Office of the Comptroller of the Currency

# Bank Accounting Advisory Series

August 2024

# Message From the Office of the Chief Accountant

The Office of the Chief Accountant (OCA) is pleased to present the August 2024 edition of the *Bank Accounting Advisory Series* (BAAS). The BAAS expresses the OCA's interpretations of accounting topics relevant to national banks and federal savings associations (collectively, banks or institutions, unless otherwise specified). It does not represent rules or regulations of the Office of the Comptroller of the Currency (OCC). The BAAS is updated annually to address accounting questions, newly issued and updated accounting standards, and emerging issues observed through March 31, 2024.

This edition of the BAAS does not include new questions or substantive updates to existing questions. As part of the OCA's annual review process, we have incorporated edits to improve general clarity, including revision, relocation, and renumbering of certain existing entries. These edits do not alter the OCA's prior conclusions or interpretations. The content in the following topics and subtopics has been superseded:

- Subtopic 1B, Other-Than-Temporary Impairment
- Subtopic 2A, Troubled Debt Restructurings
- Subtopic 2G, Acquired Loans
- Topic 4, Allowance for Loan and Lease Losses

The goal of the BAAS is to provide timely, relevant, and clear accounting interpretations of generally accepted accounting principles (GAAP) for bankers and examiners, even when the issues are complex and controversial. We hope that you find this publication useful and that it continues to be a practical resource for bankers and examiners. If you have comments or questions related to the BAAS, please contact us at BAAS@occ.treas.gov.

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Office of the Comptroller of the Currency

# Contents

# Topic 1 Investment Securities

## 1A. Investments in Debt and Equity Securities

### Question 1

How should a bank account for changes in foreign currency exchange rates for debt securities denominated in a foreign currency?

### Staff Response

Foreign currency-denominated AFS debt securities are recorded at fair value. Any change in fair value, excluding the amount recorded in the ACL, is recorded as an unrealized holding gain or loss in other comprehensive income. The net unrealized holding gains and losses on these AFS debt securities, including the portions related to changes in foreign currency exchange rates, should generally be excluded from earnings until the security is sold.

If the foreign currency-denominated debt securities are categorized as HTM, the gain or loss attributable to changes in foreign currency exchange rates is recorded in earnings. Banks should follow the accounting guidance provided in ASC 830 for such investments.

### Question 2

What is the appropriate accounting for transfers of debt securities between investment categories?

### Staff Response

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

- **HTM to AFS:** On the transfer date, reverse any remaining previously recorded ACL into earnings and transfer the HTM debt security to AFS at its amortized cost basis. The security should then be analyzed to determine if an ACL is necessary under ASC 326-30. The unrealized holding gain or loss at the date of the transfer, excluding the amount recorded in the ACL, is recognized in AOCI, net of applicable taxes.
- **AFS to HTM:** On the transfer date, reverse any remaining previously recorded ACL into earnings and transfer the AFS debt security to HTM at its amortized cost basis. The amortized cost basis will include the amount of any remaining unrealized holding gain or loss existing at the time of transfer, resulting in a premium or discount. The unrealized holding gain or loss at the date of transfer will continue to be reported in AOCI and amortized over the remaining life of the security as a yield adjustment. Further, the premium or discount in the security's amortized cost is also amortized over the remaining life of the security as a yield adjustment. Amortization of the amount in AOCI offsets the amortization of the related

premium or discount in earnings. The HTM security should then be analyzed to determine if an ACL is necessary under ASC 326-20.

- **All transfers to the trading category:** The debt security is accounted for at fair value on the transfer date. The unrealized holding gain or loss at the date of transfer, net of applicable taxes, shall be recognized in earnings immediately.
- **All transfers from the trading category:** The debt security is accounted for at fair value on the transfer date. The unrealized holding gain or loss at the date of transfer will have already been recognized in earnings and shall not be reversed.

Transfers from HTM to AFS should be rare and could result in tainting of the portfolio. Due to the nature of trading securities, transfers in and out of the trading category should also be rare.

## Question 3

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

## Staff Response

Generally, there are few restrictions on how bank management chooses to allocate the securities in its portfolio among the investment categories. ASC 320 requires that a security, such as an IO strip, not be accounted for as HTM, if it can be contractually prepaid or otherwise settled, so that its holder would not recover substantially all of its cost basis.

Additionally, an institution may not classify a convertible debt security as HTM. Convertible debt bears a lower interest rate than an equivalent security without such a feature because it provides the owner with potential benefits from stock price appreciation. Use of this feature, however, requires the owner to dispose of the debt security before maturity. Accordingly, the acquisition of such a security implies that the owner does not intend to hold it to maturity.

No restrictions prevent a bank from pledging HTM securities as collateral for a loan. A bank may also pledge HTM securities in a repurchase agreement if the agreement is not effectively a sale in accordance with ASC 860.

## Question 4

How should banks account for investments in mutual funds?

## Staff Response

Mutual funds are generally accounted for as an equity investment in accordance with ASC 321, even if the mutual fund's underlying investments are debt securities. Mutual funds are generally measured at fair value with changes in fair value recognized through earnings.

## Question 5

How should gains and losses be reported when mutual fund investments are sold?

## Staff Response

In accordance with ASC 321, all changes in a mutual fund's fair value should be reported in earnings at each reporting date. The sale of a mutual fund generally does not give rise to a gain or loss except to the extent a bank has not yet recorded the mutual fund's change in fair value at the time of sale.

## Question 6

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

## Staff Response

ASC 320 establishes the following "safe harbors" under which HTM securities may be sold without tainting the entire portfolio:

- Evidence of a significant deterioration in the issuer's creditworthiness.
- A change in the tax law that eliminates or reduces the tax-exempt status of interest on the debt security (but not a change in tax rates).
- A major business combination or disposition that necessitates the sale of the securities to maintain the bank's existing interest rate risk position or credit risk policy.
- A change in statutory or regulatory requirements that significantly modifies either the definition or level of permissible investments that may be held.
- A significant increase in industry-wide regulatory capital requirements that causes the bank to downsize.
- A significant increase in the risk weights of debt securities for risk-based capital purposes.

There is also a limited exclusion for certain unusual events (see question 13).

Additionally, sales of HTM securities that meet either of the following conditions may be considered as maturities and would not taint the remaining HTM portfolio:

- The sale of a security occurs near enough to its maturity (for example, within three months) that interest rate risk is substantially eliminated as a pricing factor.
- The sale of a security occurs after the bank has already collected a substantial portion (at least 85 percent) of the principal outstanding at acquisition due either to prepayments on the debt security or to scheduled payments on a debt security payable in equal installments (both principal and interest) over its term. For variable-rate securities, the scheduled payments need not be equal. Refer to ASC 320-10-25-15 through 25-17 for additional guidance.

## Question 7

What are the ramifications of selling debt securities that have been classified as HTM and that do not meet any of the safe harbor exemptions set forth in question 6?

## Staff Response

A sale outside of the safe harbor exemptions would taint the HTM portfolio. Once a portfolio is tainted, all remaining securities in the existing HTM portfolio must be transferred to the AFS category. In addition, future purchases of securities may not be classified as HTM. After the tainting, judgment is required in determining when circumstances have changed such that management can assert with a greater degree of credibility that it now has the intent and ability to hold debt securities to maturity. ASC 320 does not provide specific guidance about the length of time required for management to assert with a greater degree of credibility that it now has the intent and ability to hold debt securities to maturity. The SEC staff previously expressed the view that the tainting period for sales or transfers of HTM securities that do not meet any of the safe harbor exemptions should be two years.

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

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

## Question 8

Would this sale of securities from the HTM portfolio taint the remaining securities in the portfolio?

## Staff Response

Yes. Except for the safe harbor exceptions stated in question 6, sales or transfers out of the HTM portfolio taint the portfolio. Sales for liquidity reasons are excluded from the ASC 320 safe harbor exceptions. As a result, the HTM portfolio would be considered tainted as of the sale date.

**Facts** In anticipation of converting from a taxable corporation to Subchapter S status, a bank sells some tax-exempt municipal securities that had been included in the HTM category of the investment portfolio. The bank sold the securities because it no longer benefits from the tax-free status of the municipal securities, and the individual shareholders do not need the tax-exempt income.

## Question 9

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

## Staff Response

Yes. Selling securities from the HTM portfolio because of a change in tax status of the bank to Subchapter S is not one of the safe harbor exceptions included in ASC 320. Although ASC 320 does provide an exception for changes in tax law that eliminate or reduce the tax-exempt status of interest, this exception does not extend to changes in the tax status of the bank. Accordingly, the HTM portfolio is tainted.

This change resembles a change in tax rates more than a change in tax law. Therefore, it is not covered by the safe harbor exceptions in ASC 320.

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

## Question 10

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

## Staff Response

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

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

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

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

## Question 11

Should the accrual of interest income be discontinued on the trust preferred securities that are not paying scheduled interest payments but are not in legal default according to the terms of the instrument?

## Staff Response

Yes, Bank A should discontinue the accrual of interest income on its investment in the trust preferred securities and include the securities as a nonaccrual asset on Schedule RC-N of the call report. Previously accrued but unpaid interest should be reversed.

In this case, both the 20X4 third-quarter and fourth-quarter distribution (interest) payments will not be made because of the financial condition and operating losses of HC B. Payments may resume in 20X5, but only if HC B becomes profitable. Accordingly, there is no assurance that Bank A will receive these or future payments. Therefore, it meets the criteria for nonaccrual status set forth in the call report instructions.

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

Although the nonaccrual policies of the banking agencies are not specifically codified in GAAP, the call report instructions contain certain specific reporting guidance that falls within the range of acceptable practice under GAAP.

Further, the trust preferred securities are classified by Bank A as AFS and are currently trading at a substantial discount from par. Therefore, in addition to the uncertainty about the collection of the interest income, concern exists about recovery of the principal.

## Question 12

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

## Staff Response

When the fair value of trust preferred securities declines, the securities should be evaluated to determine if an ACL must be recognized. See Subtopic 12A for further discussion of ACL on debt securities.

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

## Question 13

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

## Staff Response

Under normal circumstances, the sale of any HTM investment would call into question a bank's intent to hold its remaining HTM investments to maturity. ASC 320-10-25 indicates that events that are isolated, nonrecurring, and unusual for the bank that could not be reasonably anticipated, however, may cause a bank to sell or transfer an HTM security without necessarily calling into question its intent to hold other HTM debt securities to maturity. ASC 320-10-25-11 specifically states that extremely remote disaster scenarios should not be anticipated by an entity in deciding whether it has the positive intent and ability to hold a debt security to maturity. Accordingly, in this situation the sale of any HTM investment security would not necessarily call into question the bank's intent to hold its remaining HTM investment securities until maturity.

## Question 14

How should a bank account for investments in FHLB and FRB stock?

## Staff Response

Investments in FHLB and FRB stock should be accounted for in accordance with ASC 942-325-35. FHLB and FRB stock should be carried at cost and evaluated for impairment based on the bank's expectation of the ultimate recoverability of the stock's par value. Dividend income on FHLB stock should be reported as other interest income in the call report when the dividend is declared. Banks may accrue dividends on FRB stock when and if they are entitled to receive them in accordance with Regulation I, 12 CFR 209.4(e). Dividend income on FRB stock should be reported as other interest income in the call report as it is earned and accrued.

**Facts** A bank owns common stock in a company that provides IT services to banks. The cost basis in the common stock is $145,000, and it is accounted for under the cost method. Recently, the bank purchased an additional $100,000 in common stock, which increased the bank's ownership interest from 13 percent to 22 percent. The bank has concluded that its ownership now allows it to exert significant influence over the investee as defined in ASC 323-10. Due to the increase in ownership, the bank is now required to change its accounting for this equity investment from the cost method to the equity method.

## Question 15

Is the bank required to apply the equity method retroactively to the date of the original investment?

## Staff Response

No. In accordance with ASC 323-10-35-33, on the date the bank obtains the ability to exert significant influence over an investee, the bank is required to change to the equity method of accounting. The change is made prospectively, and the previous cost basis of the asset is increased by the amount of the additional investment purchased. The bank would increase the cost basis from $145,000 to $245,000 and apply the equity method of accounting in subsequent periods.

## Question 16

How should a bank account for premiums and discounts on securities?

## Staff Response

Premiums and discounts generally should be accounted for as adjustments to the yield of the security. ASC 310-20-35-18 generally requires institutions to follow the interest method when amortizing a premium or accreting a discount on a security. A premium must be amortized, and a discount must be accreted, from the date of purchase to the maturity date, not an earlier call date, unless the security meets one of the exceptions described in question 17.

## Question 17

What are the exceptions to the use of the maturity date when amortizing premiums or accreting discounts on HTM and AFS debt securities?

## Staff Response

There are two exceptions in GAAP to using the maturity date for amortizing premiums and accreting discounts on HTM and AFS debt securities.

1. **Prepayments:** ASC 310-20-35-26 permits banks to consider prepayments on holdings of similar debt securities for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated. In practice, MBSs and CMOs generally are prepayable instruments and institutions can reasonably estimate the amount of prepayments. For securities that meet the conditions of ASC 310-20-35-26, banks may consider estimates of prepayments in determining the appropriate amortization period for the premium or discount.

2. **Call options:** ASC 310-20-35-33 requires that at each reporting period banks amortize premiums on debt securities that are callable at fixed prices and on preset dates or periods to the next call date, unless the first exception is applied (refer to #1 of this staff response). The premium to be amortized to the next call date is the amount by which the amortized cost exceeds the amount repayable at the next call date.

To illustrate, assume a bank purchases a $100 par bond on 1/15/XX for $110. The bond can be called on a preset date of 4/15/XX at $107. Under this exception, the bank would amortize $3 from the purchase date to the next call date on 4/15/XX, as that is the difference between the $110 purchase price and the $107 call price. If not called on 4/15/XX and a subsequent call date does not exist, the remaining $7 premium is amortized to par over the bond's remaining contractual maturity.

If another call date exists, however, the difference in call prices is amortized over the period between the call dates and then subsequently amortized to par over the period from the second call date to the bond's remaining contractual maturity. For example, if the $107 call price on the debt security described in the previous paragraph is followed by a $105 call price on 7/15/XX, the $2 difference in call prices is amortized over the period from 4/15/XX to 7/15/XX. If the security is still not called at the subsequent call date, the remaining $5 in premium is amortized to par over the bond's remaining contractual maturity.

## Question 18

Is the premium on a callable debt security amortized differently than the amortization explained in question 17 if the debt security is callable during a preset period rather than on a preset date?

## Staff Response

No. If a debt security is callable during a preset period rather than on a preset date, the bank would amortize the premium from the purchase date to the beginning of the initial call period, such that the balance-sheet amount reflects the call price on the first date that the debt security is eligible to be called at that price. Using the example in question 17, if the debt security purchased at $110 is callable on or after 4/15/XX at $107, the bank would amortize $3 from the purchase date to the beginning of the call period on 4/15/XX. Then, the difference between the initial period's call price (e.g., $107) and the next period's call price (e.g., $105) is amortized from the first day of the initial call period to the first day of the subsequent call period. Last, the remaining premium is subsequently amortized to par over the period from the beginning of the second and final call period to the bond's remaining contractual maturity.

**Facts** A bank purchased a CMO tranche, classified as HTM, that has moderate prepayment risk. The acquisition price includes a premium over par. Prepayment estimates have been considered in establishing the constant yield rate under ASC 310-20-35-26.

## Question 19

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

## Staff Response

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

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**Facts** A bank acquired an equity security without a readily determinable fair value and elected to account for the investment at cost minus impairment in accordance with ASC 321-10-35-2.

In the current period, the bank identified a third-party transaction that occurred in a prior period in which an identical equity security traded in excess of the bank's cost basis. Although the transaction occurred in a prior period, information about the trade was not observable to the bank until the current reporting period. The bank deemed the transaction to be orderly. The bank's research did not reveal any other observable price changes in this security or a similar one.
As of the current reporting date, the bank also made a qualitative assessment considering impairment indicators to evaluate whether the security was impaired and determined the security was not impaired.

## Question 20

How should the bank account for its equity security as of the current reporting date?

## Staff Response

The bank should report the equity security at the current reporting date at the security's estimated fair value, using the last known transaction, and net of any impairment identified. Changes in the recorded value of the equity security are recorded in earnings in the current period.

When an observable price change is identified in an orderly transaction for an identical or similar security, the bank must use this transaction to adjust its equity security to fair value. The bank should adjust the cost basis for the observable price change, less any identified impairment, and record the offsetting adjustment in earnings. This amount becomes the new cost basis for the security.

## 1B. *Other-Than-Temporary Impairment* (Subtopic Superseded)

*This Subtopic has been superseded due to the adoption of ASC Topic 326 by all entities. See Subtopic 12A for questions and answers regarding the accounting for expected credit losses for HTM and AFS securities in accordance with ASC Topic 326.*

# Topic 2 Loans

## 2A. *Troubled Debt Restructurings* (Subtopic Superseded)

*This Subtopic has been superseded due to the adoption of ASC Topic 326 by all entities. See Subtopic 12B for questions and answers regarding the accounting for loan modifications.*

## 2B. Nonaccrual Loans

**Facts** The bank made an equipment loan and an operating loan. Both loans have been placed on nonaccrual status, and a portion of the equipment loan has been charged off. The loan balances are classified, and doubt as to full collectibility of principal and interest exists.

### Question 1

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

### Staff Response

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

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

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

### Question 2

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

### Staff Response

No. Loans should be evaluated individually. The borrower's total exposure must be considered, however, before concluding that doubt has been removed over the collectibility of either loan. Additionally, the analysis should consider a time period beyond the first year.

Projections indicate that the borrower will be able to service only one of the loans for one year. Therefore, doubt still exists about total borrower exposure over the long term. Accordingly, interest recognition generally is inappropriate.

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

## Question 3

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

## Staff Response

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

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

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

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**Facts** A loan is currently on nonaccrual status as a result of being delinquent in principal and interest payments for a period exceeding 90 days. The estimated uncollectible portion of the loan has been charged off. The remaining balance is expected to be collected.

## Question 4

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

## Staff Response

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

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

## Question 5

Upon refinancing the loan, may the bank record a $50,000 gain (the amount of the discount) and return the loan to accrual status?

## Staff Response

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

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**Facts** A bank has two loans to a real estate developer for two different projects. Loan A is secured by a fully leased office building. The collateral value exceeds the loan obligation. Loan B is secured by an apartment building with relatively few units leased to date. A collateral shortfall exists relative to the loan obligation. The obligors are separate corporations wholly owned by the developer. There is no cross-collateralization of the notes, however, and no personal guarantees by the developer. Loan A is current, and the bank expects to be repaid in full as to principal and interest. Cash flows from the project’s rentals are adequate to fully service principal and interest. Loan B is placed on nonaccrual status because of cash-flow deficiency and collateral shortfall.

## Question 6

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

## Staff Response

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

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

## Question 7

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

## Staff Response

The cross-collateral agreement alone should not prohibit interest accrual on Loan A. The bank has merely taken steps to improve its relative position with the borrower. Thus, to the extent that cross-collateralization does not change the repayment pattern of the notes or jeopardize Loan A's full repayment in due course, Loan A may remain on accrual status, even if Loan B is on nonaccrual status.

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**Facts** Loans A and B are related to separate real estate projects of a borrower and are not cross-collateralized. Loan A is fully performing and has expected cash flows sufficient to repay in full. The cash flows from Project B are expected to be insufficient to repay Loan B in full. Loan B is on nonaccrual. The bank has an obligation to fund additional monies on Project B. Because Project A had sufficient equity, additional funding was provided by a second mortgage, Loan C, on Project A. Because of current economic conditions, however, the cash flows from Project A can no longer keep Loan C current. The debt service required on Loans A and C combined exceeds available cash flows from Project A. Also, the loan-to-value ratio on project A exceeds 100 percent.

## Question 8

May Loan A remain on accrual status?

## Staff Response

Neither Loan A nor C should be on accrual status. Senior and junior liens on the same property generally should be considered as one loan. Regardless of whether Project A can fully support and repay the original Loan A, it may not be able to repay both Loans A and C. Accordingly, until *both* Loans A and C are current and fully expected to be repaid, they both must be placed on nonaccrual status.

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**Facts** Loans A and B are related to separate real estate projects of a borrower and are cross-collateralized. Loan A is fully performing and has expected cash flows sufficient to repay the loan in full. The cash flows from Project B are expected to be insufficient to repay Loan B in full. Project A has excess cash flows sufficient to meet the shortfall on Project B and provide for the debt service shortfall on Loan B, ensuring its full contractual collectibility. The developer uses these funds to keep Loan B current.

## Question 9

May both Loans A and B be reported as accruing loans?

## Staff Response

Yes. The borrower has made this possible by making the excess cash flow and equity of Project A available to service and fully repay Loan B. The borrower services debt obligations to the bank as if they were one, i.e., using any available funds to keep both obligations current. The bank should assess the accrual status by comparing the aggregate cash flows available from all repayment sources with the combined obligation.

In this situation, both Loans A and B may stay on accrual status if the combined cash flows from primary and secondary sources are considered adequate and remain available to meet fully the combined contractual obligations—and the loans remain current.

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**Facts** Loans A and B are related to separate real estate projects of a borrower and are cross-collateralized. Project A has the cash flows to repay Loan A in full but no excess to meet the shortfall in Project B. Accordingly, Project B is past due. In this case, however, the developer has not dedicated cash flows from Project A to the timely repayment of Loan A. The developer has used available cash at its discretion to make periodic payments on Loan B and other obligations. Loan A is less than 90 days past due but would be current if the developer applied all Project A cash flows to Loan A.

## Question 10

May Loan A be maintained on accrual status?

## Staff Response

No, both loans should be placed on nonaccrual status. In this instance, the total obligation of the developer should be evaluated to consider the total cash flows. The developer effectively handles these two loans as one obligation. The relative equity of the developer in each property and its value to the developer drive the debt service.

Because, in this example, the combined available cash flows are not likely to be sufficient to repay the combined principal and interest due on Loans A and B, both loans should be placed on nonaccrual.

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

## Question 11

Must both notes be placed on nonaccrual status?

## Staff Response

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

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

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**Facts** Loans A and B are related to separate real estate projects of a borrower and are cross-collateralized. Project A has the cash flows to repay Loan A in full but no excess to make up the shortfall in Loan B. In the aggregate, the combined cash flows of Projects A and B are not likely to repay the outstanding principal and interest in full on both loans.

Loan A is current and has a consistent dedicated source of repayment. Although Loan B is both collateral and cash-flow deficient, the bank asserts that the cross-collateralization of the loans is unlikely to hinder the ability of Loan A to be repaid fully according to the contractual terms.

## Question 12

May Loan A be maintained on accrual status?

## Staff Response

Possibly. The assertion that cross-collateralization of the loans will not affect the orderly and contractual repayment of Loan A, however, must be supported. Support would include the existing lender–borrower relationship and the bank's history in working with troubled borrowers. This includes the current likelihood of the lender to work with the borrower to avoid foreclosure or of the borrower to take steps to cure Loan B and preserve some equity in Project A. If facts exist to support the bank's assertion that the timely and complete repayment of Loan A will proceed in due course, Loan A may remain on accrual status.

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

## Question 13

May the loan be returned to accrual status?

## Staff Response

Yes. If the doubt about full collectibility of the entire amount due, including the charged off amount, has been removed, the loan meets the criteria in the call report for return to accrual status.

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**Facts** A loan is past due in principal and interest. The bank takes a partial charge-off on the loan because it believes that it will be unable to collect part of the obligation. The loan is also placed on nonaccrual status. One year later, the borrower's financial condition improves dramatically. The borrower has made regular monthly payments and is paying additional amounts to reduce the past due amount. Although the bank now fully expects to collect the original contractual obligation, including the amount previously charged off, the loan is not yet contractually current.

## Question 14

May this loan be returned to accrual status?

## Staff Response

Yes. A loan, on which the borrower has resumed paying the full amount of the scheduled contractual obligation, may be returned to accrual status, even though it has not been brought fully current, if: (a) all principal and interest amounts contractually due are reasonably assured of repayment within a reasonable period of time and (b) there is a sustained period of repayment performance by the borrower (generally a minimum of six months).

**Facts** A bank placed a loan on nonaccrual status because the borrower's financial condition has deteriorated and the bank does not expect full repayment of contractual principal and interest. Simultaneously, the bank reversed previously accrued but unpaid interest in accordance with the call report instructions. The bank's credit evaluation concludes that no charge-off of principal is necessary. Because of doubt about collectibility, however, certain interest payments received were applied to reduce principal.

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

## Question 15

May the bank, either now or when the loan is brought contractually current, reverse the application of interest payments to principal?

## Staff Response

No. Application of cash-interest payments to principal was based on a determination that principal may not be recovered. It should not be reversed when that determination changes. In this situation, the staff believes the previously foregone interest should be recognized as interest income prospectively as cash payments are received.

If the loan eventually returns to accrual status, interest income would be recognized based on the new effective yield to maturity on the loan. The new effective yield is the discount rate that would equate the present value of the future cash payments to the recorded amount of the loan. Any interest paid by the borrower and applied to principal while on nonaccrual is accounted for similar to a loan discount, upon the loan returning to accruing status. The contractual principal collected, in excess of the principal balance recorded, is recognized as a yield adjustment in interest income over the remaining life of the loan; it is not fully recognized immediately upon the loan returning to accrual status.

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

## Question 16

Is this an acceptable treatment?

## Staff Response

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

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**Facts** A loan is guaranteed by the U.S. government (or a government-sponsored enterprise). The guarantee covers 90 percent of the principal and interest. The borrower experiences financial difficulty and is past due more than 90 days on loan payments. Collection of the guaranteed portion is expected; however, collection of the unguaranteed portion is uncertain.

The bank proposes to place 90 percent of the loan (the guaranteed portion) on accrual status and classify the remaining 10 percent as nonaccrual. Interest income would also be recognized accordingly.

## Question 17

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

## Staff Response

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

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## Question 18

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

## Staff Response

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

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

## Question 19

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

## Staff Response

No. The decision to place the loan on nonaccrual indicates that there was doubt about full collection of principal and interest. The charge-off was based on management's determination that recovery of the principal was not expected. The reversal of the interest was based on the determination that the accrued interest may not be collected.

The determination of collectibility is an accounting estimate as defined by ASC 250-10. That standard requires changes in accounting estimates to be accounted for in the period of change and future periods when the change affects both. Accordingly, payments would be accounted for in accordance with GAAP, and recoveries recorded as received. This would apply to both principal and interest payments.

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

## Question 20

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

## Staff Response

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

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

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

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

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**Facts** A bank has placed a loan of $200,000 on nonaccrual status because payment in full of contractual principal and interest is not expected. The bank had previously accrued late fees of $500 before placing the loan on nonaccrual status.

## Question 21

May the bank continue to accrue late fees on a loan on nonaccrual status?

## Staff Response

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

## Question 22

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

## Staff Response

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

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

## Question 23

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

## Staff Response

Yes. If the contractual terms of the loan permit, the payment of delinquent property taxes becomes part of the recorded balance of the loan. The bank should consider the increase in the loan amount when evaluating the loan for credit losses and any amounts deemed uncollectible should be promptly charged off. The staff believes the existence of delinquent property taxes, which could result in a lien attachment on underlying collateral of a collateral-dependent loan, represents credit-related loss and, therefore, should be included in the ACL or charged off as appropriate. The accounting treatment for payment of real estate taxes on property held as OREO is discussed in Subtopic 5A, question 11.

