Department of the Treasury
Office of Thrift Supervision

# RESCINDED

Transmittal

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The Federal Financial Institutions Examination Council (FFIEC) has issued a notice that requests public comment on certain implementation issues arising from a new accounting standard on loan impairment. The new accounting standard, Statement of Financial Accounting Standards (FAS) No. 114, "Accounting by Creditors for Impairment of a Loan," was issued in May 1993, and is effective for fiscal years that begin after December 15, 1994. The major issues the FFIEC is requesting comment on are: (1) whether the allowance for credit losses created under FAS 114 is a general allowance (that is includable in supplementary capital) or whether it is a specific allowance (that is not includable in capital) and (2) whether the agencies should retain nonaccrual policies in light of FAS 114. Attached is a copy of the FFIEC notice.

The notice was published in the May 17, 1994 edition of the *Federal Register*, Vol. 59, No. 94, pp. 25656-25659. Written comments must be received on or before July 1, 1994, and should be addressed to: Joe M. Cleaver, Executive Secretary, Federal Financial Institutions Examination Council, 2100 Pennsylvania Avenue, NW, Suite 200, Washington, DC 20037.

Jonathan L. Fiechter
Acting Director
Office of Thrift Supervision

Attachment

## FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

### Implementation Issues Arising From FASB Statement No. 114, "Accounting by Creditors for Impairment of a Loan"

**AGENCY:** Federal Financial Institutions Examination Council.

**ACTION:** Request for comment.

**SUMMARY:** The Federal Financial Institutions Examination Council (FFIEC)[1] is seeking public comment on certain issues arising from the adoption by the Financial Accounting Standards Board of Statement No. 114 (FAS 114), "Accounting by creditors for Impairment of a Loan." These issues include the character of the FAS 114 allowance (i.e., whether it should be a general allowance that is includible in Tier 2 capital, or a specific allowance that is not includible in Tier 2 capital) and whether regulatory nonaccrual rules should be maintained for purposes of reporting on the Consolidated Reports of Condition and Income (Call Report) filed by banks and the Thrift Financial Report (TFR) filed by savings associations. After reviewing the public comments and making final decisions on these issues, appropriate changes will be made to the instructions for the Call Report and TFR and other regulatory guidance to incorporate changes arising from the adoption of FAS 114.

**DATES:** Comments must be received by July 1, 1994.

**ADDRESSES:** Comments should be directed to Joe M. Cleaver, Executive Secretary, Federal Financial Institutions Examination Council, 2100 Pennsylvania, Avenue, NW, suite 200, Washington DC 20037. (Fax number

[1] The FFIEC consists of representatives from the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS) (referred to as the "agencies"), and the National Credit Union Administration. However, this request for comment is not directed to credit unions. Section 1006(c) of the Federal Financial Institutions Examination Council Act requires the FFIEC to develop uniform reporting standards for federally-supervised financial institutions.

202–634–6556.) Comments will be available for public inspection during regular business hours at the above address. Appointments to inspect the comments are encouraged (202) 634–6526.

**FOR FURTHER INFORMATION CONTACT:**
At the FRB: Gerald A. Edwards, Jr., Assistant Director (202) 452–2741 or Charles H. Holm, Project Manager (202) 452–3502. For questions pertaining to regulatory capital issues, Rhoger H. Pugh, Assistant Director (202) 728–5883, or Kevin M. Bertsch, Senior Financial Analyst (202) 452–5265.

At the FDIC: Robert F. Storch, Chief, Accounting Section, Division of Supervision (202) 898–8906, or Doris L. Marsh, Examination Specialist, Accounting Section, Division of Supervision (202) 898–8905.

At the OCC: Eugene W. Green, Deputy Chief Accountant, (202) 874–4933, or Frank Carbone, National Bank Examiner (202) 874–5170.

At the OTS: Robert Fishman, Acting Deputy Assistant Director for Supervision Policy (202) 906–5672, or Timothy Stier, Deputy Chief Accountant (202) 906–5699.

**SUPPLEMENTARY INFORMATION:**

## I. Summary of FAS 114

FAS 114 was adopted in May, 1993 by the Financial Accounting Standards Board (FASB) and is effective for fiscal years beginning after December 15, 1994. The statement applies to all creditors and to all loans that are identified for evaluation of collectibility, except: (1) large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment (such as credit card, residential mortgage, and consumer installment loans); (2) loans that are measured at fair value or at the lower of cost or fair value (such as loans held for sale); (3) leases; and (4) debt securities.

