to provide the liquidity risk disclosures only for annual reporting periods.

Equity Method of Accounting

Criteria for Application of the Equity Method of Accounting

The proposed Update would have added a "related operations" criterion to the "significant influence" criterion that must be met under current U.S. GAAP to qualify for the equity method of accounting. However, only the "significant influence" criterion will be retained, which leaves the criteria for the equity method of accounting unchanged from current U.S. GAAP.

An entity would be required to classify and measure equity investments that otherwise would qualify for the equity method of accounting at fair value with changes in fair value included in net income if the investment is held for sale. An entity would perform a "held for sale" evaluation upon the investment's initial qualification for the equity method of accounting, and the entity could not subsequently change the classification of the investment. The following indicators would be determinative that an investment is held for sale:

1. The entity has specifically identified potential exit strategies even though it may not yet have determined the specific method of exiting the investment.
2. The entity has defined the time at which it expects to exit the investment, which may be either an expected date or range of dates; a time defined by specific facts and circumstances, such as achieving certain milestones; or the investment objectives of the entity.

Fair Value Option for Equity Method Investments

A fair value option would not be available for equity method investments.

Impairment of Equity Method Investments

An entity would apply a single-step impairment approach for equity method investments in which the entity assesses qualitative factors (that is, impairment indicators) to determine whether an equity method investment is impaired. A single impairment model would be applied to both marketable and nonmarketable equity method investments.

An entity that accounts for an investment under the equity method may not reverse previously recognized impairment losses.

Disclosures of Equity Method Investments

The Board will consider the implications of additional qualitative disclosures about investments accounted for under the equity method at a future meeting.

Hedge Accounting

The Board has not begun redeliberations on hedge accounting. See Proposed *Accounting Standards Update* for a summary of the Board's decisions to date.

In December 2010, the IASB published the Exposure Draft, *Hedge Accounting*. The comment period for the Exposure Draft ended on March 9, 2011. The FASB participated in the IASB's discussion of the feedback that the IASB received on its Exposure Draft and will consider the feedback during its redeliberations.

On February 9, 2011, the FASB issued an Invitation to Comment, *Selected Issues about Hedge Accounting*, to solicit input on the IASB Exposure Draft, in order to improve, simplify, and bring about convergence of the financial reporting requirements for hedging activities. The comment period on the Invitation to Comment ended on April 25, 2011. The FASB has discussed the feedback received on the Invitation to Comment, which it will consider during its redeliberations.

TOPIC 4: ALLOWANCE FOR LOAN AND LEASE LOSSES

4A. ALLOWANCE FOR LOAN AND LEASE LOSSES

Question 1: (September 2001)

Regulatory guidance included in the *Comptroller's Handbook* booklet "Allowances for Loan and Lease Losses" discusses the concept of "inherent loss." What is "inherent loss," and how does it differ from "future loss?"

Staff Response:

In defining "inherent loss," the handbook does not introduce a new concept to estimate the ALLL. Rather, it describes the use of concepts developed in Statement of Financial Accounting Standards No. 5 (SFAS 5), a process that bankers, accountants, and examiners have performed for years.

"Inherent losses" are losses that meet the criteria in SFAS 5 for recognition of a charge to income. This requires a conclusion that an asset has probably been impaired. Proper accounting recognition of a loan impairment requires that a provision be made to the ALLL in the period when the loss event probably occurred, and the loss amount can be estimated. Earnings would be charged at that time. It is inappropriate to wait to charge earnings until the loss is confirmed or realized (i.e., the asset is charged off).

A "loss event" is an event that probably has occurred that impairs the value of a loan. If such a loss event occurred, even though it cannot be identified specifically, a charge is made to earnings and a provision to the ALLL. The occurrence of a "confirming event" results in the asset being classified loss and charged off against the ALLL.

A provision to the ALLL ensures that impairments or loss events that have occurred, but have not yet been identified specifically, are provided for in the period in which they occurred. Thus, the ALLL is an estimate.

Question 2: (December 2008)

What are "estimated credit losses?"

Staff Response:

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

SFAS 5 requires the accrual of a loss contingency when information available prior to the issuance of the financial statements indicates it is probable that an asset has been impaired at the date of the financial statements, and the amount of loss can be reasonably estimated. These conditions may be considered in relation to individual loans or groups of similar types of loans. If the conditions are met, accrual should be made even though the particular loans that are uncollectible may not be identifiable.

Under SFAS 114, an individual loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. It is implicit in these conditions that it must be probable that one or more future events ("confirming event") will occur confirming the fact of the loss.

Question 3: (December 2008)

How should a bank identify loans to be individually evaluated for impairment under SFAS 114?

Staff Response:

Determining loan impairment is a multi step process. First, the bank must set the criteria for determining loans to be reviewed for impairment under SFAS 114. Second, based on those criteria, the bank would identify the loans to be individually evaluated for impairment. Finally, the selected loans are reviewed for impairment.

Footnote 1 of SFAS 114 identifies the following sources of information that is useful in identifying loans for individual evaluation for impairment:

- A specific materiality criterion.
- Regulatory reports of examination.
- Internally generated listings such as "watch lists," past due reports, overdraft listings, and listings of loans to insiders.
- Management reports of total loan amounts by borrower; historical loss experience by type of loan.
- Loan files lacking current financial data related to borrowers and guarantors.

- Borrowers experiencing problems such as operating losses, marginal working capital, inadequate cash flow, or business interruptions.

- Loans secured by collateral that is not readily marketable or that is susceptible to deterioration in realizable value.

- Loans to borrowers in industries or countries experiencing economic instability.

- Loan documentation and compliance exception reports.

Question 4: (December 2008)

What documentation should a bank maintain to support its measurement of impairment on an individually impaired loan under SFAS 114?

Staff Response:

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

For example, for collateral-dependent loans for which a bank must use the fair value of collateral method, the institution should document: how fair value was determined including the use of appraisals, valuation assumptions, and calculations; the supporting rationale for adjustments to appraised values, if any; the determination of costs to sell, if applicable; and quality, expertise, and independence of the appraisal. This is consistent with the 2001 Policy Statement, which discusses the supporting documentation needed.

Question 5: (December 2008)

Are large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment within the scope of SFAS 114?

Staff Response:

Generally, no. Large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment are not included in the scope of SFAS 114. Such groups of loans may include, but are not limited to, “smaller” commercial loans, credit card loans, residential mortgages, and consumer installment loans. SFAS 114 would apply, however, if the terms of any of these loans are modified in a troubled debt restructuring as defined by SFAS 15. Otherwise, the relevant accounting guidance for these groups of smaller-balance homogeneous loans is contained in SFAS 5.

Question 6: (December 2008)

Can “larger” versus smaller” balance loans be quantified to identify loans that should be evaluated for impairment under SFAS 114?

Staff Response:

A single-size test for all loans is impractical because a loan that may be relatively large for one bank may be relatively small for another. Deciding whether to individually evaluate a loan is subjective and requires a bank to consider the individual facts and circumstances, along with its normal review procedures in making that judgment. In addition, the bank should appropriately document the method and process for identifying loans to be evaluated under SFAS 114.

Question 7: (December 2008)

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

Staff Response:

There are valid reasons to review a loan individually rather than in a pool of loans. Loans should be evaluated separately when sufficient information exists to make a reasonable estimate of the inherent loss. Individual loan review is generally applicable for large or otherwise significant (i.e., classified doubtful) credits, loans to companies in a deteriorating industry, or a combination of the above. In such situations, substantial information on the credit should be available, and a separate review is appropriate. If an individually analyzed loan is determined to be impaired, it should be specifically allocated for in accordance with SFAS 114, and not as part of the pool.

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

Question 8: (September 2001)

Does criticism of a loan indicate an inherent loss?

Staff Response:

Criticism of a loan, an important signal, does not always indicate existence of an inherent loss in the credit. The degree of criticism is important. For example, all loans classified doubtful have, by definition, inherent loss. The risk of loss on the loan is probable, even though the timing and exact amount has not been determined.

In a substandard credit, the loan is inadequately protected by the current sound worth and paying capacity of the borrower or the collateral. Although a distinct possibility exists that the bank may sustain a loss if weaknesses in the loan are not corrected, this is only a potential loss. Further, in substandard loans, inherent loss generally cannot be identified on a loan-by-loan basis.

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

Question 9: (September 2001)

What are some examples of loss events and confirming events affecting pools of loans?

Staff Response:

Loss events for loans in pools are the same as those for individual loans. Commercials loans could suffer from a decline in the economy or in profits, or an event that affects their future prospects. Consumer loans might be affected by the loss of a job or personal bankruptcy. Delinquency statistics are the most common indicators of the level of inherent losses in pools. However, external events, such as changes in the local or national economy, can also signal problems for a pool of loans before one can see change in delinquency rates.

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

Question 10: (December 2008)

May banks project or forecast changes in facts and circumstances that arise after the balance sheet date when estimating the amount of loss under SFAS 5 in a group of loans with similar risk characteristics at the balance sheet date?

Staff Response:

No. SFAS 5 only allows the recognition of estimated losses at the measurement date based on the facts and circumstances present at the date. In developing loss measurements for groups of loans with similar risk characteristics, a bank should consider the impact of current qualitative or environmental factors that exist as of the balance sheet date. It should also document how those factors were used in the analysis and how they affect the loss measurements. For any adjustments to the historical loss rate reflecting current environmental factors, a bank should support and reasonably document the amount of its adjustments and how the adjustments reflect current information, events, circumstances, and conditions. Questions 11 through 16 illustrate this concept.

Facts:

A bank evaluates a real estate loan for estimated credit loss. The loan was made during a recent boom period for the real estate industry. However, both the general real estate market and the loan currently are troubled. Loan repayment will come primarily from the operation and eventual sale or refinancing of the collateral. Further, the value of the underlying collateral is declining. A properly performed appraisal indicates that the value of the property is 95% of the outstanding loan balance.

Historically, three real estate cycles have occurred in the last 25 years. In each cycle, real estate values fluctuated significantly. However, it is not possible at this time to determine whether local real estate properties will experience additional declines in value.

Question 11: (December 2008)

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

Staff Response:

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

Facts:

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

Question 12: (September 2001)

How should the local bank, in analyzing the adequacy of its ALLL, respond to rumors that the military base may appear on the list of possible closures?

Staff Response:

On a continuous basis, the bank should review the concentrations of credit risk arising from its loans to businesses and individuals associated with or dependent upon the base. The bank's assessment of the effect of the closing on the local economy and its borrowers should be regularly updated. But an unsubstantiated rumor is not an event that would require increased provisions to the ALLL. However, a concentration of credit centered on the military base is relevant to the assessment of the bank's capital adequacy.

Question 13: (December 2008)

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

Staff Response:

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

Question 14: (December 2008)

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

Staff Response:

A loss event has now occurred that probably will result in the bank subsequently charging off loans to a number of its borrowers. The bank's loan review system should identify those significant, individual borrowers that should be evaluated for impairment under SFAS 114. This standard requires that loan impairment be measured based on the present value of the expected future cash flows discounted at the loan's effective interest rate.

However, as a practical expedient, SFAS 114 allows the use of the loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. In reviewing the loan portfolio, the bank should address issues, such as the effect of the closing on:

- Borrowers with investments in the local real estate and housing rental markets.

- Borrowers operating businesses dependent on the base or its employees, and general retail trade.

For loans previously identified as impaired, an increased provision to the ALLL may be warranted, depending on whether the base closing affects the bank's estimate of the probable loss on these credits. For loans reviewed under SFAS 5, the bank should begin to adjust the historical loss rates as its estimates of probable loss increase for smaller criticized loans in a pool of similar loans, especially those credits that are currently performing and not criticized, but that are likely to be affected adversely by the base closing. The bank should review and monitor such credits. Although the amount of probable loss on those individual credits cannot be estimated yet, it can be measured for pools of similar loans. Those pools should encompass all loans not identified as individually impaired expected to be affected by the base closing, including loans in the commercial, real estate, and consumer portfolios. The more homogeneous are the pools, the easier it will be to analyze and adjust the historical loss rates. The ALLL should reflect the probable increased exposure to loss arising from loans to this group of borrowers.

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

Question 15: (December 2008)

How is the bank's analysis of the ALLL affected in the 12- to 18-month period following the announcement by the base closing?

Staff Response:

The bank should continue to focus on identifying, monitoring, and measuring the effect of the base closing on its borrowers, and on adjusting the ALLL to cover its best estimate of the inherent loss in its portfolio. Estimates of the probable loss should be refined as additional information becomes available. The risk ratings of these loans should also be appropriately adjusted. Additional provisions should be made to the ALLL, when necessary, and loans charged off when they are no longer bankable assets. As the actual effect of the base closing becomes easier to measure, the bank should continue to adjust the loss rates it applies to its loan pools. In time, the bank can identify most of the borrowers affected and have risk rated and provided appropriately for their loans.

Estimates of probable losses on both individual loans and pools of loans should continue to be refined, and appropriate adjustments made to historical loss factors and the balance of the ALLL. This is an ongoing process, and should not be calendar driven.

Facts:

State government officials announce their decision six months after the base closing to open a new minimum security prison facility on the former base site. Conversion of the site will begin in three months, and the prison will open in 12 months.

Question 16:

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

Staff Response:

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

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

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

Question 17: (September 2001)

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

Staff Response:

Pool analysis is used because there is generally insufficient information to reach loan-by-loan conclusions about the exposure to loss on substandard loans. Accordingly, adequate measurement of the inherent loss may require a pool analysis. As noted in Question 2, inherent losses do exist in the aggregate for substandard loans and an estimate of the inherent loss in a pool of loans generally can be made. The estimate is based on the bank’s historical loss experience, adjusted for current conditions, on similar pools of loans.

To estimate the level of ALLL required for all substandard loans, some banks differentiate between levels of exposure to loss on significant, individual credits in the substandard category. However, the assertion that individually analyzed substandard loans require a level of allowances that is significantly below the historical loss rate for pools of similar loans must be supported clearly by the nature of the collateral or other circumstances that distinguish the loan from similarly classified credits.

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

Facts:

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

Question 18: (December 2008)

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

Staff Response:

Given the definition, a "Substandard" loan that is individually evaluated for impairment under SFAS 114 (and that is not the remaining recorded investment in a loan that has been partially charged off) would not automatically meet the definition of impaired. However, if a "Substandard" loan is significantly past due or is in nonaccrual status, the borrower's performance and condition provide evidence that the loan is impaired, i.e., that it is probable that the bank will be unable to collect all amounts due according to the contractual terms of the loan agreement. An individually evaluated "Substandard" loan that is determined to be impaired must have its allowance measured in accordance with SFAS 114.

For “Substandard” loans that are not determined to be impaired in accordance with SFAS 114, experience has shown that there are probable incurred losses associated with a group of “Substandard” loans that must be provided for in the ALLL under SFAS 5. Many banks maintain records of their historical loss experience for loans that fall into the regulatory “Substandard” category. A group analysis based on historical experience, adjusted for qualitative or environmental factors, is useful for such loans.

For groups of loans with similar risk characteristics that include both loans classified “Substandard” (and not determined to be impaired) and loans that are not adversely classified, the bank should separately track and analyze the “Substandard” loans in the group. This analysis will aid in determining whether the volume and severity of these adversely classified loans differs from such loans during the period over which the bank’s historical loss experience was developed. This will aid in determining the qualitative adjustment necessary for the group of loans under SFAS 5.

Question 19: (December 2008)

Assume a substandard credit has its ALLL allocation measured in accordance with SFAS 114. Does a percentage relationship between the allocation amount and loan balance suggest the assignment of nonaccrual status and/or doubtful classification?

Staff Response:

There is no allocation percentage that would automatically require a doubtful classification and/or nonaccrual status for a substandard loan. However, specific allocations for individual substandard loans measured in accordance with SFAS 114 raise some difficult questions. First, doesn’t a bank’s estimate of the amount of allowance necessary for the loan present prima facie evidence that there is doubt about its collectibility? Further, if there is doubt about its collectibility, shouldn’t the loan be classified doubtful and put on nonaccrual? While the response to the nonaccrual issue is straight forward, the classification issue is more difficult. With respect to the nonaccrual issue, the call report instructions require that a bank not accrue interest on any loan for which payment in full of principal or interest is not expected. If a loan has been determined to be impaired, doubt of collectibility in accordance with its contractual terms therefore exists. This requires the loan to be placed on nonaccrual in accordance with the call report instructions.

The classification issue requires careful judgment. No two loans are alike. Each classification definition must be applied to loans that possess varying degrees of risk. In most portfolios, a few substandard loans will fall on the line between special mention and substandard, and a few others will be almost doubtful. Although some loans classified as substandard are weaker than others, it may be appropriate to determine that those weaknesses are not so severe as to warrant a doubtful classification. One must keep in mind when deciding whether to make individual allocations for substandard loans that two elements of risk are reflected in our classification system. The risk that the loan will not perform as agreed (the risk of default), and the risk that it will not be repaid in full (the risk of loss).

Loans are classified as substandard because their weaknesses do not reflect the risk of default that warrants a doubtful classification. Nevertheless, in the event of default, varying degrees of exposure to loss will occur within the substandard category. Consideration of collateral, guarantees, etc., is necessary. Exposure to loss on a large, unsecured substandard loan may be substantially greater than on a similarly sized substandard loan that is secured by real estate.

Question 20: (September 2001)

What is a migration analysis and when is it used?

Staff Response:

Migration analysis is a methodology for determining, through the bank's experience over a historical analysis period, the rate of loss incurred on pools of similar loans. Migration analysis may take many forms, ranging from a simple average of the bank's historical loss experience over time to a sophisticated analysis that also weighs differences in underwriting standards, geographic locations, seasoning of loans, etc. The staff has not identified any particular form of migration analysis as being the best, or most appropriate, for all banks.

Question 21: (December 2008)

If a bank concludes that an individual loan specifically identified for evaluation is *not* impaired under SFAS 114, should that loan be included in the assessment of the ALLL under SFAS 5?

Staff Response:

Yes, that loan should be evaluated under SFAS 5. If the specific characteristics of the individually evaluated loan that is not impaired indicate that it is probable that there would be an incurred loss in a group of loans with those characteristics, the loan should be included in the assessment of the ALLL for that group of loans under SFAS 5. Banks should measure estimated credit losses under SFAS 114 only for loans individually evaluated and determined to be impaired.

Under SFAS 5, a loss is recognized if characteristics of a loan indicate that it is probable that a group of similar loans includes some estimated credit losses even though the loss cannot be identified to a specific loan. Such a loss would be recognized if it is probable that the loss has been incurred at the date of the financial statements and the amount of loss can be reasonably estimated. This response is consistent with EITF D-80, Question 10.

Question 22: (December 2008)

If a bank assesses an individual loan under SFAS 114 and determines that it is impaired, but it measures the amount of impairment as zero, should that loan be included in the assessment of the ALLL under SFAS 5?

Staff Response:

No. For an impaired loan, no additional loss recognition is appropriate under SFAS 5 even if the measurement of impairment under SFAS 114 results in no allowance. An example would be when the recorded investment in the impaired loan has been written down to a level where no allowance is required. This response is consistent with EITF D-80, Question 12.

However, before concluding that an impaired SFAS 114 loan needs no associated loss allowance, the bank should determine and document that its measurement process is appropriate and that it considered all available and relevant information. For example, for a collateral-dependent loan, the following factors should be considered in the measurement of impairment under the fair value of collateral method: volatility of the fair value of the collateral, timing and reliability of the appraisal or other valuation, timing of the bank's or third party's inspection of the collateral, confidence in the bank's lien on the collateral, historical losses on similar loans, and other factors as appropriate for the loan type.

This response is consistent with the *Policy Statement on the Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions* (2001 Policy Statement), Question 3, and the Securities and Exchange Commission's Staff Accounting Bulletin No. 102, Question 7.

Question 23: (December 2008)

Is the practice of "layering" the ALLL appropriate?

Staff Response:

No. Layering is the inappropriate practice of recording in the ALLL more than one amount for the same estimated credit loss. When measuring and documenting estimated credit losses, banks should take steps to prevent the layering of loan loss allowances. One example of inappropriate layering occurs when a bank includes a loan in one loan category, determines its best estimate of loss for that loan category, and then includes the loan in another loan category, which receives an additional ALLL amount.

Another example of inappropriate layering occurs when an allowance has been measured for a loan under SFAS 114, but the loan is then included in a group of loans with similar risk characteristics for which an ALLL is estimated under SFAS 5. The allowance provided for an individually impaired loan under SFAS 114 can not be supplemented by an additional allowance under SFAS 5. Inappropriate layering occurs when a bank includes a loan in two different SFAS 5 pools of loans for purposes of providing an allowance. When measuring and documenting estimated credit losses, banks should take steps to prevent the layering of loan loss allowances. This is consistent with the 2001 Policy Statement, Appendix B.