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

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

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

## Question 24

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

## Staff Response

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

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

All modified loans must be evaluated to determine whether the modification must be reported as a modification to a borrower experiencing financial difficulty in the call report, as discussed in Subtopic 12B, Loan Modifications.

## Question 25

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

## Staff Response

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

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

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

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

## Question 26

May interest income be recognized while a commercial loan is on nonaccrual status?

## Staff Response

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

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

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

## Question 27

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

## Staff Response

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

## Question 28

Should interest income be recognized on a purchased loan when the seller maintained the loan on nonaccrual status and the buyer does not have a reasonable expectation about the amount expected to be collected?

## Staff Response

Call report guidance does not prohibit placing (or keeping) purchased loans on nonaccrual status at acquisition or thereafter. If the buyer determines the loan has experienced a more-than-insignificant deterioration in credit quality since origination, then accrual of interest income is dependent upon having a reasonable expectation about the amount expected to be collected.

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

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

Subsequent to converting the unpaid overdraft balances and accrued but unpaid fees into a term loan, the borrower's demand deposit account frequently continues to be in an overdrawn position. The bank continues to accrue unpaid overdraft fees. Overdraft fees on the borrower's demand deposit account incurred after the overdraft term loan was originated are, however, no longer added to the loan balance.

## Question 29

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

## Staff Response

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

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**Facts** A $10 million loan is secured by income-producing real estate. Cash flows are sufficient to service only a $9 million loan at a current market rate of interest. The loan is on nonaccrual. The bank modifies the loan by splitting it into two separate notes. Note A is for $9 million, is collateral-dependent, and carries a current market rate of interest. Note B is for $1 million and includes an interest rate reduction. The bank charges off all of Note B but does not forgive it.

## Question 30

May the bank return Note A to accrual status?

## Staff Response

Yes, but only if all of the following conditions are met:

- The partial loan charge-off is supported by a good faith credit evaluation of the loan(s). The charge-off should be recorded before or at the time of the modification and should represent the portion of the original loan that is deemed uncollectible (i.e., Note B).
- The ultimate collectibility of all amounts contractually due on Note A is not in doubt. If such doubt exists, the loan should not be returned to accrual status.
- There is a period of satisfactory payment performance by the borrower (either immediately before or after the modification) before Note A is returned to accrual status.

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

## Question 31

What constitutes a period of satisfactory performance by the borrower?

## Staff Response

Analogizing to ASC 942-310-35 for loans to troubled countries, some period of performance is required to assess collectibility that would permit returning the loans to accrual status as part of the credit evaluation noted in question 30. Accordingly, the bank normally may not return Note A to accrual status until or unless this period of performance is demonstrated, except as described in question 32.

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

If the borrower was materially delinquent on payments before the modification but shows potential capacity to meet the modified terms, the loan would likely continue to be maintained on nonaccrual until the borrower has demonstrated a reasonable period of performance (generally, at least six months) in order to remove doubt as to ultimate collection of principal and interest in full.

If the borrower does not perform under the modified terms, the modification probably was not appropriately structured and the loan should remain on nonaccrual status.

## Question 32

The previous response indicates that performance is required before a formally modified loan may be returned to accrual status. When may a modified loan be returned to accrual status without performance?

## Staff Response

The staff continues to believe that evidence of performance under the modified terms is one of the most important considerations in assessing the likelihood of full collectibility of the modified principal and interest. In rare situations, however, the loan modification may coincide with another event that indicates a significant improvement in the borrower’s financial condition and ability to repay. These might include substantial new leases in a troubled real estate project, significant new sources of business revenues (i.e., new contracts), and significant new equity contributed from a source not financed from the bank. A preponderance of this type of evidence could obviate the need for performance or lessen the period of performance needed to assure ultimate collectibility of the loan.

## Question 33

Given that evidence of performance under the modified terms will likely be relied on to determine whether to place a loan modification on accrual status, may performance before the modification be considered?

## Staff Response

Performance before the modification should be considered in assessing whether the borrower can meet the modified terms. The modified terms often reflect the level of debt service that the borrower has already been making. If this is the case, and the borrower will likely be able to continue this level of performance and fully repay the new contractual amounts due, continued performance after the modification may not be necessary before the loan is returned to accrual status.

## Question 34

How would the absence of an interest rate reduction on Note B affect the accrual status of Note A?

## Staff Response

The accrual status of Note A would not change due to the absence of an interest rate reduction on Note B. Note A should be accounted for and reported as a nonaccrual loan. In substance, the bank has merely charged down its $10 million loan by $1 million, leaving a $9 million recorded loan balance. A partial charge-off of a loan does not provide a sufficient basis by itself for restoring the loan to accrual status.

Furthermore, the bank should record loan payments as principal reductions as long as any doubt remains about the ultimate collectibility of the recorded loan balance. When that doubt no longer exists, interest payments may be recorded as interest income on a cash basis.

## Question 35

Assume that Note B was not charged off, because it was not deemed uncollectible but was placed on nonaccrual. How would that affect the accrual status and the reporting of the loan modifications to borrowers experiencing financial difficulties on the call report for Note A?

## Staff Response

Because the modified loans are supported by the same source of repayment and collectibility is in doubt (cash flows can only service $9 million), both loans would be reported on nonaccrual. Additionally, because the interest rate on Note B was reduced, both notes would be reported as loan modifications to borrowers experiencing financial difficulties on the call report.

**Facts** Assume, as discussed in question 35, that Note B was not charged off, before or at the time of modification, because Note B was not deemed uncollectible. Also, expected cash flows will not be sufficient to repay Notes A and B at a market rate. The cash flows would be sufficient to repay Note A at a market rate.

## Question 36

Would Note A be reported as an accruing market-rate loan and Note B as nonaccrual?

## Staff Response

No. Even after a loan modification, the two separate recorded balances are supported by the same source of repayment and should not be treated differently for reporting as nonaccrual or loan modifications to borrowers experiencing financial difficulties. Both loans must be reported as nonaccrual unless the combined contractual balance and the interest contractually due are expected to be collected in full.

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**Facts** A bank negotiates a loan modification to a borrower experiencing financial difficulty on a real estate loan. As part of the modification, a portion of the loan is charged off. The borrower has been unable to make contractually owed payments, sell the underlying collateral at a price sufficient to repay the obligation fully, or refinance the loan. The bank, as part of the modification, reduces the contractual interest rate. In the modification, the bank splits the loan into two notes that require final payment in five years. The bank believes that market conditions will improve by the time the loan matures, enabling a sale or refinancing at a price sufficient to repay the modified obligation in full. The original interest rate was 9 percent.

Note A carries a 9 percent contractual interest rate. Note B, equal to the charged-off portion, carries a 0 percent rate. Note A requires that interest be paid each year at a rate of 5 percent, with the difference between the contractual rate of 9 percent and the payment rate of 5 percent capitalized as part of the loan balance. The capitalized interest and all principal are due at maturity. Additionally, interest on the capitalized interest compounds at the 9 percent rate to maturity.

## Question 37

If the borrower makes the interest payments at 5 percent as scheduled, may Note A be on accrual status?

## Staff Response

No. The terms of the modified loan allow for the deferral of principal payments and capitalization of a portion of the contractual interest requirements. Accordingly, these terms place undue reliance on the balloon payment for a substantial portion of the obligation.

Generally, capitalization of interest is precluded when the creditworthiness of the borrower is in question. Other considerations about the appropriateness of interest capitalization are

- whether interest capitalization was included in the original loan terms to compensate for a planned temporary lack of borrower cash flow.
- whether similar loan terms can be obtained from other lenders.

For a loan modification to a borrower experiencing financial difficulty, the answer to each consideration is presumed to be negative, absent objective evidence to the contrary.

First, the bank, in dealing with a borrower experiencing financial difficulty, must overcome the doubt associated with the borrower's inability to meet the previous contractual terms. To do this, objective and persuasive evidence must exist for the timing and amount of future payments of the capitalized interest. In this case, the repayment of the capitalized interest is deferred contractually until the underlying loan is refinanced or the collateral is sold. A refinancing or collateral sale at a price adequate to repay the loan was not possible at the time of modification. The bank has offered no objective evidence to remove the doubt about repayment that existed before the modification. It is relying solely on a presumption that market conditions will improve sufficiently to enable the borrower to repay the principal and capitalized interest. Accordingly, the timing and collectibility of future payments of this capitalized interest are uncertain.

Second, the temporary lack of cash flow is generally a reason to make a loan modification to a borrower experiencing financial difficulty. The capitalization of interest was not provided for in the original loan terms.

Third, the interest rate reduction was granted because of the borrower's inability to find other market financing to repay the original loan.

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

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

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

## Question 38

For the modified loan to be eligible for return to accrual status, must the contingent payment also be deemed fully collectible?

## Staff Response

No. Contingent cash payments should not be considered in assessing the collectibility of amounts contractually due under the modified terms.

**Facts** A $10 million loan is secured by income-producing real estate. Due to a previous $1 million charge-off, the recorded balance is $9 million. Cash flows are sufficient to service only $9 million of debt at a current market rate of interest. The loan is modified and placed on nonaccrual. The bank protects its collateral position, however, by modifying the loan into two separate payment tranches, rather than two separate notes. Tranche A requires $9 million in principal payments and carries a current market rate of interest. Tranche B requires $1 million in principal payments and carries a reduced rate of interest. Although the loan was restructured to include the full $10 million legally owed by the borrower, the loan's amortized cost remains at the pre-modification amount of $9 million.

## Question 39

May the bank return Tranche A to accrual status?

## Staff Response

It depends. The use of one note with two payment tranches, instead of two separate notes, could prevent Tranche A from being returned to accrual status. The note must meet the conditions set forth in the staff response to question 30 for return to accrual status.

**Facts** A borrower has a revolving line of credit of $35 million that is fully drawn and a term loan in the amount of $28 million with the bank. The revolving line of credit and term loan do not have the same collateral. Payments are current, but the loans are in default because of major financial covenant violations. Further, there is serious concern regarding the borrower's ability to continue to make payments in accordance with the terms of the loans. Accordingly, both loans have been placed on nonaccrual status.

The credit line is modified into a new revolving line of credit of the same amount at an interest rate of prime plus 3 percent, which does not represent a reduction in interest rate. Further, the line of credit is considered to be both fully collectible and fully secured. The term loan is modified into two new term loans, Loan X and Loan Y.

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

The second loan, Loan Y, provides for a reduction in interest rate. Loan Y also matures in three years but does not require principal or interest payments until maturity, representing an other-than-insignificant delay in payment. Further, given that the borrower's repayment capacity and collateral are considered inadequate to repay any portion of this loan, the loan is deemed uncollectible and should be charged off.

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

## Question 40

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

## Staff Response

Consistent with the response in question 30, the revolving line of credit and Loan X may be returned to accrual status when there has been a period of satisfactory payment performance by the borrower. In this situation, however, Loan X does not require principal payments during the first year. Accordingly, consideration should be given to whether the borrower can continue making the required payments of principal and interest after the first year.

## Question 41

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

## Staff Response

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

## Question 42

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

## Staff Response

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

## Question 43

Should retail loans that are reported as modifications to borrowers experiencing financial difficulties be placed on nonaccrual status and reported on call report Schedule RC-N?

## Staff Response

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

## Question 44

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

## 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 an allowance for credit losses for the uncollectible interest and fees or place the delinquent loans on nonaccrual status. Regardless of the method employed, however, banks must ensure that income is measured accurately.

## 2C. Commitments

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

### Question 1

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

### Staff Response

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

### Question 2

How should this loan commitment be accounted for?

### Staff Response

As noted in question 1, this commitment is not subject to fair value accounting for derivatives under ASC 815. This commitment would be accounted for at fair value only if the bank had elected the FVO under ASC 825-10. If this commitment is not accounted for under the FVO, the bank may still need to recognize a loss related to this commitment as an off-balance-sheet credit exposure, unless the commitment is unconditionally cancellable by the bank. The determination and consideration of any such loss (i.e., which market and/or credit changes must be considered) depend on the bank's intent to either sell or hold the loan after origination.

Loan commitments to originate a loan that a bank intends to hold for investment should be evaluated for expected credit losses in accordance with ASC 326-20. Similar to the accounting for loans HFI, expected losses on commitments for these loans should be based on credit-related losses, not market-related losses. Loan commitments, or portions of loan commitments, to originate loans that the company intends to sell should not be considered HFI.

When accounting for loan commitments that relate to loans a bank intends to hold for sale (syndicate), a bank should establish and apply a consistent accounting policy. A bank may make an accounting policy election to account for the loan commitments using the following methods:

**Method 1**: Measure expected losses on these loan commitments based on the lower of amortized cost basis or fair value, which incorporates expected credit and non-credit losses. If the amortized cost basis of the loans to be originated exceeds the estimated fair value, the bank recognizes non-interest expense and a liability equal to the difference between the amortized cost basis and fair value.

**Method 2**: Recognize the loan commitment at amortized cost and account for expected credit losses under ASC 326-20-30 and any contingent losses related to non-credit risks under ASC 450-20-25. Once the commitment has been funded and the loan is classified as held-for-sale, the off-balance-sheet credit exposure on the loan commitment no longer exists and the associated held-for-sale loan is not within the scope of ASC 326-20. Thus, any previously recorded expected credit losses under ASC 326-20-30 would be reversed.

Once a bank makes an accounting policy election, the bank should generally continue to apply the elected accounting policy. If the bank elects to change its accounting policy election, the bank would need to consider if a preferability assessment is necessary.

## Question 3

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

## Staff Response

OCC Bulletin 2013-9 establishes sound risk management principles for approvals, limits, and exceptions to hold levels related to loan syndications. Generally, there is no prohibition in GAAP for a bank changing its intent to sell. As noted in OCC Bulletin 2013-9, hold limits should be established for each borrower, approved during underwriting, and strong pipeline management policies and procedures should include real-time information on exceptions to hold levels. Changing a hold level during the commitment phase should be reflected in pipeline management reporting, receive proper re-approval, and contain the bank's analysis from a credit and interest-rate-risk perspective of how the intent change is consistent with the bank's overall risk management policies and procedures.

## Question 4

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

## Staff Response

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

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## Question 5

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

## Staff Response

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

- It has one or more underlyings and one or more notional amounts or payment provisions or both.
- It requires little or no initial net investment.
- Its terms require or permit net settlement or the equivalent thereof, it can be readily settled net by means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

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

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

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

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## Question 6

What is the accounting for commitments to originate mortgage loans?

## Staff Response

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

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

## Question 7

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

## Staff Response

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

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

## Question 8

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

## Staff Response

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

Based on the guidance in ASC 815-10-S99-1, the expected future cash flows related to the associated servicing of loans should be considered in recognizing derivative loan commitments. However, ASC 815-10-S99-1 also indicates that no other internally developed intangible assets (such as customer relationship intangible assets) should be recognized as part of derivative loan commitments.

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

## Question 9

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

## Staff Response

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

Numerous factors, including the following, cause pull-through rates to vary:

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

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

## Question 10

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

## Staff Response

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

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

## Question 11

How should the bank account for this hedging strategy?

## Staff Response

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

Best-efforts forward loan sale agreements must be evaluated under ASC 815-10-15 to determine whether the agreements meet the definition of a derivative (refer to the characteristics of a derivative in question 5). Best-efforts forward loan sale agreements that meet the definition of a derivative should also be reported at fair value on the balance sheet with changes in fair value included in earnings. If the best-efforts forward loan sale agreement does not meet the definition of a derivative, the instrument would be considered an off-balance-sheet contract reported in Schedule RC-L of the call report.

## Question 12

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

## Staff Response

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

## Question 13

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

## Staff Response

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

For those commitments to purchase debt securities that are not accounted for as derivatives, the bank should consider the guidance in ASC 815-10-35-5. This standard states that changes in the fair value of forward contracts to purchase securities that will be accounted for as trading should be recognized in earnings as they occur. Changes in the fair value of forward contracts to purchase securities that will be accounted for as AFS should be recognized in other comprehensive income with credit losses on the underlying securities recorded through an ACL under ASC 326-30. Additionally, changes in the fair value of forward contracts to purchase securities that will be accounted for as HTM should not be recognized. Expected credit losses on the underlying HTM securities should, however, be recorded through an ACL under ASC 326-20.

## 2D. Origination Fees and Costs

### Question 1

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

### Staff Response

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

### Question 2

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

### Staff Response

ASC 310-20-25 provides for deferral of costs on a loan-by-loan basis. The use of averages is acceptable, however, provided that the bank can demonstrate that the effect of a more detailed method would not be materially different. Usually, averages are used for large numbers of similar loans, such as consumer or mortgage loans.

**Facts** A bank purchases loans for investment. As part of those purchases, the bank incurs internal costs for due diligence reviews on loans that were originated by another party (the seller).

### Question 3

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

### Staff Response

No. The bank’s investment in a purchased loan or group of purchased loans is the amount paid to the seller, plus any fees paid or less any fees received. Under ASC 310-20-25-23, additional costs incurred or committed to purchase loans should be expensed. Furthermore, only certain direct loan origination costs should be deferred under ASC 310-20-25. Because the loans have been originated already by the seller, additional costs incurred by the buyer do not qualify as direct loan origination costs.

## Question 4

ASC 310-20-35-2 requires that loan origination fees and direct loan origination costs be deferred and accounted for as an adjustment to the yield of the related loan. How should these amounts be amortized for balloon or bullet loans?

## Staff Response

ASC 310-20-35 was designed to recognize the effective interest over the life of the loan. In addition, accounting is based usually on the economic substance of a transaction when it differs from the legal form. Therefore, the terms of the loan and the historical relationship between the borrower and the lender must be analyzed.

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

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

## Question 5

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

## Staff Response

Credit card fees and related origination costs should be deferred and amortized on a straight-line basis over the period that the cardholder is entitled to use the card. This is consistent with ASC 310-20-35-5. Normally, the customer is entitled to use the credit card for a period of one to three years. In some cases, the actual period of repayment on advances from the card may exceed that period. The amortization period is deemed to be the period that the cardholder may use the card, however, not the expected repayment period of the loan.

**Facts** A bank has an outstanding unfunded letter of credit. It originally determined the chances were remote that the letter of credit would be exercised. Accordingly, a portion of the commitment fees was recognized as income. All remaining fee income was deferred, however, after the bank concluded that the underlying obligor’s financial difficulties made it no longer remote that the letter of credit would be drawn upon. Additionally, the bank has incurred substantial legal fees to prevent future losses and assure collection on the letter of credit.

## Question 6

May those legal costs be offset against the unamortized deferred fee income?

## Staff Response

No. Legal fees incurred by the bank for litigation should be expensed as incurred. Only legal fees that represent the direct costs of originating the commitment may be offset against the deferred fee income. ASC 310-20-25 requires fees and direct costs of originating a loan commitment to be offset similar to loan origination fees and costs. Legal fees to recover or prevent potential losses, however, are not direct costs of origination under ASC 310-20-25 and should be expensed as incurred.

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## Question 7

A bank enters into an agreement with a related party, such as its holding company, to perform certain loan solicitation and origination activities. How should these costs be accounted for by the bank?

## Staff Response

These costs should be accounted for in the same manner as if the related activities had been performed by the bank. Accordingly, if the costs meet the deferral requirements in ASC 310-20-25, they would be deferred and amortized by the bank. All other lending-related costs should be expensed as incurred.

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

## Question 8

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

## Staff Response

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

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**Facts** A bank originates $100 million of residential mortgage loans, which it intends to sell. It charged loan origination fees totaling $2 million and incurred direct loan origination costs of $1 million. The bank holds the loans for two months and sells them for $99.5 million.

## Question 9

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

## Staff Response

The net fees or net costs related to these loans HFS are reported as part of the cost basis in the loans, the same as they would be for any other loans. Accordingly, the cost basis in the loans should be $99 million ($100 million less the net fees and costs of $1 million). On loans HFS, the loan origination fees and direct loan origination costs are not amortized, however. Consistent with ASC 948-310-25, these fees and costs are deferred until the loan is sold.

## Question 10

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

## Staff Response

When the loans are sold, the difference between the sales price and the cost basis in the loans is the gain or loss on the sale of the loans. In this case, the bank would record a gain on the sale of $500,000 ($99.5 million sales price less $99 million cost basis). Because the bank was not amortizing the loans' origination fees and costs, the cost basis remains at $99 million until the loans are sold.

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## Question 11

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

## Staff Response

The net deferred loan fees are recognized through the ACL, resulting in a reduction of the charge-off. This is because the cost basis in a loan includes principal, accrued interest, net deferred loan fees or cost, and unamortized premium or discount. Consistent with

ASC 310-20-35-2, the net deferred loan fees are accreted into income as a yield adjustment over the life of the loan. At the time a loan is charged off, the unamortized net deferred loan fees would effectively reduce the cost basis in the loan and therefore the amount of the charge-off.

## 2E. Loans Held for Sale

### Question 1

What loans are covered under the "Interagency Guidance on Certain Loans Held for Sale" (the interagency HFS guidance) included in OCC Bulletin 2001-15, "Loans Held for Sale: Guidance"?

### Staff Response

The interagency HFS guidance is directed toward loans that have declined in credit quality and applies when

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

### Question 2

What loans are not covered under the interagency HFS guidance?

### Staff Response

The interagency HFS guidance does not cover mortgage loans HFS that are subject to ASC 948 or other loans (or portions of them) originated with the intent to sell.

**Facts** A bank decides to sell a loan from its HFI portfolio that has experienced a decline in fair value due to credit quality concerns. Management evaluated the credit quality decline and determined that the loan is within the scope of the interagency loans HFS guidance in OCC Bulletin 2001-15.

### Question 3

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

### Staff Response

The proper accounting for this situation requires application of a two-step process with the order of operations being to first apply the regulatory charge-off policy from the interagency HFS guidance followed by accounting for the transfer from HFI to HFS.

Step 1 – Upon the decision to sell, apply the regulatory charge-off policy from the interagency HFS guidance: The interagency HFS guidance requires recognizing the confirmed loss via a charge-off against the ACL. The amount of the credit loss to be charged off is measured as the excess of the loan's amortized cost basis over the loan's fair value. The charge-off is reflected as a write-down of the loan resulting in a new amortized cost basis. To the extent that the loan's fair value loss has not already been provided for in the ACL, an additional provision for credit losses is made to provide sufficient allowance to absorb the charge-off.

Step 2 – Account for the transfer: After the write-down is taken, the bank applies the guidance for HFI to HFS transfers in ASC 310 or ASC 948, as applicable. If the ACL amount on the transferred loan at the transfer date to the HFS category exceeds the amount of the charge-off, any remaining excess ACL is reversed into earnings. Following any write-down and reversal of ACL, the loan to be sold is transferred to the HFS category at the new amortized cost basis and accounted for at the lower of cost or fair value. After the transfer, the bank should establish a valuation allowance, if needed, for any excess of the loan's amortized cost basis over fair value until the loan is sold.

## Question 4

After transferring loans from HFI to HFS, should the bank also write down similar loans that remain in the HFI loan portfolio?

## Staff Response

No, not necessarily. HFS accounting does not apply to the loans remaining in the HFI category that the bank does not intend to sell. The need for any additional allowance or write-down on the remaining loans should be evaluated in accordance with the bank's normal credit review, allowance, and charge-off policies.

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**Facts** A bank has identified certain loans in its portfolio that it may sell in the future, but there is no definitive sale plan or sale date. The fair value of these loans may be less than the carrying amount.

## Question 5

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

## Staff Response

No. If the bank has not made the decision to sell these loans, the loans should continue to be accounted for as HFI and the loans should be evaluated in accordance with the bank's normal credit review, allowance, and charge-off policies. HFS accounting is not applicable until the bank has made a decision to sell the loans.

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

## Question 6

At what point should such loans be transferred to HFS?

## Staff Response

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

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

## Question 7

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

## Staff Response

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

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

## Question 8

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

## Staff Response

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

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

## Question 9

When should these loans be reported as HFS?

## Staff Response

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

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

## Question 10

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

## Staff Response

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

## Question 11

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

## Staff Response

Any ACL recorded on the loan prior to the transfer to HFS should be reversed into earnings at the transfer date. The loan to be sold should then be transferred to HFS at its amortized cost basis and accounted for at the lower of amortized cost or fair value. An adjustment to account for the HFS loan at the lower of cost or fair value is reflected through the establishment of an HFS valuation allowance. Because the decline in fair value did not result from credit concerns, the regulatory charge-off policy from the interagency HFS guidance does not apply and the loss should be recorded as other noninterest expense and not as a charge to the allowance.

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**Facts** In the loan market, revolving credit facilities tend to trade at lower prices than funded term-loan facilities of the same company, even though the remaining term to maturity may be shorter. For example, a bank has granted both a $10 million term loan and a $10 million revolving credit facility to Company B. Both loans have the same interest rate. The revolving facility is currently funded at 50 percent or $5 million, while the term loan is funded fully at $10 million. A commitment fee is charged on the unfunded portion of the revolving facility. The secondary market generally is unwilling to pay the same price (as a percentage of outstanding balances) for both the term loan and the partially funded revolving credit facility. This is because of the loss of expected interest income if the unused commitment on the revolving credit is never funded. Thus, the fair value of the partially funded revolving credit facility is less than the fair value of the term loan.

## Question 12

If the bank decides to sell the revolving credit facility, how should the bank account for the difference in the fair values of the revolving credit and the term loan?

## Staff Response

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

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## Question 13

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

## Staff Response

There is no prohibition on transferring HFS loans back into the HFI loan portfolio. The loan must be transferred into the HFI portfolio at its amortized cost basis. If the HFS loan had a valuation allowance, it would need to be reversed at transfer. After the transfer back into the HFI category, the loan should be evaluated for an appropriate ACL in accordance with the bank's normal credit review and allowance policies.

**Facts** A bank originates or acquires a loan and intends to sell it on a best-efforts basis. The bank is unable to sell this loan.

## Question 14

Is the unsold loan considered HFS?

## Staff Response

Yes. If a bank intends to sell a loan on a best-efforts basis, the loan should be reported as HFS. If this loan cannot be sold, the HFS designation of that loan does not change. Question 13 discusses the accounting if a bank subsequently transfers a loan that is designated as HFS to the HFI category.

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

## Question 15

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

## Staff Response

No. By entering into a sales contract, the bank has demonstrated that it has decided to sell the loans. Loans should be transferred to HFS when the decision to sell them has been made, consistent with ASC 326-20-35-7.

## Question 16

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

## Staff Response

ASC 310-20 provides accounting guidance for loan origination fees and costs. When a loan is HFI, the net origination fees or costs are amortized as a yield adjustment. The remaining unamortized net fees or costs are part of the cost basis of the loan. Consistent with ASC 948-310-25-3, if a loan is HFS, the loan origination fees and costs are deferred until the loan is sold (rather than amortized). Therefore, if a loan is transferred to HFS, amortization of the net origination fees or costs ceases and the remaining unamortized net deferred fees or costs are carried over as part of the cost basis of the loan. The loan will then be carried at the lower of cost or fair value. When the loan is sold, the difference between the sales price and the carrying amount of the loan is the gain or loss on the sale of the loan.

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

## Question 17

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

## Staff Response

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

## Question 18

If a bank transfers loans from the HFI category to HFS, are there any "tainting" provisions similar to the treatment for HTM securities under ASC 320-10-25-6?