Under this standard, a loan is impaired when it is probable that a creditor will be unable to collect all amounts due (including interest and principal) according to the contractual terms of a loan agreement. When a loan is impaired, a creditor must measure the extent of that impairment by determining the present value of expected future cash flows discounted at the loan's effective interest rate, or as practical expedients, either the loan's observable market price or the fair value of the collateral of a loan if it is collateral dependent. Although a creditor is generally allowed to use any of these three measurement methods to determine the amount of impairment, a creditor must measure impairment based on the fair value of collateral when the creditor determines that foreclosure is probable. If the value of the impaired loan (using the methods described in FAS 114) is less than the recorded balance of the loan, a creditor must recognize the impairment by creating a valuation allowance (referred to in the standard as an "allowance for credit losses") for the difference and recognizing a corresponding bad debt expense.

The FASB has recently proposed to amend FAS 114 to eliminate certain income recognition requirements specified in the standard to permit institutions flexibility in deciding how income on impaired loans should be reported. In addition, certain disclosures regarding income recognition on impaired loans would be required under the proposed amendment to FAS 114.

## II. Regulatory Reporting Guidance Related to FAS 114

The FFIEC and the agencies are requiring institutions to adopt FAS 114 as of its effective date for purposes of reporting on the Call Report and TFR. Furthermore, the agencies will permit early adoption. Additional regulatory guidance regarding impaired, collateral dependent loans and the adequacy of the allowance for loan and lease losses (ALLL) is provided below, which the agencies plan to incorporate into regulatory reporting and examination guidance, as appropriate.

The FFIEC and the agencies intend to adhere to the FAS 114 measurement standards discussed above for regulatory reporting purposes in most cases. However, consistent with the "Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans," issued on November 7, 1991, the FFIEC and the agencies will expect institutions to measure impaired, collateral-dependent loans for purposes of regulatory reports at the fair value of the collateral.[2]

FAS 114 does not address the overall adequacy of the ALLL. However, in addition to requiring an allowance for credit losses for impaired loans, FAS 114 requires each institution to continue to maintain an allowance that complies with Statement of Financial Accounting Standards No. 5 (FAS 5), "Accounting for Contingencies." Thus, consistent with existing regulatory policy, the ALLL should be adequate to cover all estimated credit losses arising from the loan and lease portfolio, including losses on loans that do not meet FAS 114's impairment criterion.

The agencies do not plan to automatically require additional allowances for credit losses for impaired loans over and above what is required on these loans under FAS 114. However, an additional allowance on impaired loans may be necessary based on consideration of institution-specific factors, such as historical loss experience compared with estimates of such losses, concerns about the reliability of cash flow estimates, or the quality of an institution's loan review function and controls over its process for estimating its FAS 114 allowance.

## III. Issues for Comment

The adoption of FAS 114 may require changes in certain existing regulatory reporting and capital requirements and in other supervisory policies. The FFIEC is seeking comment on the specific reporting issues described below.

### *1. The Character of the FAS 114 Allowance*

Should that portion of an institution's allowance established pursuant to FAS 114 be reported and considered as a specific allowance and, thus, not be eligible for inclusion in Tier 2 capital under the agencies' current capital rules? Alternatively, should the FAS 114 allowance be regarded as a general allowance which would be eligible for inclusion in Tier 2 capital subject to existing limits?

The agencies' risk-based capital rules are based upon, and consistent with, the Basle Accord.[3] Under this international framework and the agencies' rules, "general allowances" for loan and lease losses that have been created against unidentified losses and that are not ascribed to particular assets or groups of assets may be included in Tier 2 capital subject to certain limitations.[4] The Accord also states that "where, however, provisions or reserves have been created against identified losses or in respect of an identified deterioration in value of any asset or group or subsets of assets, they are not freely available to meet unidentified losses which may subsequently arise elsewhere in the portfolio and do not possess an essential characteristic of capital. Such provisions or reserves should not,

[2] This supervisory treatment would be applied to all collateral-dependent loans, regardless of the type of collateral.

[3] The Basle Accord is a risk-based capital framework that was proposed by the Basle Committee on Banking Supervision (Basle Supervisors Committee) and endorsed by the Central Bank Governors of the Group of Ten (G–10) countries in July, 1988.