Question 24: (September 2001)

Assume the loan review and allocation process operates satisfactorily, and losses are recognized promptly. Is it acceptable for there to be no provision to the ALLL for a pool of uncriticized loans?

Staff Response:

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

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

Migration analysis is often applied to pools of past due and/or classified loans, because their classification reflects the fact that a loss event has probably already occurred.

Question 25: (December 2008)

Is it appropriate to estimate an allowance for “pass” loans?

Staff Response:

Yes. In determining an appropriate level for the ALLL, a bank must analyze the entire loan and lease portfolio for probable losses that have been incurred that can be reasonably estimated. A loan designated “pass” generally would not be impaired if individually evaluated. However, if the specific characteristics of such a loan indicate that it is probable that there would be an estimated credit loss in a group of loans with similar characteristics, then the loan should be included in the assessment of the ALLL for that group of loans under SFAS 5.

Under SFAS 5, the determination of estimated credit losses may be considered for individual loans or in relation to groups of loans with similar characteristics. This determination should be made on a group basis even though the loans that are uncollectible in the group may not be individually identifiable. Accordingly, the ALLL for a group of loans with similar risk characteristics, which includes loans designated as "pass," should be measured under SFAS 5.

Question 26: (September 2001)

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

Staff Response:

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

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

Question 27: (December 2008)

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

Staff Response:

As noted in the 2006 Policy Statement, banks should support adjustments to historical loss rates and explain how the adjustments reflect current information, events, circumstances, and conditions in the loss measurements. Management should maintain reasonable documentation to support which factors affected the analysis and the impact of those factors on the loss measurement. Support and documentation includes descriptions of each factor, management's analysis of how each factor has changed over time, which loan groups' loss rates have been adjusted, the amount by which loss estimates have been adjusted for changes in conditions, an explanation of how management estimated the impact, and other available data that supports the reasonableness of the adjustments. Examples of underlying supporting evidence could include, but are not limited to, relevant articles from newspapers and other publications that describe economic events affecting a particular geographic area, economic reports and data, and notes from discussions with borrowers.

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

Question 28: (December 2008)

If a bank measures impairment based on the present value of expected future cash flows for SFAS 114 purposes, what factors should be considered when estimating the cash flows?

Staff Response:

The bank should consider all available information reflecting past events and current conditions when developing its estimate of expected future cash flows. All available information would include a best estimate of future cash flows taking into account existing "environmental" factors (e.g., existing industry, geographical, economic, and political factors) that are relevant to the collectibility of that loan. This response is consistent with EITF D-80, Question 16.

Facts:

A bank writes down an individually impaired loan to the most recently appraised value of the collateral because that portion of the loan has been identified as uncollectible, and, therefore, is deemed to be a confirmed loss.

Question 29: (December 2008)

Should there be a loan loss allowance under SFAS 114 associated with the remaining recorded investment in the loan?

Staff Response:

Generally, yes. Typically, the most recent appraised value will differ from fair value (less costs to sell) as of the balance sheet date. For an impaired collateral-dependent loan, the bank should generally charge off any portion of the recorded investment in excess of the fair value of the collateral. Estimated costs to sell also must be considered in the measure of the ALLL under SFAS 114 if these costs are expected to reduce the cash flows available to satisfy the loan.

Although the bank should consider the appraised value of the collateral as the starting point for determining its fair value, the bank should also consider other factors and events that may affect the current fair value of the collateral since the appraisal was performed. The bank's experience with realization of the appraised values of impaired collateral-dependent loans should also be taken into account. In addition, the timing of expected cash flows from the underlying collateral could affect the fair value of the collateral if the timing differs from that contemplated in the appraisal. This may result in the appraised value of the collateral being greater than the bank's current estimate of the collateral's fair value (less costs to sell).

As a consequence, the bank's allowance for the impaired collateral-dependent loan under SFAS 114 is based on fair value (less costs to sell), but the charge-off (the confirmed "loss") is based on the higher appraised value. The remaining recorded investment in the loan after the charge-off will have a loan loss allowance for the amount by which the estimated fair value of the collateral (less costs to sell) is less than its appraised value. This is consistent with the guidance in Appendix B of the 2001 Policy Statement, which notes that the bank would classify as "Loss" the portion of the recorded investment deemed to be the confirmed loss, and classify the remaining amount as "Substandard."

Facts:

Some banks remove loans that become adversely classified from a group of "pass" loans with similar risk characteristics in order to evaluate the loans individually under SFAS 114 (if deemed impaired) or collectively in a group of adversely classified loans with similar risk characteristics under SFAS 5.

Question 30: (September 2001)

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

Staff Response:

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

Question 31: (December 2008)

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

Staff Response:

Yes, the ALLL may include an amount labeled as “unallocated” as long as it reflects estimated loan losses determined in accordance with GAAP and is properly supported. The term “unallocated” is not defined in GAAP, but has various meanings in practice. For example, some banks refer to the portion of the ALLL based on qualitative or environmental factors as “unallocated,” while others consider those adjustments to be an element of the “allocated” ALLL under SFAS 5. Still others believe “unallocated” refers to any ALLL amounts that are not attributable to or were not measured on any particular groups of loans.

Economic developments that surface between the time management estimates credit losses and the date of the financial statements, as well as certain other factors such as natural disasters that occur before the date of the financial statements, are examples of environmental factors that may cause losses that apply to the portfolio as a whole and are difficult to attribute to individual impaired loans or to specific groups of loans and, as a consequence, result in an “unallocated” amount.

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

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

Question 32: (December 2008)

Is there a specific period of time that should be used when developing historical experience for groups of loans to estimate the SFAS 5 portions of the ALLL?

Staff Response:

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

A bank should maintain supporting documentation for the techniques used to develop its loss rates. Such documentation includes evidence of the average and range of historical loss rates (including gross charge-offs and recoveries) by common risk characteristics (e.g., type of loan, loan grade, and past due status) over the historical period of time used. At larger banks, this information is often further segmented by originating branch office or geographic area. A bank's supporting documentation should include an analysis of how the current conditions compare to conditions during the time period used in the historical loss rates for each group of loans assessed under SFAS 5. A bank should review the range of historical losses over the time period used, rather than relying solely on the average historical loss rate, and should identify the appropriate historical loss rate from within that range to use in estimating credit losses for the groups of loans. This ensures that the appropriate historical experience is captured and is relevant to the bank's current portfolio.

Question 33: (December 2008)

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

Staff Response:

As noted in the 2006 Policy Statement, historical loss experience provides a reasonable starting point for the bank's analysis. However, historical losses, or even recent trends in losses, are not by themselves a sufficient basis to determine the appropriate level for the ALLL. Because the bank's historical loss experience is minimal, any SFAS 5 allowances that exceed the historical loss experience should be based on qualitative or environmental factors. Management should consider such factors as changes in lending policies, changes in the trend and volume of past due and adversely classified loans, changes in local and national economic conditions, and effects of changes in loan concentrations. This will ensure that the ALLL reflects estimated credit losses in the current portfolio.

Question 34: (December 2008)

How should guarantor payments and proceeds anticipated from conversion of collateral be handled when measuring impairment under SFAS 114 using the present value of expected cash flows method?

Staff Response:

All expected cash flows should be included when measuring the amount of impairment for an individually evaluated credit. Per SFAS 114, estimated cash flows should be based on reasonable and supportable assumptions and projections considering all available evidence. Anticipated payments directly from the borrower serve as the primary component in the discounted cash flow model. In addition, any anticipated repayment from a guarantor or through collateral conversion (reduced by estimated selling costs) should be captured in the expected cash flow analysis.

Question 35: (September 2001)

Do “trends” in describing the qualitative factors imply recognition of future losses?

Staff Response:

The word “trends” refers to the effect of current trends on the historical rate of loss. It refers only to effects through the evaluation date and does not imply that the bank should try to capture the effects of possible future events in its adjustment for historical loss factors. Qualitative adjustments to historical loss experience are important in estimating the level of loss inherent in the current loan portfolio. As an example, a recent adverse trend in delinquencies and nonaccruals reflects loss events that have already occurred. The resulting increase in charge-offs may not yet be reflected fully in the historical loss experience. However, this trend must be considered when determining the adequacy of the ALLL.

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

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

Question 36:

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

Staff Response:

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

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

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

Question 37: (December 2008)

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

Staff Response:

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

Question 38: (December 2008)

Must bank management review the appropriateness of the ALLL quarterly?

Staff Response:

The appropriateness of the ALLL must be reviewed at least quarterly. Otherwise, management may not be able to determine the accuracy of the bank's call reports. However, significant loans analyzed individually should be monitored regularly, and provisions made to the ALLL as events occur. This should be a continuous, and not calendar driven, process.

The amount of time that elapses between reviews for pools of loans and other less significant, individually analyzed loans affects the strength of the loan review process. The process should also react to internal and external events that might indicate problems in a particular credit or group of credits.

Question 39: (September 2001)

Do materially excessive allowances also pose a problem?

Staff Response:

The risk of error or imprecision is inherent in the entire allocation process. Accordingly, as noted in Emerging Issues Task Force Topic D-80, most guidance has discussed the ALLL in the context of a range of reasonable estimates. A bank should recognize its best estimate within its estimated range of losses. In this process, banks should take into account all available information existing as of the measurement date, including "environmental" factors.

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

Question 40: (December 2008)

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

Staff Response:

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

Facts:

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

Question 41: (April 2005)

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

Staff Response:

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

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

Facts:

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

Question 42: (April 2005)

How should the bank account for uncollectible overdraft protection fees?

Staff Response:

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

Question 43: (June 2003)

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

Staff Response:

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

Question 44: (June 2003)

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

Staff Response:

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

Question 45: (December 2008)

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

Staff Response:

As noted in Question 5, large groups of smaller-balance homogeneous loans, such as credit card loans, that are collectively evaluated for impairment are not included in the scope of SFAS 114, and the guidance for groups of smaller-balance homogeneous loans contained in SFAS 5 is applied. However, if the smaller-balance loan has been modified in a troubled debt restructuring as defined by SFAS 15, impairment should be assessed in accordance with SFAS 114. Banks should determine whether the credit card workout program qualifies as troubled debt restructurings.

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

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

Question 46: (June 2003)

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

Staff Response:

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

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

Facts:

Two severe hurricanes caused severe damage to certain geographic regions late in the third quarter of 20XX.

Question 47: (May 2006)

How should banks with borrowers affected by the hurricanes determine the appropriate amount to report for their ALLL in their financial statements for the third quarter of 20XX?

Staff Response:

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

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

In particular, for commercial loans whose terms have been modified in a TDR that provides for a reduction of either interest or principal (referred to as a modification of terms), banks should measure the impairment loss on the restructured loan in accordance with SFAS 114. In this regard, a credit analysis should be performed in conjunction with the restructuring to determine the loan's collectibility and estimated impairment. The amount of this impairment should be included in the ALLL. As additional information becomes available indicating a specific commercial loan, including a loan that is a TDR, will not be repaid, an appropriate charge-off should be recorded.

Facts:

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

Question 48: (December 2008)

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

Staff Response:

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

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

Credit Loss

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

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

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

Operational Loss

Losses that arise outside of a relationship between a creditor and a borrower (i.e. the bank does not have the legal ability to collect from a borrower) are considered operational losses. If these losses are "probable" and "reasonably estimable" as defined in SFAS 5, an expense should be accrued and an other liability recorded. Once the actual losses are confirmed, they should be charged against the other liability.

Facts:

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

Question 49: (December 2008)

Should these losses be charged against the ALLL?

Staff Response:

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

Allowances for Loan and Lease Losses in the Current Economic Environment: Loans Secured by Junior Liens on 1-4 Family Residential Properties

Allowance Concepts and Requirements

The Interagency Policy Statement on the Allowance for Loan and Lease Losses, issued by the federal financial institution regulatory agencies in December 2006,[1] states that the allowance for loan and lease losses (ALLL)

> represents one of the most significant estimates in an institution's financial statements and regulatory reports. Because of its significance, each institution has a responsibility for developing, maintaining, and documenting a comprehensive, systematic, and consistently applied process for determining the amounts of the ALLL and the provision for loan and lease losses (PLLL). To fulfill this responsibility, each institution should ensure controls are in place to consistently determine the ALLL in accordance with GAAP [i.e., generally accepted accounting principles], the institution's stated policies and procedures, management's best judgment, and relevant supervisory guidance.
>
> As of the end of each quarter, or more frequently if warranted, each institution must analyze the collectibility of its loans and leases held for investment (hereafter referred to as "loans") and maintain an ALLL at a level that is appropriate and determined in accordance with GAAP. [Footnote omitted.]

An appropriate ALLL covers estimated credit losses on:

- Loans that an institution individually evaluates and determines to be impaired under Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*;[2] and
- Groups of loans with similar risk characteristics that the institution evaluates collectively for impairment under Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5).[3]

According to the Interagency Policy Statement, the term "estimated credit losses" means an estimate of the current amount of loans that it is probable the institution will be unable to collect given facts and circumstances as of the evaluation date. Estimates of credit losses should reflect consideration of all significant factors that affect the collectibility of the portfolio as of the evaluation date.[4]

The Interagency Policy Statement further notes that changes in the level of the ALLL should be directionally consistent with changes in the factors, taken as a whole, that evidence credit losses, keeping in mind the characteristics of an institution's loan portfolio. In this regard, if declining credit quality trends relevant to the types of loans in an institution's portfolio are evident, which is generally the case in the current economic environment, the ALLL level as a percentage of the portfolio should generally increase, barring exceptionally high charge-off activity.

In particular, institutions are reminded that, when estimating credit losses on each group of loans with similar risk characteristics under FAS 5, they should consider their historical loss experience on the group, *adjusted for changes in trends, conditions, and other relevant factors* that affect repayment of the loans in the group as of the ALLL evaluation date.

Considerations Related to Loans Secured by Junior Liens on 1-4 Family Residential Properties

The need to consider all significant factors that affect the collectibility of loans is especially important for loans secured by junior liens on 1-4 family residential properties, both closed-end and open-end, in areas where there have been declines in the value of such properties. Thus, consistent with the Interagency Policy Statement, after determining the appropriate historical loss rate for each group of junior lien loans with similar risk characteristics, an institution's management should consider those current qualitative or environmental factors that are likely to cause the estimated credit losses on these loans as of the ALLL evaluation date to differ from the group's historical loss experience.

As noted in the Interagency Policy Statement, these qualitative or environmental factors include, but are not limited to, changes in the volume and severity of past due loans in each group of junior lien loans and changes in economic and business conditions and other developments that affect the collectibility of the junior lien loans. Furthermore, given the unique nature of junior lien loans, other factors that an institution should take into account would include, for example:

- Changes in the repayment status of the junior lien borrowers' loans secured by first (and any other more senior) liens on the same 1-4 family residential properties, including the extent and severity of delinquencies and the volume of senior lien loan modifications that represent troubled debt restructurings, regardless of whether the junior lien loans themselves are current or past due;
- Changes in the value of the junior lien borrowers' underlying real estate collateral, including the extent to which these borrowers' more senior lien loan balances, or the combined balances of the more senior lien loans and the institution's junior lien loan, currently exceed the value of the underlying real estate; and
- The institution's policies regarding the initiation of foreclosure action on junior lien loans and the submission of bids on foreclosure sales initiated by more senior lienholders when the value of the underlying real estate collateral is insufficient to adequately protect the institution's junior lien position.

The FDIC recognizes that determining the appropriate level for the ALLL for each group of loans with similar risk characteristics under FAS 5 is inevitably imprecise and requires a high degree of management judgment. Nevertheless, delaying the recognition of estimated credit losses on junior lien loans secured by 1-4 family residential properties by failing to properly consider the current effect of more senior liens on the collectibility of an institution's existing junior lien loans is an inappropriate application of GAAP. Additional supervisory action may also be warranted based on the magnitude of the deficiencies in this aspect of the institution's ALLL process. Furthermore, the failure to timely recognize estimated credit losses could delay appropriate loss mitigation activity, such as restructuring junior lien loans to more affordable payments or reducing principal on such loans to facilitate refinancings. Examiners will continue to evaluate the effectiveness of an institution's loss mitigation strategies for loans as part of their assessment of the institution's overall financial condition.

[1] http://www.fdic.gov/news/news/financial/2006/fil06105a.pdf.(PDF Help)

[2] In the Financial Accounting Standards Board's Accounting Standards Codification™, see Section 310-10-35, Receivables – Overall – Subsequent Measurement.

[3] In the Accounting Standards Codification™, see Subtopic 450-20, Contingencies – Loss Contingencies.

[4] Thus, under GAAP, the purpose of the ALLL is not to absorb all of the risk in the loan portfolio, but to cover probable credit losses that have already been incurred.

Sample Letter Sent to Public Companies on MD&A Disclosure Regarding Provisions and Allowances for Loan Losses

In August 2009, the Division of Corporation Finance sent the following illustrative letter to certain public companies identifying a number of disclosure issues they may wish to consider in preparing Management's Discussion and Analysis.

August 2009

Name
Chief Financial Officer
XYZ Bank
Address

Dear Chief Financial Officer:

Clear and transparent disclosure about how you account for your provision and allowance for loan losses has always been critically important to an investor's understanding of your financial statements. While generally accepted accounting principles regarding how to account for these items have not changed in recent years, the current economic environment may require you to reassess whether the information upon which you base your accounting decisions remains accurate, reconfirm or reevaluate your accounting for these items, and reevaluate your Management's Discussion and Analysis disclosure.

Item 303 of Regulation S-K requires you to discuss, in your Management's Discussion and Analysis, any known trends, demands, commitments, events or uncertainties you reasonably expect to have a material favorable or unfavorable impact on your results of operations, liquidity, and capital resources. Set forth below are a number of common Management's Discussion and Analysis disclosure suggestions we have provided to financial institutions that you should consider if they are relevant and material to you.

Higher-Risk Loans

Certain types of loans, such as option ARM products, junior lien mortgages, high loan-to-value ratio mortgages, interest only loans, subprime loans, and loans with initial teaser rates, can have a greater risk of non-collection than other loans. Additional information about higher-risk loans may be useful to an understanding of the risks associated with your loan portfolio and to evaluating any known trends or uncertainties that could have a material impact on your result of operations. With regard to your higher-risk loans, consider disclosing:

- the carrying value of your higher-risk loans by loan type, for example, junior lien mortgages, and, to the extent feasible, allowance data for these loans;

- current loan-to-value ratios by higher-risk loan type, further segregated by geographic location to the extent the loans are concentrated in any areas. Disclose how you calculated the ratios and identify the source of the underlying data you used;

- the amount and percentage of refinanced or modified loans by higher-risk loan type;

- asset quality information and measurements, such as delinquency statistics and charge-off ratios by higher-risk loan type;

- your policy for placing loans on non-accrual status when a loan's terms allow for a minimum monthly payment that is less than interest accrued on the loan. Discuss how this policy impacts your non-performing loan statistics;

- the expected timing of adjustment of option ARM loans and the effect of the adjustment on future cash flows and liquidity, taking into consideration current trends of increased delinquency rates of ARM loans and reduced collateral values due to declining home prices; and

- the amount and percentage of customers that are making the minimum payment on their option ARM loans.

Changes in Practices

Changes in the practices you follow to determine your allowance for loan losses can impact that amount and an understanding of the credit quality information you present. If you changed your practices, please discuss why you made the change and, to the extent possible, quantify the effect of those changes. Also, consider disclosing and discussing changes in:

- the historical loss data you used as a starting point for estimating current losses;

- how you incorporated economic factors affecting loan quality into your allowance estimate;

- the level of specificity you used to group loans for purposes of estimating losses;

- your non-accrual and charge-off policies;

- your application of loss factors to graded loans; and

- any other estimation methods and assumptions you used.

Declines in Collateral Value

A decline in the value of assets serving as collateral for your loans may impact your ability to collect on those loans. Consider disclosing:

- the approximate amount (or percentage) of residential mortgage loans as of the end of the reporting period with loan-to-value ratios above 100%;

- how you take into consideration housing price depreciation, and the homeowners' loss of equity in the collateral, in your allowance for loan losses for residential mortgages. Discuss the basis for your assumptions about housing price depreciation; and

- discuss the timing and frequency of appraisals and identify the sources of those appraisals for collateral-dependent loans.

Other

To the extent relevant and material, consider whether investors would benefit from disclosure in your Management's Discussion and Analysis regarding:

- any risk mitigation transactions you used to reduce credit risk exposure, such as insurance arrangements, participation in the U.S. Treasury Home Affordable Modification Program, credit default agreements or credit derivatives. Discuss how these transactions impact your financial statements;

- the reasons why key ratios (such as your non-performing loan ratio) changed from period to period, and how you considered this information and other relevant credit statistics in determining whether your allowance for loan losses was appropriate; and

- how your accounting for an acquisition under SFAS 141R or your accounting for loans under SOP 03-3 affects trends in your allowance for loan losses, including non-performing asset statistics, charge-off ratios, and allowance for loan loss to total loans.