## Staff Response

No. Once a decision is made to sell loans not previously classified as HFS, the bank should transfer such loans from the HFI to the HFS category at the amortized cost basis. After the transfer, the bank should establish a valuation allowance, if needed, for the difference between the loan's amortized cost basis and fair value. Unlike the treatment for securities, there is no "tainting" provision for the remaining HFI loans after the transfer to HFS.

## Question 19

After a loan has been transferred to HFS, how and when is a valuation allowance established?

## Staff Response

A valuation allowance is established at the time of transfer or any period thereafter when the fair value is below cost for an individual HFS loan or a group of HFS loans. Consistent with ASC 948-310-35-3, either the aggregate or individual loan basis may be used in determining the lower of cost or fair value for each type of loan.

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

## Question 20

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

## Staff Response

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

## Question 21

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

## Staff Response

A change in intent from HFS to HFI is only appropriate when bank management has the positive intent and ability to hold the loans for the foreseeable future or until maturity and no longer has the intent to sell. When the bank decides not to sell the loan, the loan must be transferred to the HFI category at its amortized cost basis. The bank should document that management now has the positive intent and ability to hold the loans for the foreseeable future or until maturity. Such documentation should include management's definition of "foreseeable future" as it relates to the type of loans transferred to the HFI category. The definition of "foreseeable future" should be consistent for homogeneous loans. Additionally, the documentation should include consideration of budgets that support the bank's ability to hold these loans into the foreseeable future.

The transfer date is important, because it is used to establish a new cost basis for that loan. Immediately after the transfer into the HFI category, the loan should be evaluated in accordance with the bank's normal credit review and allowance policies to establish an ACL.

A bank changing its intention and selling the loan(s) or transferring the loan(s) back to the HFS category would likely cause increased scrutiny by the auditor and examiner, especially if the sale or transfer occurred during the period the bank originally considered its foreseeable future.

**Facts** A bank commits to fund a non-mortgage loan with the intention of selling the loan after origination. After the commitment date but prior to origination, disruptions in the market make it difficult to sell the loan and the bank decides that it no longer intends to sell the loan.

## Question 22

When the loan is funded should the bank recognize changes in the loan's fair value due to changes in market interest rates and secondary loan market movements that took place since the terms of the loan were agreed to?

## Staff Response

The answer depends on whether the bank can support that it changed its intent and now plans to hold the loan for investment.

If the bank can demonstrate that during the commitment phase and once funded the loan is now HFI, the bank will not recognize subsequent changes in the fair value of the loan (unless the FVO has been elected). Similar to the guidance in ASC 310-10-35-47, nonmortgage loans should be accounted for only as HFI if management has the intent and ability to hold for the foreseeable future or until maturity or payoff. Any declines in fair value of the loan from the commitment date to the time the bank changed its intent from HFS to HFI are recognized and accounted for based on the bank's accounting policy for loan commitments that relate to loans the bank intends to hold for sale (see Subtopic 2C, question 2).

If the bank cannot demonstrate that it intends to hold the loan for investment, the loan continues to be accounted for as HFS and subsequent declines in fair value due to market conditions are recognized in earnings.

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**Facts** A bank originates HFS loans and elects the FVO as permitted under ASC 825. Subsequently, circumstances change, and the bank transfers the loans from HFS to HFI for appropriate business reasons.

## Question 23

Should the bank continue to apply fair value accounting after the loans are transferred to HFI?

## Staff Response

Yes. The FVO election is irrevocable (unless a new election date occurs, which is rare). This transfer does not result in a new fair value election date as defined in ASC 825-10-25-4. Accordingly, the bank should continue to account for the transferred loans using fair value accounting with unrealized gains and losses recognized in net income.

## 2F. Loan Recoveries

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

### Question 1

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

### Staff Response

No. The staff believes that the anticipated proceeds at death are a contingent gain. ASC 450-30-25-1 indicates that contingent gains are usually not booked, because doing so may result in revenue recognition before its realization. Because the bank can currently realize the cash surrender value of the policy, however, a loan loss recovery of $250,000 should be recorded at the transfer date.

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

### Question 2

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

### Staff Response

No. The $60,000 judgment itself does not represent a recovery. Proceeds from the judgment, as they are received, would be the basis for the recovery. If the $60,000 is actually received by the bank, the proceeds would be a recovery of both the previously charged-off loan and the loss on the sale of the collateral. Accordingly, the bank would record $50,000 as a loan loss recovery and $10,000 as other noninterest income.

**Facts** A bank made a $500,000 unsecured loan to a corporation that is 100 percent owned by one person. The corporation experienced economic problems and was unable to perform on the loan. Collection of the loan was considered unlikely, and it was charged off.

Subsequently, the bank advanced an additional $400,000 to the owner of the corporation. In exchange, the bank received title to five undeveloped building lots that had an appraised value in excess of $900,000. The exchange agreement provides the borrower with a four-year option to repurchase the land. Additionally, the agreement provides that during this four-year period the bank is precluded from disposing of the property.

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

## Question 3

May a loan loss recovery be recorded on this transaction?

## Staff Response

No. The substance of the transactions is that the bank restructured the unsecured loan with the borrower into a four-year loan secured by real estate. In exchange for receiving collateral, the bank also agreed to advance additional funds. The bank effectively does not have economic control of the property.

Accordingly, the bank should report the $400,000 advance as a loan, and not report the real estate as OREO. Because $500,000 of the loan was previously charged off, the loan has a cost basis of $400,000. Because of the financial condition of the borrower and the uncertainty of loan collectibility, income on the loan should not be accrued. Subsequent payments received should be recognized in accordance with GAAP and call report instructions.

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**Facts** A bank sells loan receivables with a contractual balance of $100,000 for $5,000 to an independent third party. The receivables had been previously charged off through the ACL four months before the sale and therefore have a current cost basis of $0.

## Question 4

How should the bank account for the proceeds from the sale?

## Staff Response

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

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

## Question 5

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

## Staff Response

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

In December 2010, the recovery from the insurance company represents a contingent loss recovery. A contingent loss recovery should be recorded only if collection is probable and estimable (see Subtopic 5C, question 7). In accordance with ASC 855-10-25, banks should recognize in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the balance-sheet date.

In this situation, the borrower obtained the bond insurance and, therefore, realization of payment was assured in December 2010. Situations in which the lender has insurance on a loan that subsequently defaults are discussed in Subtopic 5A, question 31.

## 2G. *Acquired Loans* (Subtopic Superseded)

*This Subtopic has been superseded due to the adoption of ASC Topic 326 by all entities. See Subtopic 12C for questions and answers regarding the accounting for acquired loans in accordance with ASC Topic 326.*

# Topic 3 Leases

## 3A. Lessor Classification and Accounting (Bank as Lessor)

### Question 1

What criteria must be met for a lessor to classify a lease as a sales-type lease at lease commencement?

### Staff Response

In accordance with ASC 842-10-25-2, a lease is classified as a sales-type lease if any one of the following criteria is met at lease commencement:

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- The lease term is for the major part of the remaining economic life (e.g., 75 percent or more) of the underlying asset. This criterion should not be used for classifying the lease if the commencement date of the lease falls at or near the end of the economic life of the underlying asset (e.g., a commencement date that may fall within the last 25 percent of the total economic life of the underlying asset).
- The present value of the sum of the lease payments and any residual value guaranteed by the lessee equals or exceeds substantially all (e.g., 90 percent or more) of the fair value of the underlying asset. (Note: For banks, the fair value of the underlying asset at commencement of the lease is assumed to equal the underlying asset's cost, adjusted for any applicable volume or trade discounts. However, if a significant length of time has passed between the acquisition of the underlying asset and the commencement of the lease, fair value should be calculated based on the principles of ASC 820.)
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

When none of the criteria above are met, a lessor should classify the lease as either a direct financing lease or an operating lease (see question 2).

As explained in ASC 842-10-25-3A, a lessor should classify a lease with variable lease payments that do not depend on an index or a rate as an operating lease at lease commencement if classifying the lease as a sales-type or direct financing lease would result in the recognition of a selling loss (even if the lease otherwise meets the requirements of a sales-type or direct financing lease).

## Question 2

What criteria must be met for a lessor to classify a lease as a direct financing lease at lease commencement?

## Staff Response

In accordance with ASC 842-10-25-3, a lease is classified as a direct financing lease if it does not meet any of the criteria for classification as a sales-type lease per ASC 842-10-25-2 (see question 1) and it meets both of the following at lease commencement:

- The present value of the sum of the lease payments and any residual value guaranteed by the lessee, and/or any third party unrelated to the lessor, equals or exceeds substantially all the fair value of the underlying asset. In accordance with ASC 842-10-55-2, 90 percent or more of the fair value of the underlying asset may amount to substantially all of the fair value of the underlying asset.
- It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy the residual value guarantee.

If a lease does not meet the criteria outlined in question 1 to be classified as a sales-type lease and neither of the criteria above are met, a lessor should classify the lease as an operating lease.

As explained in ASC 842-10-25-3A, a lessor should classify a lease with variable lease payments that do not depend on an index or a rate as an operating lease at lease commencement if classifying the lease as a sales-type or direct financing lease would result in the recognition of a selling loss (even if the lease otherwise meets the requirements of a sales-type or direct financing lease).

## Question 3

Do all leases need to be evaluated for collectibility?

## Staff Response

Yes. Collectibility of amounts due under a lease arrangement must be evaluated. At lease commencement, bank management should review the risks affecting collectibility by ensuring that the lessee’s income and financial resources demonstrate its ability and intent to pay according to the established terms.

If collectibility of a sales-type or direct financing lease is probable at lease commencement, the lessor does not subsequently reassess collectibility for lease classification purposes. Subsequent changes in the credit risk of the lessee are accounted for in accordance with CECL.

**Direct financing lease:** If collectibility is not probable at the lease commencement date, the lease is classified as an operating lease.

**Operating lease:** If collectibility is not probable at the lease commencement date, operating lease income is limited to the lesser of (1) the income that would be recognized if collectibility was probable in accordance with ASC 842-30-25-11(a) through (b) or (2) the lease payments collected (i.e., cash basis). If the assessment of collectibility changes after the commencement date, any difference between (1) and (2) from the preceding sentence is recognized as a current-period adjustment to lease income.

**Sales-type lease:** If collectibility is not probable at the lease commencement date, the bank, as lessor, should not derecognize the leased asset nor recognize the net investment in the lease. Instead, the bank should recognize lease payments received as a deposit liability (not a bank deposit), in accordance with ASC 842-30-25-3, until the earlier of the following:

- The collectibility of amounts due under the lease becomes probable
- Either of the following events occurs:
  - The contract has been terminated and the lease payments received are nonrefundable
  - The bank has repossessed the leased asset, has no further obligation under the lease, and the lease payments received are nonrefundable.

If collectibility of a sales-type lease subsequently becomes probable, the bank shall

- derecognize the carrying amount of the underlying leased asset and deposit liability from its balance sheet,
- recognize the net investment in the lease on the basis of the remaining lease payments and remaining lease term, using the rate implicit in the lease determined at the commencement date,
- recognize any selling profit or loss,
- and follow the subsequent measurement guidance for a sales-type lease.

If collectibility of a sales-type lease does not become probable before the contract is terminated or the leased asset is repossessed, and the lease payments are nonrefundable, the lessor should derecognize the carrying amount of any deposit liability, with the corresponding amount recognized as lease income. The lessor should continue to apply the impairment guidance in ASC 360 to the underlying asset.

## Question 4

How should a lessor determine the lease term?

## Staff Response

An entity should determine the lease term as the noncancelable period of the lease, together with all of the following:

- Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option.

- Periods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the lessor.
- Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

Generally, leases are accounted for on the basis of the legally enforceable terms and conditions of the arrangement, including enforceable rights or obligations outside the written lease contract. As a result, in determining the lease term, lessors must generally consider all relevant factors that create an economic incentive for the lessee to extend the lease term beyond what is stated in the written contract or to terminate the lease. Specific factors to consider may relate to the contract, the leased asset, the market, and the lessee. Examples of these factors include:

- If leasehold improvements are expected to have significant economic value at the end of the stated lease term.
- The importance of the leased asset and its location relative to the lessee's operations.
- Costs related to signing a new lease, such as costs of negotiating a new lease, identifying another location that is suitable for the bank, and relocation.

As a practical expedient, in accordance with ASC 842-10-15-3A, private and certain not-for-profit entities may use the written terms and conditions of a related party arrangement between entities under common control to determine whether a lease exists and, if so, to account for common control leases without further assessing the legal enforceability of those terms. Eligible entities may use this practical expedient, which cannot be applied to verbal agreements, to determine the lease term.

## Question 5

For lessor accounting, what is included in lease payments for purposes of lease classification?

## Staff Response

Lease payments include the following per ASC 842-10-30-5:

- Fixed payments, including in substance fixed payments, less any lease incentives paid or payable to the lessee.
- Variable lease payments dependent on an index or rate, measured using the index or rate at lease commencement.
- The exercise price of a purchase option to purchase the underlying asset if the lessee is reasonably certain to exercise that option.
- Payments for lease termination penalties if the lessee is reasonably certain to exercise the termination option.
- Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction.

Fixed lease payments include unavoidable, "in-substance" fixed payments. An annual percentage increase included in a lease contract that is both fixed and unavoidable by the lessee is an example of an "in-substance" fixed lease payment.

Reimbursements from the lessee of costs initially paid by the lessor are recorded in revenue as variable lease payments.

Real estate taxes and building insurance premiums paid by the lessor directly to the taxing jurisdiction and insurance company, and reimbursed by the lessee, are recorded as lessor costs (a period expense) separately from the lessee's variable payments thereof (variable lease revenue for the lessor). If the lessee pays real estate taxes and building insurance premiums directly to third parties, the lessor should not recognize those as lessor costs (a period expense) or the lessee's payments as variable lease revenue.

A lessor should not remeasure the lease payments unless the lease is modified and that modification is not accounted for as a separate contract in accordance with ASC 842-10-25-8.

## Question 6

How are direct financing and sales-type leases recorded on the balance sheet, for financial reporting and call report purposes, for a lessor?

## Staff Response

Generally, the net investment in the direct financing or sales-type lease is recorded in loans and lease financing receivables and is composed of the following:

- The lease receivable which includes the present value of
  - the future lease payments and
  - the guaranteed residual asset value.
- The present value of the unguaranteed residual asset value.

Deferred selling profit also reduces the net investment in a direct financing lease.

To calculate the present value of the future lease payments, the guaranteed residual asset value, and the unguaranteed residual asset value, the lessor uses the implicit rate, which is the rate of interest that, at a given date, causes the aggregate present value of the lease payments and the amount that a lessor expects to derive from the underlying asset following the end of the lease term to equal the sum of the fair value of the underlying asset and any deferred initial direct costs of the lessor. The fair value of the underlying asset used in the calculation is reduced for any related investment tax credits retained and expected to be realized by the lessor.

The lease receivable is increased for accrued interest and reduced by cash payments received from the lessee.

The residual asset is recorded at its present value and accreted to its final expected value at the expiration of the lease term.

## Question 7

How does lease classification affect the lessor's income statement?

## Staff Response

Lease classification may affect the timing of recognition of the selling profit, initial direct costs, and interest income. However, total income and expenses over the lease term may be the same. Refer to the table below for a summary of how lease classification changes the recognition of lease income and expense.

**Summary of Lessor Accounting for Income Statement Activities by Lease Classification**

| Type of Activity | Sales-type lease | Direct financing lease | Operating lease (2) |
|---|---|---|---|
| Selling profit (1) | Recognize at lease commencement if collectibility is probable.<br>If collectibility is not probable at lease commencement, recognize when collectibility becomes probable. | Defer and include as a reduction to the net investment in the lease. | NA |
| Selling loss (1) | Recognize at lease commencement if collectibility is probable.<br>If collectibility is not probable at lease commencement, recognize when collectibility becomes probable. | Recognize at lease commencement. | NA |
| Initial direct costs | If fair value of the underlying asset does not equal its carrying amount, expense at lease commencement and exclude from determination of the rate implicit in the lease.<br><br>If the fair value of the underlying asset equals its carrying amount, defer and include in the net investment in the lease and in determination of the rate implicit in the lease. | Defer and include in the net investment in the lease and in determination of the rate implicit in the lease. | Defer and expense over the lease term on the same basis as lease income. |

| Type of Activity | Sales-type lease | Direct financing lease | Operating lease (2) |
|---|---|---|---|
| Lease income | Interest income on the net investment in the lease is determined based on the amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease. (3) | Interest income on the net investment in the lease is determined based on the amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease. (3) | Recognize lease revenue (rental payments) on a straight-line basis, unless another systematic and rational basis better represents the pattern in which benefit is expected to be derived from use of the underlying asset. (4)<br><br>If collectibility is not probable, limit revenue to the lesser of the straight-line revenue (or another systematic basis, if applicable) or the lease payments that have been collected. |

(1) When collectibility is probable, at the lease commencement date, selling profit or selling loss equals the lower of the fair value of the underlying asset or the sum of the lease receivable and any prepaid lease payments, less the carrying amount of the underlying asset net of any unguaranteed residual value, less any deferred initial direct costs of the lessor. If collectibility subsequently becomes probable, selling profit or selling loss equals the sum of the lease receivable and the carrying amount of the deposit liability, less the carrying amount of the underlying asset (net of the unguaranteed residual asset).

(2) As the underlying asset in the operating lease is not derecognized, depreciation is recorded as an expense over the asset's useful life, which could extend beyond the lease term.

(3) For sales-type and direct financing leases, a lessor should also recognize variable lease payments that are not included in the net investment in the lease as income in the period when the changes in facts and circumstances on which the variable lease payments are based occur.

(4) For an operating lease, a lessor should also recognize variable lease payments as income in the period in which the changes in facts and circumstances on which the variable lease payments are based occur.

## Question 8

What is the estimated residual value of a lease?

## Staff Response

The estimated residual value is the estimated fair value of the leased property at the end of the lease term. The residual asset value is a component of the net investment in the lease balance recorded at its present value at lease commencement and accreted to its final expected fair value at the expiration of the lease term. Lessors periodically update their estimates of the residual value of the leased asset over the lease term when applying ASC 326-20.

## Question 9

What factors should be considered in determining the estimated fair value amount used for the residual value of the asset at the end of the lease?

## Staff Response

Lessors are required to assess all relevant factors at lease commencement that create an economic incentive or penalty for the lessee to exercise lease renewal, termination, or purchase options. A factor that could create an economic incentive for the lessee to exercise the purchase option might include a bargain purchase option. A factor that could create a significant economic penalty for the lessee to exercise a purchase or renewal option might include if an alternative facility is not readily available if the lessee abandoned the leasehold improvements at the end of the initial noncancelable period. If there are no options or it is not reasonably certain a lessee would exercise an option, the amount that an independent third party would pay to purchase the asset most accurately represents the market's assessment of fair value and is the preferable value to use.

The amount used as the residual value can be based on historical models and future estimates but cannot be less than zero when considering the cost of disposing of the asset. The methods used to calculate residual value may differ slightly depending on the industry and usage.

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**Facts** A bank (lessor) has an automobile lease and needs to calculate the residual value of the asset. At lease commencement, it is not known how the bank will dispose of the automobile. At the end of the lease, the automobile may be sold to the lessee, to a third-party buyer at either retail or wholesale, or at auction. Each of these disposal methods may yield a different sales price for the asset which would affect the residual value calculation. The bank has sufficient experience to determine the expected proceeds from each method and the percentage of sales for which each method would be used.

## Question 10

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

## Staff Response

When the residual value of an asset may vary depending on how the asset is disposed, the use of a weighted average is appropriate for determining the residual value of the asset. This weighted average considers the expected proceeds from each disposal method and the percentage of time the asset is expected to be disposed by each disposal method (e.g., either retail or wholesale, or at auction in this fact pattern).

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**Facts** Rather than return the property to the bank (lessor) at the end of the lease term, the lessee continues to use the property and remit monthly lease payments. This arrangement continues on a month-to-month basis, with the lessee having the right to return the property and discontinue payments at any time.

## Question 11

How should the residual value of this property be determined?

## Staff Response

It depends. If the lease becomes an "at-will" arrangement because there were no contractual agreements to renew or extend, a month-to-month lease is a cancelable lease. The payments are recorded as lease income when received, and the residual value used at the end of the lease term is depreciated monthly to the salvage value. However, if there was an agreement to automatically extend on a month-to-month basis and it was reasonably certain that extension would last for a certain period of time, the residual value at the end of the lease term would be the fair value extended to that reasonably certain time frame.

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**Facts** The bank (lessor) has a portfolio of nonhomogeneous automobile leases. The bank purchased an insurance policy that guarantees the required minimum residual value on a portfolio basis assuming that the policy's guarantee would meet the lease payments criterion for a direct financing lease classification. The guarantee does not, however, cover each individual lease.

## Question 12

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

## Staff Response

No. Each lease in a nonhomogeneous portfolio must be considered individually in the present value test. A portfolio guarantee economically assures a lessor of receiving a minimum residual value for a portfolio of assets that are subject to separate leases but not for each individual asset. Offsets of gains against shortfalls in residual value exist within the portfolio before the guarantee would be applied. Therefore, it is not possible to determine the amount of the guaranteed residual value for each individual lease when the portfolio's expected residual values are not expected to be highly correlated.

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**Facts** A bank (lessor) entered into an equipment lease with a lessee. At the time the lease was entered into, there was no residual value guarantee in place. After lease commencement, the bank entered into an arrangement with a third party to provide a guarantee.

## Question 13

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

## Staff Response

No. The calculation of the lease payments criterion must be performed as of the lease commencement date. Therefore, the guarantee entered into after lease commencement would not be included in the calculation.

## Question 14

Must a CECL methodology be used to measure expected credit losses on the net investments in leases associated with sales-type leases and direct financing leases?

## Staff Response

Yes. A lessor should determine expected credit losses on the net investments in the leases using CECL in accordance with ASC 326-20.

# 3B. Lessee Classification and Accounting (Bank as Lessee)

## Question 1

How does a lessee determine if a lease is a finance lease at lease commencement in accordance with ASC 842-10?

## Staff Response

A lease is classified as a finance lease if the lessee effectively obtains control of the leased asset. Control is considered to have been obtained if the lease meets any one of the following criteria from ASC 842-10-25-2 at lease commencement:

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- The lease term is for the major part of the remaining economic life (e.g., 75 percent or more) of the underlying asset. This criterion should not be used for classifying the lease if the commencement date of the lease falls at or near the end of the economic life of the underlying asset (e.g., a commencement date that may fall within the last 25 percent of the total economic life of the underlying asset).
- The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments in accordance with ASC 842-10-30-5(f) equals or exceeds substantially all (e.g., 90 percent or more) of the fair value of the underlying asset.
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

If none of these criteria are met, the lease is classified as an operating lease.

## Question 2

At lease commencement, how should a lessee record a lease under ASC 842?

## Staff Response

Finance and operating leases must be recognized as of the lease commencement date on the lessee's balance sheet. Accordingly, the below response is applicable to both finance and operating leases for a lessee.

On the date on which the leased asset is available for the lessee's use, the lessee should record a lease liability that is measured at the present value of the lease payments not yet paid discounted using the appropriate discount rate for the lease at lease commencement. The discount rate used is the rate implicit in the lease. If the rate implicit in the lease cannot be readily determined, the lessee would use its incremental borrowing rate, which is the rate that the lessee would pay to borrow an amount equal to the lease payments on a collateralized basis over a similar term in a similar economic environment. A lessee that is not a public business entity may make an accounting policy election to use a risk-free discount rate for the lease instead of its incremental borrowing rate when measuring its lease liability. The risk-free discount rate is determined using a period comparable to that of the lease term. This policy election is by underlying asset class and would apply to all leases within that asset class for which the lessee cannot readily determine the rate implicit in the lease.

A corresponding ROU asset should also be recorded. The ROU asset is the sum of the following:

- The lease liability.
- Any lease payments made to the lessor before the commencement date, net of any lease incentives received.
- Any initial direct costs incurred by the lessee (e.g., commissions).

If a lease term is one year or less and does not include an option to purchase the leased asset that the bank is reasonably certain to exercise, a bank can make an accounting policy election not to recognize the ROU asset and corresponding lease liability that arise from the short-term lease. This election must be made by class of leased assets. If this election is made, the bank should generally recognize the lease expense each period based on a straight-line basis over the lease term and variable lease payments in the period in which the obligation for those payments is incurred.

Additionally, a lessee is generally required to amortize leasehold improvements that it owns over the shorter of the useful life of those improvements or the lease term. However, per ASC 842-20-35-12A, leasehold improvements associated with leases between entities under common control should be amortized over the useful life to the common control group as long as the lessee controls the use of the underlying asset.

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## Question 3

After lease commencement, how should a lessee account for a lease under ASC 842?

## Staff Response

While the requirements for initial recognition and measurement of the lease liability and ROU asset are the same for every lease regardless of whether it is classified as a finance lease or an operating lease, the subsequent measurement and related expense profile differ on the basis of the lease classification.

For a finance lease, after the commencement date, the lessee records interest expense on the lease liability and amortization of the ROU asset, generally on a straight-line basis to the earlier of the end of the leased asset's useful life or lease term. In addition, the lessee should increase the lease liability to reflect accrued interest on the lease liability and decrease the lease liability for lease payments made during the period. The lessee carries the ROU asset at cost less any accumulated amortization and any accumulated impairment losses.

For an operating lease, after the commencement date, the lessee records a single lease cost, generally on a straight-line basis, unless the ROU asset is impaired (in which case the single lease cost is calculated in accordance with ASC 842-20-25-7). Variable lease payments not included in the lease liability are recognized when incurred. Any impairment of the ROU asset, determined in accordance with ASC 360, is also recognized. In addition, the lessee measures the lease liability at the present value of the lease payments not yet paid discounted using the discount rate for the lease established at the commencement date. Effectively, this approach is consistent with the model used to calculate the liability related to the finance lease. The lessee carries the ROU asset at the amount of the lease liability, adjusted for prepaid or accrued lease payments, the remaining balance of any lease incentives received, unamortized initial direct costs, and the impairment of the ROU asset.

## Question 4

How should a lessee determine the lease term?

## Staff Response

An entity should determine the lease term as the noncancelable period of the lease, together with all of the following:

- Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option.
- Periods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the lessor.
- Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

In determining the lease term, lessees must generally consider all relevant factors that create an economic incentive for the lessee to extend the lease term beyond what is stated in the written contract or to terminate the lease. Specific factors to consider may relate to the contract, the leased asset, the market, and the lessee.

As discussed in Topic 3A, question 4, private and certain not-for-profit entities may apply a practical expedient and use the written terms and conditions of a related party arrangement between entities under common control to determine whether a lease exists and, if so, to account for common control leases without further assessing the legal enforceability of those terms. Eligible entities may use this practical expedient, which cannot be applied to verbal agreements, to determine the lease term.

## Question 5

How should the lessee determine the amount of the lease liability at the commencement date of the lease?

## Staff Response

The lessee should include the sum of the present value of the following items in the calculation of the lease liability to the extent that they have not yet been paid:

- Fixed payments, including in substance fixed payments, less any lease incentives paid or payable to the lessee.
- Variable lease payments dependent on an index or rate, measured using the index or rate at lease commencement.
- The exercise price of a purchase option to purchase the underlying asset if the lessee is reasonably certain to exercise that option.
- Payments for lease termination penalties if the lessee is reasonably certain to exercise the termination option.
- Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction.
- Amounts probable of being owed by the lessee under residual value guarantees.