[4] Under the agencies' capital rules, general allowances includible in Tier 2 are limited to 1.25 percent of risk weighted assets and an institution's Tier 2 capital cannot exceed its Tier 1 capital.

therefore, be included in the capital base." Thus, if the allowances established for a certain asset or group of assets in accordance with FAS 114 are determined to be "created against identified losses or in respect of an identified deterioration in value of any asset or group or subsets of assets," then they would be reportable as "specific allowances" for purposes of the Call Report and TFR and would not be eligible for inclusion in Tier 2 capital under the Basle Accord or the current capital rules of the agencies.

Currently, the entire balance of the ALLL for banks and the general valuation allowances for loans and leases (GVAs) for savings associations are reported as general allowances and are includable in Tier 2 capital, subject only to the limitations referenced above. A rationale for this position on the ALLL has been that regulatory charge-off policies require banks to promptly write off identified deteriorations in the value of loans and thereby "cleanse" these allowances. In the case of savings associations, specific valuation allowances are reported separately from GVAs. Although the Securities and Exchange Commission's (SEC) Industry Guide 3 requires the allocation of the ALLL and GVAs to specific groups of loans in Form 10-K annual reports in part to assist analysts in assessing the overall adequacy of allowances, the agencies have determined that such allocations are solely for disclosure purposes and are not "created against identified losses." In addition, the agencies have determined that these disclosure requirements do not affect the availability of these allowances to meet identified losses arising elsewhere in an institution's portfolio.

The adoption of FAS 114 does not affect the necessity for banks to cleanse their allowances through the prompt recognition of identified losses. Furthermore, FAS 114 could be viewed as simply setting forth an estimation technique similar to that prescribed by SEC Industry Guide 3. Thus, while the FAS 114 allowance would be separately disclosed, it need not be viewed as "created against identified losses or in respect of an identified deterioration in value of any asset or group or subsets of assets." Accordingly, allowances established pursuant to FAS 114 could be viewed as general allowances.

On the other hand, FAS 114 requires that valuation allowances be established for the amount by which the value of impaired loans as determined by the analytical methods described in the standard (i.e., present or fair value) is less than the recorded balance of these loans. This analysis may be viewed as more loan specific than previous analytical methods used to estimate the ALLL and GVAs. Thus, FAS 114 could be viewed as requiring the establishment of specific allowances to account for impairment in particular assets or groups of assets.

In order to be considered general allowances under the Basle Accord, allowances must be freely available to absorb losses arising anywhere in a loan portfolio. A determination of whether FAS 114 allowances are freely available to absorb losses should take into account the requirement that, under the standard, the depletion of such allowances through the charge-off of loans other than those for which they were established requires the replenishment of these allowances. On the other hand, this determination should also recognize that the portion of an institution's allowance attributable to FAS 114 is not precluded from being available to meet identified losses on any asset in its portfolio.

While a decision on the character of the FAS 114 allowance has relatively limited reporting implications, it has more important implications for determining institutions' regulatory capital ratios. If FAS 114 allowances are viewed as specific in nature and, thus, inconsistent with the Basle Accord and the agencies' capital rules, the FAS 114 allowance would be deducted from assets and none of it could be included in regulatory capital.[5] Certain institutions may have lower regulatory capital ratios if the FAS 114 allowance is considered a specific allowance rather than a general allowance.

*2. Maintenance of Nonaccrual Reporting Requirements*

Should regulatory nonaccrual standards be maintained for loans subject to FAS 114?

Under the longstanding reporting standards of the banking agencies (OCC, FRB, and FDIC), banks are required to discontinue the accrual of income on a loan when:

(a) The institution places the loan on a cash basis because of deterioration in the financial condition of the borrower.

(b) The collection in full of contractual principle *or* interest is not expected, or

(c) Principal or interest has been in default for 90 days or more unless the loan is both well secured and in the process of collection.

This third nonaccrual criterion does not apply to 1-to-4 family residential mortgages or consumer loans of banks. However, these organizations are expected to establish appropriate policies for these types of loans in order to prevent the overstatement of income. These nonaccrual requirements prevent the accrual of income in advance of payment on seriously delinquent loans. Savings associations follow similar nonaccrual practices.[6]

FAS 114 was viewed by many as superseding current regulatory nonaccrual standards since it established a method to recognize income based on an impaired loan's present value. However, FASB has recently issued, for public comment, a proposal to eliminate the detailed guidance in the statement on the recognition of income on impaired loans. This proposal allows a creditor to use existing methods for recognizing interest income on impaired loans. Thus, if this proposed change is adopted, an institution's continued use of the regulatory nonaccrual requirements for income recognition purposes would not be inconsistent with FAS 114.