Finally, although determining your allowance for loan losses requires you to exercise judgment, it would be inconsistent with generally accepted accounting principles if you were to delay recognizing credit losses that you can estimate based on current information and events. Where we believe a financial institution's financial statements are inconsistent with GAAP, we will take appropriate action.

Please contact me if you have any questions.

Sincerely,

Senior Assistant Chief Accountant

Sample Letter Sent to Public Companies on Accounting and Disclosure Issues Related to Potential Risks and Costs Associated with Mortgage and Foreclosure-Related Activities or Exposures

In October 2010, the Division of Corporation Finance sent the following illustrative letter to certain public companies as a reminder of their disclosure obligations to consider in their upcoming Form 10-Qs and subsequent filings, in light of continued concerns about potential risks and costs associated with mortgage and foreclosure-related activities or exposures.

October 2010

Name
Chief Financial Officer
ABC Company
Address

Dear Chief Financial Officer:

The purpose of this letter is to remind you of disclosure obligations that you should consider for your upcoming Form 10-Q and subsequent filings in light of continued concerns about potential risks and costs associated with mortgage and foreclosure-related activities or exposures.

Items that should be considered include, without limitation, the impact of various representations and warranties regarding mortgages made to purchasers of the mortgages (or to purchasers of mortgage-backed securities) including to the government-sponsored entities (GSEs), private-label mortgage-backed security (MBS) investors, financial guarantors and other whole loan purchasers. While not an exhaustive list, these representations and warranties may include the following:

- ownership of the loan;
- validity of the lien securing the loan;
- the absence of delinquent taxes or liens against the property;
- the process used to select the loan for inclusion in a transaction;
- the loan’s compliance with any applicable loan criteria established by the buyer, including underwriting standards;
- delivery of all required documents to the trust; and
- the loan’s compliance with applicable federal, state and local laws.

In addition, we understand that some issuers are undertaking reviews of their loan documentation and foreclosure practices, and, in some cases, have suspended foreclosures pending completion of such reviews.

Item 303 of Regulation S-K requires you to discuss, in your Management's Discussion and Analysis of your Forms 10-Q or Form 10-K, any known trends or any known demands, commitments, events or uncertainties that you reasonably expect to have a material favorable or unfavorable impact on your results of operations, liquidity, and capital resources. Item 103 of Regulation S-K requires disclosure of legal proceedings, including proceedings known to be contemplated by governmental authorities. Item 1 of Part II of Form 10-Q requires you to address legal proceedings when they first become a reportable event and in subsequent quarters when there have been material developments.

In addition, ASC Subtopic 450-20 (SFAS 5) requires you to establish accruals for litigation and other contingencies when it is probable that a loss has been incurred and the amount of the loss can be reasonably estimated. When a loss is not both probable and estimable, an accrual is not recorded, but disclosure of the contingency is required to be made when there is at least a reasonable possibility that a loss or an additional loss has been incurred. The disclosure should indicate the nature of the contingency and give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Rule 10-01(a)(5) of Regulation S-X requires the disclosure of material contingencies in interim financial statements.

As appropriate, you should provide clear and transparent disclosure regarding your obligations relating to the various representations and warranties that you made in connection with your securitization activities and whole loan sales. In addition, you should discuss any implications of any foreclosure review, including potential delays in completing foreclosures, if applicable. These disclosures should address your role as an originator, securitizer, servicer, and investor, as applicable. Depending on your circumstances, please consider the following points as you prepare your Form 10-Q and subsequent filings:

- Risks and uncertainties associated with potentially higher repurchase requests as a result of any foreclosure review process and any changes to the methodology or processes you use to estimate any repurchase reserve;

- Litigation risks and uncertainties related to any known or alleged defects in the securitization process, including any potential defects in mortgage documentation or in the assignment of the mortgages;

- Litigation risks and uncertainties related to any known or alleged breach of the pooling and servicing criteria, including any potential defects in the foreclosure process;

- Risks and uncertainties associated with any agreements or understandings, including for indemnification and settlement, with title, mortgage, and bond insurers regarding coverage;

- Potential effects of defects in the securitization process or improper application of the pooling and servicing criteria on the valuation and any possible impairment of your mortgage servicing rights (MSR);

- Potential effects of defects in the securitization process or improper application of the pooling and servicing criteria on the recognition or impairment of servicing advances, and related effects to your liquidity; and

- Potential effects of changes in the timing of sales of loans, other real estate owned, and mortgage-backed securities resulting from such issues to your liquidity and any related effects on the valuation and impairment of these assets.

In addition, if you have established a reserve relating to representations and warranties attributable to loans that you have sold, you should consider providing a roll-forward of this reserve presenting separate amounts for increases in the reserve due to changes in estimate and new loan sales and decreases attributable to utilizations/realization of losses.

This is not an exhaustive list of the disclosures you should consider. It is your responsibility to determine the disclosures that should be provided in your particular circumstances.

Some of these issues are not limited to financial institutions that sold or securitized mortgages or mortgage-backed securities. Issuers that engage in mortgage servicing, title insurance, mortgage insurance, and other activities relating to residential mortgages should also consider the impact of these and similar issues for their disclosures.

Please contact me if you have any questions.

Sincerely,

Senior Assistant Chief Accountant

A state member bank's authority to hold real estate is governed by state law. A bank is permitted to include owned real estate in its premises account if the real estate serves as premises for operations or is intended to be used as premises. In addition, a bank may hold other real estate owned (OREO), which is defined below. State laws dictate the terms and conditions under which state-chartered banks may acquire and hold OREO.

DEFINITION

Other real estate comprises all real estate, other than bank premises, owned or controlled by the bank or its consolidated subsidiaries, including real estate acquired through foreclosure, even if the bank has not received title to the property. Bank holdings of OREO may arise from the following events:

- the bank purchases real estate at a sale under judgment, decree, or mortgage when the property secured debts previously contracted;
- a borrower conveys real estate to the bank to fully or partially satisfy a debt previously contracted (acceptance of deed in lieu of foreclosure);
- real estate is obtained in exchange for future advances to an existing borrower to fully or partially satisfy debts previously contracted;
- a bank takes possession (although not necessarily title) of collateral in a collateral-dependent real estate loan (i.e., an in-substance foreclosure);
- a bank has relocated its premises and has not yet sold the old premises;
- a bank abandons plans to use real estate as premises for future expansion; and
- a bank has foreclosed real estate that is under contract for sale.

There are three major phases of the OREO life cycle: acquisition, holding period, and disposition.

ACCOUNTING AND REPORTING STANDARDS

The accounting and reporting standards for the acquisition phase are set forth in Accounting Standards Codification (ASC)[1] 310-40, Receivables-Troubled Debt Restructurings by Creditors (formerly known as FAS 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings"); ASC 360-10-30, Property, Plant and Equipment-Initial Measurement (formerly included in FAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets"); and ASC 360-10-35, Property, Plant and Equipment-Subsequent Measurement. The disposition of other real estate is addressed in ASC 360-20-40, Property, Plant and Equipment-Real Estate Sales-Derecognition (formerly within FAS 66, "Accounting for Sales of Real Estate"), which includes specific criteria for the recognition of profit. Reference should also be made to the instructions for the FFIEC Consolidated Report of Condition and Income for a Bank with Domestic and Foreign Offices (Call Report) as to the reporting of OREO transactions.

TRANSFER OF ASSETS TO OREO

Real estate assets transferred to OREO should be accounted for individually (on an asset-by-asset basis) on the date of transfer. Each transferred real estate asset should be recorded at its "fair value" less estimated cost to sell the asset. This "fair value" becomes the cost of the asset. "Fair value" is the amount the creditor should reasonably expect to receive for the asset in a current sale between a willing buyer and a willing seller (that is, not a forced liquidation sale).

The recorded amount of a loan (or an investment in a loan) at the time of foreclosure involving real estate transferred to OREO is the unpaid balance adjusted for any unamortized premium or discount and unamortized loan fees or costs, less any amount previously charged off, plus recorded accrued interest. Any excess of the recorded amount of the loan over the transferred property's fair value is a loss that must be charged against the allowance for loan and lease losses (ALLL) immediately upon the property's

1. This section uses the Financial Accounting Standards Board (FASB)'s *Accounting Standards Codification* (ASC) numbering system, references, and titles, which it approved in June 2009 for its authoritative pronouncements. Within this section, each first "ASC" reference is followed by its "pre-codification" FASB reference and title.

transfer to OREO. If the fair value (less costs to sell) of the property exceeds a recorded loan amount, the excess should be reported as a recovery of a previous charge-off or in current earnings, as appropriate. Legal fees and other direct costs incurred by the bank should generally be included in expenses.

The value of OREO properties must be reported at the fair value minus estimated selling expenses or the recorded loan amount. For example, if the recorded investment in the property is $125, the fair value of the property is $100, and the estimated selling expenses are $6, the carrying value for this property would be $94. The difference between the recorded loan amount of $125 and the fair value of $100 minus the $6 estimated cost to sell the property, or $31, would be charged to the ALLL at the time the property was transferred to OREO. Subsequent to the acquisition date, the OREO property should be reported at the lower of the cost of the property ($94 in this case) or the fair value of $100 less cost to sell of $6, which is also $94. Any subsequent declines in value should be recorded by creating a valuation allowance.

Alternatively, if the recorded loan amount is $250, the property's fair value is $275, and the estimated selling expenses are $18, the property's carrying value would be $257 (the property's fair value of $275 less estimated cost to sell of $18). The $7 difference between the fair value (less costs to sell) and the recorded loan amount would be recorded as a recovery of a previous charge-off or in current earnings, as appropriate. Before recording the $7 in earnings, significant scrutiny should be applied to understand why the borrower would risk losing the equity in the property. Additionally, in some states, lenders are required to return recovered amounts, in excess of the amount owed, to the borrower.

EVALUATIONS OF REAL ESTATE TO DETERMINE THE CARRYING VALUE OF OREO

The transfer of real estate pledged as collateral for a loan to OREO is considered to be a ''transaction involving an existing extension of credit'' under 12 CFR 225.63(a)(7) and is exempt from Regulation Y's appraisal requirement. However, under 12 CFR 225.63(b), the bank must obtain an ''appropriate evaluation'' of the real estate that is ''consistent with safe and sound banking practices'' to establish the carrying value of the OREO. A bank may elect, but is not required, to obtain an appraisal to serve as the ''appropriate evaluation.'' Until the evaluation is available, a bank should rely on its best estimate of the property's value to establish the carrying value. The federal banking agencies have issued appraisal and evaluation guidelines to provide guidance to examining personnel and federally regulated institutions regarding prudent appraisal and evaluation policies, procedures, practices, and standards.

The appraisal or evaluation should provide an estimate of the parcel's market value. (Refer to section 4140.1, ''Real Estate Appraisals and Evaluations.'') The subsection titled, ''Appraisal Content,'' includes a definition of *market value*. Generally, appraisals or evaluations contain an estimate of the property's fair value based on a forecast of expected cash flows, discounted at an interest rate that is commensurate with the risks involved. The cash flow estimate should include projected revenues and the costs of ownership, development, operation, marketing, and sale. In such situations, the appraiser or evaluator should fully describe the definition of value and the market conditions that have been considered in estimating the property's fair value.

PROPERTY ACQUIRED THROUGH FORECLOSURE—JUNIOR LIENHOLDER

When a bank acquires a property through foreclosure as a junior lienholder, whether or not the first lien has been assumed, the property should be recorded as an asset at its fair value less its estimated cost to sell. Any senior debt (principal and accrued interest) should be recorded as a corresponding liability. Senior debt should not be netted against the assets. Any excess of the recorded loan amount over the property's fair value less estimated cost to sell should be charged off to the ALLL. The recorded investment may not exceed the sum of any senior and junior debt. Payments made on senior debt should be accounted for by reducing both the asset and the liability. Interest that accrues on the senior debt after foreclosure should be recognized as interest expense.

COLLATERAL-DEPENDENT LOANS

Collateral-dependent loans are those for which repayment is expected to be provided solely from the underlying collateral when there are no other available and reliable sources of repayment. Guidance for the treatment of certain troubled debts and collateral dependent loans is found in ASC 310-40, Receivables-Troubled Debt Restructurings by Creditors (formerly within FAS 15, as amended by FAS 114 and Accounting Principles Board Opinion no. 21, ''Interest on Receivables and Payables''). According to the instructions in the Call Report, collateral-dependent real estate loans should be transferred to OREO only when the lender has taken possession (title) of the collateral; otherwise they should remain categorized as loans. To facilitate administration and tracking, however, banks may choose to include a collateral-dependent real estate loan in the OREO portfolio as potential or probable OREO. Impairment of a collateral-dependent loan must be measured using the fair value of the collateral. In general, any portion of the recorded amount of a collateral-dependent loan in excess of the fair value of the collateral (less the estimated cost to sell) that can be identified as uncollectible should be promptly charged off against the ALLL. Examiners should review these loans using the same criteria applied to OREO.

PROPERTY ACQUIRED FOR FUTURE USE

Property the bank originally acquired for future use as premises, but for which plans have been abandoned, and property that formerly served as bank premises, should be accounted for at the lower of (1) its fair value less cost to sell or (2) the cost of the asset on the date of transfer to OREO. Any excess of book value over fair value should be charged to other operating expense during the current period.

CARRYING VALUE OF OREO

A bank should have a policy for periodically determining the fair value of its OREO property by obtaining an appraisal or an evaluation, as appropriate. While the Federal Reserve has no prescribed time frame for when a bank should reappraise or reevaluate its OREO property, the bank's policy should conform to state law, if applicable, and take into account the volatility of the local real estate market. A bank should determine whether there have been material changes to the underlying assumptions in the appraisal or valuation that have affected the original estimate of value. If material changes have occurred, the bank should obtain a new appraisal or evaluation based on assumptions that reflect the changed conditions.

ACCOUNTING FOR SUBSEQUENT CHANGES IN FAIR MARKET VALUE

Charges for subsequent declines in the fair value of OREO property should never be posted to the ALLL. If an appraisal or evaluation indicates a subsequent decline in the fair value of an OREO property, the loss in value should be recognized through the income statement by a charge to earnings. Banks should attempt to determine whether a property's decline in value is not recoverable, taking into consideration each property's characteristics and existing market dynamics. The preferred treatment for nonrecoverable losses in value is the direct write-down method, in which the charge to expenses is offset by a reduction in the OREO property's carrying value. If the reduction in value is deemed temporary, the charge to earnings may be offset by establishing a valuation allowance specifically for that property. In the event of subsequent appreciation in the value of an OREO property, the increase can only be reflected by reducing this valuation allowance or recognizing a gain upon disposition, but never by a direct write-up of the property's value. A change to the valuation allowance should be offset with a debit or credit to expense in the period in which it occurs.

In addition to the preceding treatment of the write-down in the OREO value, the previous subsection ''Transfer of Assets to Other Real Estate Owned'' discusses setting up a valuation allowance for estimated selling expenses associated with the sale of the other real estate. The balance of this valuation allowance can fluctuate based on changes in the fair value of the property held, but it can never be less than zero. The following examples are presented to illustrate the treatment that subsequent depreciation and appreciation would have on OREO properties.

Depreciation in OREO Property Value

Assume a bank has written down its initial recorded investment in an OREO property from $125 to its fair value of $100 minus costs to sell (assume costs to sell of $6), or $94. Assume that a new appraisal indicates a fair value of $90, with reduced estimated selling expenses of $5. If the bank determines this decline in value is nonrecoverable, the bank must expense the depreciation of $9.

Appreciation in OREO Property Value

Assume a bank has written down its recorded investment in an OREO property to its fair value of $110 less costs to sell of $10, or $100, and it subsequently created a valuation allowance for the $10 temporary decline in value. A new appraisal indicates an increase in the fair value of the property to $112 less costs to sell of $9, or $103. Notwithstanding the property's increased fair value, the recorded investment value cannot be increased above $100. The valuation allowance for selling expenses can never be less than zero, thus prohibiting an increase in the value of the property above the recorded investment. In this case, the bank would reduce the valuation allowance to zero, which would increase the recorded value to $100.

Accounting for Income and Expense

Gross revenue from OREO should be recognized in the period in which it is earned. Direct costs incurred in connection with holding an OREO property, including legal fees, real estate taxes, depreciation, and direct write-downs, should be charged to expense when incurred.

A bank can expend funds to develop and improve OREO when it appears reasonable to expect that any shortfall between the property's fair value and the bank's recorded book value will be reduced by an amount equal to or greater than the expenditure. Such expenditures should not be used for speculation in real estate. The economic assumptions relating to the bank's decision to improve a particular OREO property should be well documented. Any payments for developing or improving OREO property are treated as capital expenditures and should be reflected by increasing the property's carrying value to the extent that those expenditures increase the value of the property.

DISPOSITION OF OREO

OREO property must be disposed of within any holding period established by state law and, in any case, as soon as it is prudent and reasonable. Banks should maintain documentation reflecting their efforts to dispose of OREO property, which should include

- a record of inquiries and offers made by potential buyers,
- methods used in advertising the property for sale whether by the bank or its agent, and
- other information reflecting sales efforts.

The sale or disposition of OREO property is considered a real estate-related financial transaction under the Board's appraisal regulation. A sale or disposition of an OREO property that qualifies as a federally related transaction under the regulation requires an appraisal conforming to the regulation. A sale or disposition that does not qualify as a federally related transaction nonetheless must comply with the regulation by having an appropriate evaluation of the real estate, that is consistent with safe and sound banking practices.

The bank should promptly dispose of OREO if it can recover the amount of its original loan plus additional advances and other costs related to the loan or the OREO property before the end of the legal holding period. The holding period generally begins on the date that legal title to the property is transferred to the bank, except for real estate that has become OREO because the bank no longer contemplates using it as its premises. The holding period for this type of OREO property begins on the day that plans for future use are formally terminated. Some states require OREO property to be written off or depreciated on a scheduled basis, or to be written off at the end of a specified time period. The bank should determine whether such requirements exist and comply with them.

Financing Sales of OREO

Gains and losses resulting from a sale of OREO properties for cash must be recognized immediately. A gain resulting from a sale in which the bank provides financing should be accounted for under the standards described in ASC 360-20-40, Property, Plant and Equipment-Real Estate Sales-Derecognition (formerly within Statement of Financial Accounting Standards 66 (FAS 66)). ASC 360-20-40 recognizes that differences in terms of the sale and in selling procedures lead to different profit recognition criteria and methods. The standards establish five different methods of accounting for dispositions of real estate. In practice, most banks have primarily used either the full accrual or the deposit method. The full accrual method accounts for the transaction as a sale of real estate, while the deposit method does not. The deposit method is the only method whereby disposition and financing by the seller does not result in a sale and corresponding recognition of a loan.

Banks may facilitate the sale of foreclosed real estate by requiring little or no down payment, or by offering loans with favorable terms. Profit shall only be recognized in full when the collectibility of the sales price is reasonably ensured and when the seller is not obligated to perform significant activities after the sale to earn the profit. Unless both conditions exist, recognition of all or part of the profit should be deferred. Collectibility of the sale price of OREO property is demonstrated when the buyer's investment is sufficient to ensure that the buyer will be motivated to honor his or her obligation to the seller rather than lose the investment. Collectibility shall also be assessed by considering factors such as the credit standing of the buyer, age and location of the property, and adequacy of cash flow from the property.

Bank records should (1) indicate the accounting method used for each sale of OREO, (2) support the choice of the method selected, and (3) sufficiently document that the institution is correctly reporting associated notes receivable, as either loans or OREO property, with valuation allowances when appropriate.

Full Accrual Method

Under this method, the disposition of the real estate is recorded as a sale. The practice of recognizing all profit from the sale of bank-financed OREO at the time of the sale is referred to as the full-accrual method. A bank shall not recognize profit using this method until all of the following general criteria are met:

- a sale is consummated,
- the buyer's initial and continuing investments adequately demonstrate a commitment to pay for the property,
- the bank's loan is not subject to future subordination,
- the bank has transferred to the buyer the usual risks and rewards of ownership, and
- the buyer's initial investment (down payment) and continuing investment (periodic payments) are adequate to demonstrate the buyer's commitment to pay for the property.

A sale will not be considered consummated until the parties are bound by the terms of the contract, all consideration has been exchanged, and all conditions precedent to closing have been performed.