A lessee should remeasure lease payments if any of the following occur:

- The lease is modified, and that modification is not accounted for as a separate contract.
- A contingency upon which some or all of the variable lease payments that will be paid over the remainder of the lease term are based is resolved such that those payments now meet the definition of lease payments.
- There is a change in any of the following: (1) the lease term, (2) the assessment of whether the lessee is reasonably certain to exercise or not to exercise an option to purchase the underlying asset, or (3) amounts probable of being owed by the lessee under residual value guarantees.

In accordance with ASC 842-20-35-4, a lessee should remeasure the lease liability to reflect changes to the lease payments. A lessee should recognize the amount of the remeasurement of the lease liability as an adjustment to the ROU asset. However, if the carrying amount of the ROU asset is reduced to zero, a lessee should recognize any remaining amount of the remeasurement in profit or loss. Additionally, the lessee should update the discount rate for the lease at the date of remeasurement on the basis of the remaining lease term and the remaining lease payments unless the remeasurement of the lease liability is the result of one of the changes referenced in ASC 842-20-35-5. The changes referenced are either (1) a change in the lease term or the assessment of whether the lessee will exercise an option to purchase the underlying asset and the discount rate already reflects the lessee’s option to extend or terminate the lease or purchase the underlying asset, (2) a change in the amounts probable of being owed by the lessee under a residual value guarantee, or (3) a change in the lease payments resulting from the resolution of a contingency upon which some or all of the variable lease payments are based.

**Facts** A bank has made an accounting policy election to not apply the requirements to record the ROU asset and lease liability that arise from leases with a term of one year or less. The bank enters into a one-year lease with 10 one-year renewal options.

## Question 6

May the bank account for this lease under its current short-term lease accounting policy?

## Staff Response

It depends. In assessing the lease term, the bank must consider periods covered by renewal options if the bank is reasonably certain to exercise that option or if the option is controlled by the lessor. If after considering the relevant factors in ASC 842-10-55-26 the bank determines that it is reasonably certain that one or more of the renewal options will be exercised, the lease should not be accounted for under the bank's current short-term lease accounting policy, and a lease liability and related ROU asset should be recorded. Per ASC 842-10-55-26, examples of economic factors to consider include (1) contractual terms and conditions for the optional periods compared with current market rates, (2) significant leasehold improvements that are expected to have significant economic value for the lessee, (3) costs relating to the termination of the lease, among others, and (4) the importance of the underlying asset to the lessee's operations.

## Question 7

How should the ROU asset and lease liability be reported in the call report?

## Staff Response

The ROU asset should be reflected in Schedule RC, "Premises and fixed assets," and included in the risk-based capital and leverage ratio denominators. The ROU asset should be risk-weighted at 100 percent. The FASB did not directly address whether the ROU asset is a tangible or intangible asset. For regulatory capital purposes, however, the ROU asset is not deducted from regulatory capital as an intangible asset.

The lease liability for operating leases is reported in Schedule RC, "Other liabilities," and Schedule RC-G, "All other liabilities." The lease liability for finance leases should be reported in Schedule RC-M, "Other borrowings," and "Amount of 'Other borrowings' that are secured."

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**Facts** A bank is leasing branch space and appropriately classifies the lease as an operating lease. The bank subleased a portion of the branch space for five years and did not terminate or modify the existing operating lease agreement with the lessor. The bank determined that the sublease agreement is classified as an operating lease. The sublessee is an unrelated third party and is the principal with respect to the sublease as assessed in ASC 606-10-55-39.

## Question 8

How should the sublease income be reported in the call report?

## Staff Response

The sublease does not alter the accounting treatment of the original lease. The bank continues to report the original operating lease ROU asset, lease liability, and rental expense. As sublessor, the income received from the sublease should be included in Schedule RI, “Expenses of premises and fixed assets,” as a reduction (offset) of the rental expense amount.

## Question 9

How should a sublessee in a common control group amortize leasehold improvements if the intermediate lessor leases the property from an unrelated party?

## Staff Response

If a lessee has a lease with an unrelated party and subsequently subleases the asset to a related party under common control, the sublessee should generally amortize the leasehold improvements over a period that does not exceed the term of the lease between the intermediate lessor and the unrelated party. However, if the lease between the intermediate lessor and the unrelated party contains an option to purchase the underlying asset that the intermediate lessor is reasonably certain to exercise or contains an option for automatic transfer of ownership, the leasehold improvements should be amortized by the sublessee over the useful life of the leased asset to the common-control group.

## 3C. Sale-Leaseback Transactions

**Note**

ASC 842 requires that sale-leaseback transactions qualify as a sale under ASC 606 in order to derecognize the asset. If a transaction does not qualify as a sale, it would be accounted for as a financing (i.e., failed sale), and the bank may not derecognize the asset or recognize a gain or loss on sale. In the following fact pattern, it is assumed that the transaction qualifies for sales recognition under ASC 606.

**Facts** A bank transfers its premises (building) to its holding company through a dividend. At the date of transfer, the fair value of the building is greater than the carrying amount. The holding company sells the building to a third party, who leases it back to the bank.

### Question 1

How should this transaction be accounted for?

### Staff Response

To determine the appropriate accounting for this transaction, the bank must determine if a sale occurred based on the guidance in ASC 606. Generally, a sale has occurred if control over the leased asset has been transferred to a third party. The existence of a leaseback with a third party does not, in isolation, prevent a third party from obtaining control of the building. However, for example, if the leaseback is a direct financing lease, the bank has not transferred control of the building to a third party.

The bank transferred control of the building as part of this transaction and a sale has occurred. As a result, the leaseback is classified as an operating lease, the property is derecognized, and the excess of the fair value over the carrying value is recognized as a gain in noninterest income. The bank should also record an ROU asset and related lease liability for the term of the lease.

Additionally, consistent with call report instructions, the property dividend to the holding company should be recorded at fair value. The fair value of the building is charged to retained earnings as a noncash dividend.

### Question 2

Assume the same facts as in question 1, except that the holding company returns the sales proceeds to the bank in the form of a capital contribution. How is this transaction accounted for?

## Staff Response

The accounting for this transaction would be the same as in question 1, except that the bank would also record the amount of the capital contribution by crediting the surplus account. Therefore, the bank's total capital would increase by the amount of gain recognized. The bank's ability to pay future dividends has decreased, however, because retained earnings have been reduced by the amount of the dividend, and the capital contribution has been credited to surplus.

## Question 3

How should sale-leaseback transactions with a related party be accounted for?

## Staff Response

The bank must determine if a sale occurred based on the guidance in ASC 606. The sales contract criteria outlined in ASC 606-10-25-1 through 25-8 require, among other things, that a contract with a related party have commercial substance. That is, the risk, timing, or amount of the bank's future cash flows is expected to change as a result of the contract. Related party contracts that lack commercial substance will not qualify as sale-leaseback transactions.

Assuming there is commercial substance, if control of the building has not been transferred (guidance in ASC 606 has not been met), the bank should not derecognize the property or record a lease or any related gain (if applicable). Instead, the bank should account for the transaction as a borrowing with the related party.

Assuming there is commercial substance, if control of the building has been transferred (and thus guidance in ASC 606 has been met), the bank should derecognize the property and record a lease and any related gain (if applicable).

# 3D. Lease Exit Costs

**Facts** A bank is a lessee of a branch office site and equipment. The bank has closed the branch and abandoned the equipment without canceling the related leases. The bank must continue to make contractual payments on the leases for the remaining lease terms. The remaining lease terms exceed one year, and the leases are accounted for as operating leases.

## Question 1

How should the bank account for the lease payments due after the closing of the branch office and abandonment of the leased equipment?

## Staff Response

Because the bank will not be canceling the leases, and none of the triggers for remeasuring the lease liability in ASC 842-10-35-4 have been met, the lease liabilities will continue to be measured at the present value of lease payments not yet paid, discounted using the rate established at commencement or the most recent remeasurement date. The ROU assets will need to be evaluated for impairment in accordance with ASC 360-10, as discussed in question 2.

## Question 2

How should the ROU assets be evaluated for impairment?

## Staff Response

An impairment evaluation of the ROU assets should be conducted no later than the date the decision is made to close the branch office and cease use of the equipment. The ROU assets, as part of the long-lived asset group, are evaluated for impairment under ASC 360-10-35 when there is an indicator that the carrying amount of the asset group is not recoverable.

If the bank has no plans or doesn't have a contractual right to sublease the property, the ROU asset is generally considered impaired and should be written off entirely by the earlier of the cease-use date or the end of the lease term (ASC 842-20).

If the bank plans to sublease the underlying asset and has the contractual right to do so, the bank should still consider whether any impairment indicators exist and if so, measure and recognize any impairment. Additionally, the estimated useful life of any remaining ROU asset is adjusted in accordance with ASC 360-10, unless the lessee continues to sublease the asset through the remaining lease term.

If an impairment charge is recorded, the adjusted carrying amount of the ROU asset becomes its new cost basis and is amortized over the shorter of the ROU asset's useful life or the remaining lease term.

# Topic 4 *Allowance for Loan and Lease Losses* (Topic Superseded)

*This Topic has been superseded due to the adoption of ASC Topic 326 by all entities. See Subtopic 12D for questions and answers regarding the allowance for credit losses in accordance with ASC Topic 326.*

# Topic 5 OREO and Other Assets

## 5A. Other Real Estate Owned

### Question 1

How should banks account for their investment in OREO property?

### Staff Response

The call report instructions require that OREO and its sales be accounted for in accordance with GAAP:

- ASC 310 and ASC 360 provide general guidance for recording OREO.
- ASC 970-340 provides guidance on accounting for costs during the development and construction period.
- ASC 835-20 provides guidance on capitalization of interest costs.

Upon receipt of the real estate, OREO should be recorded at the fair value of the asset less the estimated costs to sell, and the remaining balance of the loan should be derecognized. The amount by which the cost basis in the loan exceeds the fair value (net of estimated costs to sell) of the OREO is a loss that is charged to the ACL. Upon transfer to OREO, the fair value less estimated costs to sell becomes the new cost basis for the OREO property.

Subsequent holding period 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. A valuation allowance allocated to one property may not be used to offset losses incurred on another property. Unallocated valuation allowances are not acceptable. Subsequent increases in the fair value of a property may be used to reduce the valuation allowance but not below zero.

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

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**Facts** As part of the foreclosure process, a mandatory redemption period applies in certain states after legal title to the residential real estate property passes in a sheriff’s sale. During the redemption period, the borrower can redeem the affected residential real estate property collateralizing a residential mortgage loan as long as the borrower pays the consideration required for the redemption. During the redemption period, the borrower may occupy the property. Generally, a bank does not have the ability to enter the property until the redemption period has expired. Therefore, the bank has foreclosed on the property and has obtained title but does not have access to the property during the redemption period. The length of the redemption period varies by state, but it generally ranges from three months to one year. During the redemption period, the bank is entitled to sell the foreclosed property, but the property remains subject to the borrower's right of redemption.

## Question 2

Should the bank reclassify the residential mortgage loan to OREO at the time of foreclosure (sheriff's sale) if the collateral is subject to a redemption period?

## Staff Response

Yes. The bank should reclassify the residential mortgage loan to OREO upon taking legal title of the property even if the borrower has the redemption right, in accordance with ASC 310-20-55-18F. In this case, the bank should transfer the loan to OREO when it obtains title at the time of the sheriff's sale.

Consistent with ASC 310-20-35-12C, OREO received in satisfaction of debt is recorded at its fair value less estimated costs to sell. Recognizing residential real estate property as OREO is required when a creditor receives "physical possession," which, for residential real estate, means either through obtaining legal title to the property upon completion of foreclosure or through borrower conveyance of all interest in the property via completion of a deed in lieu of foreclosure. The bank will continue to report OREO if the property is not redeemed within the statutory time frame. In the event of redemption, the bank will report the sale of OREO for the amount of the proceeds received.

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

## Question 3

Does the accounting guidance in ASC 310-20-55-18F on physical possession of residential real estate property collateralizing a consumer mortgage loan affect when a bank should derecognize a loan collateralized by property other than residential real estate, such as a commercial real estate loan and an auto loan?

## Staff Response

No. The bank should reclassify such a loan to a foreclosed or repossessed asset at the earlier of physical possession of or legal title to property other than residential real estate. In these cases, when legal title has not been received, physical possession relates to actual custody or control over the collateral rather than the legal definition that applies to residential real estate. In addition, the bank may obtain legal title to the borrower's property even if the borrower has a redemption right. Consistent with ASC 310-20-40-6, the bank should derecognize a loan collateralized by property other than residential real estate and recognize the property that collateralized the loan when the bank receives physical possession of the property through an in-substance foreclosure or repossession.

ASC 310-20-55-18F applies only to mortgage loans collateralized by residential real estate and clarifies when a creditor is considered to have received physical possession (resulting from an in-substance foreclosure or repossession) of residential real estate. That is, either (1) the creditor obtains legal title to the residential real estate or (2) the borrower conveys all interest in the residential real estate collateral to the creditor through completion of a deed in lieu of foreclosure or a similar legal agreement. The scope of the clarification guidance, however, is limited to mortgage loans collateralized by residential real estate properties and does not apply to other types of loans when determining if there is an in-substance foreclosure or repossession.

## Question 4

Do the requirements for physical possession presented in ASC 310-20-55-18F apply to investor-owned one- to four-family residential real estate properties?

## Staff Response

Yes. ASC 310-20-55-18F addresses physical possession of residential real estate property collateralizing a consumer mortgage loan. For purposes of applying ASC 310-20-55-18F, a consumer mortgage loan includes investor-owned one- to four-family residential real estate properties.

**Facts** A bank is in the process of foreclosing on a $150,000 loan. The loan is secured by real estate with a fair value, based on a current appraisal, of $190,000. The estimated costs to sell this property are estimated at $15,000. This fact pattern indicates that the borrower has equity in the property.

## Question 5

At what value should the OREO be recorded?

## Staff Response

Upon receipt of the real estate, the property should be recorded at $175,000 in accordance with ASC 310 and ASC 360. This represents the fair value ($190,000) less the estimated costs to sell the property ($15,000).

The fair value determined in the appraisal should be scrutinized closely, consistent with safe and sound risk management practices. Because the borrower has equity in the property, the bank should address the issue of why the borrower would risk losing the property in foreclosure. If concern exists about the accuracy of the appraisal, further analysis should be performed. If the appraisal properly supports the fair value of the property, the $25,000 increase in value is recognized 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 ACL would be appropriate.

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**Facts** A bank acquires real estate in full satisfaction of a $200,000 loan through foreclosure. 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 6

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 estimated costs to sell the property ($15,000). The amount by which the cost basis in the loan ($200,000) exceeds the fair value less estimated costs to sell ($175,000) is $25,000 and should be recorded as a charge against the ACL.

Subsequent to the acquisition date, the OREO is carried at the lower of cost ($175,000) or fair value less estimated costs to sell. When the fair value declines to $170,000, the fair value less estimated costs to sell would be $155,000. This represents a $20,000 decline in value, a loss which is recorded through a valuation allowance with a charge to net gains (losses) on sales of OREO under noninterest income.

## Question 7

If two years later the fair value of the property is $195,000, how should the increase in value be accounted for?

## Staff Response

The increase in the fair value ($25,000) may be recognized only up to the 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.

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## Question 8

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

## Staff Response

No. The direct write-off establishes a new cost basis for the property. Reversing a previous write-off and rebooking a written-off asset is not in accordance with GAAP. However, subsequent to the direct write-off at foreclosure, the bank may establish a valuation allowance for any subsequent fair value decline rather than record an additional direct write-off.

## Question 9

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

## Staff Response

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

ASC 970-340-25-8 provides an exception for real estate property taxes incurred "during periods in which activities necessary to get the property ready for its intended use are in progress." Therefore, real estate taxes incurred during the construction period may be capitalized, up to the fair value of the property. This limited exception would not cover periods in which the bank is merely holding property for future sale. Such costs incurred at other times, however, must be expensed as incurred as stated in ASC 970-340-25-8.

**Facts** A bank forecloses on a loan secured by a second lien on a real estate property. The bank does not formally assume the senior lien.

## Question 10

How should the bank account for the senior debt?

## Staff Response

The amount of any senior debt should be reported as a liability at the time of foreclosure, even though the bank may not formally assume the liability of the senior lien on the property. The OREO balance would be increased by a corresponding amount. The resultant carrying value of the OREO, however, cannot exceed the fair value, net of sales costs, of the property. Any difference between the carrying value of the OREO and the sum of the liens should be charged against the ACL at the time of foreclosure.

## Question 11

The bank pays delinquent real estate taxes incurred prior to foreclosure of the associated property to avoid lien attachment by the taxing authority. How should the bank account for the delinquent real estate taxes and the associated tax payment?

## Staff Response

Certain costs incurred by a bank to perfect its lien before foreclosure may be included in the recorded amount of the loan satisfied. Examples of these costs are payments of delinquent property taxes to clear tax liens, payments to contractors and subcontractors to clear mechanic's liens, or paying off first lien positions on properties for which the bank holds the second lien. As such, the delinquent real estate taxes may be capitalized as part of the cost basis of the loan satisfied. As noted in Subtopic 2B, question 23, delinquent real estate taxes should have been considered when assessing credit losses before transferring the property to OREO. If the delinquent real estate taxes are not paid before or at the time of transfer to OREO, this amount should be recorded as a liability.

Real estate taxes and other costs incurred after the property becomes OREO (after foreclosure) are considered holding costs and expensed as incurred. 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. However, for property under construction, GAAP allows for capitalization of property taxes and other costs during the development period of the OREO property.

## Question 12

Prior to foreclosure, the bank purchases the real estate tax lien certificate on the property rather than pay the delinquent real estate taxes, as in question 11. Would the response change if the bank purchased the real estate tax lien certificate rather than pay the delinquent real estate taxes?

## Staff Response

No. The substance of this transaction when the bank purchases the tax lien certificates on property on which it has a lien or has foreclosed is the same as if the bank were paying the property taxes directly. Accordingly, the guidance in question 11 would apply.

## Question 13

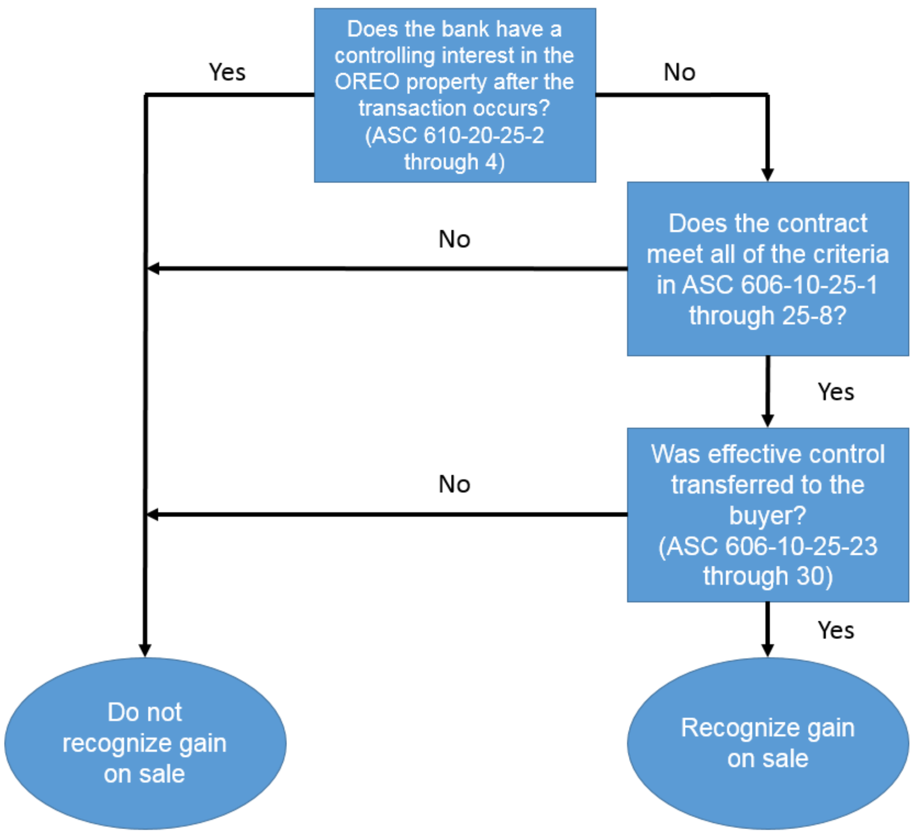
A bank finances the sale of an OREO property at market terms. The contract price is greater than the carrying value of the OREO property. How should the bank account for the transaction?

## Staff Response

Banks should follow the income recognition guidance in ASC 610-20 for seller-financed sales of OREO (as long as the bank does not have a controlling financial interest in the legal entity buying OREO per ASC 810). Under this standard, a bank recognizes the entire gain or loss on sale, if any, and derecognizes the OREO at the time of sale if (1) an ASC 606 sales contract exists and (2) control of the OREO has been transferred to the buyer as described in ASC 606.

Refer to questions 14 and 15 for staff responses on evaluating sales contract criteria and question 16 regarding the transfer of effective control.

The following flowchart can be used as an aid to determine the appropriate accounting for the transaction.




## Question 14

What conditions must be present for an ASC 606 sales contract to exist?

## Staff Response

In order for an arrangement (such as the loan agreement and a purchase/sale agreement) to be a contract, it must meet all of the following five criteria:

a. The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations. See question 15.
b. The bank can identify each party's rights regarding the OREO to be transferred.
c. The bank can identify the payment terms for the OREO to be transferred.
d. The contract has commercial substance (that is, the risk, timing, or amount of the bank's future cash flows is expected to change as a result of the contract).
e. It is probable that the bank will collect substantially all of the consideration to which it will be entitled in exchange for the OREO that will be transferred to the buyer (i.e., the transaction price). In evaluating whether collection is probable, a bank should consider only the buyer's intent and ability to pay the transaction price. See question 15.

If an arrangement between the bank and the buyer does not meet all five of these criteria, an ASC 606 sales contract does not exist.

## Question 15

What factors should the bank consider when assessing the buyer's commitment to perform described in criterion (a) and the collectibility of the transaction price described in criterion (e) of the staff response to question 14?

## Staff Response

The amount and character of a buyer's initial equity (typically the down payment) in the property immediately after sale and the existence of recourse provisions are important factors to consider when evaluating criteria (a) and (e). Under criterion (a), for example, if a buyer is not required to make a down payment or does not have recourse risk, the buyer may not have demonstrated a commitment to executing the rest of the contract. Furthermore, a borrower's inability to provide a down payment to purchase the property, or the absence of recourse provisions, calls into question the ability of the bank to collect substantially all of the transaction price as outlined in criterion (e).

A transaction with an insignificant down payment and nonrecourse financing requires considerable support from other factors to justify a conclusion that an ASC 606 sales contract exists. Support from other factors recedes in importance for a transaction with a substantial down payment and recourse financing to a buyer with adequate capacity to repay.

Facts and circumstances related to the buyer's intent and ability to pay the transaction price may include the following:

- Amount of cash paid as a down payment
- Existence of recourse provisions
- Credit standing of the buyer
- Age and location of the property
- Cash flow from the property

- Payments by the buyer to third parties
- Other amounts paid to the selling bank, including current or future contingent payments
- Transfer of noncustomary consideration (i.e., something other than cash and a note receivable)
- Other types of financing involved with the property or transaction
- Financing terms of the loan (reasonable and customary terms, amortization, any graduated payments, balloon payments)
- Underwriting inconsistent with the bank's underwriting policies for loans not involving OREO sales
- Future subordination of the seller's receivable

## Question 16

What factors should the bank consider when assessing whether the bank has transferred control of the OREO to the buyer?

## Staff Response

ASC 606-10 includes the following indicators of the transfer of control:

a. The bank has a present right to payment for the asset.
b. The customer has legal title to the asset.
c. The bank has transferred physical possession of the asset.
d. The customer has the significant risks and rewards of ownership of the asset.
e. The customer has accepted the asset.

For seller-financed sales of OREO, transfer of control generally occurs on the closing date of the sale, when the bank obtains the right to receive payment for the property and transfers legal title to the buyer. Banks must consider all relevant facts and circumstances to determine whether control of the OREO has transferred, which may include the bank's

- involvement with the property following the transaction.
- obligation to repurchase the property in the future.
- obligation to provide support for the property following the sale transaction.
- retention of an equity interest in the property.

For example, if a bank has the obligation or right to repurchase the OREO, control has not transferred from the bank to the buyer. The buyer is limited in its ability to direct the use of and obtain substantially all of the remaining benefits from the asset, even though the buyer may have physical possession. In this situation, a bank should account for the contract as a financing arrangement in accordance with ASC 606 or as a lease under ASC 842.

In addition, there may be situations in which the bank has legal title to the OREO while the original borrower still has redemption rights to reclaim the property in the future. If such redemption rights exist, the bank may not be able to transfer control to the buyer and recognize a gain or loss on sale, if any, until the redemption period expires. However, if the sale price that could be obtained if the OREO were sold indicates a decline in the fair value of the property (less estimated costs to sell), the loss must be recognized to ensure the OREO is maintained at the lower of cost or fair value (less estimated costs to sell) even though the sale is not recognized.

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**Facts** A bank finances the sale of a parcel of bank-owned OREO property (undeveloped land) for $100,000 and receives a $40,000 down payment. Simultaneous to the transaction, the bank extends a line of credit for $35,000 to the buyer.

## Question 17

Does this transaction qualify as a sale under ASC 606?

## Staff Response

ASC 606 removes the prescriptive treatment for funds provided directly or indirectly to the buyer by the bank. The bank should evaluate the down payment in conjunction with other facts and circumstances to determine if it is probable the bank will collect substantially all of the transaction price. The bank should evaluate the down payment relative to the amount of the financing.

If the line of credit for $35,000 is provided to the buyer to fund the $40,000 down payment, then the bank should consider the down payment to be $5,000. Given the amount of the $5,000 down payment relative to the $100,000 transaction price, the staff believes the down payment is insignificant and raises questions about the bank's ability to collect substantially all of the transaction price. Without additional facts to support collectibility, the staff does not believe this transaction would qualify as a sale.

If the bank makes the line of credit conditional on the proceeds being used for a purpose other than the down payment, such as to make improvements to the property, the bank may consider the down payment to be $40,000. Given the amount of this down payment relative to the transaction price, and absent any facts and circumstances that would negatively impact the borrower's ability and intent to pay the transaction price, the staff believes the transaction would likely meet contract criteria (a) and (e) in ASC 606-10-25-1.

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

## Question 18

Does this transaction qualify as a sale under ASC 606?

## Staff Response

While the down payment may demonstrate the buyer's commitment to the contract (i.e., ASC 606-10-25-1 criterion (a)), the IO structure may raise questions about the buyer's ability and intent to pay substantially all of the transaction price (i.e., criterion (e)). Additional support from other facts and circumstances would be needed to conclude that the contract criteria in ASC 606 have been met to achieve sale accounting. Refer to question 14 on how the bank evaluates contract criteria.

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**Facts** A bank owns a piece of OREO recorded at an appraised value, less estimated costs to sell, of $15 million. The bank agrees to sell the property for $13.5 million (net of estimated costs to sell) to an unrelated buyer after negotiating from an original offer of $11 million. Immediately before closing, the buyer has difficulty obtaining financing for the purchase, and the deal falls through.