If FASB's proposed changes are adopted and the agencies retain their nonaccrual rules for impaired loans, interest income recognized from such loans would generally be limited to the amount of cash interest received. However, to the extent that this limitation reduces the amount of interest income that institutions would be able to recognize on impaired loans, institutions would generally have a corresponding reduction in the provision for credit losses necessary to bring the values of impaired loans to their present values as defined by FAS 114. Thus, the agencies do not believe that the retention of the regulatory nonaccrual standards would in many cases materially affect the total amount of income reported by institutions.[7]

The agencies have identified several reasons for maintaining their existing nonaccrual requirements. First, retention of the nonaccrual rules for impaired loans will maintain a framework so that institutions report

[5] Consistent with FAS 114 disclosure requirements, the agencies plan to require supplemental reporting of the amount of FAS 114 allowances in regulatory reports.

[6] Under existing generally accepted accounting principles (GAAP) and regulatory reporting instructions, and institution should consider the amount of any accrued but uncollected interest included in its reported assets when estimating its ALLL or GVA.

[7] On the other hand, in other cases, the total amount of income reported under a FAS 114 approach without nonaccrual requirements could materially differ from the total that would be reported if the agencies' nonaccrual requirements apply in conjunction with FAS 114. For example, such a difference could arise when loans are 90 days or more past due but are not deemed to be impaired by the institution.

*interest* income on a consistent basis. GAAP generally has been silent on whether the accrual of interest is appropriate on impaired loans. As a result, the agencies' regulatory rules have been adopted by institutions for purposes of both their regulatory reports and financial statements and thus became GAAP in practice. Second, nonaccrual policies would prohibit *interest* income from being recognized on impaired loans for uncollected contractual interest. Third, not all seriously delinquent loans would be subject to FAS 114 and the agencies would need to maintain some standard to ensure that interest income is not overstated on these loans.[8] Fourth, since nonaccrual requirements are consistent with the current reporting structure, institutions would not have to significantly change their reporting systems and statistical consistency would be maintained for all uses of these data by regulators, bankers, analysts, and others. Fifth, FASB staff may undertake a project to determine the proper recognition of income on impaired loans. Since such a project could change the income recognition rules under GAAP within a few years, retaining current nonaccrual standards could eliminate the possibility that institutions might have to significantly change their internal systems twice in a short period of time and could thus potentially reduce reporting burden. Finally, if the current reporting requirements for nonaccrual of interest income are retained, the agencies may not have to make significant changes to existing reporting and disclosure requirements for past due and impaired loans.

On the other hand, while retaining regulatory nonaccrual requirements would not be inconsistent with GAAP, it could be viewed as adding another element to accounting for impaired loans, and, thus, could increase the complexity of implementing FAS 114. Furthermore, as noted above, if the regulatory nonaccrual rules for impaired loans are eliminated, the total amount of income reported under FAS 114 for many impaired loans may be the same as if the regulatory nonacrual rules are maintained.

[8] If the agencies retain their nonaccrual requirements for loans subject to FAS 114, it would be less likely that total income from certain past due loans could be overstated by the recognition of uncollected contractual interest solely based on an expectation of collection (as permitted under FAS 114).

*3. Other Issues*

In addition to the issues discussed above, the agencies seek written comments on the following issues.

1. Comment is sought on (a) how much the adoption of FAS 114 is expected to change overall allowance levels, and (b) what portion of total overall allowances are expected to be related to impaired loans evaluated pursuant to FAS 114.

2. Comment is sought on implementation issues arising from FAS 114 to the extent they relate to U.S. branches and agencies of foreign banks. These entities are required to file quarterly the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (002 Report), which in many respects is similar to the bank Call Report. The 002 Report requires U.S. branches and agencies of foreign banks to report the amount of nonaccrual loans (see issue 2 "Maintenance of Nonaccrual Reporting Requirements").

3. Comment is sought on how FAS 114 might affect an institution's internal loan review process and its internal loan classification system for loans subject to FAS 114. In this regard, the FFIEC notes that according to the December 21, 1993, Interagency Policy Statement on the Allowance for Loan and Lease Losses, each institution should ensure that it has a formal credit grading system that can be reconciled with the classification framework used by the agencies.

Dated: May 12, 1994.

Signed:

**Keith J. Todd,**

*Assistant Executive Secretary, Federal Financial Institutions Examination Council.*

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