Initial investment, as defined within ASC 360-20-40, includes only cash down payments, notes supported by irrevocable letters of credit from an independent lending institution, payments by the buyer to third parties to reduce existing debt on the property, and other amounts paid by the buyer that are part of the sale price. In these situations, the standards require that profit on the sale be deferred until a minimum down payment has been received and annual payments equal those for a loan for a similar type of property with a customary amortization period. Payments must be sufficient to repay the loan over the customary term for the type of property. The amount of down payment required varies by property category: land, 20–25 percent; commercial and industrial, 10–25 percent; multifamily residential, 10–25 percent; and single-family residential, 5–10 percent. Ranges within these categories are defined further in the statement.

Continuing investment requires the buyer to be contractually obligated to make level annual payments on his or her total debt for the purchase price of the property. This level annual payment must be able to service principal and interest payments amortized for no more than 20 years for raw land, and for no more than the customary amortization term for a first-mortgage loan by an independent lending institution for other types of real estate. For example, the customary repayment term for a loan secured by a single-family residential property could range up to 30 years.

The Installment Method

This method is used when the buyer's down payment is insufficient to allow the full-accrual method, but when recovery of the cost of the property is reasonably assured if the buyer defaults. The installment method recognizes the sale of the property and the corresponding loan, although profits from the sale are recognized only as the bank receives payments from the buyer. Under this method, interest income is recognized on an accrual basis.

Since default on the loan usually results in the seller (the bank) reacquiring the real estate, the bank is reasonably assured that it will be able to recover its costs with a relatively small down payment. Cost recovery is especially likely when loans are made to buyers who have verifiable net worth, liquid assets, and income levels adequate to service the loan. Reasonable assurance of cost recovery also may be achieved when the buyer pledges adequate additional collateral.

The Cost-Recovery Method

This method recognizes the sale of the property and the booking of the corresponding loan. This method may apply when dispositions do not qualify under the full accrual or installment methods. All income recognition is deferred. Principal payments are applied by reducing the loan balance, and interest payments are accounted for by increasing the unrecognized gross profit. No profit or interest income is recognized until either the buyer's aggregate payments exceed the recorded amount of the loan or a change to another accounting method (for example, the installment method) is appropriate. Consequently, the loan is maintained on nonaccrual status while this method is being used.

The Reduced Profit Method

This method is used in certain situations when the sale of the real estate has not been consummated. The bank receives an adequate down payment, but the loan amortization schedule does not meet the requirements for use of the full-accrual method. The bank again recognizes the sale of the property and the booking of the corresponding loan, but, as under the installment method, profits from the sale are recognized only as the bank receives payments from the buyer. Since sales with adequate down payments generally are not structured with inadequate loan-amortization schedules, this method is seldom used.

The Deposit Method

This method is used when a sale of OREO has not been consummated. It also may be used for dispositions that could be accounted for under the cost-recovery method. Under this method, a sale is not recorded and the asset continues to be reported as OREO. Further, no profit or interest income is recognized. Payments received from the buyer are reported as a liability until sufficient payments or other events allow the use of one of the other methods.

Nonrecourse Financing

Banks may promote the sale of foreclosed real estate by offering nonrecourse financing to buyers. These loans should be made under the same credit terms and underwriting standards the bank employs for its regular lending activity. Financing arrangements associated with this type of transaction are subject to the accounting treatment discussed above.

CLASSIFICATION OF OREO

The examiner should generally evaluate the quality of each OREO property to determine if classification is appropriate. OREO usually should be considered a problem asset, even when it is carried at or below its appraised value. Despite the apparent adequacy of the fair or market value, the bank's acquisition of OREO through foreclosure usually indicates a lack of demand. As time passes, the lack of demand can become more apparent, and the value of the real estate can become increasingly questionable.

When evaluating the OREO property for classification purposes, the examiner must consider the property's fair value, whether it is being held in conformance with state law, and whether it is being disposed of according to the bank's plan. The amount of an OREO property subject to classification is the carrying value of the property, net of any specific valuation allowance. The existence of a specific valuation allowance does not preclude adverse classification of OREO. The examiner should review all types of OREO for classification purposes, including sales that fail to meet the standards required for the full-accrual method of accounting. When the bank provides financing, the examiner should determine whether it is prudently underwritten.

The examiner should review all relevant factors to determine the quality and risk of the OREO property and the degree of probability that its carrying value will be realized. Some factors the examiner should consider include

- the property's carrying value relative to its fair value (including the date of any appraisal or evaluation relative to changes in market conditions), the bank's asking price, and offers received;
- the source and quality of the appraisal or evaluation, including the reasonableness of assumptions, such as projected cash flow for commercial properties;
- the length of time a property has been on the market and local market conditions for the type of property involved, such as history and trend of recent sales for comparable properties;
- bank management's ability and track record in liquidating other real estate and assets acquired in satisfaction of debts previously contracted;
- income and expenses generated by the property and other economic factors affecting the probability of loss exposure;
- the manner in which the bank intends to dispose of the property;
- other pertinent factors, including property-title problems, statutory redemption privileges, pending changes in the property's zoning, environmental hazards, other liens, tax status, and insurance.

ENVIRONMENTAL LIABILITY

Under federal and state environmental liability statutes, a bank may be liable for cleaning up hazardous substance contamination of OREO. In some cases, the liability may arise before the bank takes title to a borrower's real estate collateral. A property's transition from collateral to bank ownership may take an extended period of time. As the financial problems facing a borrower worsen, a bank may become more involved in managing a company or property. Such involvement may become extensive enough that the bank is deemed to have met substantially all ownership criteria, the absence of a clear title in the bank's name notwithstanding. Generally, the more bank management is involved in such activity, the greater the bank's exposure to any future clean-up costs assessed in connection with the property. A more thorough discussion of environmental liability can be found in section 2040.1, "Loan Portfolio Management," of this manual, under the subsection "Other Lending Concerns."

TOPIC 5: OTHER ASSETS

5A. REAL ESTATE

Question 1: (December 2008)

How should banks account for their investment in other real estate owned (OREO) property?

Staff Response:

Detailed accounting guidance for OREO is provided in the call report instructions. These instructions require that OREO and its sales be accounted for in accordance with generally accepted accounting principles. In this respect, Statement of Financial Accounting Standards Nos. 15, 114 and 144 (SFAS 144) provides the general guidance for the recording of OREO. Sales of OREO are accounted for in accordance with Statement of Financial Accounting Standards No. 66 (SFAS 66). Statement of Financial Accounting Standards No. 67 (SFAS 67) provides guidance on the accounting for costs during the development and construction period, and Statement of Financial Accounting Standards No. 33 (SFAS 33) provides guidance on capitalization of interest costs.

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

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

SFAS 157 provides guidance on measuring the fair value of OREO property. Although the fair value of the property normally will be based on an appraisal (or other evaluation), the valuation should be consistent with the price that a market participant will pay to purchase the property at the measurement date. Circumstances may exist that indicate that the appraised value is not an accurate measurement of the property's current fair value. Examples of such circumstances include changed economic conditions since the last appraisal, stale appraisals, or imprecision and subjectivity in the appraisal process (i.e., actual sales for less than the appraised amount).

Facts:

A bank is in the process of foreclosing on a $150,000 loan. It is secured by real estate with a fair value, based on a current appraisal, of $180,000. The cost to sell this property is estimated at $15,000.

Question 2: (September 2004)

At what value should the OREO be recorded?

Staff Response:

Upon receipt of the real estate, the property should be recorded at $165,000 in accordance with SFAS 15, 114 and 144. This represents the fair value of $180,000 less the $15,000 cost to sell the property. However, because of safety and soundness concerns, the fair value determined in the appraisal should be scrutinized closely. Since the appraisal indicates that the borrower has equity in the property, the bank should address the issue of why the borrower would risk losing the property in foreclosure. If concern exists about the accuracy of the appraisal, further analysis should be performed. However, if the appraisal properly supports the fair value, the $15,000 increase in value is recorded at the time of foreclosure. This increase in value may be reported as noninterest income unless there had been a prior charge-off, in which case a recovery to the ALLL would be appropriate.

Facts:

A bank acquires real estate in full satisfaction of a $200,000 loan. The real estate has a fair value of $190,000 at acquisition. Estimated costs to sell the property are $15,000. Six months later the fair value of the property has declined to $170,000.

Question 3: (September 2003)

How should the OREO be accounted for?

Staff Response:

Upon receipt of the real estate, the property should be recorded at $175,000. This represents the fair value ($190,000) at acquisition less the cost to sell ($15,000) the property. The amount by which the recorded investment in the loan ($200,000) exceeds the fair value less cost to sell ($175,000) should be recorded as a charge against the ALLL. Accordingly, a $25,000 charge against the ALLL is recorded.

Subsequent to the acquisition date, the OREO is carried at the lower of cost ($175,000) or fair value less cost to sell. When the fair value declines to $170,000, the fair value less cost to sell would be $155,000. This represents a $20,000 decline in value, which is recorded through a valuation allowance in other noninterest expense.

Facts:

Continuing with Question 3, two years later the fair value of the property is $195,000.

Question 4: (September 2003)

How should the increase in value be accounted for?

Staff Response:

The increase in the fair value ($25,000) can be recognized only up to the new recorded cost basis of the OREO, which was determined at the foreclosure date. Accordingly, the valuation allowance of $20,000 would be reversed. The additional $5,000 increase in value would not be recognized.

Question 5: (September 2002)

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

Staff Response:

No. Since the bank did not establish an allowance at the time the properties were initially written down, a new basis of accounting was established. Reversing the previous write-down and rebooking the charged off asset is not in accordance with generally accepted accounting principles.

Question 6: (February 2004)

How should the revenues and expenses (including real estate property taxes) resulting from operating or holding OREO property be accounted for?

Staff Response:

Generally, the revenues and expenses from OREO property should be included in the Statement of Income for the period in which they occur. The call report instructions require that gross rentals from OREO be included in “Other noninterest income.” The expenses of operating or holding the property should be included in “Other noninterest expense.” Because the asset is held for sale, depreciation expense would normally not be recorded.

Statement of Financial Accounting Standards No. 67 (SFAS 67) provides an exception for real estate property taxes incurred “during periods in which activities necessary to get the property ready for its intended use are in progress.” Therefore, real estate taxes incurred during the construction period can be capitalized, up to the fair value of the property. However, such costs incurred at other times must be expensed as incurred. In this respect, SFAS 67 states that “costs incurred for such items after the property is substantially complete and ready for its intended use shall be charged to expense as incurred.” This limited exception would not cover periods in which the bank is merely holding property for future sale.

Facts:

A bank forecloses on a loan secured by a second lien on a piece of property. The bank does not formally assume the senior lien.

Question7:

How should the bank account for the senior debt?

Staff Response:

Although a bank may not assume formally the liability of the senior lien on the property, the amount of any senior debt should be reported as a liability at the time of foreclosure. The OREO balance would be increased by a corresponding amount. However, the resultant carrying value of the OREO cannot exceed the fair value, net of sales costs, of the property.

Any excess should be charged against the allowance for loan and lease losses at the time of foreclosure.

Question 8: (October 2010)

The bank pays delinquent real estate taxes on a property to avoid lien attachment by the taxing authority. How should the bank account for the tax payment?

Staff Response:

As noted in Topic 2B: Nonaccrual Loans, Question 23, delinquent real estate taxes should have been considered when assessing loan impairment prior to transferring the property to OREO. If the delinquent real estate taxes are not paid prior to or at the time of transfer to OREO, this amount should be recorded as a liability (see Topic 5A: Real Estate, Question 7). Real estate taxes incurred after the property becomes OREO are considered holding costs and expensed as incurred. Additionally, other such costs paid by the bank during, or in anticipation of, foreclosure should be expensed. These costs include items for which the bank may contractually be able to obtain reimbursement from the borrower, such as credit life insurance or property insurance premiums. An exception to this rule exists for property under construction. Generally accepted accounting principles allow for capitalization of property taxes during the development period of the property.

Question 9: (February 2004)

The bank purchases the real estate tax lien certificate on the property, rather than paying the delinquent real estate taxes. Would this change the response to Question 8?

Staff Response:

No. The substance of this transaction when the bank purchases the tax lien certificates on property on which it has a lien or has foreclosed is the same as if the bank were paying the property taxes on the property directly. Accordingly, the guidance in Question 8 would apply.

Question 10:

When can a sale of OREO be accounted for under the full accrual method of accounting?

Staff Response:

The full accrual method may be used when all of the following conditions have been met:

- A sale has been consummated.
- The buyer's initial investment (down payment) and continuing investment (periodic payments) are adequate to demonstrate a commitment to pay for the property.
- The receivable is not subject to future subordination.
- The usual risks and rewards of ownership have been transferred.

See Question 11 for further discussion.

Question 11:

What constitutes an adequate down payment for use of the full accrual method of accounting?

Staff Response:

The down payment requirement of SFAS 66 considers the risk involved with various types of property. The required down payments range from 5% to 25% of the sales price of the OREO.

For example, only a 10% down payment is required for commercial property subject to a long-term lease and that has cash flows sufficient to service all indebtedness. On the other hand, a 25% down payment is required for commercial property, such as hotels, motels, or mobile home parks, in a start-up phase or having cash flow deficiencies.

Question 12:

If a transaction does not qualify as a sale under the full accrual method of accounting, what other methods are available for accounting for the transaction?

Staff Response:

SFAS 66 provides four other methods for accounting for sales of real estate. They are: the installment method, the cost recovery method, the reduced-profit method, and the deposit method.

In the past, many banks have used only the deposit method to account for dispositions of OREO that did not qualify for immediate sales recognition under the full accrual method. However, depending on the circumstances, use of one of the other methods may be more appropriate. Often a disposition will qualify for immediate sales recognition under the installment method. This method recognizes a sale and the corresponding loan. Any profits on the sale are recognized as the bank receives the payments from the purchaser.

The installment method is used when the buyer’s down payment is not adequate to allow use of the full accrual method, but recovery of the cost of the property is reasonably assured if the buyer defaults. Assurance of recovery requires careful judgment case by case. Factors that should be considered include: the size of the down payment, loan to value ratios, projected cash flows from the property, recourse provisions, and guarantees.

Since default on the loan usually results in the seller's reacquisition of the real estate, reasonable assurance of cost recovery may often be achieved with a relatively small down payment. This is especially true for loans with recourse to borrowers who have verifiable net worth, liquid assets, and income levels. Reasonable assurance of cost recovery may also be achieved when the purchaser/borrower pledges additional collateral.

Dispositions of OREO that do not qualify for either the full accrual or installment methods may be accounted under the cost recovery method. It recognizes a sale and the corresponding loan, but all income recognition is deferred.

The reduced-profit method is used when the bank receives an adequate down payment, but the continuing investment is not adequate. This method recognizes a sale and corresponding loan, and apportions any profits over the life of the loan, based on the present value of the lowest level of periodic payments.

The deposit method is used when a sale of the OREO has not been consummated. It may also be used for dispositions that could be accounted for under the cost recovery method. Under this method, a sale is not recorded and the asset continues to be reported as OREO. Further, no profit or interest income is recognized. Payments received from the borrower are reported as a liability until sufficient payments or other events have occurred that allow the use of one of the other methods.

Facts:

A bank sells a parcel of OREO property (undeveloped land) for $100,000 and receives a $40,000 down payment. But the bank agrees to extend a line of credit for $35,000 to the buyer.

Question 13:

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

Staff Response:

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

There is one exception to this rule. If the bank makes a loan conditional on the proceeds being used for specified development or construction activities related to the property sold, the loan need not be subtracted in determining the buyer's investment in the property. However, the loan must be on normal terms and at 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 14:

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

Staff Response:

No. SFAS 66 establishes the requirements for recording the transaction under the full accrual method. It requires that the buyer's continuing investment (periodic payments) be at least equal to the level annual payments needed to amortize the debt over 20 years for land and the customary first mortgage period (usually 20 to 30 years) for other types of property. In this situation, the loan balance is not being amortized during the five-year period. Therefore, this transaction does not qualify for recognition under the full accrual method of accounting. The reduced-profit method probably would be used.

Facts:

OREO property with a book value of $110,000 is sold for $120,000. The bank finances the sale and receives no cash down payment. The terms of the note require 120 monthly payments of $1,000 plus interest at market rates. SFAS 66 requires a minimum initial investment of 20% 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 15: (December 2008)

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 when the deposit method is used. Therefore, the $26,000 received by the bank during the first year exceeds 20% of the sales price ($24,000).

Facts:

A bank owns a piece of OREO recorded at an appraised value of $15 million. The bank agrees to sell the property for $13.5 million to a buyer after negotiating from an original offer of $11 million. Immediately prior to closing, the buyer has difficulty obtaining financing for the purchase, and the deal falls through.

Question 16: (December 2008)

Must the bank adjust its recorded investment in the OREO?

Staff Response:

Yes, the bank should reduce the carrying value of the OREO to $13.5 million. The bank received a better indication of the asset value by negotiating a fair sale price with a willing buyer. But for the buyer's last minute difficulties in obtaining financing, the bank (a willing seller) would have sold the property at a loss in a market transaction.

Question 17:

Assume the appraised value is the same as in Question 15, except that the bank places the property for sale in an auction. The bank must set a minimum acceptable bid to attract only serious bidders. The bank sets a minimum of $11 million. Must the bank write the OREO down to $11 million, if the property is not sold?

Staff Response:

Not necessarily. If the bid is set for the purpose described and the bank is not required to accept an $11 million bid if it is the only bid, then $11 million may not be a fair price negotiated by a willing buyer and seller.

Also, the absence of bids does not necessarily mean that the minimum bid was unacceptable to any buyer. In these situations, evidence of a market price is inconclusive because a market has not been established, i.e., no willing buyer or willing seller. Accordingly, a source of fair value independent of a single market transaction, such as an appraisal, would continue to be used to determine the carrying value of the property.

Facts:

In June 20XX, a bank sells for $2 million OREO property (a motel) with a book value of $1.9 million, and receives a cash down payment of $300,000 (15% of the sales price). At the time of sale, the cash flow from the motel is not sufficient to service all indebtedness.

Because of the insufficient cash flows, SFAS 66 requires a minimum initial investment (down payment) of 25% for use of the full accrual method of accounting in this situation.

Had the motel been generating sufficient cash flows to service all indebtedness, only a 15% down payment would have been required. Accordingly, this sale is accounted for using the installment method of accounting, and only a portion of the gain is recognized at the time of sale. This portion of gain recognized is based on the ratio of the down payment to the sales price. In this case, 15% of the gain or $15,000 is recognized at the time of sale. The remainder of the gain is deferred.

Question 18: (December 2001)

Can the bank recognize periodic interest income on this loan that is accounted for under the installment method of accounting?

Staff Response:

Yes. Under the installment method, interest income is recognized at the contractual interest rate. In addition, a portion of the deferred gain (from the sale) would be recognized with each payment. However, should the loan experience delinquency problems, the nonaccrual rules would apply.

Question 19: (December 2001)

Five months later, in November 20XX, the motel's business is thriving and its cash flows are now sufficient and are expected to remain sufficient to service all indebtedness. Can the bank now reduce the down payment requirement to 15% and recognize the sale under the full accrual method?

Staff Response:

Yes. Appendix B to SFAS 66 states that if the transaction later meets the requirements for the full accrual method, the seller (bank) may change to that method. The requirements for use of the full accrual method are met when the borrower's cash flow became sufficient to service the debt. Accordingly, at that time the bank can change to the full accrual method of accounting.

Question 20: (December 2001)

Would the remainder of the deferred gain be recognized at this time?

Staff Response:

Yes. The deferred gain would be recognized in earnings at the time of the change to the full accrual method of accounting.

Facts:

A bank sells a shopping center that currently is classified as Other Real Estate Owned and finances the transaction. The buyer makes a 30% down payment and enters into a 20-year amortizing mortgage at current market rates.

The mortgage is structured in two pieces, an A note and a B note. The B note is equal to 10% of the total loan amount. If a certain major tenant vacates the property within five years and the borrower refinances the A note with an independent third-party lender within the next 180 days, the B note is forgiven. If the tenant remains in the shopping center for at least five years, both loans remain in effect. Both loans also remain in effect if the tenant vacates, but the borrower does not refinance within the stated time period. All other terms are consistent with those generally included in a mortgage on commercial real estate.

Question 21: (February 2004)

How should this sales transaction be accounted for?

Staff Response:

This sale qualifies for sales treatment under the full accrual method of accounting. However, because of the bank's exposure with respect to note B, the bank has retained continuing involvement in the property in that it has retained certain risks of ownership. SFAS 66 establishes the accounting when a portion of the risk is retained.

In this respect, the Statement requires that when the risk is limited in amount, the profit recognition should be reduced by the maximum exposure to loss. Accordingly, the profit would be reduced (or loss increased) by the amount of note B.

Question 22: (February 2004)

When would this portion of the gain be recognized?