## Question 19

Must the bank adjust the carrying amount of the OREO?

## Staff Response

Yes. The bank should reduce the carrying amount of the OREO to $13.5 million by establishing a $1.5 million valuation allowance. The bank received a better indication of the asset value by negotiating a fair sale price with a willing buyer. Had the buyer not experienced last-minute difficulties in obtaining financing, the bank (a willing seller) would have sold the property at a loss in a market transaction.

## Question 20

Assume the appraised value is the same as in question 19, 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 (net of estimated costs to sell). 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, an independent appraisal or evaluation would continue to be used as an indication of fair value, to determine the carrying amount of the property.

**Facts** In June of the current year, an OREO property (a motel) with a carrying amount of $1.9 million is sold by the bank for $2 million, an amount that includes a cash down payment of $300,000 (15 percent of the sales price). As a result of the transaction, the bank transferred control of the OREO to the borrower. At the time of sale, the borrower's cash flows are insufficient to service the debt and the borrower lacks other income or assets that could be used to repay the debt.

## Question 21

Does the transaction result in an accounting sale and the derecognition of OREO?

## Staff Response

No. The collection of substantially all of the transaction price is not probable because the cash flows from the motel are insufficient to service debt and the borrower lacks other income or assets that could be used to repay the debt. Therefore, this transaction would not meet contract criterion (e) under ASC 606-10-25-1 and would not be considered an accounting sale. Until an accounting sale occurs, any consideration received from the buyer by the bank, including the $300,000 down payment and any periodic interest payments, should be recorded as a liability, and the OREO property should remain on the bank's balance sheet.

## Question 22

Five months later, the motel's business is thriving and its cash flows are now sufficient and are expected to remain sufficient to service the debt. May the bank account for the transaction as a sale under ASC 606?

## Staff Response

Yes. Criterion (e) has now been met, because both the down payment and the borrower's cash flows are sufficient to service the debt. Assuming all other contract criteria in ASC 606-10-25-1 are also met, an accounting sale has occurred; the bank can now derecognize the OREO asset, reverse the previously recorded liability, and record a corresponding gain on the sale.

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**Facts** A bank sells a shopping center that currently is classified as OREO and finances the transaction. The buyer makes a 30 percent down payment and enters into a 20-year amortizing mortgage at current market rates.

The mortgage is structured in two pieces, an A note and a B note. The B note is equal to 10 percent of the total loan amount. If a certain major tenant vacates the property within five years and the borrower refinances the A note with an independent third-party lender within 180 days of the tenant vacating the property, 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 23

How should the bank account for the B note?

## Staff Response

The bank should account for the B note as variable consideration, because the total amount of consideration the bank is entitled to receive from the B note is contingent on whether the tenant vacates the property and, if so, a third-party refinancing occurs. The bank should estimate the amount of variable consideration to include as a component of the transaction price.

## Question 24

Assuming the transaction price, which includes the value of the variable consideration, exceeds the carrying amount of the OREO, when may the bank recognize the gain?

## Staff Response

Assuming the contract meets the five sales contract criteria in ASC 606-10-25-1, the bank would recognize a gain on the sale of OREO when the bank transfers control of the OREO to the buyer. The amount of the gain will be the difference between the carrying value (i.e., lower of fair value or cost basis) of the OREO and the transaction price, which includes the value of the variable consideration at the time of sale. At each reporting period, the bank should recalculate the transaction price, including updating the value of the variable consideration. The bank would record an additional gain or loss on the sale of OREO for any incremental change in the transaction price at each reporting date.

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**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 costs to sell are $10,000. The “when completed” appraised value of the house is $150,000, and the estimated costs to sell are $15,000. The estimated cost to complete construction of the house is $40,000.

## Question 25

At what value should the OREO be recorded?

## Staff Response

The OREO should be recorded at $90,000 in accordance with ASC 310 and 360. This amount represents the current "as is" fair value of $100,000 less the $10,000 estimated costs to sell the property.

## Question 26

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

## Staff Response

Yes. 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.

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**Facts** A bank acquired a commercial building upon the default of its borrower. The property was placed into OREO at $5 million. This amount represents the property's fair value (less estimated costs to sell) 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 27

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 declined due to the departure of the tenant. Any decline in fair value (less estimated costs to sell) should be recorded in an OREO valuation allowance.

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**Facts** A bank sells a parcel of OREO property in a transaction that meets the sales accounting contract criteria (listed in question 14) set forth in ASC 606-10-25-1. The bank, however, provides the purchaser/borrower with a mortgage loan at a preferential interest rate (i.e., below market interest rate).

## Question 28

Would the granting of a preferential interest rate in the financing of the sale of an OREO property preclude sales accounting in accordance with ASC 606?

## Staff Response

No. A preferential interest rate in and of itself does not preclude sales treatment. Under ASC 606, a preferential interest rate affects the calculation of the transaction price, as discussed in question 29. As the transaction price is a component of assessing contract criteria (a) and (e) in ASC 606-10-25-1, as discussed in question 14, the bank's sale assessment could be affected.

## Question 29

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

## Staff Response

Under ASC 606, the transaction price in a sale of OREO will generally be the contract amount stated in the purchase/sale agreement. When a bank finances the sale of its own OREO, the transaction price may differ from the amount stated in the contract if the contract contains a significant financing component. A significant financing component exists when the timing of the buyer's payments explicitly or implicitly provides either the bank or the buyer with a significant benefit of financing the transfer of the OREO. A common example of a significant financing component would be a preferential rate of interest (either to the buyer or seller).

If a significant financing component exists, the stated contract amount should be adjusted for the time value of money to reflect the cash selling price of the OREO at the time of transfer to the buyer. The discount rate used in adjusting for the time value of money should be a market rate of interest considering the buyer's credit characteristics and the terms of the financing.

Based on the facts presented, the preferential interest rate is a significant financing component. The transaction price should be calculated by discounting the contracted sales price using a market rate of interest over the contractual term of the loan. For OREO transactions involving bank financing, the contracted sales price is the sum of any down payment and all contractual principal and interest payments due from the borrower. The amount of gain (or loss) is calculated by comparing the discounted transaction price to the carrying value (i.e., lower of fair value or cost basis) of the OREO asset being sold. The difference between the transaction price and the contractual amount of the loan is recorded as a discount, and the discount is accreted to interest income over the life of the loan.

**Facts** A bank originates a mortgage loan and contemporaneously obtains lender-paid mortgage insurance as part of the underwriting. Subsequently, the borrower defaults on the loan and the bank forecloses. The bank pays the premium for the insurance, and the cost is a factor in determining the loan's interest rate. The mortgage insurance does not meet the scope of a credit derivative under ASC 815-10-15, nor is it required to be accounted for under either ASC 340-30 or ASC 944-20. Subsequently, the borrower defaults on the loan and the bank forecloses.

## Question 30

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 remaining balance of the loan should be derecognized (see question 1). The receivable related to the mortgage insurance should not be included in determining the fair value less estimated costs to sell of the mortgage loan nor recorded as part of OREO. It is recorded as a separate asset.

## Question 31

Should the bank record a mortgage insurance receivable?

## Staff Response

There are two methods that a bank can elect to account for the mortgage insurance receivable.

1. The bank recognizes a mortgage insurance receivable when the loss has been incurred and if realization of the mortgage insurance claim is assured. ASC 450-30-25 states that contingencies that might result in gains usually are not reflected in the accounts, because doing so would recognize revenue before its realization. Determining whether the realization of the mortgage insurance claim is assured requires the bank to assess the mortgage insurance company's intent and ability to pay the claim. This includes assessing the mortgage insurance company's creditworthiness, propensity for litigating claims, and history of paying claims. The bank should not recognize a receivable for the mortgage insurance claim if there are concerns about the mortgage insurance company's creditworthiness and history of litigating claims, or if the loans in question are subject to any uncertainty because of litigation. Insurance receivables are included in the call report in Schedule RC-F, item 6, "All other assets." The insurance claim benefit should be recognized as a component of noninterest income; it should not be recognized as an adjustment to provision for credit loss expense. Other noninterest income is included in the call report in Schedule RI, item 5.l, "Other noninterest income."

2. The bank recognizes an asset for the amount of credit losses expected to be recovered from the insurance policy when the expected credit loss is recorded. The accounting treatment under this method is similar to accounting for indemnification assets in ASC 805-20-25-27. Recoveries from insurance policies are included in the call report in Schedule RC-F, item 6, "All other assets." The insurance claim benefit should be recognized as a component of noninterest income; it should not be recognized as an adjustment to provision for credit loss expense. Other noninterest income is included in the call report in Schedule RI, item 5.l, "Other noninterest income." See Subtopic 5C, question 7, for additional discussion on the accounting for insurance recoveries. The bank should evaluate the need for an ACL on any recovery asset recorded. See Subtopic 12D for additional discussion on accounting for credit losses under CECL.

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**Facts** A bank sells the SBA-guaranteed portion of a loan in the form of a participating interest. The borrower subsequently defaults on the loan. To facilitate foreclosure proceedings, the bank repurchases the guaranteed portion of the defaulted loan at par.

## Question 32

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 credit loss against the ACL.

## Question 33

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, whichever comes first. The amount that the bank anticipates receiving from the SBA should be recorded as a receivable if the bank can support that it is probable that its SBA claim will be paid.

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**Facts** A bank has a nonaccrual SBA loan with a recorded investment of $150,000 secured by real property with a fair value of $125,000. The bank estimates the costs to sell this property at $12,500. The SBA guarantee is for 75 percent of any loss and is not a freestanding credit enhancement. The bank has concluded it is probable that the SBA will pay the guaranteed amount when the property is sold.

## Question 34

Assuming the bank plans to foreclose on the property, how should losses be measured on the SBA loan where repayment of the loan is expected to come from both liquidation of the collateral and the SBA guarantee?

## Staff Response

Since the bank plans to foreclose on the property and collect on the SBA guarantee, the bank should consider both the fair value of the collateral less estimated costs to sell ($112,500 in this case) and the SBA guarantee when measuring expected credit losses on the loan. Since it is probable that the bank will collect the SBA guarantee of $28,125, or 75 percent of the calculated foreclosure loss of $37,500 ($150,000–$112,500), the ASC 326-20 expected credit loss would be $9,375 ($37,500–$28,125). Given this fact pattern, the expected credit loss amount of $9,375 appears to be uncollectible and should be charged off.

## Question 35

Assuming the fair value of the collateral less estimated costs to sell remains unchanged from the previous fact pattern, what would the accounting entries be for this loan when it is transferred to OREO?

## Staff Response

The entry to record the transaction would be:

| Entry | Debit | Credit |
|---|---|---|
| OREO (fair value less estimated costs to sell) | $112,500 | |
| SBA receivable | $ 28,125 | |
| Loan (after previous partial charge-off: $150,000 – $9,375) | | $140,625 |

**Facts** A bank transfers OREO originally acquired through a deed in lieu of foreclosure to a wholly owned community development corporation subsidiary specializing in LIHTC projects. The community development corporation converts the OREO into a LIHTC project. The transfer meets the legal definition of a “disposal”; therefore, subsequent to the transfer, the LIHTC project is not subject to the OREO regulatory holding period limitation. Further, the HFS criteria in ASC 360-10-45 are not met subsequent to the transfer date.

## Question 36

Before the transfer date, the bank reports the foreclosed property as OREO HFS at lower of cost or fair value (less estimated costs to sell). Subsequent to the transfer date, should the bank continue to report the property as OREO HFS at lower of cost or fair value (less estimated costs to sell) when converted into a LIHTC project by the wholly owned community development corporation subsidiary?

## Staff Response

No. The property is no longer subject to the regulatory holding period limitation and the LIHTC project does not meet the HFS criteria in ASC 360-10-45. Therefore, subsequent to the transfer date, the subsidiary accounts for the LIHTC project as held for use and reports it in call report Schedule RC, item 9, “Direct and indirect investments in real estate ventures.”

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**Facts** A bank finances the sale of an OREO property. The buyer pledges collateral (in addition to the OREO property) to the bank as security related to the financing.

## Question 37

Should the value of the collateral be included in the assessment of probability that the bank will collect substantially all of the transaction price from the buyer?

## Staff Response

In evaluating whether the transaction meets the contract criteria in ASC 606-10-25-1, the value of the pledged collateral, excluding the OREO property, represents an amount at risk of loss and can be considered in determining whether it is probable the bank will collect substantially all of the transaction price from the buyer for the OREO property.

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**Facts** A bank sells an OREO property to a third-party buyer for $800,000 and provides a loan of $800,000, thus financing 100 percent of the sale. Estimated costs to sell equal $65,000. Before the sale, the carrying amount of the property equals the appraised value (less estimated costs to sell) of $1 million. Because the loan’s interest rate was the same as what is offered to borrowers with a 20 percent down payment, the bank determined that a preferential interest rate was granted to the borrower. The present value of the contracted sales price at a market interest rate is $700,000. The bank considers the preferential interest rate granted to the borrower to be a significant financing component.

## Question 38

How should the bank account for the transaction?

## Staff Response

The OREO property should be measured and carried at the lower of cost or fair value less estimated costs to sell. The transaction price is a better indication of the current fair value of the asset than the appraised value. The transaction price is the present value of the contracted sales price, or $700,000. Refer to question 29. The bank should recognize a loss of $365,000 (i.e., the difference between the carrying amount of $1 million and fair value of $700,000 less estimated costs to sell of $65,000) and increase the valuation allowance for the OREO by $365,000.

The bank should then evaluate if the sale transaction meets the requirements of ASC 606. Given that the sale is 100 percent financed, the contract criterion (e) of ASC 606-10-25-1 will not be met without considerable support from other facts to support sale treatment. If the contract criteria are not met, a sale for accounting purposes has not occurred, and the bank may not derecognize the OREO asset. Any payments received from the buyer should generally be recorded as a liability until a sale can be recognized for accounting purposes.

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**Facts** Bank A enters into a contract for deed with a customer on an OREO property that is an amusement park not currently in operation. The customer does not qualify for any of the bank's traditional financing options for this type of property. The contract for deed requires the customer to make a significant nonrefundable down payment as well as monthly fixed payments. The contract for deed also allows the customer to begin renovations and subsequently operate the amusement park; however, the bank retains title to the property until the final payment under the contract is made. The customer's projections of cash flows from the renovated amusement park support continued service of the contract. Further, the customer's willingness to renovate the amusement park provides additional positive evidence that the loan will be repaid according to contractual terms.

## Question 39

Must a bank transfer legal title to achieve sales accounting treatment for a parcel of OREO?

## Staff Response

No. Banks should follow ASC 606-10-25-30 to evaluate whether control has been transferred. For example, if a bank retains legal title solely as protection against the customer's failure to pay, those rights of the bank would not preclude the customer from obtaining control of an asset.

## Question 40

How should Bank A account for the transaction?

## Staff Response

ASC 610-20 prohibits derecognition of OREO until both of the following occur: (1) The contract satisfies all criteria in ASC 606-10-25-1, and (2) control of the asset has been transferred to the buyer. Based on the above fact pattern, the staff believes it is probable that the bank will collect substantially all of the consideration to which it is entitled per the contract. Further, the staff believes that effective control has passed to the borrower based on the borrower's ability to renovate and operate the amusement park. As such, the contract satisfies both of the above requirements, and the property should be derecognized from OREO.

## Question 41

What is the classification and measurement guidance in GAAP for government-guaranteed mortgage loans upon a bank's foreclosure of the property that collateralizes the loan?

## Staff Response

ASC 310-20-40-7 through 40-8 provides such guidance. A creditor must derecognize a government-guaranteed mortgage loan and recognize a separate "other receivable" (rather than OREO) upon foreclosure of the real estate collateral if the following conditions are met:

- The loan has a government guarantee that is not separable from the loan before foreclosure.
- At the time of foreclosure, the institution has the intent to convey the property to the guarantor and make a claim on the guarantee and it has the ability to recover under that claim.
- At the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed (that is, the real estate property has been appraised for purposes of the claim and thus the institution is not exposed to changes in the fair value of the property).

This guidance is applicable to fully and partially government-guaranteed mortgage loans provided the three conditions identified above have been met. In such situations, upon foreclosure, the separate other receivable should be recognized and measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor.

**Facts** The bank forecloses a residential mortgage partially guaranteed by the VA. The VA guarantee was not separable from the loan before foreclosure. The property is eligible for conveyance to the VA. The bank intends to convey the property to the VA and to make a claim to the VA of $105,000. The $105,000 is a fixed amount based on the property's fair value at the time of foreclosure. The bank expects to collect the entire $105,000 from the VA.

## Question 42

How should the bank account for the loan at the time of foreclosure?

## Staff Response

The three conditions as mentioned in question 41 are all met. Therefore, at the time of foreclosure of the property, the bank shall derecognize the mortgage loan and recognize an "other receivable" of $105,000 that the bank claims and expects to collect from the VA. Any excess of the cost basis in the loan immediately before the foreclosure over the "other receivable" is charged to the ACL.

**Facts** Assume the same loan as the previous question, except that at the time of foreclosure the loan is a "VA no-bid," since the property is not eligible for conveyance to the VA. The bank expects to collect the VA guarantee.

## Question 43

How should the bank account for the "VA no-bid" loan at the time of foreclosure?

## Staff Response

Not all of the three conditions mentioned in question 41 are met, because the bank cannot convey the property to the VA. Therefore, at the time of foreclosure of the property, the bank should derecognize the mortgage loan and recognize the foreclosed property as the OREO at its fair value less estimated costs to sell. The amount the bank expects to collect from the VA should be recorded as an "other receivable" if collection is probable (see Subtopic 5A, questions 34 and 36, and Subtopic 5C, question 7). If the cost basis in the loan at the time of foreclosure exceeds the sum of OREO and the "other receivable," the difference should be charged against the ACL.

# 5B. Life Insurance and Related Deferred Compensation

**Facts** A bank has purchased split-dollar life insurance policies on several key officers. These are cash value policies wherein both the bank and the officer's family are beneficiaries. The bank's benefit is limited to a refund of the gross premiums paid. All other benefits are designated for the officer's beneficiaries.

## Question 1

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

## Staff Response

Consistent with ASC 325-30 the bank should record the amount that it could realize under the insurance policy (i.e., its portion of the cash surrender value) as of the date of the financial statements as an "other asset." Further, the bank should recognize a liability for the expected future benefits provided to the employee (insured officer). Based on the substantive agreement with the employee, the liability would be determined in accordance with ASC 715-60 (if a post-retirement benefit plan exists) or ASC 710-10 (if the arrangement is an individual, deferred-compensation contract).

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**Facts** Bank A has purchased "key-man" life insurance policies on the life of several key officers. These are cash value policies. They differ from the policies discussed in question 1, however, in that the bank is the sole beneficiary.

## Question 2

How should these "key-man" life insurance policies be accounted for?

## Staff Response

Consistent with ASC 325-30, the bank should record the amount that it could realize under the insurance policy (i.e., the cash surrender value) as of the date of the financial statements as an "other asset." The change in cash surrender value during the period is an adjustment of the premium paid in determining the expense (other noninterest expense) or income (other noninterest income) to be recognized for the period.

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**Facts** A bank enters into deferred-compensation agreements with each of its three executive officers.

## Question 3

Which accounting pronouncements provide guidance on the accounting for such transactions?

## Staff Response

ASC 715-30 applies to deferred-compensation contracts with individual employees when those contracts, taken together, are equivalent to a post-retirement income plan, and ASC 715-60 applies when the equivalent is a post-retirement health or welfare benefit plan. Other deferred-compensation contracts should be accounted for in accordance with ASC 710-10.

## Question 4

Are the deferred-compensation agreements with the three executive officers equivalent to a post-retirement income plan or a post-retirement health or welfare benefit plan?

## Staff Response

The determination of whether deferred-compensation contracts, taken together, are equivalent to a post-retirement plan should be based on facts and circumstances. Consideration should be given to the number of employees covered and the commonality of terms of the contracts. ASC 715-10-15-5 states that an employer's practice of providing post-retirement benefits to selected employees under individual contracts with specific terms determined on an individual basis does not constitute a post-retirement benefit plan. In this situation, the bank's deferred-compensation agreements with only three employees do not constitute a plan. Accordingly, these contracts would be accounted for in accordance with ASC 710-10.

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**Facts** A bank purchases a single-premium policy to provide funds for a deferred-compensation agreement with a bank executive. The agreement states that the bank executive is entitled to receive deferred compensation based on the "excess earnings" of this insurance policy. The compensation agreement provides for a base earnings amount on the initial investment in the policy to be computed using a defined index. All earnings over this base amount (the "excess earnings") accrue to the benefit of the employee, during both employment and retirement years. Payment is made to the employee, however, during his or her retirement years.

The deferred-compensation agreement provides for a "primary" and "secondary" benefit. The earnings on the policy that accumulate for the employee's benefit before retirement are paid out in 10 equal installments upon retirement and are the "primary benefit." The "secondary benefit" is the earnings that accrue for the employee's benefit after retirement. These amounts are paid each year in addition to the primary benefit. The secondary benefit will continue to accrue and be paid to the employee throughout his or her life.

## Question 5

How should the bank account for the costs associated with this deferred-compensation agreement?

## Staff Response

These benefits should be accounted for in accordance with ASC 710-10. The present value of the expected future benefits to be paid to the employee from the deferred-compensation plan should be based on the terms of the individual contract. The benefits should be accrued in a systematic and rational manner over the required service periods to the date the employee is fully eligible for the benefits.

The future payment amount is not guaranteed but is based on the expected performance of the insurance policy. That fact does not release the bank from the requirement that it recognize the compensation expense over the employee's expected service period. The estimate of the expected future benefits should be reviewed periodically, however, and revised, if needed. Any resulting changes should be accounted for prospectively, as a change in accounting estimate.

## Question 6

What discount rate should be used in determining the present value of the expected future benefit payments to be made to the employee?

## Staff Response

ASC 710-10 does not specify how to select the discount rate to measure the present value of the expected future benefit payments to be made to an employee. Therefore, other relevant accounting literature must be considered in determining an appropriate discount rate. The staff believes either the bank's incremental borrowing rate or the current rate of return on high-quality, fixed-income debt securities to be acceptable discount rates by which to measure a deferred-compensation-agreement obligation. The bank must select and consistently apply a discount rate policy that conforms to relevant accounting literature.

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**Facts** A bank purchased a BOLI policy with a face value of $250,000 as key-person life insurance on its chairman approximately 20 years ago. The chairman recently retired and purchased the policy from the bank for its current surrender cash value of $147,308.

## Question 7

How should this transaction be recorded?

## Staff Response

The bank should estimate the fair value of the BOLI policy based on the net present value of cash flows considering the expected premium payments, death benefit, and expected mortality. The difference between the estimated fair value and the $147,308 paid for the policy would be reported as gain on sale with an offsetting employee compensation expense (i.e., retirement bonus) amount. The cash surrender value would be removed from the books, because the bank is no longer entitled to it. This would not affect net income, because the gain on sale and employee compensation expense would offset each other.

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**Facts** A bank acquires BOLI policies on certain key employees. In addition, the bank entered into supplemental life insurance agreements with those employees whereby the bank has agreed to share death benefits on the BOLI policies with the employees' beneficiaries should those employees die while actively employed by the bank. The terms of the supplemental life insurance agreements with those employees do not include provisions giving rise to an in-substance post-retirement benefit plan or to in-substance individual deferred-compensation contracts.

## Question 8

Should the bank accrue a liability for the death benefits due the employees' beneficiaries if the employees die while actively employed by the bank?

## Staff Response

No. For endorsement split-dollar life insurance arrangements an employer must recognize a liability for future benefits in accordance with ASC 715-60 if, in substance, a post-retirement benefit plan exists or ASC 710-10 if the arrangement is, in substance, an individual deferred-compensation contract. The arrangement between the bank and the employee is neither a post-retirement benefit plan nor a deferred-compensation contract. The supplemental life insurance agreements between the bank and the employees only provide for sharing death benefits if an employee dies while actively employed by the bank.

## 5C. Miscellaneous Other Assets

**Facts** Various federal, state, and local laws require the removal or containment of dangerous asbestos or other environmental contamination from building and land sites. Such removal or containment of dangerous materials can be expensive, often costing more than the value of the property. In certain jurisdictions, however, the property owners must clean up the property, regardless of cost. Further, sometimes a company must clean up property that it does not currently own. For banks, this liability may extend not only to bank premises but also to OREO.

### Question 1

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

### Staff Response

Cleanup costs for asbestos may be capitalized only up to the fair value of the property. Cleanup costs for asbestos discovered when the property was acquired are part of the acquisition costs. Costs incurred to clean up waste on existing property represent betterments or improvements. This is consistent with ASC 410-30.

Generally, environmental contamination (toxic waste) treatment costs should be charged to expense. When recoverable, however, these costs may be capitalized, consistent with ASC 410-30-25-18, if one of the following is met:

- The costs extend the life, increase the capacity, or improve the safety or efficiency of property owned by the company.
- The costs mitigate or prevent future environmental contamination. In addition, the costs improve the property's condition as compared with its condition when constructed or acquired, if later.
- The costs are incurred in preparing for sale a property currently HFS.

### Question 2

How should a bank account for the costs associated with the development of software for internal use?

### Staff Response

ASC 350-40, with respect to the accounting for costs associated with the development of software for internal use, requires the capitalization of certain costs associated with obtaining or developing internal-use software. Specifically, the software development process is separated into three stages:

- Preliminary project stage
- Application development stage
- Post-implementation operational stage

The costs associated with the application development stage (the second stage) are capitalized. This includes the external direct costs of materials and services, salary and related expenses directly associated with the project, and certain interest expense. All costs associated with the preliminary project and post-implementation operational stages (first and third stages, respectively) are expensed as incurred.

**Facts** A bank decides to convert from its current in-house data processing arrangement to a third-party data processing servicer. The bank enters into a long-term contract (e.g., seven years) with the servicer. The contract states that the servicer will purchase the bank's data processing equipment at book value ($1 million), although fair value is significantly less ($400,000).

## Question 3

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

## Staff Response

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

Therefore, the bank should record the sale of its equipment at fair value, recognizing the loss of $600,000 ($1 million−$400,000) and a corresponding liability to the servicer for $600,000, and amortize this amount in accordance with the terms of the contract. In addition, interest expense should be recorded on the unamortized portion of this liability in accordance with ASC 835-30.

**Facts** A bank decides to convert from its current in-house data processing arrangement to a third-party data processing servicer. The bank enters into a long-term contract (e.g., seven years) with the servicer. The bank will continue to own its data processing equipment but anticipates that it will no longer be used once conversion to the servicer occurs.

## Question 4

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

## Staff Response

ASC 360-10 requires that the equipment be accounted for as held for use as long as the equipment is still intended to be used. As a result of entering into this contract, the bank should revise the estimated useful life of the equipment to reflect the shortened useful life. Once the bank has stopped using the old data processing equipment, the carrying amount of the equipment should equal its salvage value (if any).

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**Facts** When a property tax bill becomes delinquent, the taxing authority places a tax lien on the property. In many states, the taxing authority is authorized to sell tax liens by issuing tax lien certificates. A tax lien certificate transfers to a third party the taxing authority's right to collect delinquent property taxes and the right to foreclose on the property. A tax lien has a superior priority status that supersedes any existing non-tax liens, including first mortgages, and accrues interest and fees.

## Question 5

How should a bank report the acquisition of a tax lien certificate in the call report?

## Staff Response

Tax lien certificates should be reported in "Other assets" in Schedule RC and Schedule RC-F. The staff does not believe a tax lien certificate meets the definition of a loan provided in the call report instructions, because an interest in a tax obligation does not result from direct negotiations between the holder of the certificate and the property owner, or between the taxing authority and the property owner.

## Question 6

Should a bank accrue interest on a tax lien certificate?

## Staff Response

Accrual status should be determined in accordance with call report instructions and the bank's nonaccrual policy. Delinquency should be calculated from the date the taxes were due the taxing authority. At the time a bank purchases a tax lien certificate, the property owner's tax obligation generally meets the criteria for nonaccrual status set forth in the call report instructions; therefore, tax lien certificate income should generally be recognized on a cash basis. Tax lien certificates should be reported in the past-due and nonaccrual schedule of the call report (Schedule RC-N) in the item for "Debt securities and other assets" on nonaccrual status. When income is recognized on a tax lien certificate, it should be reported as "Other noninterest income" in Schedule RI and Schedule RI-E.

**Facts** A bank obtains an insurance policy to indemnify itself against litigation defense expenses incurred. As legal costs are incurred, the bank files insurance claims with the insurer for reimbursement. The bank recognizes an insurance claim receivable in other assets for the amount of total claims submitted because the insurer has historically paid in full all claims filed. The insurer subsequently denies a portion of the bank's claims. The bank sues the insurer to recover the denied claims.

## Question 7

How should the bank account for the disputed insurance claims receivable asset?

## Staff Response

The bank should recognize a full valuation allowance against the disputed insurance claims receivable because it is subject to litigation and, therefore, collection of the receivable is presumed not probable.

Insurance recoveries are contingencies accounted for in accordance with ASC 450-30. In accordance with that standard, a contingency that might result in a gain should not be reflected in the financial statements because to do so might recognize revenue before realization.

Recognition of a contingency related to the recovery of a loss recognized in the financial statements where the recovery is less than or equal to the amount of the loss recognized (i.e., a loss recovery) should be distinguished from a recovery of a loss not yet recognized in the financial statements or an amount recovered in excess of the loss recognized in the financial statements (i.e., a gain contingency). The recognition criteria for a loss contingency (i.e., probable and estimable) should also be applied to recoveries, but a gain contingency should not be recognized until resolved.

| Type of contingency | Description | Recognition criteria |
|---|---|---|
| (1) Loss recovery | Related to recovery of a loss when the recovery is less than or equal to the amount of the loss recognized in the financial statements | Recognize if collection is probable and estimable |
| (2) Gain contingency | Recovery of a loss not yet recognized in the financial statements or an amount in excess of the loss recognized in the financial statements | Recognize when resolved |

The staff finds the nature of the insurance claims in this case to be consistent with a contingent loss recovery. As such, the claim should be recognized to the extent recovery is probable. Because the insurance claim is subject to litigation, there is a presumption that recovery of the claim is not probable. Unless the rebuttable presumption can be overcome, the bank should recognize a valuation allowance against the full amount of the insurance claim receivable.

## Question 8

How can the bank overcome the rebuttable presumption that the recovery of the claims is not probable?

## Staff Response

First the bank should obtain a written opinion from competent and independent legal counsel that explicitly states that it is probable that the bank will prevail in its litigation against the insurer. The opinion letter should provide support for the assertion, such as examples of existing legal precedent. If the bank cannot rebut the presumption, a valuation allowance against the full amount of the insurance claim receivable must be recorded.

It is also important to note that even if the bank rebuts the presumption, it must demonstrate the insurer has the financial capacity to pay the obligation. This includes an evaluation of the financial condition of the insurer and the insurer’s ability to pay the insurance claim receivable amount in full. If the bank cannot demonstrate the insurer has the financial capacity to pay the full amount of the insurance claim receivable, the bank must establish a valuation allowance for the portion of the insurance claim receivable the bank does not expect to collect.

# Topic 6 Liabilities

## 6A. Contingencies

**Facts** A legal action was brought against a bank. The court issued a judgment against the bank, and the bank has appealed. The bank has not accrued any reserve (liability) for a possible loss resulting from this litigation.

### Question 1

Should the bank accrue a reserve for this possible litigation loss as a result of the court issuing a judgment against the bank?

### Staff Response

ASC 450-20-25 requires that a loss contingency be recorded when a loss is probable and the amount of the loss can be reasonably estimated. To determine whether a loss is probable and the amount of the loss can be reasonably estimated, the expected outcome of the bank's appeal must be assessed. This is a legal determination that requires an evaluation of the bank's arguments for reversal of the judgment. Therefore, the bank's counsel should provide a detailed analysis of the basis for the appeal and the probability the judgment issued by the court will be reversed. If a loss is probable and there is a range of reasonably estimated losses, a reserve and corresponding expense should be recorded for the amount that appears to be a better estimate than any other estimate within the range or for the minimum amount in the range if no amount within the range is a better estimate than any other amount.

If the bank's counsel cannot provide an opinion or analysis to support the position that the judgment will be reversed or reduced substantially, the staff believes a reserve should generally be recorded for the amount of the judgment. This is because a lower court has already decided against the bank and no additional information is being provided by the bank to support that the litigation loss is not probable and the amount of the loss cannot be reasonably estimated.

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**Facts** Fraudulent acts by former officers cause a bank to incur losses of $2 million, including legal fees. The bank filed a $2 million claim with its fidelity bond carrier for payment of the total amount of coverage under the bond.

### Question 2

Should the bank record a receivable for the $2 million when the claim is filed with the insurer?

## Staff Response

No. It is generally inappropriate for a fidelity claim to be recognized before a written settlement offer has been received from the insurer. However, the bank may not defer recognition of the $2 million loss because of the possibility of future recovery under fidelity insurance coverage.

An asset related to a loss recovery should be recognized when a loss event has occurred, and the recovery is considered probable. If the potential recovery exceeds the loss recognized in the financial statements, such excess recovery should only be recognized when appropriate under the gain contingency model (when the gain is realized or realizable).

Generally, the filing of the fidelity claim would not result in the recovery of the loss being probable. This conclusion is based on the uncertainty that often exists for insurance coverage of bonding claims. Bonding policies normally are complicated and contain numerous exceptions. Accordingly, it is not certain whether the claim will be honored and, if so, for what amount. Insurers investigate these claims carefully and generally do not acknowledge their validity or the amount for which they are liable until shortly before payment.

## Question 3

Assume the previous facts, but the insurer offers a settlement of $1 million. Would the accounting differ?

## Staff Response

Yes. An asset related to a loss recovery may be recorded for the settlement offer of $1 million if the recovery is considered probable. If the bank concludes that the recovery of the $1 million is probable, it is appropriate to record the amount of the settlement offer as a receivable with a corresponding insurance recovery amount in the income statement which will reduce the $2 million loss previously recognized.

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**Facts** A bank originates mortgage loans that are sold in the secondary market. The sales agreements include the normal “reps and warranties” clause that requires the bank to repurchase any loan that has incomplete documentation or has an early payment default (e.g., during the first 90 days after the sale).

## Question 4

How should the bank account for this recourse?

## Staff Response

The requirement to repurchase loans with incomplete documentation or early payment default represents a recourse obligation. ASC 860-20 requires the bank to recognize a liability at the time of the sale in the amount of the fair value of the recourse obligation. This recourse obligation is recorded as an other liability rather than as part of the ACL because these loans have been sold by the bank and are no longer part of its loan portfolio.

Subsequently, the bank should assess whether there has been a change in probable and reasonably estimated losses related to its recourse obligation. The bank should adjust its other liability amount to the extent that probable and reasonably estimated losses related to its recourse obligations (based on historical experience adjusted for current trends) are different from the carrying amount of the related liability.

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**Facts** A bank wants to increase its deposits through the use of a promotional raffle or sweepstakes (also known as prized-linked savings). The bank sponsors a $300 monthly raffle effective January 1 through December 31, 20X1, and a grand prize raffle of $10,000 to be awarded in January 20X2. For every new savings account opened with a minimum deposit of $100 during each month in 20X1, that deposit customer is entered to win the monthly $300 raffle prize and is also entered into the $10,000 grand prize raffle that will be awarded in January 20X2. During year 20X1, the bank will have 12 monthly raffles of $300 each for total prizes of $3,600 and, in January 20X2, one grand prize raffle of $10,000 will be awarded.

## Question 5

How should the bank account for such raffles?

## Staff Response

In accordance with ASC 450-20, the bank should record an expense and a corresponding liability for each raffle as soon as the bank's obligation to pay each raffle prize is both probable and can be reasonably estimated. Therefore, the bank should record an expense and a corresponding liability for both the monthly and the grand prize raffle at the time the first eligible deposit is made for each raffle.

Since raffles, sweepstakes, and prize-linked savings are generally used for promotional purposes, the bank should recognize the prizes as a marketing or promotional expense. Assuming a qualifying deposit is made each month, the bank would record a $300 marketing expense each month in 20X1 and would record the $10,000 grand prize as a liability and marketing expense in January 20X1, when the first eligible deposit for each raffle is made.

## 6B. Other Borrowings

**Facts** Bank A regularly uses the FHLB as a funding source. The bank has an outstanding $10 million FHLB advance with a 10-year contractual maturity and a remaining term of four years bearing an interest rate of 4.3 percent per year. The current market rate for a 10-year advance is 2.5 percent. The bank prepays the $10 million advance and incurs a prepayment penalty. It does not contemporaneously replace the FHLB advance with another FHLB advance.

### Question 1

How should the bank account for the prepayment penalty?

### Staff Response

The loss resulting from payment of the prepayment penalty on the borrowing should be reported as other noninterest expense on the call report. The accounting and reporting standards for extinguishment of liabilities are set forth in ASC 405-20.

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**Facts** Bank B has the same fact pattern as Bank A in question 1, except that instead of prepaying the original FHLB advance, the bank has negotiated with the FHLB to roll the prepayment penalty into a new 10-year advance with an above-market rate of interest. The interest rate on the new advance is 3.5 percent, rather than the current market rate of 2.5 percent. The bank's goal is to spread the cost of the prepayment penalty over the life of the new advance.

### Question 2

How should the bank account for the new advance?

### Staff Response

The bank must determine whether the new advance represents a new loan or a modification of the original advance. If the new advance is "substantially different" from the original advance in accordance with ASC 470-50-40-6 through 40-12, the restructuring would be considered an extinguishment of the original debt. The bank would then initially record the new debt at fair value and use that amount to determine the loss on extinguishment of the original debt in the period of the restructuring (recorded in other noninterest expense), as well as to establish the effective interest rate of the new debt.

One example of being "substantially different" is when there is at least 10 percent difference between the present value of the cash flows of the new advance and present value of the remaining cash flows of the original advance using the effective interest rate of the original advance as the discount rate to compute both present values.

Conversely, if the new advance is not considered "substantially different" from the original advance, the restructuring would not be considered an extinguishment of the original debt. In this case, the bank would amortize the effect of the penalty (i.e., the above-market rate of interest) as an adjustment of interest expense over the remaining term of the new debt using the interest method and the new effective rate of 3.5 percent.

# Topic 7 Income Taxes

## 7A. Deferred Taxes

### Question 1

How do changes in the tax law, including tax rate changes, affect a bank's DTAs and DTLs?

### Staff Response

A bank must adjust its DTAs and DTLs to reflect changes in tax rates or other provisions of tax law. Any resulting adjustments from recalculating DTAs and DTLs should be recorded in earnings in the period when the new tax legislation is enacted. The enactment date for a change in tax law, including tax rate changes, is generally the date that the legislation becomes law.

### Question 2

May a bank use existing forecasts of future taxable income that it prepared for its budget to estimate realizable amounts under ASC 740-10-25?

### Staff Response

Yes. Banks routinely prepare budgets and future income forecasts. These projections typically serve as the starting point for the bank's estimate of future taxable income in applying ASC 740-10-25. The assumptions underlying these projections must be reasonable and supported by objective and adequately verifiable evidence.

### Question 3

When both positive and negative evidence exists about a bank's ability to earn future taxable income, what specific guidance should a bank follow to determine if a valuation allowance is needed for the bank's DTAs to reflect realizable amounts?

### Staff Response

All available evidence, both positive and negative, should be considered in determining whether a valuation allowance is needed to reduce the measurement of DTAs not expected to be realized. Accordingly, a bank should consider its current financial position and the results of operations for current and preceding years. Historical information should be supplemented by currently available information for future years.

A bank must use judgment when both positive and negative evidence exists. In such situations, examples of positive evidence that might support a conclusion that no valuation allowance is needed include

- a strong earnings history, excluding the loss that created the future tax deduction, coupled with evidence indicating that the loss is an unusual or infrequent item.
- a change in operations, such as installation of new technology, which permanently reduces operating expenses.
- a significant improvement in the quality of the loan portfolio.

Examples of negative evidence that might support a conclusion that a valuation allowance is needed include

- cumulative losses in recent years.
- a history of operating losses or tax credit carryforwards expiring unused.
- an expectation that operating losses will continue in early future years and that positive income will not be realized until the more distant future.
- unsettled circumstances that, if unfavorably resolved, would adversely affect future operations and profit levels on a continuing basis in future years.
- a carryback or carryforward period that is so brief it would limit the ability to realize the DTA.

The weight given to the potential effects of negative and positive evidence should be commensurate with the extent to which the evidence can be verified objectively. For example, a history of operating losses would likely carry more weight than a bank's assessment that the quality of its loan portfolio has improved.

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**Facts** A bank has been in existence for five years. Although it has had occasional profitable quarters, it has never reported positive annual income. Its cumulative losses exceed $2 million. In the latest fiscal year, its most profitable year ever, the bank lost $150,000. The bank's total assets have been growing steadily, and management expects the bank will reduce costs and begin earning positive operating income in the coming year. Management estimates the bank will show taxable income of $200,000 next year. Management's expectations are based on several factors, including an improved loan portfolio and a higher net interest margin, which it believes will result from future decreases in market interest rates.

## Question 4

How should the bank account for its DTAs?

## Staff Response

In this case, the bank should have previously established a valuation allowance for the full amount of its DTAs, given the lack of sufficient evidence to support a conclusion that the DTAs were realizable. The bank should continue to evaluate the realizability of its DTAs and maintain an appropriate valuation allowance. The lack of a strong earnings history raises doubt that the bank can generate sufficient positive income to recover its DTAs.

The recent history of operating losses provides objective evidence of the bank's failure to generate profits. Such evidence should be given more weight than less quantifiable estimates that depend on subjective data (e.g., interest rate forecasts).

## Question 5

When determining a bank's carryback potential under ASC 740-10 and the regulatory capital limit, how should a bank consider income taxes paid in prior years when the prior period tax rates are different from the tax rate currently used to record DTAs?

## Staff Response

In determining its carryback potential to apply ASC 740-10 and the capital limitation, a bank should consider the actual amount of income taxes previously paid that it could potentially recover through the carryback of NOL (carryback potential), where permitted under tax law.

## Question 6

How does the valuation allowance for DTAs that may be needed under ASC 740-10-30 relate to the regulatory capital limitations?

## Staff Response

The valuation allowance for DTAs (if any) needed under ASC 740-10-30 is not the same as the limitation on the amount of DTAs that may be included in regulatory capital. Accounting standards limit the net amount of DTAs that are recognized based on a "more likely than not" realization criteria. Regulatory capital rules may further limit the amount of DTAs that may be included in regulatory capital. For purposes of regulatory capital, any valuation allowances are netted against DTAs before the application of any regulatory capital limitations.

A bank should determine the balance-sheet amount of DTAs (net of any valuation allowance) for reporting on its call report in accordance with ASC 740. Under ASC 740-10-30, a bank calculates DTAs by multiplying its NOL carryforwards and deductible temporary differences by the applicable enacted tax rate (the rate expected to apply during the period when the DTAs will be realized). DTAs for tax credit carryforwards, if any, are determined separately. Under ASC 740-10-25, a bank may recognize the benefit of a tax position only if that tax position is "more likely than not" to be sustainable, assuming the taxing authority has full knowledge of the position and all relevant facts.

If necessary, a bank should record a valuation allowance to reduce the amount of DTAs to an amount that is “more likely than not” to be realized. A bank should consider all available positive and negative evidence in assessing the need for a valuation allowance.

The amount of DTAs (net of any valuation allowance) determined in accordance with the previous paragraphs will be evaluated against regulatory capital limitations.

## 7B. Tax Sharing Arrangements

**Facts** The bank is a member of a consolidated group subject to a tax sharing agreement with its parent holding company. During the current year, the bank incurs a loss that would result in a tax refund from the taxing authority on a separate entity basis. The consolidated group previously has carried back its losses (as permitted under then existing tax law), however, and recovered all available tax refunds from the IRS.

### Question 1

Should the bank record a tax receivable for the benefit of its current-year loss?

### Staff Response

Yes. Per call report instructions, a subsidiary bank should generally report its taxes as if it were a separate entity. Because the bank has NOL carryback potential available on a separate entity basis under the tax law at the time, it should receive the tax benefit of its current-year loss.

From a regulatory perspective, a parent holding company should reimburse the subsidiary bank the amount the bank would have received on a separate entity basis. If the parent holding company fails to reimburse the subsidiary bank, the amount of the tax benefit should be recorded as a dividend paid by the bank to the parent holding company.

Per call report instructions, a parent holding company should not adopt an arbitrary tax allocation policy if it results in a significantly different amount of applicable income taxes for its bank subsidiary than would have been provided on a separate entity basis. In this case, the bank would have received a tax refund directly from the taxing authority if it had filed a separate return. Therefore, it should record the tax benefit of its current-year loss and receive an equitable refund from its parent in a timely manner, based on the amount the bank would have received on a separate entity basis.

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**Facts** The bank is a subsidiary of a parent holding company that files a consolidated return. In accordance with the tax sharing agreement, the subsidiary bank calculates and remits its estimated taxes to the parent holding company quarterly.

### Question 2

May a subsidiary bank remit estimated tax payments to its parent holding company during periods when the consolidated group does not have, or expect to have, a current tax liability?

## Staff Response

Yes. The call report instructions allow a bank to remit the amount of current taxes payable calculated on a separate entity basis. However, consistent with the "Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure" (Tax IPS) (November 1998), the bank should not remit any portion of a deferred tax liability to its parent holding company. The tax sharing agreement between the subsidiary bank and the parent holding company, however, must contain a provision to reimburse the bank when it incurs taxable losses that the bank could carryback on a separate entity basis, where permitted under tax law. Such remittances of current taxes from the bank to the parent holding company may be made quarterly if the bank would have made such payments on a separate entity basis. This is permitted even if the parent has no consolidated tax liability.

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**Facts** The bank is a subsidiary of a parent holding company that files a consolidated tax return. The consolidated group incurs a loss in the current year and carries it back to prior years, as permitted under then existing tax law, resulting in a refund of substantially all taxes previously paid to the IRS. Under the tax sharing agreement, the subsidiary bank that produced the loss will receive a pro rata share of the total tax refund from the IRS.

## Question 3

How should the subsidiary bank record the tax benefit of its individual losses?

## Staff Response

The Tax IPS and call report instructions indicate that an individual subsidiary bank should compute and record the tax benefit of a loss on a separate entity basis. Additionally, the subsidiary bank should receive the full benefit as if it had filed for a refund as a separate entity.

The subsidiary bank should record a tax receivable for the full tax benefit of the bank's stand-alone losses. The parent holding company should pay the entire amount due to the bank on a separate entity basis (not only a pro-rated portion) in a timely manner. In addition, the tax sharing agreement should be amended consistent with the Tax IPS and call report instructions.

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**Facts** The bank is a member of a consolidated group subject to a tax sharing agreement. During the current year, the bank incurs a taxable loss that it can carryback as a separate entity, as permitted under then existing tax law. A mortgage banking subsidiary of the bank, however, is profitable for the year.

## Question 4

Should the mortgage banking subsidiary be included with the bank in determining its income tax expense/benefit as a separate entity?

## Staff Response

Yes. Per call report instructions, a subsidiary bank should generally report its taxes as if it were a separate entity. At the bank level, the reporting entity includes its mortgage banking subsidiary and any other subsidiaries that the bank may own. Payment of taxes to and refunds from the parent holding company would be based on the consolidated tax position of the bank and its subsidiaries. The mortgage banking subsidiary would pay taxes to the bank, not to the parent holding company. This applies the separate entity concept to each subsidiary level.

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**Facts** The bank is a member of a consolidated group subject to a tax sharing agreement. On a stand-alone basis, the bank has recognized a DTA arising from an NOL carryforward. The bank has not been able to use the NOL carryforward on a stand-alone basis. The consolidated group likewise has previously been unable to use the NOL carryforward. In the current period, the consolidated tax filing group incurs a tax loss and does not have a tax liability, so the bank's NOL carryforward remains unused.

## Question 5

Is the bank permitted to sell or transfer its DTA arising from an NOL carryforward to the parent of the consolidated tax filing group?

## Staff Response

No. Call report instructions state that a bank should generally account for income taxes as if the bank were a separate entity. The Tax IPS indicates that tax sharing agreements should prohibit the payment or other transfer of deferred taxes by the institution to another member of the consolidated group. Thus, it would not be appropriate for the bank to sell or transfer its DTA arising from an NOL carryforward to the parent holding company.

Because the consolidated tax filing group does not have a current tax liability, the parent of the consolidated tax filing group cannot use the bank's NOL carryforward in the current period. Therefore, the bank cannot sell or transfer its DTA arising from an NOL carryforward to the parent of the consolidated tax filing group in the current period.

## Question 6

Assume that the bank is not able to use the NOL carryforward on a standalone basis but the parent in the consolidated tax filing group has a tax liability in the current period that can be offset by the bank's NOL carryforward. In this scenario, is the bank permitted to be reimbursed for the parent's use of the bank's DTA arising from an NOL carryforward (sometimes referred to as selling or transferring the DTA arising from an NOL carryforward)?

## Staff Response

Yes. Because the consolidated tax filing group has a tax liability in the current year, which can be offset with the use of the bank's NOL carryforward, the bank is permitted to be reimbursed in the current period by the parent for the consolidated group's use of the bank's DTA arising from an NOL carryforward.

While the parent is permitted to reimburse the bank in instances when the bank could not use the NOL carryforward on a stand-alone basis, the parent should reimburse the bank for use of the bank's DTA arising from an NOL carryforward if the bank would have been able to use the NOL carryforward to offset its standalone tax liability, even if it cannot be used by the consolidated group.

## 7C. Marginal Income Tax Rates

**Facts** A parent holding company has multiple subsidiary banks and files a consolidated tax return. Because of their common ownership, the affiliated entities are entitled to only one surtax exemption. During the period in question, current IRS regulations permitted the arbitrary allocation of the surtax exemption to any member of a group under common control, even if a consolidated return is not filed. As a result, the parent holding company, which was operating at a loss, allocated the entire surtax exemption to itself.

### Question 1

For regulatory purposes, what is the proper allocation of the surtax exemption among bank subsidiaries when determining the amount of each bank's tax payments to be forwarded to the parent holding company?

### Staff Response

The one surtax exemption should be allocated among the affiliates in an equitable and consistent manner. Additionally, the surtax exemption should only be allocated to profitable entities because it is used only to compute the tax liability.

A subsidiary bank of a parent holding company that files a consolidated return should report as current taxes and pay to its parent holding company the amount that would otherwise be due had it filed a tax return as a separate entity. Accordingly, the amount of the subsidiary bank's current tax liability should include the allocation of the available surtax exemption. This accounting treatment is set forth in the call report instructions.

### Question 2

Would the answer to question 1 be different if there were only one subsidiary bank?

### Staff Response

No. A subsidiary bank would receive an allocated portion of the consolidated group's surtax exemption in accordance with the call report instructions regardless of the number of subsidiaries involved.

**Facts** Assume the marginal tax rate for corporate taxable income over $10 million is 35 percent. Under this rate structure, a consolidated group could have taxable income in excess of $10 million that would be taxed at 35 percent. The taxable income of the bank within the consolidated group, measured on a separate entity basis, may be taxed at a lower rate, because the bank's taxable income is less than $10 million.

## Question 3

What rate should the bank use to compute its income tax expense as a separate entity?

## Staff Response

The bank may use an income tax rate of 35 percent. Per call report instructions, a subsidiary bank should report its income tax expense as if it were a separate entity. Those instructions, however, also allow adjustments to allocate additional amounts among members of a consolidated tax-paying group, provided the allocation is equitable and applied consistently. An adjustment for the consolidated groups' incremental tax rate, properly applied, would be in accordance with the call report instructions.

# Topic 8 Capital

## 8A. Sales of Stock

**Facts** Bank A has a stock offering. The purchasers finance the stock purchase by obtaining unsecured loans from an unaffiliated bank, Bank B. Several years later, Bank A acquires Bank B. Accordingly, the loans to Bank A shareholders are now owned by Bank A.

### Question 1

After the acquisition of Bank B by Bank A, should the loans funded by Bank B and used to purchase the stock of Bank A in the prior transaction continue to be classified as an asset or as a deduction from the stockholders' equity of Bank A?

### Staff Response

The loans provided by Bank B to purchasers of Bank A stock should be recorded as an asset of Bank A after the acquisition because before the acquisition the stock issuer (Bank A) and the stock purchasers' loan provider (Bank B) were unrelated. In this situation, it was not the intent of Bank A to finance the sale of its own stock and the loan was not made in contemplation of the acquisition. The funds provided by Bank B at the time of the transaction were not used to purchase stock of Bank B.

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**Facts** A bank has a successful stock offering. The bank incurs certain costs directly related to the stock offering for legal, accounting, and printing expenses.

### Question 2

How should these expenses that are directly related to the stock offering be accounted for?

### Staff Response

Expenses that are directly related to a successful stock offering are accounted for as a reduction of the amount of the offering. Accordingly, they would be included as a reduction of the surplus account and not an expense charged to current operations through the income statement. This response is consistent with AICPA Technical Questions and Answers, Section 4110.

### Question 3

How should these expenses be accounted for if the stock offering is not successful (i.e., no stock is sold)?

## Staff Response

Expenses that are related to an unsuccessful stock offering are charged as an expense to current operations through the income statement.

# 8B. Quasi-Reorganizations

## Question 1

What is a quasi-reorganization?

## Staff Response

As defined in ASC 852-20-05-1, a quasi-reorganization is a corporate readjustment procedure in which an entity restates its balance sheet to fair value without the creation of a new corporate entity and without the intervention of formal court proceedings. This corporate readjustment procedure may eliminate an accumulated deficit (in retained earnings). The staff believes it is based on the concept that an entity, which previously suffered losses but has now resolved the conditions that gave rise to the entity's losses, should be allowed to present its financial statements on a "fresh start" basis.

Under GAAP, an entity undergoing a quasi-reorganization must revalue all its assets and liabilities to their current fair value. The effective date of the readjustment of values should be as near as practicable to the date on which the shareholders gave their approval for the reorganization. The tax benefits of operating loss or tax credit carryforwards that existed as of the date of the quasi-reorganization should be added to surplus when subsequently realized.

Consistent with ASC 852-20-S99-1, a quasi-reorganization must meet certain conditions and is not to be employed repeatedly. A quasi-reorganization is appropriate only under circumstances that would justify an actual reorganization or formation of a new corporation. The procedure should, so far as possible, eliminate the need for future quasi-reorganizations.