Staff Response:

The gain would be recognized into income when the contingency expires. That would occur at the end of five years, or if the tenant vacates the property, at the end of the 180-day refinancing period. However, if the tenant vacates the property and the borrower does not refinance, a careful evaluation of this loan for impairment would be appropriate.

Facts:

A bank forecloses on a construction loan on a house that is unfinished. The recorded balance of the loan is $120,000. The "as is" appraised value of the house is $100,000, and the estimated disposal costs are $10,000. The "when completed" appraised value of the house is $150,000, and the estimated disposal costs are $15,000. The estimated cost to complete construction of the house is $40,000.

Question 23: (September 2004)

At what value should the OREO be recorded?

Staff Response:

The OREO should be recorded at $90,000 in accordance with SFAS 15 and SFAS 144. This amount represents the current "as is" fair value of $100,000 less the $10,000 estimated costs to sell the property.

Question 24: (September 2004)

Can the bank capitalize the costs incurred to complete the construction of the house?

Staff Response:

Costs incurred to complete the construction may be capitalized; however the recorded balance of the OREO should not exceed the "when completed" fair value less estimated costs to sell. The bank should monitor the estimated cost to complete construction to ensure that the estimated cost does not exceed original estimates. The recorded balance of the OREO should never exceed fair value less estimated costs to sell.

Facts:

A bank acquired a commercial building upon the default of its borrower. The property was placed into OREO at $5,000,000. This amount represents the property's fair value (less disposal costs) at the time the bank took possession. Subsequently, a tenant who was paying an above market rent rate terminated its lease by paying the bank an early termination penalty fee of $500,000.

Question 25: (April 2005)

How should this $500,000 fee be recorded?

Staff Response:

The $500,000 fee should be included in the bank's other noninterest income. The loss of this tenant may be an indication of impairment in the value of the property. Therefore, the bank should update its appraisal to determine whether the estimated fair value of the building has become further impaired due to the departure of the tenant. Any decline in fair value should be recorded in an OREO valuation account, if the decline is temporary, or as a direct write down of the OREO balance.

Facts:

A bank sells a parcel of OREO property in a transaction that meets the four criteria (see Question 10) set forth in SFAS 66 for use of the full accrual method of accounting. However, the bank provides the purchaser/borrower with a mortgage loan at a preferential rate (i.e., below market rate) of interest.

Question 26: (January 2007)

Would the granting of a preferential interest rate preclude use of the full accrual method of accounting?

Staff Response:

No. As noted, this transaction meets the four criteria set forth in SFAS 66 (see Question 10 for a listing of the four criteria) for use of the full accrual method of accounting. Accordingly, the transaction qualifies for use of the full accrual method. The preferential rate of interest does not affect that determination. However, as discussed in Question 27, the sales price, amount of gain (or loss), and future recording of interest income would be affected.

Question 27: (January 2007)

How would the sales price, gain (or loss) on the transaction, and future interest income be determined?

Staff Response:

The loan should be discounted and recorded at its fair value, using a market rate of interest. This discount would also reduce both the effective sales price of the property and any gain (or increase the loss). The difference between the fair value and the contractual or face value of the loan is deferred interest income and is recognized into income as a yield adjustment over the life of the loan.

Facts:

A bank originates a mortgage loan and contemporaneously obtains lender paid mortgage insurance as part of the underwriting. Subsequently, the borrower defaults on the loan and the bank forecloses. The bank pays the premium for the insurance, and the cost is a factor in determining the loan's interest rate. The mortgage insurance does not meet the scope of a credit derivative under SFAS 133.

Question 28: (December 2008)

At what amount should the OREO property be recorded?

Staff Response:

Upon receipt of the real estate, OREO should be recorded at the fair value of the asset less the estimated costs to sell, and the loan account reduced for the remaining balance of the loan (see Question 1). The receivable related to the mortgage insurance should not be included in determining the fair value less costs to sell of the mortgage loan nor recorded as part of OREO. It is recorded as a separate asset.

Question 29: (December 2008)

Should the bank record a mortgage insurance receivable?

Staff Response:

The bank should evaluate the probability that the mortgage insurance claim will be paid. SFAS 5 states that contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization. However, if realization of the mortgage insurance claim is assured, then a receivable may be recognized. Determining if the realization of the mortgage insurance claim is assured requires the bank to assess the mortgage insurance company's intent and ability to pay the claim. This includes assessing the mortgage insurance company's creditworthiness, propensity for litigating claims, and history of paying claims. The bank should not recognize a receivable for the mortgage insurance claim if there are concerns about the mortgage insurance company's creditworthiness, the mortgage insurance company's history of litigating claims, or the loans in question are subject to any uncertainty because of litigation.

Facts:

A bank sells the Small Business Administration (SBA) guaranteed portion of a loan. The borrower subsequently defaults on the loan. To facilitate foreclosure proceedings, the bank repurchases the guaranteed portion of the defaulted loan.

Question 30: (December 2008)

At what amount should the purchase of the defaulted SBA loan be recorded?

Staff Response:

The purchased loan should be recorded at its fair value. While the repurchased loan is "guaranteed" by the SBA, the fair value may be less than par because of the time value of money and the length of time it takes to get a liquidation plan accepted by the SBA. This difference would be recorded as a loan loss against the ALLL.

Question 31: (December 2008)

At what amount should a foreclosed SBA loan be recorded in OREO?

Staff Response:

The OREO should be recorded at fair value less estimated costs to sell when the loan is foreclosed or the bank receives physical possession of the property. The amount that the bank anticipates receiving from the SBA should be recorded as a receivable if the bank believes it is probable that its SBA claim will be paid.

Facts:

A bank has a nonaccrual SBA loan that is on the books for $150,000 secured by property with a fair value of $125,000. The bank estimates the cost to sell this property to be $12,500. The SBA guaranty is for 75% of any loss. The SBA will probably pay the guaranteed amount when the property is sold.

Question 32: December 2008)

What would the accounting entries be for this loan when it is transferred to OREO?

Staff Response:

The OREO property is initially recorded at $112,500 (fair value of $125,000 less cost to sell of $12,500). The estimated loss before the SBA guarantee is the recorded value of the loan ($150,000) less the fair value of the OREO ($112,500), including the costs to sell, or $37,500. Since the SBA guarantees 75% of the loss, the value of the SBA guaranty is expected to be $28,125. The value of the SBA guarantee reduces the total loss to $9,375.

The entry to record the transaction would be:

DEBIT		**CREDIT**
OREO	$112,500	
ALLL (Charge-Off)	9,375	
SBA Receivable	28,125	
Loans		$150,000

OCC 2011-10

Subject: Other Real Estate Owned
Date: March 24, 2011

To: Chief Executive Officers of All National Banks, Department and Division Heads, and All Examining Personnel

Description: Exchanging Other Real Estate Owned for Other Assets

Background

The deterioration in asset quality due to the weak economic environment has led to an increase in nonperforming assets, including other real estate owned (OREO), on bank balance sheets. Several companies have started marketing OREO exchange programs to national banks as a means to reduce problem assets. These programs purport to reduce nonperforming assets by exchanging OREO for an interest in another asset, which is represented to be performing. This "performing asset" is often an equity interest in the entity acquiring the OREO or a trade for a large volume of loans such as home equity lines of credit. These programs can raise significant safety and soundness, legal, and accounting concerns and the Office of the Comptroller of the Currency (OCC) strongly encourages national banks to consult with their supervisory offices before entering into any such agreements.

Common issues associated with the exchange of OREO assets for an equity interest (generally in a limited liability company (LLC)) include

- The bank's loss of control over its OREO assets,
- The exchange of OREO for an asset of questionable liquidity and value,
- The commingling of the bank's OREO with other real estate that may be of poorer quality,
- Significant up-front fees and recurring management fees paid to the organizing company, and
- Unfavorable priority of payments between the banks and equity investors.

In addition, the entity acquiring the OREO is often involved in activities that are not permissible for national banks, making the exchanged asset acquired by the bank an impermissible asset. Moreover, the structure of the exchange transaction typically does not meet the accounting definition of a true sale. Thus, rather than improving its position, the bank ends up in an economically inferior situation, with additional legal and accounting issues.

Another example of transactions offered to national banks to reduce their nonperforming asset balances is an "adjusted price trade." This type of transaction involves an offer to purchase the bank's nonperforming real estate loans or OREO at book value, with the stipulation that the bank purchase other assets, at inflated values, from the same party. The "adjusted price trade" is not only unsafe and unsound but may constitute fraud if it results in the misrepresentation of the bank's financial statements.

In a limited number of circumstances, a national bank may acquire a noncontrolling equity interest in an LLC in exchange for its interest in OREO. The OCC has approved only one type of exchange, in which an LLC was established as a means *for the participants in the original loan* to hold the real estate collateral acquired through or in lieu of foreclosure. In this case, the participants in the original loan were the members of the LLC, and each participant held an interest in the LLC equivalent to its participation interest in the loan and OREO. The LLC was established specifically to manage and dispose of the OREO. The member banks retained control over the OREO asset and maintained the same level of risk as before the exchange. The exchange, however, enabled the participants to manage and dispose of the OREO more efficiently than if each bank had to manage its own partial interest in the property.

A national bank wishing to complete such an exchange of its loan interest for an equivalent LLC interest has two alternatives. The bank may follow the well-established licensing procedures in 12 CFR 5.36 for making a noncontrolling investment by submitting a notice (limited to well-capitalized, well-managed banks) or application, as appropriate.[1] Alternatively, the bank may seek approval from its supervisory office under the standards established in OCC Interpretive Letter No. 1123 (September 18, 2009).[2] The supervisory office approval under the standards established in Interpretive Letter No. 1123 is available only for those instances, as described previously, in which the participants in a loan form an entity to hold, manage, and dispose of the OREO collateral acquired for debts previously contracted. Interpretive Letter No. 1123 does not provide legal support for national banks to exchange OREO for equity interest in an entity aggregating various unrelated OREO parcels from multiple banks.

Considerations

Banks need to use caution when looking at novel methods of trading nonperforming OREO balances for other assets. Before entering into any type of OREO exchange, the bank should have a detailed, documented plan. Bank management and the board of directors, at a minimum, should

- Document how the exchange is permissible and in the best interest of the bank and how it would improve the ability of the bank to recover, or otherwise limit, its loan loss. This determination should address how the transaction is in line with board-established strategies to reduce nonperforming assets. The board of directors should review the determination before approving the transaction.
- Make a determination as to whether the exchange qualifies as a sale under Accounting Standards Codification Topic 860, *Transfers and Servicing*. Policies and procedures should be in place to ensure that the bank is following generally accepted accounting principles. The accounting policies and procedures should also address how to value and account for expenses related to the OREO and/or the exchanged asset at consummation of the transaction and on an ongoing basis.
- Identify the reasons that are preventing the bank from selling the OREO and provide documentation supporting why the exchange will make the real estate more marketable.
- Ensure that an accurate value of the exchanged asset is established; and determine a schedule or trigger points for when to update the value.
- Ensure that adequate risk management, measurement systems, and controls are in place to enable the bank to exchange for, hold, and dispose of the acquired interest in a safe and sound manner.
- Set parameters and methods for tracking assets received in the OREO exchange to avoid multiple exchanges for interests in any other real or personal property.
- Ensure that any entity in which the bank acquires an interest complies with the provisions of the OCC's OREO regulation, 12 CFR 34, subpart E, including requirements for additional expenditures, and appraisals or evaluations.
- Conduct adequate due diligence to determine and document that all activities are permissible banking activities. The activities to be performed by any entity in which the bank acquires an interest in exchange for the OREO should be clearly documented and the bank should obtain a commitment from the third party with regard to activities performed.

- Have processes in place to dispose of its interest in any such entity no later than five years from the date the bank initially acquired title to the OREO (unless granted an extension by the OCC as allowed by 12 USC 29).

Although the transaction may be marketed as a simple way to reduce nonperforming assets, these transactions can be very complicated and must be reviewed thoroughly before entering into them.

Further Information

Please contact your supervisory office with questions on specific exchange programs or processes. You may also direct questions or comments to Darrin Benhart, Director of Commercial Credit Risk, at 202-874-4564; or Steven Key, Special Counsel, Bank Activities and Structure, at 202-874-5300.

Timothy W. Long
Senior Deputy Comptroller for Bank Supervision Policy
and Chief National Bank Examiner

[1] http://edocket.access.gpo.gov/cfr_2010/janqtr/pdf/12cfr5.36.pdf
[2] http://www.occ.gov/static/interpretations-and-precedents/oct09/int1123.pdf

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

SR 95-16 (SUP)
March 28, 1995

**TO THE OFFICER IN CHARGE OF SUPERVISION
AT EACH FEDERAL RESERVE BANK**

SUBJECT: Real Estate Appraisal Requirements for Other Real Estate Owned (OREO)

The June 1994 amendments to the Board's real estate appraisal regulation[See footnote 1] revised the appraisal exemption for real estate related transactions involving an existing extension of credit. As a result of this revision, questions have arisen regarding the treatment of other real estate owned (OREO) transactions under this appraisal exemption. In general, transactions involving most loan renewals, modifications, workouts, and refinancings are considered to be transactions arising from an existing extension of credit and do not require an appraisal, but do require an evaluation.

Real estate posted as collateral that has been acquired by an institution through foreclosure, or a deed in lieu of, (collectively referred to as OREO) now qualifies for the appraisal exemption for existing extensions of credit. Therefore, when acquiring OREO, an institution is not required to obtain an appraisal, but is required to obtain an evaluation. In general, it is expected that an appraisal or evaluation will be obtained prior to entering into a transaction. When the transaction involves a foreclosure or deed in lieu of, an institution may first act to prudently protect its collateral interest by initiating the foreclosure proceeding and may obtain the evaluation in a reasonable amount of time after title to the property is taken.

Because the sale or disposal of OREO does not arise from an existing extension of credit, it does not qualify for the appraisal exemption. Thus, an institution is required to have a valid appraisal to support the transaction. However, if the sale price of the OREO is to be below the $250,000 appraisal threshold, the institution would only be required to obtain an evaluation. If an institution finances the sale of the OREO, this extension of credit would be considered a new transaction and would require a valid appraisal, unless the transaction qualifies for the threshold exemption or another exemption in the regulation.

In any OREO transaction, if an institution already has an appraisal (or an evaluation) of the real estate collateral and it is determined to be valid, the institution need not obtain a new appraisal. The determination that an appraisal remains valid (i.e., no material change in the market value reported in the appraisal) should be made by an individual who has appropriate real estate expertise and market knowledge. The individual should provide written documentation for the loan file to support the determination that the appraisal is still valid or that a new appraisal is necessary. The basis for determining whether an appraisal continues to be valid will vary depending upon the circumstances of the property and marketplace. Some of the factors that need to be taken into account include: the passage of time; the volatility of the local market; the availability of financing; the inventory of competing properties; new improvements to, or lack of maintenance of, the subject property or competing, surrounding properties; change in zoning; or environmental contamination.

In the course of monitoring OREO assets, financial institutions should have appropriate policies and procedures in place to help determine when a new appraisal or evaluation should be obtained. An institution may be required to substantiate the valuation of the OREO asset for financial reporting purposes.[See footnote 2] If an institution determines that an appraisal or evaluation should be obtained, the appraisal or evaluation must conform to the requirements of the agencies' appraisal regulations or guidelines.

The above represents the Board's position on appraisals and evaluations for OREO for state member banks and bank holding companies. In addition, state licensed branches and agencies of foreign banks should consider these requirements in relation to their polices and procedures for OREO. Banks subject to another primary regulator should seek guidance from their regulator.

Reserve Banks should communicate immediately this clarification to regulated institutions. Any questions on the Board's appraisal regulation should be directed to Stanley Rediger 202/452-2629 or Virginia Gibbs at 202/452-2521.

Richard Spillenkothen
Director

Footnote: 1 These amendments were issued on June 7, 1994, in the Federal Register (59 FR 29482).

Footnote: 2 The Accounting Standards Division of the American Institute of Certified Public Accountants issued a Statement of Position No. 92-3, "Accounting for Foreclosed Assets." This statement provides guidance on the balance sheet treatment of foreclosed assets after foreclosure.

Financial Institution Letters

Guidance on Other Real Estate

Continued weakness in the housing market and the rapid rise in foreclosures have increased the potential for higher levels of other real estate (ORE) held by FDIC-supervised institutions ("institutions"). In this regard, as stated in Financial Institution Letters 35-2007, "Working With Residential borrowers: FDIC Encourages Institutions to Consider Workout Arrangements for Borrowers Unable to Make Mortgage Payments," and 76-2007, "Servicing for Mortgage Loans: Loss Mitigation Strategies," the FDIC encourages institutions to avoid unnecessary foreclosures of residential properties through loan modifications that achieve affordable, sustainable mortgage obligations. Where foreclosures are unavoidable, this Financial Institution Letter reminds institutions of the need to establish policies and procedures for acquiring, holding, and disposing of ORE. These policies and procedures should ensure that the institution's interests in the ORE are protected while mitigating the impact on the value of surrounding properties; ORE is accounted for in conformance with the *Instructions for the Consolidated Reports of Condition and Income* (*Instructions for Call Reports*); and the institution complies with applicable federal and state laws and regulations pertaining to holding ORE.

For regulatory reporting purposes, ORE consists of:

- all real estate, other than bank premises, actually owned or controlled by the institution and its consolidated subsidiaries, including real estate acquired through foreclosure, even if the institution has not yet received title to the property;
- certain direct and indirect investments in real estate ventures;
- property originally acquired for future expansion but no longer intended to be used for that purpose; and
- foreclosed real estate sold under contract and accounted for under the deposit method of accounting.

Safety and soundness matters regarding ORE are discussed below, and a summary of the primary accounting issues associated with ORE is provided in the Appendix – "Accounting for Other Real Estate (ORE)."

VALUATION OF ORE

Institutions typically acquire ORE through foreclosure or deed in lieu of foreclosure after a borrower defaults on a loan. Institutions should obtain a new or updated valuation that complies with state law at the time of acquisition.

Many state laws require institutions to obtain an annual valuation for each parcel of ORE. Institutions should implement procedures to obtain updated ORE valuations as needed to ensure that any material change in market conditions or the physical aspects of the property are recognized.

Further, upon the disposition of ORE, certain state laws may govern appraisals and/ or valuations. If an institution is selling *and* financing the transaction, Part 323 of the ***FDIC Rules and Regulations*** and applicable state laws require an appraisal or an evaluation.

MAINTAINING ORE

Part 364, Appendix A of the ***FDIC Rules and Regulations***, *Interagency Guidelines Establishing Standards for Safety and Soundness*, requires institutions to identify problem assets and prevent deterioration in those assets. Institutions are reminded that maintaining and protecting ORE from further deterioration is critical to maximizing recovery value. Typical expenses incurred during the ORE holding period include:

- **Maintenance.** ORE should be maintained in a manner that complies with local property and fire codes. Other requirements, such as homeowner association covenants, may also require careful attention. Efforts to ensure an ORE property is maintained in a marketable condition not only improve an institution's ability to obtain the best price for the property, but also minimize liability and reputation risk.
- **Real Estate Taxes**. Taxes on ORE should be paid in a timely manner to avoid unnecessary penalties and interest.
- **Insurance**. A review of an institution's umbrella insurance policies should be performed to determine if adequate hazard and liability coverage for ORE exists. If not, management should consider obtaining policies on each parcel of ORE. If an institution decides to self-insure, this decision should be documented in the ORE file.
- **Other Expenses**. Management should implement reasonable procedures for managing any other miscellaneous expenses the institution may incur during the ORE holding period. These expenses could include, but are not limited to, sewer and water fees, utility charges, property management fees, and interest on prior liens.

Appendix – Accounting for Other Real Estate (ORE)

In general, the accounting and reporting standards for foreclosed real estate are set forth in Statement of Financial Accounting Standards No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings (FAS 15),* and Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets (FAS 144).* In addition, certain provisions of the American Institute of Certified Public Accountants (AICPA) Statement of Position 92-3, *Accounting for Foreclosed Assets (SOP 92-3)*, have been retained because they represented prevalent and safe and sound banking practices. The provisions retained from AICPA SOP 92-3 include that when an institution receives ORE from a borrower in full satisfaction of a loan, the long-lived asset is presumed to be held for sale, and the institution should initially record the ORE at its fair value less cost to sell.

The life cycle of foreclosed real estate consists of three phases: acquisition, holding period, and disposition. Banks should ensure that proper accounting policies and controls are in place during each phase (see summary of the three phases below). Management should refer to the applicable accounting standards and the *Instructions for Call Reports* to determine the appropriate regulatory reporting of ORE based on the specific facts and circumstances relating to the property and related transactions. Management is encouraged to consult with knowledgeable accounting professionals as necessary, especially in those situations where the transaction is uncommon or complex in relation to the bank's expertise.