## Question 2

As part of the revaluation of its assets and liabilities to their current fair values resulting from a quasi-reorganization, may a bank record a core deposit intangible for the intangible value of its own deposit base?

## Staff Response

No. As noted in question 1, a quasi-reorganization requires the entity to present its existing assets and liabilities at current fair value, on a "fresh start" basis. This "fresh start" allows the entity accounting treatment similar to that of a new or start-up company. The use of fair value, however, has created the misconception that a quasi-reorganization should be recorded in a manner similar to a business combination accounted for under the acquisition method. This is not the case. In a quasi-reorganization, the existing assets and liabilities are recorded at fair value, but no increase in net assets can be recognized (as discussed in ASC 852-20-S99-2). New intangible assets should not be recorded. Existing intangible assets may be remeasured at fair value.

## Question 3

May total capital increase as a result of revaluing a bank's net assets in a quasi-reorganization?

## Staff Response

No. Although the individual elements that make up equity capital may increase or decrease, there may not be an increase in total capital because of a quasi-reorganization. This is based on the historic cost model and the accounting concept that generally precludes recognition of gains until realized.

## Question 4

12 USC 56 does not allow the payment of dividends by national banks that have an accumulated deficit in retained earnings. How does the fact that a national bank has entered into a quasi-reorganization to eliminate the deficit affect the payment of dividends?

## Staff Response

A goal of a quasi-reorganization is to eliminate an accumulated deficit in retained earnings. Therefore, in applying 12 USC 56, only the retained earnings (undivided profit) amount since the date of the quasi-reorganization would be considered for dividend purposes. Losses before the date of the quasi-reorganization are ignored. However, prudent judgment is required when determining if dividend payments are appropriate and should consider the bank's financial condition and anticipated future financial needs.

# 8C. Employee Stock Options

## Question 1

If bank holding company stock, rather than bank stock, is issued to a bank employee as compensation, must the compensation expense be recorded (pushed down) in the financial statements of the bank?

## Staff Response

Yes. ASC 718-10-15 requires that share-based payments awarded to an employee of an entity (the bank) by a related party (the bank holding company) as compensation for services provided should be accounted for as a share-based payment of that entity (the bank) unless the transaction is clearly for a purpose other than compensation. The substance of such a transaction is that the issuer of the shares (the holding company) made a capital contribution to the reporting entity (the bank).

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**Facts** A bank holding company sponsors an ESOP solely for the benefit of the employees of its bank subsidiary. An ESOP trust is formed for the purpose of acquiring holding company stock that will be distributed to participating bank employees in future periods as compensation for services performed for the bank. The trust initially has no funds and therefore has to borrow funds to purchase the holding company stock. The ESOP trust borrows funds from the holding company, so the trust has two account balances on its books: a debit balance asset account, representing the cost of the unallocated shares acquired, and a credit balance liability account for the loan payable to the holding company. Based on the guidance in ASC 718-40-05-3, this is considered an internally leveraged ESOP[1] arrangement between the bank and holding company.

## Question 2

If the ESOP trust obtains a loan from the holding company, is the ESOP loan payable obtained by the trust recorded as a liability in the bank's financial statements?

## Staff Response

Generally, no. ASC 718-40 does not require a loan that is part of an internally leveraged arrangement to be recorded at the subsidiary bank level. However, recording this loan payable by the trust at the subsidiary bank level is permitted if, based on management's judgment (and external auditor concurrence, where applicable), this accounting treatment is needed to

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[1] An internally leveraged arrangement does not directly involve an outside lender. An ESOP is internally leveraged when it borrows funds from the employer, either in the form of an employer loan or an indirect loan. An employer loan is one made by the employer to the ESOP, with no related loan from an outside lender. An indirect loan is one made by the employer to the ESOP, with the employer obtaining a related loan from an outside lender.

accurately report the subsidiary bank's financial condition in the call report or the subsidiary bank's audited financial statements, both of which are presented on a bank-only level.

For a leveraged ESOP that involves an outside lender (i.e., is not part of an internally leveraged arrangement), the bank would record the loan payable if the subsidiary bank assumes the holding company's debt, retires all or part of the holding company's debt with the proceeds from a bank debt or equity offering, guarantees the holding company's debt, or pledges bank assets as collateral for the holding company's debt. These situations should be rare because banks are generally not permitted to assume or guarantee the parent company's debt, nor are banks permitted to pledge their assets as collateral for the holding company's debt. Therefore, it is unlikely that the parent company's debt to an outside lender would be reported at the subsidiary bank level.

# Topic 9 Income and Expense Recognition

## 9A. Transfers of Financial Assets and Servicing

**Facts** A bank originates $1 million of mortgage loans with a contractual interest rate of 8.5 percent. The bank transfers the pool of mortgage loans to an unaffiliated entity for par ($1 million). The bank continues to service the loans. The contract states that the bank will receive a servicing fee of 1 percent and will also receive a beneficial interest in the form of an IO strip in connection with the sale. At the date of transfer, the fair value of the loans (with an 8.5 percent coupon), including servicing, is $1.1 million. The fair value of the servicing asset is $44,000 and the fair value of the IO strip is $56,000. The fair value of the principal and interest sold equals the sales price of $1 million. The amortized cost of the loans also equals $1 million. This transfer meets the conditions set forth in ASC 860-10-40-5 for sale accounting treatment of an entire financial asset.

### Question 1

How should the bank account for this transaction?

### Staff Response

The bank should derecognize all the assets sold and recognize any assets obtained or liabilities assumed in the sale, including cash, servicing assets/liabilities, and beneficial interests, at their respective fair values. In accordance with ASC 860-20-25-4, servicing assets and IO strips are separate identifiable assets considered part of the proceeds received—not a retained interest in the financial instruments sold—and each should be recognized at fair value. The bank should remove loans in the amount of $1 million from the balance sheet and record the proceeds from the sale, which consist of cash of $1 million, a servicing asset of $44,000, an IO strip of $56,000, and a resulting gain of $100,000.

### Question 2

How should the servicing asset be accounted for on an ongoing basis?

### Staff Response

In accordance with ASC 860-50-35, the subsequent accounting for servicing assets is based on the bank's accounting policy election. Separately, for each class of servicing assets, the bank may elect either

- the amortization method under which the servicing assets are amortized in proportion to and over the period of estimated net servicing income and assessed for impairment based on fair value at each reporting date, or

- the fair value measurement method under which the servicing assets are reported at fair value at each reporting date with changes in fair value reported in earnings when the changes occur.

If the bank elects the fair value measurement method for a class of servicing asset, that election cannot be changed. If the bank elects the amortization method for a class of servicing asset, the bank may subsequently make an irrevocable decision to elect the fair value measurement method at the beginning of the bank's fiscal year.

## Question 3

How should the IO strip be accounted for on an ongoing basis?

## Staff Response

ASC 860-20-35-2 requires that the IO strip and any other financial asset that can contractually be prepaid or otherwise settled so that the holder would not recover substantially all of its recorded investment be accounted for similar to an investment in debt securities classified as AFS or trading under ASC 320-10. Accordingly, the IO strip should continue to be measured at its fair value after initial recognition.

In addition, if the IO strip is classified as AFS, changes in fair value are recognized in AOCI, and the IO strip should be assessed for credit losses consistent with the guidance in ASC 326-30-35 and ASC 325-40-35. See Subtopic 12A for additional guidance on identifying, measuring, and recognizing credit losses in the ACL. When the IO strip is classified as a trading asset, all changes in fair value are recognized in earnings. Interest income of the IO strip should be measured and recognized in accordance with ASC 325-40-35.

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**Facts** A bank sold a portion of the underlying credit card account relationships to a third party (other than the buyer of the loans) for cash. These account relationships were sold at a premium of $25 million. At that time, these credit card loans had a material amount of loan balances still outstanding.

## Question 4

How should the sale of the account relationships be accounted for?

## Staff Response

An account relationship is a separately identifiable asset from an underlying credit receivable and is accounted for as another intangible asset after the account relationship is sold in accordance with ASC 350-30. This transaction is analogous to the sale of the MSRs on loans owned by other parties, which are covered under ASC 860-50-40. Accordingly, a gain should be recognized based on the $25 million premium, because the transaction was settled in cash.

**Facts** A bank originates, funds, and services credit card accounts. The bank enters into a transaction whereby it will sell the future gross income stream (i.e., interest income and late fees) from its existing credit card balances. It will, however, continue to own the credit card relationship and make advances to the credit card customers. Any income received on new credit card advances accrues to the bank. The bank will also continue to service the accounts for a monthly fee. Further, the bank may cancel the sales transaction through payment of a lump sum amount to the purchaser.

## Question 5

How should this transaction be accounted for?

## Staff Response

The proceeds from the sale of the future income stream on the credit card accounts should be accounted for as a borrowing because the transfer of future gross income does not qualify as a sale. Accordingly, the proceeds are recorded as a liability and amortized using the interest method over the estimated life of the accounts. This conclusion is based on ASC 470-10-25.

The sales proceeds may be classified as either debt (a borrowing) or deferred income (sale) depending on the specific facts and circumstances. In this respect, ASC 470-10-25 set forth six criteria for determining whether the sales proceeds should be classified as debt or deferred income. If the transaction meets any of the six criteria, the sales proceeds generally would be reported as debt. The criteria, as listed in the standard, are as follows:

1. The transaction does not purport to be a sale.
2. The entity has significant continuing involvement in the generation of the cash flows due the investor (for example, active involvement in the generation of operating revenues of a product line, subsidiary, or a business segment).
3. The transaction is cancelable by either the entity or the investor through payment of a lump sum or other transfer of assets by the entity.
4. The purchaser's rate of return is implicitly or explicitly limited by the terms of the transaction.
5. Variations in the bank's revenue or income underlying the transaction have only a trifling impact on the purchaser's rate of return.
6. The purchaser has recourse to the bank relating to the payments due the purchaser.

This transaction meets two of the six criteria for debt classification. First, the bank has a significant continuing involvement in the generation of cash flows because it will continue to service and fund the credit card receivables. Additionally, the transaction is cancelable by the bank through payment of a lump sum amount.

**Facts** Under ASC 860-50, a servicing asset results when the benefits of (revenues from) servicing are expected to provide more than "adequate compensation" to the servicer. If the benefits of servicing are not expected to compensate a servicer adequately for performing the servicing, the contract results in a servicing liability.

## Question 6

How is "adequate compensation" defined in ASC 860?

## Staff Response

The ASC glossary defines adequate compensation as "the amount of benefits of servicing that would fairly compensate a substitute servicer should one be required, which includes the profit that would be demanded in the marketplace." It goes on to say, "adequate compensation is determined by the marketplace; it does not vary according to the specific costs of the servicer."

The recorded value of a servicing contract is based on the marketplace. Accordingly, a servicing asset is based on the servicing revenue an institution expects to receive relative to the compensation a third party would require and is not based on an institution's own cost of servicing. As a result, an inefficient servicer incurring losses may not be required to record a servicing liability if the servicing income is sufficient to compensate fairly a substitute (third party) servicer.

**Facts** A bank originates a $100,000 loan that is 75 percent guaranteed by the SBA. The bank transfers the SBA-guaranteed portion of the loan to a third party for $80,000 with servicing retained. The benefits of the servicing are expected to more than adequately compensate the bank for performing the servicing.

## Question 7

How should the bank make the determination that the transfer qualifies for sale treatment?

## Staff Response

The bank should first determine that the transfer of the guaranteed portion of the loan meets all of the ASC 860-10-40-6A criteria for a participating interest. One of the criteria in the definition of a participating interest requires there be no recourse (other than standard representations and warranties) to, or subordination by, any participating interest holder. There is an exception to this general rule for recourse in the form of independent third-party guarantees, such as SBA guarantees. The independent third-party guarantee does not influence the pro-rata distribution of cash flows required by a participating interest. As long as the other criteria for a participating interest are met, the guaranteed and unguaranteed portions of the SBA loan meet the definition of a participating interest.

The bank should then determine if the other requirements for a sale under ASC 860-10-40 are met. If all of the requirements are met, the bank would account for this transfer as a sale in accordance with ASC 860-20-40.

## Question 8

If the transfer qualifies for sales treatment, how should the bank account for the transfer of the guaranteed portion of the loan?

## Staff Response

The bank must allocate the previous carrying amount of the entire loan ($100,000) between the retained (25 percent) and sold (75 percent) portions, based on the relative fair values at the date of the transfer in accordance with ASC 860-20. For this loan, the bank received $80,000 for the 75 percent SBA-guaranteed portion of the $100,000 loan. If the book value of the retained portion of the loan approximates fair value (i.e., $25,000) the guaranteed portion of the loan has a relative fair value of 76.19 percent of the total loan. Therefore, the sold portion of the loan should be removed from the books for 76.19 percent of the carrying value of the original loan, or $76,190. Additionally, the gain of $3,810 should be recorded through earnings.

| | Fair value | Percentage of fair value | Allocated carrying value |
|---|---|---|---|
| Sold portion | $80,000 | 76.19%<br>(80,000/105,000) | $76,190<br>(76.19%*100,000) |
| Retained portion | $25,000 | 23.81%<br>(25,000/105,000) | $23,810<br>(23.81%*100,000) |
| **Total** | **$105,000** | **100%** | **$100,000** |

## Question 9

If the transfer qualifies for sales treatment, how should the bank account for the retained (unguaranteed) portion of the loan?

## Staff Response

As shown in the table calculating the relative fair values, the transfer of the guaranteed portion of the loan results in a carrying value of $23,810 for the unguaranteed portion of the loan retained by the bank. The $1,190 difference between the loan's par amount ($25,000) and relative fair value ($23,810) is recorded as a loan discount and accreted into interest income using the interest method in ASC 310-20.

## Question 10

If the transfer qualifies for sales treatment, are there any other assets or liabilities that should be recorded as a result of the transfer?

## Staff Response

Yes. As stated in the facts, the bank will retain servicing. At the time of the transfer, the bank should record a servicing asset related only to the guaranteed portion of the loan sold. The servicing asset should be recorded at fair value at the time of the transfer with a credit to noninterest income.

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**Facts** A bank transfers a participation in an originated loan to a third party. The bank receives a premium on the transfer, which is subject to a provision that requires the seller to refund any premium received if the borrower fails to make any of the first three payments (90-day period).

## Question 11

How should this transaction be accounted for?

## Staff Response

The transfer of the loan participation would not initially be accounted for as a sale since the participation does not meet all the characteristics of a participating interest described in ASC 860-10-40-6A. In this case, the premium refund provision is considered to be recourse that is beyond standard representations and warranties and results in a disproportionate allocation of cash flows. During the 90-day recourse period, the transaction would not be eligible for sales treatment and therefore would be accounted for as a secured borrowing until the recourse provision expires. Any gain resulting from the premium received on the transfer should not be reflected as other noninterest income, nor should a servicing asset be recorded, until the provision expires, the participation meets the definition of participating interest, and the transfer meets all criteria for sale accounting.

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**Facts** A bank formed a $1 billion pool of receivables from credit card accounts and transferred the receivables to a trust. The trust is consolidated by the bank in accordance with ASC 810-10. During a specified reinvestment period (i.e., 48 months), the trust will purchase additional credit card receivables generated by the selected accounts. During the revolving period, the investors' dollar investment remains constant, because principal payments, allocated to the investors' interest are reinvested in additional credit card receivables. The up-front transaction expenses of $5 million consist of legal fees, accounting fees, rating agency fees, and underwriting fees.

## Question 12

How should the bank account for the up-front transaction costs of the securitization?

## Staff Response

Debt issuance costs, such as the fees described previously, are capitalized and amortized in accordance with the terms of the debt agreement. Because the trust is consolidated and, therefore, the trust's outstanding bonds are reported on the bank's balance sheet, all debt issuance costs should be capitalized and amortized accordingly.

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**Facts** A bank issues GNMA mortgage-backed securities, which are securities backed by residential mortgage loans that are insured or guaranteed by the Federal Housing Administration, USDA Rural Development Guaranteed Housing Loan Program, or VA. This program allows, but does not require, the bank as servicer to buy back individual delinquent mortgage loans that meet certain criteria from the securitized loan pool that qualifies as a VIE. At the servicer's (bank's) option and without GNMA's prior authorization, the servicer may repurchase such a delinquent loan for an amount equal to 100 percent of the remaining principal balance of the loan. The bank is not the primary beneficiary, as defined by ASC 810-10-20, of the VIE, into which the residential mortgages were transferred, and does not consolidate the VIE.

## Question 13

Does the buy-back provision preclude the bank from recognizing the transfer as a sale?

## Staff Response

No. In accordance with ASC 860-10-40-25, the bank's conditional or contingent buy-back option generally does not maintain the bank's effective control of the transferred loans, because the conditions might not occur to allow the option to be exercised. Accordingly, the loans are removed from the bank's balance sheet and are not required to be consolidated by the bank if all sale criteria are met.

## Question 14

When individual loans later meet GNMA's specified delinquency criteria and are eligible for repurchase, how should the bank account for the loans?

## Staff Response

When individual loans later meet the delinquency criteria and are eligible for repurchase, the issuer (bank), providing the issuer is also the servicer, is deemed to have regained effective control over the loans. Accordingly, under ASC 860-10-40, the loans may no longer be reported as sold. The loans must be brought back on the issuer/servicer's (bank's) books as an asset and initially recorded at fair value, regardless of whether the bank intends to exercise the buy-back option. An offsetting liability also would be recorded.

## Question 15

Would the staff response to the two preceding questions change if the loans were not guaranteed or issued by an entity affiliated with the federal government?

## Staff Response

No. The staff response would not change. The issuer of the security is permitted to treat the transaction as a sale for accounting purposes, because the conditional or contingent nature of the buy-back option means that the issuer does not maintain effective control over the loans.

## Question 16

How should the assets and the related liability (see response to question 14) be reported on the call report (balance sheet)?

## Staff Response

The loans should be reported as loans HFS or loans HFI, based on the facts and circumstances, in accordance with GAAP. The loans should not be reported as "Other assets." The offsetting liability should be reported as "Other borrowed money" on the call report.

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**Facts** The bank enters into a contractual arrangement with a third party whereby it will provide funding to the mortgage company at the time of closing for mortgage loans originated by the third party, up to a specific funding amount. The interest received by the bank is at a fixed rate and not dependent on the rate paid by the borrower on the underlying mortgages. The third party provides the bank with a blanket assignment on these loans and has entered into forward-purchase commitments with parties unrelated to the bank on each of the loans that the bank funds.

## Question 17

Should this transaction be recorded by the bank as an individual purchase of each underlying mortgage?

## Staff Response

No. The bank must evaluate the terms of the transaction to determine if it meets the requirements for a sale under ASC 860-10-40-5. Under this accounting principle, the third party must have surrendered control (i.e., no longer maintains control) of the financial asset for the transaction to qualify as a sale. The economic benefits provided by a financial asset (generally, the right to future cash flows) are derived from the contractual provisions that underlie that asset, and the entity that controls the benefits should recognize the benefits as its asset. The fact pattern above leads to the conclusion that the seller is maintaining control of the asset, as it will continue to receive the economic benefits from the contractual terms of the contract (mortgage servicing rights, coupon rate of interest) while paying the bank a fixed rate independent of any terms under the contractual arrangement. The mortgage company's control of the party to whom the loan is sold through its forward-sale commitment is also problematic in obtaining sales treatment. Both of these factors are consistent with the determination that this transaction is a secured financing and should be accounted for as such by the bank. These types of arrangements are traditionally referred to as warehouse facilities.

## Question 18

A lead bank has transferred loan participations to other participating banks in LIFO and FIFO participations. What is the proper accounting treatment for these types of loan participations transferred?

## Staff Response

LIFO or FIFO participations transferred do not qualify for sale accounting because they do not meet the definition of a participating interest under ASC 860-10-40- 6A, which specifically requires cash flows to be divided proportionally among the participating interest holders. Therefore, LIFO or FIFO participations are accounted for as secured borrowings.

For the lead bank (transferor), the entire loan balance remains on the books and a liability is recorded to reflect the proceeds received from the participating bank(s) for the transferred participations. Assets and liabilities of the lead bank are therefore higher than they would be if the transfer was recognized as a sale. Loan participations transferred but not qualifying for sale accounting should be included in the lead bank's loan balance for purposes of estimating the ACL. The allowance analysis should consider potential exposure from the full underlying loan.

**Facts** A bank (transferor) plans to transfer MSRs on previously sold mortgage loans to an unrelated entity for cash. The bank is preparing an MSR transfer accounting analysis to determine whether substantially all of the risks and rewards of the MSRs have been transferred to the purchaser to achieve sales accounting. The bank retains the responsibility for representations and warranties relating to underwriting standards on the serviced loans associated with the MSRs. Upon repurchase of the mortgage loans due to a breach of representations and warranties, the bank is obligated to repurchase the related MSRs at a specified fixed price based on the time elapsed since the original MSR transfer date. The MSR repurchase price may not be equivalent to fair value at the time of repurchase.

## Question 19

In determining whether the MSR transfer qualifies for sale accounting, does the bank need to consider the potential required MSR repurchases related to loan representations and warranties as retention of risk as part of the protection provisions?

## Staff Response

Yes. Depending on the facts and circumstances, the potential that the seller repurchases the MSR may or may not be considered a protection provision. When the MSR purchaser is being compensated at a "predetermined price," it may be considered a form of yield protection for the MSR purchaser in the MSR transfer accounting analysis.

In accordance with ASC 860-50-40, one quantitative test requires aggregating all the protection provisions (e.g., indemnifications and recourse obligations that protect the yield or value of the MSR to the MSR purchaser) retained by the transferor after the MSRs transfer date. To qualify for sale accounting under this test, such aggregate obligations need to be minor (10 percent or less) in relationship to the sales price (as adjusted), as determined for each unit of account. In the bank's facts and circumstances, the MSR repurchase is considered a protection provision because the seller may be required to pay a pre-determined fixed price greater than the actual fair value of the MSR at the time of the repurchase. The protection provision needs to be analyzed under ASC 860-50-40-4(1) because it may be more than minor on the MSR transfer date. If a bank pays fair value on the specific MSR at the repurchase date, recourse would be zero (i.e., there would be no protection provision). In contrast, since the bank pays a fixed amount for the repurchase of the MSR, the amount paid may be higher than the actual fair value of the MSR. In some instances, the MSR has a zero or negative fair value on the transfer date, but the purchaser is still compensated at a pre-determined amount if the MSR is repurchased by the transferor.

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**Facts** A bank plans to transfer MSRs on previously sold mortgage loans to an unrelated entity for cash. The MSR sales contract transfers servicing of different underlying pools comprised of mortgage loans governed under different servicing contracts, with similar legal and servicing provisions except that one servicing contract has a different recourse provision on certain vintages of loans within the pools of loans sold. Since some loans in this servicing contract are subject to a different recourse provision retained by the seller, these underlying loan pools are dissimilar to those covered under other servicing contracts to be sold.

## Question 20

What "unit of account" should be used to evaluate whether the MSR transfers qualify as sales under GAAP?

## Staff Response

The staff views the group of MSRs associated with each underlying loan pool under the servicing contract with different recourse as a separate unit of account. Each of these pools needs to be separately evaluated for the 10 percent test in MSR transfer accounting analysis and therefore should not be aggregated with the others.

When the MSRs related to the underlying loan pools share the same protection provision, then these homogeneous pools may be aggregated for the 10 percent test in the MSR transfer accounting analysis. It is inappropriate to aggregate established units of account to achieve the desired sales result for the 10 percent test.

MSRs are not financial assets. The accounting model used to evaluate whether the transfer of an MSR asset qualifies for a sale is based on a risks and rewards approach. Although ASC 860-50-40-4 is not specific about how the 10 percent test needs to be completed, individual facts and circumstances need to be considered if it appears the transaction was structured to meet the sales rules. To determine the appropriate level at which the sale accounting analysis should be performed, the bank should evaluate the risks retained or unique characteristics of underlying serviced loans associated with the MSRs governed under the contracts that are dissimilar because they have a specific recourse provision retained by the MSR transferor.

## 9B. Credit Card Affinity Agreements

**Facts** In 20XX, a bank entered into a 12-year contract with an affinity group for the exclusive right to offer credit cards to the group's members in return for a nonrefundable payment to the group of $50 million per year. The affinity group has a stable membership, and, therefore, the number of credit card customers is expected to remain relatively constant. Further, the services performed by the parties are constant throughout the life of the contract.

The contract also contains a royalty calculation provision that uses an escalating scale that bears no relationship to the expected earnings from the credit card portfolio or services performed under the contract. Under this escalating scale, the royalty provision provides for a $10 million amount in the first year and in excess of $100 million in the final year of the contract. Although the excess of the annual payment over the royalty amount is not refundable, it may be used to offset future royalties. The bank proposes to record a $10 million expense the first year and include the $40 million amount difference as a prepaid expense (other asset) on its balance sheet.

### Question 1

Should the bank capitalize $40 million of the $50 million payment related to this affinity agreement as a prepaid asset because of the royalty calculation provision?

### Staff Response

No. GAAP requires that the expense be determined in a systematic and rational manner to the periods in which the payments are expected to provide benefit. In this situation, the benefits of the relationship and the services of the affinity group are being provided consistently throughout the contract period. Further, the royalty calculation provision in the contract is not related to the expected earnings on the portfolio or the services performed by the affinity group.

Accordingly, an accounting method that recognizes expense on a periodic basis relative to the benefits received should be used. In this case, the periodic payments from the bank to the affinity group are the best measurement of that benefit. This accounting is consistent with ASC 450. ASC 842-30-25 also provides guidance that requires leases with accelerated payment structures to be accounted for by recognizing income or expense on a straight-line basis or another income recognition method that provides a systematic pattern consistent with the benefits derived.

# 9C. Organization Costs

## Question 1

What are start-up activities and organization costs?

## Staff Response

Start-up activities are defined broadly as those one-time activities related to opening a new facility, introducing a new product or service, conducting business in a new territory, conducting business with a new class of customer, or commencing a new operation. Start-up activities include activities related to organizing a new entity— such as a new bank—that are commonly referred to as organization costs.

Organization costs for a bank are the direct costs incurred to incorporate and charter the bank. Such costs include professional (e.g., legal, accounting, and consulting) fees and printing costs directly related to the chartering or incorporation process, filing fees paid to chartering authorities, and the cost of economic impact studies.

## Question 2

What is the accounting for start-up activities, including organization costs?

## Staff Response

Costs of start-up activities, including organization costs, should be expensed as incurred. Costs of acquiring or constructing premises and fixed assets and getting them ready for their intended use are capitalized as fixed assets. The costs of using such assets that are allocated to start-up activities (e.g., depreciation of computers), however, are considered start-up costs. For a new bank, pre-opening expenses such as salaries and employee benefits, rent, depreciation, supplies, directors' fees, training, travel, postage, and telephone are considered start-up costs.

Guidance on the accounting and reporting for start-up activities, including organization costs, is set forth in ASC 720-15 and the call report instructions glossary under "start-up activities."

## Question 3

What is the accounting for the organization costs of forming a holding company?

## Staff Response

Although holding company organization costs are sometimes paid by a bank owned by the holding company, those costs are the holding company's organization costs and should not be reported as expenses of the bank. Call report instructions require any unreimbursed holding company organization costs paid for by the bank on behalf of the holding company to be recorded as a cash dividend paid from the bank to the holding company. Similarly, if the holding company application is unsuccessful or abandoned, the costs are the responsibility of the holding company organizers. Therefore, unreimbursed amounts should be recorded as a dividend.