Accounting for ORE at Acquisition

Foreclosed real estate received in full or partial satisfaction of a loan should be recorded at the fair value less costs to sell the property at the time of foreclosure. This amount becomes the "cost" of the foreclosed real estate. According to FAS 144, "costs to sell are the incremental direct costs to transact a sale," which include "broker commissions, legal and title transfer fees, and closing costs that must be incurred before legal title can be transferred."

When foreclosed real estate is received in full satisfaction of a loan, the amount, if any, by which the recorded amount of the loan exceeds the fair value less cost to sell the property is a loss which must be charged to the allowance for loan and lease losses at the time of foreclosure.[1] The amount of any senior debt (principal and accrued interest) to which foreclosed real estate is subject at the time of foreclosure must be reported as a liability in the Call Report as "Other borrowed money." Legal fees and other direct costs incurred in a foreclosure should be expensed as incurred.

Accounting for ORE during the Holding Period

After foreclosure, each foreclosed real estate asset must be carried at the lower of (1) the fair value of the asset minus the estimated costs to sell the asset or (2) the "cost" of the asset. This determination must be made on an asset-by-asset basis. If the fair value of a foreclosed real estate asset minus the estimated costs to sell the asset is less than the asset's cost, the deficiency must be recognized as a valuation allowance against the asset which is created through a charge to expense. The valuation allowance should thereafter be increased or decreased (but not below zero) through charges or credits to expense for changes in the asset's fair value or estimated selling costs. Changes in the valuation allowance should be recorded in Schedule RI – Income Statement, item 5.j, "Net gains (losses) on sales of other real estate owned," of the Call Report.

In preventing ORE from further deterioration during the holding period, institutions typically incur a variety of expenses. These holding costs generally should be expensed as incurred and reported in Schedule RI – Income Statement, item 7.d, "Other noninterest expense," of the Call Report, except for interest on prior liens, which should be reported in item 2.c, "Interest on trading liabilities and other borrowed money."

If permanent improvements are made to a foreclosed real estate asset that increase the property's value, these expenditures generally would be eligible for capitalization to the cost of the ORE. In addition, banks that complete the construction of foreclosed real estate projects should refer to such standards as Statement of Financial Accounting Standards No. 34, *Capitalization of Interest Cost (FAS 34)*, and Statement of Financial Accounting Standards No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects (FAS 67),* for relevant accounting guidance. In addition, if the property generates revenue during the holding period, the institution should recognize the income generated from the property and report it in Schedule RI – Income Statement, item 5.l, "Other noninterest income," of the Call Report.

Accounting for ORE in the Disposition Phase

The primary source of accounting guidance for sales of foreclosed real estate is Statement of Financial Accounting Standards No. 66, *Accounting for Sales of Real Estate (FAS 66).* This standard, which applies to all transactions in which the seller provides financing to the buyer of real estate, establishes five methods to account for the disposition of ORE -- full accrual, installment, cost recovery, reduced profit, and deposit. If a profit is involved in the sale of real estate, each method sets forth the manner in which the profit is to be recognized based on the terms of the sale. However, regardless of which method is used, any loss on the disposition of ORE should be recognized immediately. Refer to the *Instructions for Call Reports* and FAS 66 for further guidance on the appropriate method to be used based on the individual facts and circumstances relating to the sale of ORE, including such factors as the buyer's initial investment (down payment).

In situations where ORE is sold *shortly* after it is received in a foreclosure (i.e., the holding period was minimal), the *Instructions for Call Reports* state that it would generally be appropriate to substitute the value received in the sale (net of the cost to sell) for the fair value (less cost to sell) estimated at the time of foreclosure. Any adjustment made to the loss originally recognized at the time of foreclosure would be charged against or credited to the allowance for loan and lease losses. In all other instances where the foreclosed real estate is held for more than a minimal period, any declines in value after foreclosure and the gain or loss from the sale or disposition of the real estate should be reported in Schedule RI – Income Statement, item 5.j, "Net gains (losses) on sales of other real estate owned."

[1] The "recorded amount of the loan" is the loan balance adjusted for any unamortized premium or discount and unamortized loan fees or costs, less any amount previously charged off, plus recorded accrued interest.

Deloitte.

Financial institutions: converting commercial mortgages to REO — valuation and accounting considerations

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Overview

The commercial real estate markets are currently experiencing unprecedented declines resulting in escalating mortgage defaults and a sharp spike in Real Estate Owned (REO) assets held by lenders. An REO asset is a property that is in the possession of a lender as a result of foreclosure or forfeiture by a borrower. Taking over the ownership of an asset is just one of several options that a financial institution has in managing non-performing loans on commercial real estate. In fact, REO is often considered a last resort by lenders after other options such as loan workouts and sales of the loans are considered; this is because many lenders do not have the resources and/or experience to manage and operate the real estate to maximize its value. Nonetheless, the number of REO assets has increased dramatically from April 2009 thru December 2009; a trend which may continue in the foreseeable future.

There are many valuation and accounting considerations that factor into the decisions that executives at financial and lending institutions make when converting commercial mortgages to REO assets. This topic is particularly relevant in the current challenging economic times as financial institutions are faced with very difficult decisions related to their troubled loan portfolios.

Current commercial real estate market and debt conditions

Commercial real estate market

Over the twelve months from 4Q 2008 to 4Q 2009, the commercial real estate market has experienced a significant downturn. As illustrated in the table below, transaction volume for the five primary property types has decreased by approximately 22% for retail properties to 76% for office properties from 4Q 2008 to 4Q 2009.

U.S. transaction volume ($mil)

Property type	4Q 2008	4Q 2009	Percent change
Office	7,640	1,834	-76.0%
Industrial	3,100	1,120	-63.9%
Retail	3,141	2,445	-22.2%
Hotel	1,005	296	-70.5%
Apartment	4,922	2,901	-41.1%

Source: Real Capital analysis

These figures demonstrate the drastic reduction in sales activity within the market across these primary property types. Similarly, property returns have been severely impacted.

As presented in the following table, annualized long-term historical returns for commercial real estate fall within the range of 8% to 10%, whereas returns from 3Q 2008 to 3Q 2009 across these primary property types were approximately -22%.

U.S. transaction volume ($mil)

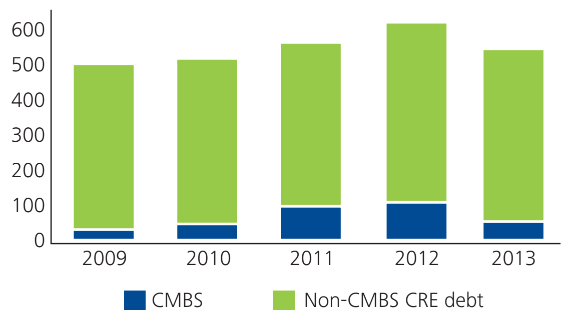
Property type	3Q 2008 to 3Q 2009	2Q 2009	3Q 2009	Annual since inception	Inception date
Office	-24.50%	-6.52%	-3.30%	8.20%	4Q 1977
Industrial	-22.38%	-5.09%	-3.94%	9.24%	4Q 1977
Retail	-15.78%	-3.03%	-3.14%	9.35%	4Q 1977
Hotel	-26.45%	-5.46%	-4.47%	8.36%	1Q 1997
Apartment	-23.03%	-5.13%	-3.00%	8.26%	3Q 1984
National	-22.09%	-5.20%	-3.32%	8.91%	4Q 1977

Source: Real Capital analysis

Commercial real estate debt

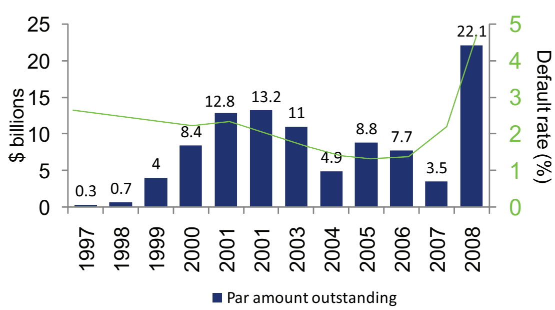
It is estimated that approximately $2.5 trillion in commercial mortgage backed securities (CMBS) and non-CMBS debt on commercial real estate will come due between 2009 and 2013. A Real Estate Roundtable report projects that upcoming debt maturities will exceed $500 billion in 2010 and peak at nearly $600 billion in 2012. These upcoming debt maturities, combined with the downturn in commercial real estate values/returns and much tighter underwriting standards, point to the potential for significant distressed debt in the near term for financial institutions and possible further deterioration in the commercial real estate market.

Annual CMBS and Non-CMBS debt maturities



Source: Real Estate Roundtable, Green Street Advisors, Mortgage Bankers Association, Wells Fargo, Trepp, Bank of America

As to be expected, default rates have increased dramatically and continue to do so. As of December 2008, the level of leveraged loan debt in default was over $22 billion, which is an increase of over 500% from the levels experienced in December 2007 at $3.5 billion.



Source: North American Distressed Debt Market Outlook 2009, Debtwire North America (January 2009), Federal Reserve website

Although there is distressed debt in the market related to almost every property type, multi-family and retail loans have experienced the highest level of delinquencies. Retail delinquencies may continue to increase substantially as consumer spending continues to suffer and store closings and retailer bankruptcies occur. Delinquencies on hospitality assets may also rise as both business and leisure travel are projected by several data sources to remain slow in the foreseeable future. Across property types, development assets currently have an extremely high level of delinquency, because the fair value of the underlying collateral may have declined, there is no current income and in many cases, there is no projected income for five to seven years.

According to Realpoint Research, delinquencies in Florida, Texas, and California account for approximately 30% of CMBS delinquency. Further, the 10 largest states by delinquent unpaid balance comprise 56% of CMBS delinquency.

As previously noted, REO is often a last resort for financial institutions holding non-performing loans on commercial real estate. As of December 29, 2009, the total dollar amount of distressed assets for which the mortgage is in default, the owner is bankrupt, or the property has already been foreclosed upon in the U.S. was approximately $170.74 billion. Of this amount, nearly 12%, or $20.65 billion, pertained to REO assets. Many of the $170.74 billion in assets classified as "troubled" may eventually become REO assets.

The following is a comparison of the information presented in the above chart over the eight months from the end of April through the end of December 2009. This illustrates that the number of distressed assets is increasing substantially and an increasing number of the assets are being taken into REO by the lenders. In fact, the carrying value of distressed REO properties has increased by approximately 125% over this eight month period.

A geographic breakdown of the distressed and potentially troubled assets is presented by region below. While the Southeast region of the United States has the highest amount of distressed properties including the largest proportion of properties in lender REO, the Northeast region has the highest amount of troubled properties. The Southeast and West regions have the highest amount of lender REO properties.

Pre-REO planning

Taking a property into REO is often a time-consuming and complicated process for a financial or lending institution. The lender should consider many factors, including:

- Is the property distressed or is the borrower distressed (i.e., is it a bad asset and a good borrower or a good asset and a bad borrower)?
- What are the potential risks of owning the property and how can they be mitigated?
- Is construction on the property completed or is it considered a development asset?
- What are the management requirements of the property?
- Does the lender have the resources and experience to manage the property in a way that maximizes the asset's value?
- What are the benefits and costs of outsourcing certain aspects of the asset/property management?
- What are the short-term capital requirements (including dealing with any deferred capital or maintenance expenditures) to maintain the property and keep it competitive in the market?
- What are the normal operating expenses (e.g., real estate taxes, insurance, etc.) to be incurred during the holding period?
- What is the expected timeframe until a sale (holding period) to a third-party once the property becomes REO?
- Can the anticipated appreciation or depreciation during the holding period be projected?

- What are the costs to take the property into REO and what are the projected costs to sell the property (e.g., advertising, broker's commission)?
- What type of internal controls should be implemented to manage risks?
- How should the property be accounted for under U.S. GAAP?
- What type of valuation policy should be implemented?
- What are the tax implications?

Although all of the items above are important considerations for a lender considering taking a property into REO, the accounting and valuation considerations are highly important to the REO strategy and can have immediate accounting and reporting implications to the financial statements of the lender.

Once a lender takes back a REO asset, one of the first decisions that should be considered is regarding the asset's disposition strategy, which determines the classification of the asset, and in turn, the initial accounting treatment of the REO. Under an immediate sales strategy, assuming certain criteria[1] are achieved under accounting principles generally accepted in the United States (GAAP), the REO would be classified as a "Held for Sale" asset. If the asset doesn't qualify for the "Held for Sale" criteria, the asset is classified as "Held and Used".

Once this determination of the classification of the REO is made, the lender would adhere to troubled debt restructuring rules[2] under GAAP and record the REO asset and remove the related loan from its books. After the troubled debt restructuring, the lender accounts for assets received in satisfaction of a receivable the same as if the assets had been acquired for cash.

REO asset classified as "Held for Sale"

The REO would initially be recorded at fair value less cost to sell. The lender would record a loss on the cancellation of the loan asset for any excess of the recorded net investment in the receivable satisfied over the fair value of assets received less estimated cost to sell.

The "Held for Sale" classification requires the lender to report the REO using single financial statement line item presentation, rather than a traditional operating model (gross presentation) used by an owner of real estate. Under the "Held for Sale" reporting presentation, all the related assets of the REO are grouped into a single asset caption ("Assets Held for Sale") and all the related liabilities of the REO are grouped into a single liability caption ("Liabilities Related to Assets Held for Sale") on the lender's balance sheet. In addition, if material and meets the definition of a component under GAAP, the related operations of the REO would be collapsed and reported as discontinued operations in the lender's income statement.

[1]ASC 360-10-45-9 through 45-11 *Property, Plant, and Equipment* (formerly known as FAS 144 *Accounting for the Impairment or Disposal of Long-Lived Assets*)

[2]ASC 310-40 Receivables - *Troubled Debt Restructurings by Creditors* (formerly known as FAS 15 *Accounting by Debtors and Creditors for Troubled Debt Restructurings*)

While the REO is classified as "Held for Sale", depreciation of the REO asset is suspended, while interest and other expenses attributable to the liabilities continue to be accrued. Legal fees and other direct costs incurred by a creditor to effect a troubled debt restructuring are included in expense when incurred.

Once the REO is sold, a true-up of the estimated selling costs is made in the final determination of the recognized gain or loss on the sale of the REO asset. Typically, the related gain/loss on the disposition of the REO would be reported within the discontinued operations section of the lender's income statement.

What happens if the lender decides not to sell the REO in the near term?

If circumstances arise that previously were considered unlikely and, as a result, the lender decides not to sell the REO asset, the asset shall be reclassified as "Held and Used". Under GAAP, the reclassified asset is measured at the lower of its (a) carrying amount before the asset was classified as "Held for Sale" adjusted for any depreciation expense that would have been recognized had the asset been continuously classified as "Held and Used" or (b) the fair value at the date of the subsequent decision not to sell.

REO asset classified as "Held and Used"

The REO asset would initially be recorded by the lender at the fair value of the real estate. The lender would record a loss on the cancellation of the loan asset for any excess of the recorded net investment in the receivable satisfied over the fair value of assets received.

Unlike "Held for Sale" treatment, a "Held and Used" REO asset is accounted for as if the lender purchased the asset to operate for a period of time. The lender would generally be required to account for the acquired asset under the acquisition method of accounting for business combinations.[3] As a result, the lender must recognize and measure in its financial statements the identifiable assets acquired and the liabilities assumed related to the REO asset based on fair value. After the allocation of purchase price is determined, the REO asset (including its separate identifiable tangible and intangible assets and liabilities) is depreciated and amortized. Many accounting estimates are required to be made by the lender in order to properly account for the "Held and Used" REO asset. The lender must first allocate the purchase price to the various identifiable tangible and intangible assets and liabilities based on their fair values. In addition, the lender must establish the useful lives of each of the REO assets in order to properly determine the related depreciation or amortization charge that would be recognized in the lender's financial statements. Similar to the "Held for Sale" accounting treatment discussed above, legal fees and other direct costs incurred by a creditor to effect a troubled debt restructuring shall be included in expense when incurred.

Besides the initial and ongoing accounting for operating real estate, the lender should establish internal accounting and reporting processes, modify or implement a financial system to record and process real estate related transactions, as

[3]ASC 805 *Business Combinations*

well as establish a comprehensive system of internal control over maintaining REO assets.

Besides the asset management considerations of REO, financial institutions should consider the financial reporting implications of managing REO. Several reporting implications will likely change the lender's financial statements. First, the lender will be required to consolidate the real estate investment on its books and perform the accounting, as if it had originally acquired real estate, rather than merely providing a loan to a borrower. As a result, additional real estate investment disclosures could be required under GAAP, thereby expanding the complexity of the lender's financial statements. As a result of owning and operating REO assets, a lender may experience cash flow and earnings volatility. Such volatility may result from changes in occupancy, rental rates, incentives provided to tenants, planned or unexpected capital expenditures, unreimbursed operating expenses and property impairments.

REO valuation issues

There are a number of valuation issues that financial institutions should consider when bringing assets into REO.

Institutions typically acquire REO through foreclosure or deed in lieu of foreclosure after a borrower defaults on a loan. To adhere with guidance published by the FDIC, financial institutions should obtain a new or updated valuation that complies with state law at the time of acquisition of REO, as well as, the *Appraisal Regulation (12CFR Part 323), Interagency Appraisal and Evaluation Guidelines*. Additionally, many state laws may require institutions to obtain annual or periodic valuations for each parcel of REO to determine that any material change in market conditions or the physical aspects of the property are recognized. Lastly, upon the disposition of REO, certain state laws may require appraisals if an institution is selling an asset or financing the transaction.

Fair value for financial reporting

There are three phases in the life cycle of foreclosed real estate: acquisition, holding period, and disposition. For purposes of financial reporting for the REO at both acquisition and during the holding period, an estimate of fair value is required.

At acquisition, and if the asset is classified as "Held for Sale", the foreclosed real estate should be recorded at the fair value less estimated costs to sell the property at the time of foreclosure. This amount then becomes the "cost" or carrying value of the foreclosed real estate. GAAP defines costs to sell as "the incremental direct costs to transact a sale," which include "broker commissions, legal and title transfer fees, and closing costs that must be incurred before legal title can be transferred.

During the holding period, each foreclosed real estate asset must be carried as outlined above. At the time of disposition, typically no fair value estimate is required.

Fair value defined

A determination of fair value is necessary to properly account for REO assets under GAAP. As such, it is important to understand the definition of fair value and its implications for financial reporting.

Fair value is defined under GAAP as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."[4]

GAAP also states that an orderly transaction "is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale)."[5] Based on this definition, a valuation specialist should state and justify the estimated exposure time.

Another provision included in the definition of fair value is the concept of an exit price. Under GAAP, "the transaction to sell the asset or liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the objective of a fair value measurement is to determine the price that would be received to sell the asset or paid to transfer the liability at the measurement date (an exit price)."[6] It is important to note that fair value does not incorporate transaction costs. As such, for purposes of establishing the carrying value of a foreclosed property for financial reporting purposes, the costs to sell should be estimated by a valuation specialist or other qualified professional and deducted from the concluded fair value estimate.

Other important considerations in the definition of fair value are (1) a fair value measurement assumes that the transaction to sell the asset occurs in the principal or most advantageous market for the asset; (2) the fair value should be based on the assumptions of market participants defined as "buyers and sellers in the principal (or most advantageous) market for the asset…"[7]; and (3) a fair value measurement assumes the highest and best use (the use of an asset that maximizes its value) of the asset by market participants.

Valuation techniques

There are three generally accepted valuation techniques for estimating the fair value of real estate: the market approach, income approach, and cost approach. Fair value accounting guidance states that "valuation techniques that are appropriate in the circumstances and for which sufficient data are available shall be used to measure fair value."[8] This guidance indicates that in some cases a single valuation technique will be appropriate and in other cases multiple valuation techniques will be appropriate. If multiple valuation techniques are applied, the indications of value derived from each technique should be weighted and reconciled appropriately.

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[4]ASC 820 *Fair Value Measurements* (formerly known as FAS 157 *Fair Value Measurements*)
[5]ASC 820 *Fair Value Measurements*
[6]ASC 820 *Fair Value Measurements*
[7]ASC 820 *Fair Value Measurements*
[8]ASC 820 *Fair Value Measurements*

Financial accounting

In some cases, a financial institution acquiring an REO asset may be required to account for the tangible and intangible components of the asset in accordance with accounting for business combinations.[9]

Tangible components of commercial real estate typically include:

- Land;
- Building;
- Site Improvements; and
- Tenant Improvements.

Intangible components of commercial real estate may include:

- Foregone Rent and Expenses;
- Unamortized Leasing Commissions;
- Unamortized Legal Expenses;
- Above Market Leases;
- Below Market Leases;
- Customer or Tenant Relationships;
- Management Contracts; and
- Other.

Regulatory considerations

Based on information provided in the Comptroller's Handbook (Section 219) published by the Comptroller of the Currency; Administrator of National Banks as well as information provided by the Office of Thrift Supervision ("OTS"), there are several regulatory issues to consider with REO properties. The following are some of the more relevant considerations.

In accordance with 12 CFR 560.172, a savings association must appraise each parcel of REO at acquisition. As such, upon transfer to REO, fair value must be substantiated by a current appraisal prepared by an independent, qualified appraiser. This requirement is waived when the entire property is recorded at or below the lower of 5% of the bank's equity capital or $25,000. Additionally, the requirement can be deferred three months after the bank takes title when the bank can document reasonable expectation of a sale other than in a covered transaction. Throughout the holding period, prudent management policy dictates the timing and frequency of appraisals.

An REO property can generally not be held by a financial institution for longer than a period of five years. In certain instances a bank may be permitted to hold the REO up to an additional five-year period beyond the original one if approved by the OTS.

An appraisal for an REO property should estimate the cash price that might be received upon exposure to the open market for a reasonable time, considering the property type and local market conditions. When a sale within 12 months is unlikely, the appraiser must discount all cash flows generated by the property to obtain the estimate of fair value.

[9]ASC 805 *Business Combinations* (formerly known as FAS 141R (revised 2007), *Business Combinations*)

Conclusion

The decision by lenders to take back real estate is not as simple as one might expect when a borrower is in default on their mortgage note. Often times, those decisions become difficult and complex given that many financial institutions have not recently been active in owning and operating real estate. If the lender decides to hold and operate REO assets, it should consider carefully developing a comprehensive strategy for acquisition, operation, and disposition of its REO inventory.

Prior to taking back a REO asset, financial institutions should consider fully evaluating the risks and rewards of owning real estate. When a lender takes possession of the loan collateral, the lender typically intends to maximize the value of the REO asset through efficient operations to reposition the asset, and/or realize additional incremental value through longer term appreciation. In these volatile market conditions, the decision to hold and operate an asset could be a winning strategy for the lender if future disposition of the property results in recovery of previously recognized losses on the loan or generates a gain greater than if it had held the original mortgage note. In other cases, the lender may decide that an immediate disposition strategy is best to extract immediate cash proceeds from the REO asset, rather than taking on additional risks as an owner of real estate. These critical decisions multiply when financial institutions take back portfolios of REO assets. Either strategy will likely result in significant accounting, valuation and financial reporting impacts on the financial statements of the lender.

As the U.S. economy climbs out of the global recession, a growing number of investors will likely take advantage of new investment opportunities in areas that serve as a bridge or substitution to the existing capital markets. A number of sources indicate that investors have seen a rise of new commercial real estate investment funds, initial public offerings, nonlisted blind pool registrations, asset recovery funds, and mortgage REITs, which could serve to augment the existing CMBS market and create an additional source of purchasers of mortgage-backed investments. These funds could also serve as the eventual buyers of REO assets from financial institutions when these lenders execute their REO disposition strategy.

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Accounting Standards Update

No. 2011-02
April 2011

Receivables (Topic 310)

A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring

An Amendment of the *FASB Accounting Standards Codification®*

Financial Accounting Standards Board
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Accounting Standards Update 2011-02

Receivables (Topic 310)

A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring

April 2011

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Summary

Why Is the FASB Issuing This Accounting Standards Update (Update)?

Given the recent economic downturn, the volume of debt restructured (modified) by creditors has increased. Several stakeholders raised concerns about whether additional guidance or clarification is needed to help creditors in determining whether a creditor has granted a concession and whether a debtor is experiencing financial difficulties for purposes of determining whether a restructuring constitutes a troubled debt restructuring. Diversity in practice could adversely affect the comparability of information for users about restructurings of receivables.

Who Is Affected by the Amendments in This Update?

The amendments in this Update apply to all creditors, both public and nonpublic, that restructure receivables that fall within the scope of Subtopic 310-40, Receivables—Troubled Debt Restructurings by Creditors.

What Are the Main Provisions?

In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude that both of the following exist:

1. The restructuring constitutes a concession.
2. The debtor is experiencing financial difficulties.

The amendments to Topic 310 clarify the guidance on a creditor's evaluation of whether it has granted a concession as follows:

1. If a debtor does not otherwise have access to funds at a market rate for debt with similar risk characteristics as the restructured debt, the restructuring would be considered to be at a below-market rate, which may indicate that the creditor has granted a concession. In that circumstance, a creditor should consider all aspects of the restructuring in determining whether it has granted a concession. If a creditor determines that it has granted a concession, the creditor must make a separate assessment about whether the debtor is experiencing financial difficulties to determine whether the restructuring constitutes a troubled debt restructuring.
2. A temporary or permanent increase in the contractual interest rate as a result of a restructuring does not preclude the restructuring from being

considered a concession because the new contractual interest rate on the restructured debt could still be below the market interest rate for new debt with similar risk characteristics. In such situations, a creditor should consider all aspects of the restructuring in determining whether it has granted a concession. If a creditor determines that it has granted a concession, the creditor must make a separate assessment about whether the debtor is experiencing financial difficulties to determine whether the restructuring constitutes a troubled debt restructuring.

3. A restructuring that results in a delay in payment that is insignificant is not a concession. However, an entity should consider various factors in assessing whether a restructuring resulting in a delay in payment is insignificant. The amendments include examples illustrating the assessment of whether a restructuring results in a delay in payment that is insignificant.

The amendments to Topic 310 clarify the guidance on a creditor's evaluation of whether a debtor is experiencing financial difficulties as follows:

1. A creditor may conclude that a debtor is experiencing financial difficulties, even though the debtor is not currently in payment default. A creditor should evaluate whether it is probable that the debtor would be in payment default on any of its debt in the foreseeable future without the modification.

In addition, the amendments to Topic 310 clarify that a creditor is precluded from using the effective interest rate test in the debtor's guidance on restructuring of payables (paragraph 470-60-55-10) when evaluating whether a restructuring constitutes a troubled debt restructuring.

How Do the Main Provisions Differ from Current U.S. Generally Accepted Accounting Principles (GAAP) and Why Are They an Improvement?

There is currently diversity in practice in identifying restructurings of receivables that constitute troubled debt restructurings for a creditor. The clarifying guidance in this Update should result in more consistent application of U.S. GAAP for debt restructurings.

When Will the Amendments Be Effective?

For Public Entities

The amendments in this Update are effective for the first interim or annual period beginning on or after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. As a result of applying these amendments, an entity may identify receivables that are newly considered impaired. For purposes of measuring impairment of those receivables, an entity should apply the amendments prospectively for the first interim or annual period beginning on or after June 15, 2011. An entity should disclose the total amount of receivables and the allowance for credit losses as of the end of the period of adoption related to those receivables that are newly considered impaired under Section 310-10-35 for which impairment was previously measured under Subtopic 450-20, Contingencies—Loss Contingencies.

An entity should disclose the information required by paragraphs 310-10-50-33 through 50-34, which was deferred by Accounting Standards Update No. 2011-01, *Receivables (Topic 310): Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20,* for interim and annual periods beginning on or after June 15, 2011.

For Nonpublic Entities

The amendments in this Update are effective for annual periods ending on or after December 15, 2012, including interim periods within those annual periods.

Early Adoption

Early adoption is permitted for public and nonpublic entities. A nonpublic entity may early adopt the amendments for any interim period of the fiscal year of adoption. A nonpublic entity that elects early adoption should apply the provisions of this Update retrospectively to restructurings occurring on or after the beginning of the fiscal year of adoption.

How Do the Provisions Compare with International Financial Reporting Standards (IFRS)?

IFRS does not have guidance on troubled debt restructurings. IFRS 7, *Financial Instruments: Disclosures,* requires the disclosure of the carrying amount of renegotiated debt, which is defined as debt whose terms were renegotiated that otherwise would be past due or impaired without that renegotiation.

Amendments to the *FASB Accounting Standards Codification®*

Introduction

1. The Accounting Standards Codification is amended as described in paragraphs 2–7. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is <u>underlined</u>, and deleted text is ~~struck-out~~.

Amendments to Subtopic 310-40

2. Add paragraph 310-40-15-8A and paragraphs 310-40-15-13 through 15-20 and their related headings, with a link to transition paragraph 310-40-65-1, as follows:

Receivables—Troubled Debt Restructurings by Creditors

Scope and Scope Exceptions

General

> > Troubled Debt Restructuring

310-40-15-5 A restructuring of a debt constitutes a troubled debt restructuring for purposes of this Subtopic 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.

310-40-15-6 That concession is granted by the creditor in an attempt to protect as much of its investment as possible. That concession either stems from an agreement between the creditor and the debtor or is imposed by law or a court; for example, either of the following circumstances might occur:

a. A creditor may restructure the terms of a debt to alleviate the burden of the debtor's near-term cash requirements, and many troubled debt restructurings involve modifying terms to reduce or defer cash payments required of the debtor in the near future to help the debtor attempt to improve its financial condition and eventually be able to pay the creditor.

b. The creditor may accept cash, other assets, or an equity interest in the debtor in satisfaction of the debt though the value received is less than the amount of the debt because the creditor concludes that step will maximize recovery of its investment. Although troubled debt that is fully satisfied by foreclosure, repossession, or other transfer of assets or by grant of equity securities by the debtor is, in a technical sense, not restructured, that kind of event is included in the term troubled debt restructuring in this Subtopic.

310-40-15-7 Whatever the form of concession granted by the creditor to the debtor in a troubled debt restructuring, the creditor's objective is to make the best of a difficult situation. That is, the creditor expects to obtain more cash or other value from the debtor, or to increase the probability of receipt, by granting the concession than by not granting it.

310-40-15-8 In general, a debtor that can obtain funds from sources other than the existing creditor at market interest rates at or near those for nontroubled debt is not involved in a troubled debt restructuring. A debtor in a troubled debt restructuring can obtain funds from sources other than the existing creditor in the troubled debt restructuring, if at all, only at effective interest rates (based on market prices) so high that it cannot afford to pay them.

310-40-15-8A In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor shall not apply the guidance in paragraph 470-60-55-10.

310-40-15-9 A troubled debt restructuring may include, but is not necessarily limited to, one or a combination of the following:

a. Transfer from the debtor to the creditor of receivables from third parties, real estate, or other assets to satisfy fully or partially a **debt** (including a transfer resulting from foreclosure or repossession)
b. Issuance or other granting of an equity interest to the creditor by the debtor to satisfy fully or partially a debt unless the equity interest is granted pursuant to existing terms for converting the debt into an equity interest
c. Modification of terms of a debt, such as one or a combination of any of the following:
    1. Reduction (absolute or contingent) of the stated interest rate for the remaining original life of the debt
    2. Extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk
    3. Reduction (absolute or contingent) of the face amount or maturity amount of the debt as stated in the instrument or other agreement
    4. Reduction (absolute or contingent) of accrued interest.

310-40-15-10 The guidance in this Subtopic shall be applied to all troubled debt restructurings including those consummated under reorganization, arrangement, or other provisions of the Federal Bankruptcy Act or other federal statutes related thereto.

310-40-15-11 For purposes of this Subtopic, none of the following are considered troubled debt restructurings:

a. Changes in lease agreements (for guidance, see Topic 840)
b. Changes in employment-related agreements, for example, pension plans and deferred compensation contracts
c. Unless they involve an agreement between debtor and creditor to restructure, either of the following:
    1. Debtors' failures to pay trade accounts according to their terms
    2. Creditors' delays in taking legal action to collect overdue amounts of interest and principal.
d. Modifications of loans within a pool accounted for in accordance with Subtopic 310-30 (see paragraph 310-30-15-6)
e. Changes in expected cash flows of a pool of loans accounted for in accordance with Subtopic 310-30 (see paragraph 310-30-15-6) resulting from the modification of one or more loans within the pool.

310-40-15-12 A debt restructuring is not necessarily a troubled debt restructuring for purposes of this Subtopic even if the debtor is experiencing some financial difficulties. For purposes of this Subtopic, none of the following debt restructurings, for example, are considered troubled debt restructurings:

a. The **fair value** of cash, other assets, or an equity interest accepted by a creditor from a debtor in full satisfaction of its receivable at least equals the creditor's **recorded investment in the receivable.**
b. The fair value of cash, other assets, or an equity interest transferred by a debtor to a creditor in full settlement of its payable at least equals the debtor's carrying amount of the payable.
c. The creditor reduces the **effective interest rate** on the debt primarily to reflect a decrease in market interest rates in general or a decrease in the risk so as to maintain a relationship with a debtor that can readily obtain funds from other sources at the current market interest rate.
d. The debtor issues in exchange for its debt new marketable debt having an effective interest rate based on its market price that is at or near the current market interest rates of debt with similar maturity dates and stated interest rates issued by nontroubled debtors.

<u>> > Determining Whether a Creditor Has Granted a Concession</u>

<u>**310-40-15-13** A creditor has granted a concession when, as a result of the restructuring, it does not expect to collect all amounts due, including interest accrued at the original contract rate. In that situation, and if the payment of principal at original maturity is primarily dependent on the value of collateral, an</u>

entity shall consider the current value of that collateral in determining whether the principal will be paid.

310-40-15-14 A creditor may restructure a debt in exchange for additional collateral or guarantees from the debtor. In that situation, a creditor has granted a concession when the nature and amount of that additional collateral or guarantees received as part of a restructuring do not serve as adequate compensation for other terms of the restructuring. When additional guarantees are received in a restructuring, an entity shall evaluate both a guarantor's ability and its willingness to pay the balance owed.

310-40-15-15 If a debtor does not otherwise have access to funds at a market rate for debt with similar risk characteristics as the restructured debt, the restructuring would be considered to be at a below-market rate, which may indicate that the creditor has granted a concession. In that situation, a creditor shall consider all aspects of the restructuring in determining whether it has granted a concession.

310-40-15-16 A temporary or permanent increase in the contractual interest rate as a result of a restructuring does not preclude the restructuring from being considered a concession because the new contractual interest rate on the restructured debt could still be below market interest rates for new debt with similar risk characteristics. In that situation, a creditor shall consider all aspects of the restructuring in determining whether it has granted a concession.

> > Evaluating Whether a Restructuring Results in a Delay in Payment That Is Insignificant

310-40-15-17 A restructuring that results in only a delay in payment that is insignificant is not a concession. The following factors, when considered together, may indicate that a restructuring results in a delay in payment that is insignificant:

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

310-40-15-18 If the debt has been previously restructured, an entity shall consider the cumulative effect of the past restructurings when determining whether a delay in payment resulting from the most recent restructuring is insignificant.

310-40-15-19 Examples 3, 4, and 5 in paragraphs 310-40-55-16 through 55-25 illustrate a creditor's evaluation about whether a delay in payment resulting from a restructuring is insignificant.

> > Determining Whether a Debtor Is Experiencing Financial Difficulties

310-40-15-20 In evaluating whether a receivable is a troubled debt restructuring, a creditor must determine whether the debtor is experiencing financial difficulties. In making this determination, a creditor shall consider the following indicators:

a. The debtor is currently in payment default on any of its debt. In addition, a creditor shall evaluate whether it is probable that the debtor would be in payment default on any of its debt in the foreseeable future without the modification. That is, a creditor may conclude that a debtor is experiencing financial difficulties, even though the debtor is not currently in payment default.
b. The debtor has declared or is in the process of declaring bankruptcy.
c. There is substantial doubt as to whether the debtor will continue to be a going concern.
d. The debtor has securities that have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange.
e. On the basis of estimates and projections that only encompass the debtor's current capabilities, the creditor forecasts that the debtor's entity-specific cash flows will be insufficient to service any of its debt (both interest and principal) in accordance with the contractual terms of the existing agreement for the foreseeable future.
f. Without the current modification, the debtor cannot obtain funds from sources other than the existing creditors at an effective interest rate equal to the current market interest rate for similar debt for a nontroubled debtor.

The above list of indicators is not intended to include all indicators of a debtor's financial difficulties.

3. Add paragraphs 310-40-55-16 through 55-25 and their related headings, with a link to transition paragraph 310-40-65-1, as follows:

Implementation Guidance and Illustrations

> > Example 3: Commercial Real Estate Debt with Balloon Payment

310-40-55-16 A restructuring that results in only a delay in payment that is insignificant is not a concession. This Example illustrates the guidance in paragraphs 310-40-15-17 through 15-18 for determining whether a delay in payment is insignificant. This Example assumes that the debtor is experiencing financial difficulties and is not intended to illustrate the determination of whether a debtor is experiencing financial difficulties.

310-40-55-17 A creditor originates a seven-year loan to a debtor. The debt:

a. Has a fixed interest rate
b. Is collateralized by commercial real estate
c. Requires monthly interest payments
d. Requires a balloon principal payment at maturity.

310-40-55-18 At origination, the debtor expects to repay the principal by refinancing the debt with the real estate held as collateral. That is, the collateral is the primary source of payment of the debt's principal balance, whether through a refinancing of the debt or a sale of the property. However, before maturity, the fair value of the collateral was less than the principal amount due at maturity, and as a result of market conditions, the debtor is unable to refinance the debt. The debtor plans to sell the property to repay the debt and requests an extension of the debt's maturity date to allow time to liquidate the property. In response to the debtor's financial difficulties, the creditor grants the debtor a three-month extension of the debt maturity date. At the time that this extension was granted, the debtor had not yet identified a buyer for the collateral.

310-40-55-19 The restructuring results in a delay in payment that is not insignificant. Although the delay in timing of payment is insignificant (relative to the frequency of payments due, the debt's original contractual maturity, and the debt's original expected duration), the creditor expects a significant shortfall in cash flows relative to the contractual amount due when the property is sold because the property is the sole source of repayment.

> > Example 4: Residential Mortgage Debt—Temporary Payment Deferral

310-40-55-20 A restructuring that results in only a delay in payment that is insignificant is not a concession. This Example illustrates the guidance in paragraphs 310-40-15-17 through 15-18 for determining whether a delay in payment is insignificant. This Example assumes that the debtor is experiencing financial difficulties and is not intended to illustrate the determination of whether a debtor is experiencing financial difficulties.

310-40-55-21 A debtor obtains a 30-year mortgage loan that requires monthly principal and interest payments. In year 4, the debtor experiences financial difficulties and misses two payments. On the basis of the debtor's financial hardship, the debtor and the creditor agree on a forbearance arrangement and repayment plan. Under the terms of the forbearance arrangement and repayment plan, the creditor agrees not to take any foreclosure action if the debtor increases its next four monthly payments such that each payment includes one fourth of the delinquent amount plus interest. The agreement does not result in the creditor charging the debtor interest on past due interest. At the end of the forbearance arrangement, the debtor will:

a. Have repaid all past due amounts
b. Be considered current in relation to the debt's original terms
c. Have resumed making monthly payments set out under the debt's original terms.

310-40-55-22 The restructuring results in a delay in payment that is insignificant. At the time of the forbearance arrangement, the creditor expects to collect all amounts due for the periods of delay. Furthermore, the length of delay resulting from the forbearance arrangement is considered insignificant in relation to the frequency of payments due, the debt's original contractual maturity, and the debt's original expected duration.

> > Example 5: Commercial Line of Credit—Short-Term Extension before the Finalization of Renegotiated Terms

310-40-55-23 A restructuring that results in only a delay in payment that is insignificant is not a concession. This Example illustrates the guidance in paragraphs 310-40-15-17 through 15-18 for determining whether a delay in payment is insignificant. This Example assumes that the debtor is experiencing financial difficulties and is not intended to illustrate the determination of whether a debtor is experiencing financial difficulties.

310-40-55-24 A commercial debtor has a revolving line of credit with a creditor with an original term of five years. The terms of the line of credit require interest payments every 90 days on the average daily balance of the line. As the line of credit nears maturity, the debtor and creditor begin renegotiating the terms of a new line of credit. Because of a temporary cash shortfall due to a delay in collections from two key customers, the debtor is unable to make the final interest payment before the two parties finish renegotiating the terms of the new line of credit. The terms of the renegotiated line of credit are expected to be similar to the current line of credit, which are comparable to terms available to debtors with similar risk characteristics. The creditor expects the debtor to recover quickly from this temporary cash flow shortage. Accordingly, the creditor extends a 3-month payment deferral by adding the missed interest payment to the balance of the line and requiring the debtor to make its first interest payment 90 days after the new line of credit is finalized, or 180 days after the due date of the missed interest payment.

310-40-55-25 The restructuring results in a delay in payment that is insignificant. Although the debtor is unable to make the contractual payment at the time it is due, thereby resulting in the three-month deferral, the creditor still expects to collect all amounts due, including interest at the contractual rate. Furthermore, the delay in timing of payment represents only one payment cycle under the terms of the line, which is insignificant relative to the frequency of payments due, the debt's original contractual maturity, and the debt's original expected duration.

4. Add paragraph 310-40-65-1 and its related heading as follows:

> Transition Related to Accounting Standards Update No. 2011-02, *Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*

310-40-65-1 The following represents the transition and effective date information related to Accounting Standards Update No. 2011-02, *Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*:

a. For public entities, the pending content that links to this paragraph shall be effective for the first interim or annual period beginning on or after June 15, 2011. The pending content that links to this paragraph shall be applied retrospectively to restructurings occurring on or after the beginning of the fiscal year of adoption. Early adoption is permitted.
b. As a result of the clarifications in guidance resulting from the pending content that links to this paragraph, an entity may identify receivables that are newly considered impaired under Section 310-10-35 for which impairment was previously measured under Subtopic 450-20. An entity shall disclose the total recorded investment in such receivables and the associated allowance for credit losses as of the end of the period of adoption. For purposes of measuring impairment of those receivables, an entity shall apply the pending content that links to this paragraph prospectively for the first interim or annual period beginning on or after June 15, 2011.
c. The following paragraph illustrates the disclosure required by (b) above:

> As a result of adopting the amendments in Accounting Standards Update No. 2011-02, Entity A reassessed all restructurings that occurred on or after the beginning of the current fiscal year (January 1, 2011) for identification as troubled debt restructurings. Entity A identified as troubled debt restructurings certain receivables for which the allowance for credit losses had previously been measured under a general allowance for credit losses methodology. Upon identifying those receivables as troubled debt restructurings, Entity A identified them as impaired under the guidance in Section 310-10-35. The amendments in Accounting Standards Update No. 2011-02 require prospective application of the impairment measurement guidance in Section 310-10-35 for those receivables newly identified as impaired. At the end of the first interim period of adoption (September 30, 2011), the recorded investment in receivables for which the allowance for credit losses was previously measured under a general allowance for credit losses methodology and are now impaired under Section 310-10-35 was $50.8 million, and the

allowance for credit losses associated with those receivables, on the basis of a current evaluation of loss, was $7.2 million.

d. For nonpublic entities, the pending content that links to this paragraph shall be effective for annual periods ending after December 15, 2012, including interim periods within those annual periods. Early adoption is permitted for any interim period of the fiscal year of adoption. For a nonpublic entity electing early adoption, the pending content that links to this paragraph applies to restructurings occurring on or after the beginning of the fiscal year of adoption.

5. Amend paragraph 310-40-00-1, by adding the following items to the table, as follows:

310-40-00-1 The following table identifies the changes made to this Subtopic.

Paragraph Number	Action	Accounting Standards Update	Date
310-40-15-8A	Added	2011-02	04/05/2011
310-40-15-13 through 15-20	Added	2011-02	04/05/2011
310-40-55-16 through 55-25	Added	2011-02	04/05/2011
310-40-65-1	Added	2011-02	04/05/2011

Amendments to Subtopic 310-10

6. Amend paragraphs 310-10-50-31 through 50-34 to change the effective date from *Indefinite* to *June 15, 2011*, and the link to transition paragraph 310-10-65-3 to transition paragraph 310-40-65-1.

7. Amend paragraph 310-10-00-1, by adding the following items to the table, as follows:

310-10-00-1 The following table identifies the changes made to this Subtopic.

Paragraph Number	Action	Accounting Standards Update	Date
310-10-50-31 through 50-34	Amended	2011-02	04/05/2011

The amendments in this Update were adopted by the affirmative vote of five members of the Financial Accounting Standards Board. Messrs. Buck and Schroeder abstained from voting.

Members of the Financial Accounting Standards Board:

Leslie F. Seidman, *Chairman*
Daryl E. Buck
Russell G. Golden
Thomas J. Linsmeier
R. Harold Schroeder
Marc A. Siegel
Lawrence W. Smith

Background Information and Basis for Conclusions

Introduction

BC1. The following summarizes the Board's considerations in reaching the conclusions in this Update. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background

BC2. Given the recent economic downturn, the volume of debt restructured (modified) by creditors has increased. For example, a creditor may agree to restructure a debt to defer principal payment or maturity, decrease the amount of payments due for a temporary or permanent period of time, or agree to delay collection in exchange for additional collateral or guarantees. Several stakeholders raised concerns about whether additional guidance or clarification is needed to help creditors in determining whether a creditor has granted a concession for purposes of determining whether a restructuring constitutes a troubled debt restructuring.

BC3. In response to these concerns, in July 2010, the Board added a project to its agenda to clarify the accounting for and disclosures about troubled debt restructurings by creditors. The Board determined that this project would focus on the identification as well as recognition and measurement aspects of troubled debt restructurings.

BC4. The Board issued an Exposure Draft of a proposed Update, *Receivables (Topic 310): Clarifications to Accounting for Troubled Debt Restructurings by Creditors,* on October 12, 2010. The Board received 133 comment letters on the Exposure Draft. Most respondents agreed that additional guidance was needed for the accounting for troubled debt restructurings by creditors. Several respondents stated that there is diversity in practice and inconsistency in applying the existing guidance. Others disagreed with some aspects of the proposals. The Board considered those comments during its redeliberations of the Exposure Draft at public meetings in January and February 2011.

Use of Debtor's Effective Interest Rate Test

BC5. Stakeholders told the Board that creditors were using the test in paragraph 470-60-55-10, which requires a comparison of the effective rate on the debt immediately before and immediately after a restructuring, to identify whether that restructuring constitutes a concession. That guidance is followed by debtors in evaluating whether a restructuring of a payable is a troubled debt restructuring. Because that guidance was intended to be used only by debtors, and because its use can result in inconsistent accounting among creditors, the Board decided to preclude creditors from using the test. Previously existing guidance in paragraphs 310-40-15-3 and 470-60-15-3 acknowledged that the identification of a restructuring as a troubled debt restructuring need not be symmetrical between the debtor and the creditor.

BC6. Respondents to the Exposure Draft agreed with this conclusion, noting that while the debtor's effective interest rate test may be helpful in determining whether a restructuring constitutes a troubled debt restructuring, its use is not appropriate as a source of evidence for creditors to conclude that a restructuring is not a troubled debt restructuring, because such an evaluation fails to consider all terms of the restructuring.

Consideration of the Terms of a Restructuring in Relation to Market Interest Rates

BC7. Stakeholders noted that it was often difficult to identify a market interest rate for debt with terms similar to those of the restructured debt. The Board noted that in a troubled debt restructuring, the creditor usually is not adequately compensated for the increased exposure to credit risk that results from the contractual changes or delays in payments arising from the restructuring. Also, the debtor usually could not afford what the market would charge at the time of a restructuring. To address those problems, the Exposure Draft proposed that a debtor's inability to access funds at a market rate for debt with similar risk characteristics as the restructured debt would be considered a troubled debt restructuring.

BC8. Respondents to the Exposure Draft said that the mere absence of a market rate for debt with similar risk should not automatically result in a troubled debt restructuring, because credit markets occasionally contract severely, which could affect an individual entity's access to funds at a market rate. Those respondents emphasized that, in those instances, a debtor should not be presumed to be experiencing financial difficulties. The Board agreed and decided to revise the proposed guidance in the Exposure Draft to specify that if a debtor does not otherwise have access to funds at a market rate for debt with similar risk characteristics as the restructured debt, the restructuring would be considered to be at a below-market rate, which may indicate that the creditor has granted a concession. Furthermore, the Board acknowledged that the evaluation of whether a concession has been granted is subjective and that all terms of a restructuring need to be considered and that the presence of this one indicator should not lead creditors to automatically presume that a concession has been granted.

BC9. Respondents to the Exposure Draft generally agreed that a temporary or permanent increase in the interest rate charged by a creditor should not preclude a restructuring from being identified as a troubled debt restructuring.

Indicators That a Debtor Is Experiencing Financial Difficulties

BC10. The Board also decided to clarify the guidance for determining whether a debtor is experiencing financial difficulties. The Board acknowledged that the indicators in paragraphs 470-60-55-8 through 55-9 for determining whether a debtor is experiencing financial difficulties also are, with minor revisions, applicable to a creditor's assessment of whether a restructuring is a troubled debt restructuring. Respondents to the Exposure Draft supported including these indicators in a creditor's evaluation of the debtor's financial difficulties.

BC11. The Board also noted that there may be cases where debt is restructured because the creditor's historical experience with similar debt indicates that payment default by the debtor is probable in the foreseeable future. These cases may be especially prevalent with residential mortgages that have monthly payments that increase significantly at some point during the term of the debt because of an interest-only payment period in the earlier years of the term or a feature that results in negative amortization of the principal balance. The Board decided to require creditors to consider the probability of payment default when determining whether a debtor is experiencing financial difficulties, and to clarify that a receivable for which payment default is probable in the foreseeable future is an indicator of financial difficulties. Respondents to the Exposure Draft agreed that in cases where payment default is probable, it is appropriate for a creditor to conclude that a debtor is experiencing financial difficulties.

Evaluating Whether a Restructuring Results in a Delay in Payment That Is Insignificant

BC12. The guidance for impairment of receivables in paragraph 310-10-35-17 states, "This guidance does not specify how a creditor should determine that it is probable that it will be unable to collect all amounts due according to the contractual terms of a loan. A creditor shall apply its normal loan review procedures in making that judgment. *An insignificant delay or insignificant shortfall in amount of payments does not require application of this guidance.* A loan is not impaired during a period of delay in payment if the creditor expects to collect all amounts due including interest accrued at the contractual interest rate for the period of delay. Thus, a demand loan or other loan with no stated maturity is not impaired if the creditor expects to collect all amounts due including interest accrued at the contractual interest rate during the period the loan is outstanding" (emphasis added).

BC13. The guidance in paragraph 310-10-35-17 about insignificant delays or shortfalls is meant to prevent a loan from being designated as impaired when the resulting impairment calculation would result in a nominal allowance for loan losses. In the Exposure Draft, the Board proposed precluding the application of this guidance in determining whether a restructured receivable should be designated as a troubled debt restructuring. Respondents to the Exposure Draft said that a restructuring that results in a delay in payment that is insignificant should not be considered a concession. Respondents were concerned that requiring delays in payment that are truly insignificant to be designated as troubled debt restructurings could have an unintended, adverse effect on financial reporting. Those respondents noted that reporting insignificant delays as troubled debt restructurings would significantly increase the volume of restructurings designated as troubled debt restructurings while decreasing an entity's allowance for loan losses. Users said that reporting such restructurings as troubled debt restructurings may lessen transparency and would not be cost-beneficial.

BC14. The Board agreed that delays in payment that are insignificant are not concessions but also noted that diversity in practice had developed for determining whether delays in payment are significant. The Board decided that more guidance was needed to help creditors determine whether a delay resulting from a restructuring is insignificant. Thus, the Board decided to include (a) factors that should be considered when determining whether a delay in payment resulting from a restructuring is insignificant and (b) illustrative examples.

Effective Date and Transition

BC15. For public entities, the Board decided that the amendments in this Update should be effective for interim and annual periods beginning on or after June 15, 2011. The Board decided that this effective date provides public entities with adequate time to adopt the clarifications to the definition of troubled debt restructurings.

BC16. The Board decided to require public entities to apply the amendments in this Update to restructurings occurring on or after the beginning of the annual period of adoption. The Board noted that applying the guidance that affects the identification of troubled debt restructurings requires less subjectivity than an impairment measurement. The Board decided that applying the guidance retrospectively is necessary to provide comparable and consistent information about troubled debt restructurings, at least within the fiscal year of adoption.

However, because retrospective application could be cumbersome and because a significant portion of the increase in the volume of restructurings has occurred only in recent periods, the Board limited the retrospective application to those restructurings that occurred on or after the beginning of the annual period of adoption.

BC17. The Board decided on prospective application for the guidance that changes the way that impairment is measured for receivables that are determined to be troubled debt restructurings as a result of applying the guidance in this Update. The Board noted that the information required to apply the guidance retrospectively for purposes of calculating impairment would be very difficult to obtain and would involve the use of hindsight.

BC18. For nonpublic entities, the Board decided that the amendments in this Update should be effective for annual periods ending on or after December 15, 2012, including interim periods within those annual periods. The Board concluded that a later effective date is warranted for nonpublic entities to allow them additional time to adopt the clarifications to the definition of troubled debt restructurings.

BC19. The Board did not amend the effective date of the new credit quality disclosures, except for those about troubled debt restructurings in public entities, discussed in Accounting Standards Update No. 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses.*

Benefits and Costs

BC20. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Present and potential investors, creditors, donors, and other users of financial information benefit from improvements in financial reporting, while the costs to implement new guidance are borne primarily by present investors. The Board's assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC21. While the Board acknowledges that some entities may incur significant costs as a result of the amendments in this Update, the Board believes that the amendments will provide the benefit of improving consistent application of U.S. GAAP by clarifying guidance that already exists within U.S. GAAP. Specifically, the Board requires public entities to apply the provisions of this Update retrospectively to restructurings occurring on or after the beginning of the annual period of adoption. Because retrospective application is required, public entities would disclose activity about troubled debt restructurings using a definition of troubled debt restructurings that is consistent throughout the annual period of adoption.

BC22. The Board acknowledged that retrospective calculation of impairment by public companies would be unduly burdensome and elected to require prospective application for purposes of measuring impairment. For nonpublic entities, the Board elected to require prospective application of all the provisions of this Update to reduce the cost of implementation.

August 12, 2011

FASB In Focus

FASB Simplifies Guidance for Testing Goodwill for Impairment

The FASB has approved changes that will simplify the rules for testing goodwill for impairment. Goodwill impairment occurs when the implied fair value of goodwill in a company's reporting unit declines to an amount that is less than its carrying amount.

Why Has the FASB Made These Changes?

In October and November of 2010, the FASB held roundtables to discuss the concerns of private company constituents. During those roundtables and in other sessions, preparers of private company financial statements expressed concerns to the FASB about the recurring cost and complexity of performing the first step of the two-step goodwill impairment test required under Topic 350, Intangibles—Goodwill and Other.

Current guidance requires an entity to test goodwill for impairment, at least annually, using a two-step process. In step one of the test, an entity is required to calculate the fair value of a reporting unit and compare the fair value with the carrying amount of the reporting unit, including goodwill. If the fair value of a reporting unit is less than its carrying amount, then the second step of the test must be performed to measure the amount of the impairment loss, if any.

A number of preparers from private companies recommended that the FASB consider allowing an entity to use a qualitative approach for testing goodwill for impairment to help reduce the cost and complexity associated with performing the current quantitative approach.

What Will These Changes Do?

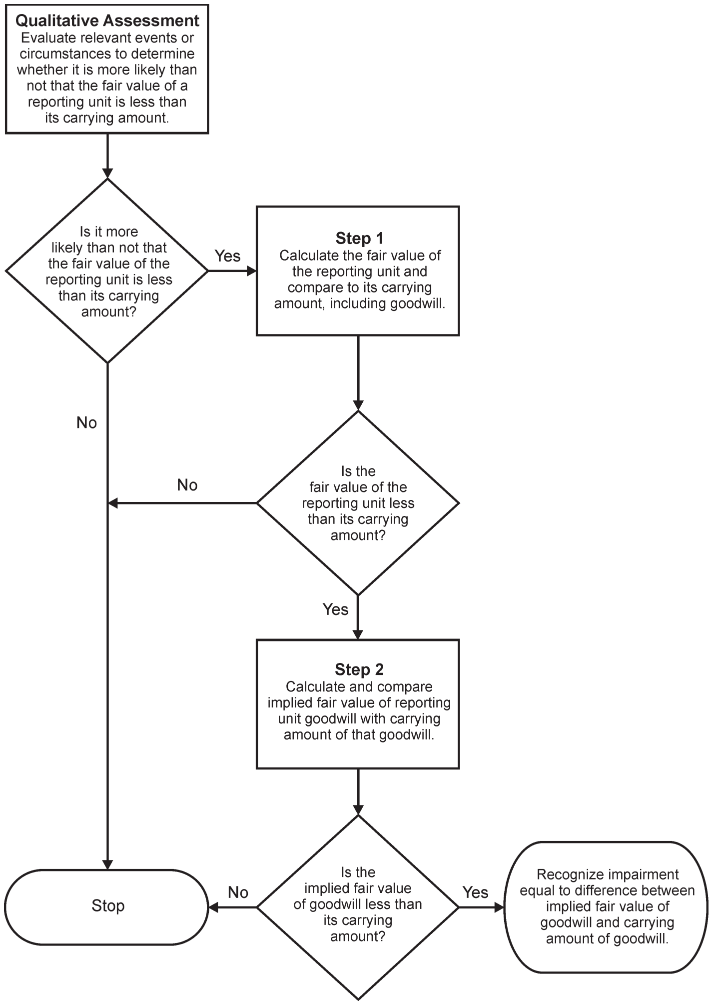
The amendments approved by the Board will reduce complexity and costs by allowing an entity (public or nonpublic) to make a qualitative evaluation about the likelihood of goodwill impairment to determine whether it should calculate the fair value of a reporting unit. Specifically, an entity will have the option of first assessing qualitative factors (events and circumstances) to determine whether it is more likely than not (meaning a likelihood of more than 50 percent) that the fair value of a reporting unit is less than its carrying amount.

If, after considering all relevant events and circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test will be unnecessary. If the entity concludes that the opposite is true, then it will be required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit as explained in current guidance. If the carrying amount of a reporting unit exceeds its fair value, then the entity will be required to perform the second step of the goodwill impairment test to measure the amount of the impairment loss, if any. Under the new guidance, an entity may choose to bypass the qualitative assessment for any reporting unit in any period and proceed directly to performing the first step of the two-step test.

The guidance also will expand upon the examples of events and circumstances that an entity should consider between annual impairment tests in determining whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. Similarly, it will improve the examples of events and circumstances that an entity having a reporting unit with a zero or negative carrying amount will consider in determining whether to measure an impairment loss, if any, under the second step of the goodwill impairment test.

The following chart illustrates the optional qualitative assessment and the two-step goodwill impairment test. Note that an entity having a reporting unit with a zero or negative carrying amount would not perform Step 1 of the test.

For more information about the project, please visit the FASB's website at www.fasb.org.



The amendments will not change how an entity measures a goodwill impairment loss. Therefore, it is not expected to affect the information reported to users of financial statements.

Next Steps

The FASB expects that the final Accounting Standards Update will be published in September 2011.

When Will the Amendments Be Effective?

The amendments will be effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption will be permitted.

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Links to Pronouncements and Policy Statements

FASB Meeting Minutes: Accounting for Financial Instruments
http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176156422130

OCC Bank Accounting Advisory Series Topic 4 - October 2010: ALLL
http://www.occ.gov/static/publications/BAAS.pdf

Financial Institution Letters: ALLL in the Current Economic Environment: Loans Secured by Junior Liens on 1-4 Family Residential Properties
http://www.fdic.gov/news/news/financial/2009/fil09043a.html

SEC: Sample Letter Sent to Public Companies on MD&A Disclosure Regarding Provisions and Allowance for Loan Losses
http://www.sec.gov/divisions/corpfin/guidance/loanlossesltr0809.htm

SEC: Sample Letter Sent to Public Companies on Accounting and Disclosure Issues Related to Potential Risks and Costs Associated with Mortgages and Foreclosure-Related Activities or Exposures
http://www.sec.gov/divisions/corpfin/guidance/cfoforeclosure1010.htm

Federal Reserve System Commercial Bank Examination Manual - Other Real Estate Owned
http://www.federalreserve.gov/boarddocs/supmanual/cbem/2000.pdf

OCC Bank Accounting Advisory Series Topic 5 - October 2010: Other Assets
http://www.occ.gov/static/publications/BAAS.pdf

OCC 2011-10: Exchanging Other Real Estate Owned for Other Assets
http://www.occ.treas.gov/news-issuances/bulletins/2011/bulletin-2011-10.html

Real Estate Appraisal Requirements for Other Real Estate Owned (SR 95-16)
http://fedweb.frb.gov/fedweb/bsr/srltrs/SR9516.HTM

FDIC Financial Institution Letter 62-2008: Guidance on Other Real Estate
http://www.fdic.gov/news/news/financial/2008/fil08062a.html

Deloitte: Converting Commercial Mortgages to REO - Valuation and Accounting Considerations
http://www.deloitte.com/assets/Dcom-UnitedStates/Local Assets/Documents/FSI/us_fsi_RE_Convertingcommercialmortgages_Feb10.pdf

ASU 2011-2 Topic 310
Receivables : A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring
http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175822278141&blobheader=application%2Fpdf

FASB Simplifies Guidance for Testing Goodwill for Impairment
http://www.fasb.org/cs/ContentServer?site=FASB&c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176158831995