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**Facts** Bank A would like to expand into a nearby state. Because of state law, a bank must have an existing charter in the state for more than five years to be able to conduct business. To achieve this, Bank A purchases and merges with Bank B's existing charter, which it acquired from Bank B's holding company for $300,000. Bank B is an independent third-party institution. Bank A does not acquire any other net assets of Bank B but now has the legal right to do business in that state. The transaction is not a business combination, because the charter in itself does not constitute a business.

## Question 4

How should Bank A account for the $300,000 paid to acquire the charter with the sole purpose of achieving the right to do business in the state?

## Staff Response

Although this cost may be consistent with the definition of an organization cost because it was created in a third-party transaction, it is considered to be an intangible asset and is accounted for under ASC 350 rather than ASC 720-15. Accordingly, this cost may be capitalized.

## Question 5

May the intangible asset noted be accounted for as goodwill?

## Staff Response

No. The intangible is not considered to be goodwill. In accordance with ASC 350-30, assets acquired outside of a business combination do not give rise to goodwill. This asset would be considered to be an identifiable intangible asset. (See Subtopic 10B for further guidance on the appropriate accounting for intangible assets.)

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**Facts** The start-up costs of forming a bank are sometimes paid by the organizing group (or founders or holding company) without reimbursement from the bank. This may occur because the organizing group or holding company wishes to contribute these funds to the bank, or because the shareholders or the OCC disallow reimbursement of certain costs.

## Question 6

How should the bank account for these start-up costs that are paid by the organizers?

## Staff Response

The bank must record these start-up costs as expenses of the bank, with a corresponding entry to surplus to reflect the capital contribution. This includes direct costs paid to third parties and services that are provided by the holding company, such as legal or accounting expertise. In the latter case, the holding company should estimate the cost of services provided, including salaries, and the bank should record these costs as start-up costs.

# Topic 10 Acquisitions, Corporate Reorganizations, and Consolidations

## 10A. Acquisitions

### Question 1

In general, what are the accounting principles for an acquirer to account for business combinations under ASC 805?

### Staff Response

The accounting requirements in ASC 805 include the following:

- Banks are not allowed to carry over the acquired bank's allowance in an acquisition. Instead, all acquired loans should initially be recorded at fair value. Acquired loans that are determined to be PCD loans will recognize an allowance at acquisition via a gross-up of the purchase price. An ACL is established via a PCL charge to earnings after acquiring loans that are not PCD.
- Other than the direct costs to issue debt and equity, transaction costs are expensed. Transaction costs should not be capitalized as part of the acquisition cost.
- The bank will recognize and, with limited exceptions, measure the identifiable assets acquired, the liabilities assumed, and any NCI at fair value as of the acquisition date. Subsequent acquisitions of the remaining NCI are accounted for as part of equity with no impact on earnings.
- Any excess of the fair value of net identifiable assets acquired over the purchase price (formerly referred to as negative goodwill) should be recognized by the acquirer in earnings as a bargain purchase gain.
- The bank should recognize an indemnification asset if the seller contractually indemnifies the bank for the outcome of a contingency or uncertainty related to all or part of a specific asset acquired or liability assumed in the business combination.
- The bank is required to recognize assets acquired and liabilities assumed arising from contingencies as of the acquisition date if acquisition-date fair value can be determined during the measurement period.

### Question 1A [PCC]

Is there an accounting alternative available for recognition of identifiable intangible assets from a business combination if the acquirer is a private company?

## Staff Response

Yes. If the acquirer does not meet the GAAP definition of a PBE, it can elect to apply the PCC accounting alternative for identifiable intangible assets in ASC 805-20. A private company that has elected this PCC accounting alternative can include in goodwill (a) customer-related intangible assets that are not able to be sold or licensed independently from other assets of the business and (b) noncompetition agreements. Customer-related intangible assets that can be sold or licensed independently from other assets of the business (e.g., mortgage servicing rights and core deposit intangibles) must be separately recognized.

A private company that elects this PCC accounting alternative must also adopt the PCC accounting alternative to amortize goodwill (see Subtopic 10B, question 1A).

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**Facts** Bank A acquires Bank B in a purchase transaction. Bank A incurs costs to terminate Bank B’s unfavorable data processing contracts and to make its data processing system compatible with Bank A’s system.

## Question 2

Should those costs be capitalized by Bank A in connection with the acquisition?

## Staff Response

No. Under ASC 805, the acquiring bank is not allowed to record transaction and restructuring costs of an acquisition as part of the purchase price. An acquiring bank may only capitalize the costs to issue debt and equity securities in connection with the acquisition.

Accordingly, costs incurred to terminate Bank B’s unfavorable contracts, including data processing contracts, should be expensed when incurred. This includes the cost to make Bank B’s data processing system compatible with Bank A. In addition, costs incurred by the acquiring institution to modify, convert, or terminate its own data processing system should also be expensed as incurred.

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**Facts** Bank A acquires Bank B from the FDIC in a purchase and assumption transaction. Bank A submits a negative bid of $5 million (i.e., the FDIC pays Bank A $5 million to acquire Bank B).

## Question 3

How should Bank A account for this transaction?

## Staff Response

The transaction should be accounted for using the acquisition method of accounting. Accordingly, the identifiable assets acquired and liabilities assumed are generally recorded at acquisition-date fair value consistent with ASC 820-10. The cash received from the FDIC (i.e., the $5 million) is recorded as an asset acquired in the acquisition. Any difference between the fair value of the net identifiable assets acquired and the purchase price should be recognized as goodwill (if purchase price exceeds the fair value of the net identifiable assets acquired) or as a bargain purchase gain (if fair value of the net identifiable assets acquired exceeds the purchase price).

## Question 4

Would the response to question 3 be different if the bank had entered into a loss-sharing agreement with the FDIC?

## Staff Response

The transaction should still be accounted for under the acquisition method. The loss-sharing agreement between the bank and the FDIC should be accounted for as an indemnification asset or a derivative, either of which is recorded at fair value on the acquisition date. If the loss-sharing agreement is recorded as an indemnification asset, the bank should account for the change in the measurement of the indemnification asset on the same basis as the change in the assets subject to indemnification. The period over which changes in the value of the indemnification asset are recognized is limited to the lesser of the term of the indemnification agreement or the remaining life of the indemnified assets.

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**Facts** FDIC-assisted acquisitions generally are made through an expedited bid process. Before submitting a bid, the acquirer (Bank A) will prepare provisional amounts for the fair value of the assets acquired and liabilities assumed. These provisional amounts are based on limited due diligence and incomplete information regarding the assets acquired and liabilities assumed by the bank.

## Question 5

Is it appropriate, in recording the acquisition, for Bank A (the acquirer) to revise the provisional fair value amounts?

## Staff Response

Yes. Not only is it appropriate, it is required. At the acquisition date the acquirer generally will not have obtained all of the information necessary to measure the fair value of the assets acquired and liabilities assumed in the acquisition in accordance with ASC 820-10.

When adjustments to provisional estimates are determined during the measurement period (see question 6), the bank records the adjustments in the reporting period in which they are identified, with no prior period restatement.

## Question 6

What is the measurement period referred to in the staff response to question 5?

## Staff Response

The measurement period is the period of time after the acquisition date, not to exceed 12 months, that is required to identify and measure the fair value of the identifiable assets acquired, liabilities assumed, and any NCI in the acquiree in a business combination. The measurement period ends as soon as the acquirer receives the information it was seeking about the facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable.

## Question 7

What is the acquisition date for purposes of determining the purchase price of an acquisition and the assignment of fair values to the assets acquired and liabilities assumed?

## Staff Response

For an acquirer, ASC 805-10-25-6 defines the acquisition date as “the date on which it obtains control of the acquiree.” Generally, control occurs when the acquirer legally transfers consideration, acquires the assets, and assumes the liabilities of the acquiree. This would normally be the consummation or closing date of the transaction.

## Question 8

If equity securities are issued in connection with the business combination, is their value also determined as of the acquisition date?

## Staff Response

Yes. Under ASC 805-10-25, the fair value on the acquisition date is used in determining the value of the securities issued.

**Facts** Bank A acquires Bank B in a transaction accounted for under the acquisition method in accordance with ASC 805. In addition to the consideration paid at the time of the acquisition, the agreements provide for additional payments by Bank A to the former owners of Bank B, based upon the occurrence of certain future events (i.e., contingent consideration).

## Question 9

Should any portion of the contingent consideration be included in the purchase price at the date of acquisition?

## Staff Response

Bank A should include the fair value of the contingent consideration on the acquisition date as part of the cost of acquiring the entity (i.e., the purchase price). If the fair value of the contingent consideration cannot be determined at the acquisition date, or during the measurement period (see question 6), the contingent consideration should not be included in the purchase price. If the fair value of contingent consideration can be determined during the measurement period, Bank A should classify the obligation as a liability or as equity at the date of acquisition in accordance with ASC 480-10. Contingent consideration classified as a liability should be remeasured at each reporting date with changes in fair value recognized in earnings. Contingent consideration classified as equity should not be remeasured at each reporting date, and its subsequent settlement should be accounted for as an equity adjustment.

## Question 10

In certain situations, the fair value of the net identifiable assets acquired exceeds the purchase price of an institution (plus fair value of the NCI, if any). How should the excess (i.e., bargain purchase gain) be recorded?

## Staff Response

Before recognizing a bargain purchase gain, ASC 805 requires the acquirer to assess whether it has correctly identified all of the assets acquired and all of the liabilities assumed to determine if any additional assets or liabilities should be recognized. The acquirer should also review the fair value estimates for the assets acquired, the liabilities assumed, and the consideration transferred. If the fair value amounts are appropriate, the acquirer should recognize the bargain purchase gain in earnings.

**Facts** Bank A acquires 100 percent of Bank B, an unaffiliated entity. Bank B is involved in litigation with a third party. Bank A, following the acquisition of Bank B, may suffer a loss due to this litigation. Bank A estimates that it may face a loss between $0 and $50 million at the acquisition date.

## Question 11

How should the contingent payment associated with the litigation (i.e., the loss contingency) be accounted for?

## Staff Response

If the fair value of the loss contingency as of acquisition date can be determined during the measurement period (see question 6), the contingent payment should be reported at fair value and included in the net assets acquired (i.e., as a liability assumed) in the business combination.

If Bank A cannot determine the acquisition-date fair value of the contingent payment during the measurement period, no liability should be recorded. Subsequent to the measurement period, the bank should account for the loss contingency in accordance with ASC 450-20. Accordingly, the liability should be recognized and included in earnings when payment is probable and the amount of the payment can be reasonably estimated.

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**Facts** Bank A acquires Bank B in a transaction accounted for under the acquisition method in accordance with ASC 805. After the acquisition, Bank B is merged into Bank A.

## Question 12

In accordance with 12 USC 60(b) and 12 CFR 5.64 (national banks) or 12 CFR 5.55 (federal savings associations), how should the retained net income amounts be determined when computing dividend limitations?

## Staff Response

One of the combining entities in the transaction is viewed as surviving the transaction and is considered the acquiring entity. The other combining entity no longer continues to be formally recognized and its net assets are considered to be purchased by the acquiring entity. The capital accounts of the acquired entity are eliminated. If there is any NCI, the NCI is recorded at fair value as part of equity. Operations of the acquired entity are included only in the income statement from the date of acquisition.

Accordingly, only the acquiring bank's retained net income (net income less dividends paid in each year) are used when computing the dividend limitations in the statute and regulation, as applicable. Therefore, the applicable retained net income and current-year net income of only the acquiring bank may be included in the calculation. Operations of the acquired bank would be included from the date of acquisition.

Because of concerns about the quality and composition of capital when there is a bargain purchase gain and the related fair value estimates have not yet been validated, the OCC may impose certain conditions in the acquisition approval to maintain and protect the safety and soundness of the acquiring institution. Conditions may include the acquiring institution excluding the gain from bargain purchase from its dividend-paying capacity calculation until the end of the period set forth in the conditional approval.

## Question 13

In a business combination effected through the exchange of equity interests, is the surviving legal entity necessarily the acquirer for accounting purposes?

## Staff Response

ASC 805-10-05-4 notes that the acquisition method requires identification of the acquirer and establishes criteria for making that determination. In that context, the entity that issues the equity interests is usually the acquirer for accounting purposes. This, however, is not always the case. In certain circumstances, the acquired bank for accounting purposes will issue the equity interests and be the surviving charter. These transactions are commonly referred to as reverse acquisitions.

Generally, the acquirer for accounting purposes is the larger entity; however, all of the facts and circumstances must be considered in making this determination.

## Question 14

In addition to the relative size of the combining banks, what other factors should be considered in determining the acquirer for accounting purposes?

## Staff Response

The following factors should be considered in determining the acquirer for accounting purposes:

- The relative voting rights of the shareholders of each entity in the combined entity—the owners of the acquirer usually retain or receive the largest voting rights in the combined entity.
- The existence of a large NCI that will have a significant voting influence over the combined entity—the owners of the acquirer usually hold the largest interest.
- The composition of the governing body (i.e., board of directors)—the owners of the acquirer usually have the ability to make changes to the majority of the members of the board of directors.
- The composition of senior management—management of the acquirer usually dominates the combined management.
- The terms of the exchange of equity interests and the values ascribed to the prices of the equity interests that are exchanged—the acquirer usually pays a premium over the value of the equity interests of the other entity.

**Facts** Bank A is the legal survivor in a business combination with Bank B. Before the merger, however, Bank A has $150 million in assets, and Bank B has $220 million in assets. After the merger, Bank A's former shareholders will own 40 percent of the outstanding stock, and Bank B's former shareholders will own 60 percent of the outstanding stock of the combined entity.

Further, former Bank B shareholders will have four members on the board of directors, and former Bank A shareholders will have three members on the board.

## Question 15

For accounting purposes, which bank is the acquirer?

## Staff Response

Bank B is the acquirer. This determination is based on the relative size of the combining banks, as well as the resulting shareholder ownership and board membership percentages. In this situation, the determination is relatively clear-cut because Bank B provided approximately 60 percent of the assets, and its former owners received approximately 60 percent of the outstanding stock and board membership. In practice, the determination will not always be this clear.

## Question 16

How is this transaction accounted for?

## Staff Response

Because Bank B is the acquirer for accounting purposes, its financial statements will be carried forward at historical cost. Bank A is accounted for as the acquired bank and its assets (including intangible assets) and liabilities are recorded at fair value. The purchase price for the acquisition is the fair value of the shares of stock owned by former Bank A shareholders. Goodwill or bargain purchase gain is recognized for the difference between the purchase price and the fair value of the net identifiable assets acquired.

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**Facts** Bank A previously acquired 20 percent of Bank B for $20 million. The carrying amount of Bank A's investment in Bank B is $22 million on March 31, 20XX. On March 31, 20XX, Bank A acquires an additional 50 percent of Bank B for $75 million. On March 31, 20XX, the fair value of Bank B's net identifiable assets is $110 million and the fair value of the remaining 30 percent interest not held by Bank A is $45 million. The fair value of Bank A's initial 20 percent investment is $30 million on March 31, 20XX.

## Question 17

How should Bank A account for the subsequent acquisition of the 50 percent interest in Bank B?

## Staff Response

ASC 805-10-25 refers to this type of transaction as a business combination in stages, or a step acquisition. Bank A should account for the subsequent purchase of the 50 percent interest using the acquisition method under ASC 805-10-25. The acquisition of the additional interest on March 31, 20XX, is the date Bank A obtains control of Bank B and is considered the acquisition date to apply ASC 805-10-25.

As the first step, Bank A should adjust the carrying amount of its initial investment to the acquisition-date fair value or $30 million, with a corresponding gain of $8 million recognized in earnings. Then Bank A should record the fair values of the net identifiable assets acquired, along with fair value of the NCI of $45 million. Finally, Bank A would record goodwill of $40 million as shown in the following:

| | |
|---|---|
| Purchase of additional 50 percent | $75 million |
| Fair value of initial 20 percent investment | $30 million |
| Fair value of 30 percent not held by Bank A | $45 million |
| Total fair value of Bank B | $150 million |
| Fair value of net identifiable assets acquired | $110 million |
| Goodwill | $40 million |

## Question 18

If Bank A subsequently acquires the remaining 30 percent of Bank B, should Bank A make any further adjustments to the reported carrying amount?

## Staff Response

Because Bank A had previously acquired control of Bank B, the acquisition of the remaining NCI should be accounted for as a capital transaction, pursuant to ASC 810-10-45-23. In this situation, Bank A controls Bank B and thus no gain or loss is recognized as a result of the purchase of the remaining 30 percent NCI. In addition, Bank A should not make any further adjustments to the assets acquired and liabilities assumed from the business combination with Bank B.

Instead, the NCI currently reported in Bank B is eliminated as an offset to the purchase price. Any difference between the purchase price and the carrying amount of the NCI is recognized as part of Bank A’s surplus.

## Question 19

What is the definition of a business?

## Staff Response

ASC 805-10 defines a business as “an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.” ASC 805-10-55 provides additional guidance that states a business consists of inputs and processes applied to those inputs that have the ability to create outputs. Although businesses usually have outputs, outputs are not required for an integrated set of activities and assets to qualify as a business. ASC 805-10-55 also provides guidance to assist with evaluating when a set of transferred assets and activities is a business, and whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses.

## Question 20

How should an institution define “substantially all” when considering an acquisition transaction?

## Staff Response

The term “substantially all” is not defined in ASC 805, but 90 percent is generally accepted in practice.

# 10B. Intangible Assets

## Question 1

In general, what are the accounting principles for recognizing and measuring goodwill and other intangible assets as part of a business combination?

## Staff Response

ASC 805 and ASC 350 include the following recognition and measurement principles for goodwill and other intangibles:

- An intangible asset should be recognized as an asset separately from goodwill, if either of the following two criteria is met:
  - It is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so; or
  - It arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

In general, the excess of the consideration transferred (plus the fair value of any NCI in the acquired entity) over the fair value of the net identifiable assets acquired should be recognized as goodwill by the acquirer.

Subsequent to the acquisition date, as long as the acquirer maintains control, any changes in the level of ownership will be treated as capital transactions; there is no further change to the goodwill amount.

Goodwill and indefinite-lived intangible assets should not be amortized; rather, they should be reviewed at least annually for impairment in accordance with ASC 350-20-35 (for goodwill) and ASC 350-30-35 (for indefinite-lived intangibles). See question 7 for more details on testing goodwill for impairment.

Other intangible assets (e.g., core deposit intangibles, PCCRs) that have a finite life should be amortized over their useful lives and assessed for impairment in accordance with ASC 360-10-35 (see question 3).

## Question 1A [PCC]

Is there a PCC accounting alternative for subsequent measurement of goodwill?

## Staff Response

Yes. A private company may elect to amortize goodwill on a straight-line basis over a useful life of 10 years (or less if more appropriate) and perform a single-step impairment test at either the entity level or the reporting unit level.

A private company that elects the PCC accounting alternative to amortize goodwill is required to perform the single-step impairment test only when an event or circumstance indicates that the fair value of the entity (or reporting unit) may be less than its carrying amount. (These events are referred to as “triggering events.”) The goodwill impairment can be measured as the excess of the carrying amount of the entity (or reporting unit) including goodwill over its fair value, but its goodwill impairment recognition should not exceed the carrying amount of goodwill. See question 7A for more details on goodwill impairment testing.

A private company may make an independent election, per the accounting policy election in ASU 2021-03, to only evaluate whether a triggering event exists as of the reporting date. An independent election would be in lieu of evaluating and identifying a triggering event as it occurs at any point during the reporting period. This election allows a private company to determine if goodwill is impaired as of the reporting date rather than the date of a triggering event, which often occurs during a reporting period rather than at the end of the reporting period. For example, for purposes of the March 31 call report, a private company that makes this election only needs to determine whether a triggering event exists as of March 31 rather than identifying the specific date of the triggering event. If a triggering event occurred during the reporting period, goodwill impairment is evaluated as of March 31 rather than the specific date of the triggering event.

## Question 2

How should an intangible asset with a finite life be amortized?

## Staff Response

An intangible asset with a finite life (e.g., core deposit intangible and PCCR) should be amortized over its estimated useful life using a method that reflects the pattern in which the economic benefit of the asset is consumed. This will generally result in the use of an accelerated method of amortization. If a usage pattern cannot be reliably determined, institutions should use the straight-line method.
The staff believes the estimated useful lives of core deposit intangibles and PCCRs will generally not exceed 10 years. In unusual circumstances, however, a longer useful life and amortization period may be justified.

## Question 3

Should discounted or undiscounted expected future cash flows be used in assessing an intangible asset with a finite life (e.g., a PCCR) for impairment?

## Staff Response

An intangible asset with a finite life should be assessed for impairment in accordance with ASC 360-10-35. An impairment loss shall be recognized if the carrying amount of the intangible asset is not recoverable. The carrying amount is not recoverable if it exceeds the sum of the undiscounted expected future cash flows from the intangible asset. If the carrying amount of the asset is not recoverable, it is written down to its fair value. Fair value of the intangible asset may be estimated using a present value technique (e.g., the sum of the discounted expected future cash flows from the intangible asset) where appropriate (see Subtopic 11D for more details on fair value).

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**Facts** Bank A acquires Bank B in a business combination accounted for using the acquisition method. Bank B is merged into Bank A. Intangible assets (core deposit intangibles and goodwill, etc.) resulting from the acquisition are recorded on the Statement of Condition of Bank A. Subsequently, Bank C acquires Bank A in a business combination accounted for using the acquisition method, and Bank A is merged into Bank C.

## Question 4

Should the intangible assets, resulting from the first acquisition, be included on the Statement of Condition for Bank C?

## Staff Response

No. The acquisition of Bank A by Bank C is recorded at the fair value of Bank A's assets and liabilities on that acquisition date. This includes any identifiable intangible assets, such as core deposit intangibles, and unidentifiable intangible assets (goodwill). The second acquisition creates a new basis of accounting for Bank A's assets and liabilities. Accordingly, the intangible assets recorded on the financial statements of Bank C, after the acquisition of Bank A, result only from that acquisition.

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## Question 5

Can a bank "sell" goodwill to its parent holding company?

## Staff Response

No. Goodwill is an unidentifiable intangible asset arising from a business acquisition. It may not be acquired or sold separately.

**Facts** A bank pays a license fee to a third party to assist the bank in establishing a new factoring program for its customers. The fee is not subject to refund and represents a contractual right. The agreement gives the bank territorial exclusivity for one year. There is also a monthly license fee that is expensed each month.

## Question 6

How should the license fee be accounted for?

## Staff Response

The license fee represents an intangible asset. The fee should be amortized over its useful life in accordance with ASC 350. ASC 350-30-35 lists pertinent factors to consider in estimating the useful life. One factor is contractual provisions that may limit the useful life. In this case, the contract provides for one year of territorial exclusivity. Once this period expires, the value of the license is diminished. Thus, a useful life of one year appears appropriate. If a longer life is considered appropriate, the value of the intangible asset should be reviewed for impairment in accordance with ASC 360-10-35.

**Facts** On December 31, 20X1, Bank A acquired Bank B in a business combination accounted for using the acquisition method of accounting and recognized goodwill for the excess of the purchase price over the fair value of the net identifiable assets acquired. Bank B is merged into Bank A and the combined operations and financial information are managed as one unit. Thus, Bank A is the reporting unit.

Two years have now passed since the acquisition, and Bank A has experienced a loss of certain key personnel and increased competition related to the acquisition. As such, Bank A performed a qualitative assessment and believes that the goodwill may be impaired.

## Question 7

How should goodwill be tested for impairment?

## Staff Response

ASC 350-20-35 gives an entity the option to first assess qualitative factors to determine whether the existence of events or other circumstances leads to a determination that it is more likely than not (i.e., likelihood of more than 50 percent) that the fair value of a reporting unit is less than its carrying amount (including goodwill). If, after assessing the totality of events or circumstances (examples illustrated in ASC 350-20-35-3C), an entity determines it is unlikely that the fair value of the reporting unit is below its carrying amount (including goodwill), then further impairment testing is unnecessary. If, however, an entity concludes otherwise, then the entity should perform the quantitative goodwill impairment test. A goodwill impairment is recognized to the extent the carrying value exceeds the fair value, not to exceed the carrying amount of goodwill. The adjusted carrying amount for goodwill becomes its new accounting basis.

An entity can elect to bypass the qualitative assessment for any reporting unit in any period and proceed directly to performing the single-step quantitative goodwill impairment test by comparing the fair value of a reporting unit to its carrying amount (including goodwill). An entity may resume performing the qualitative assessment in any subsequent period.

ASC 350-20-35-3C provides some examples (not all-inclusive) of relevant events and circumstances in evaluating whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount.

In this example, the reporting unit is considered to be Bank A. While the reporting unit is typically at a level below an operating segment, Bank B's operations and financial information have been merged into Bank A, and the combined activities are managed as one unit. Bank A performed the qualitative assessment and determined it is more likely than not that its fair value is less than its carrying amount (including goodwill). Consequently, Bank A must perform the following quantitative impairment test:

To test for goodwill impairment, one would compare the carrying amount of Bank A (including goodwill) with its estimated fair value. If the fair value of the reporting unit is less than the carrying amount (including goodwill), a goodwill impairment loss should be recognized for the difference, not to exceed the carrying amount of goodwill. After a goodwill impairment is recognized, the adjusted carrying amount of goodwill becomes the new accounting basis. If applicable, an entity should consider the income tax effect of any tax deductible amounts on the carrying amount of the reporting unit.

## Question 7A [PCC]

How should goodwill be tested for impairment if Bank A is a private company that has elected the accounting alternative to amortize goodwill?

## Staff Response

Upon adoption of the private company accounting alternative to amortize goodwill (see question 1A), Bank A should make an accounting policy election to test goodwill for impairment at the entity level or the reporting unit level. In this case, the entity level and the reporting unit level are the same.

Bank A is required to test the remaining unamortized goodwill for impairment when a triggering event occurs. A triggering event is an event or a change in circumstances that indicates that the fair value of Bank A may be below its carrying amount. When a triggering event occurs, the bank has the option to perform a qualitative impairment assessment.

If Bank A has adopted ASU 2021-03 and made an accounting policy election to evaluate whether a triggering event exists only as of the reporting date, the qualitative impairment assessment would be performed as of the end of the reporting period. If Bank A does not make this election, it is required to evaluate whether a triggering event occurred at any point during the reporting period and evaluate impairment as of the triggering event date. See question 1A for more detail.

If Bank A's qualitative assessment determines it is not more likely than not (i.e., less than 50 percent probability) that the fair value of Bank A is below its carrying amount (including goodwill), no further testing is necessary. Otherwise, Bank A must determine its fair value and compare the fair value with its carrying amount (including goodwill). If the fair value of Bank A is less than its carrying amount, a goodwill impairment loss should be recognized. The goodwill impairment loss should not exceed the carrying amount of goodwill. After goodwill impairment is recognized, the adjusted carrying amount of goodwill becomes its new accounting basis, which should continue to be amortized over the remaining useful life of the goodwill (without reassessing the useful life of goodwill).

Bank A has an unconditional option to bypass the qualitative assessment and proceed directly to a quantitative calculation by comparing its fair value with its carrying amount (including goodwill). Bank A may resume performing the qualitative assessment upon the occurrence of any subsequent triggering event or reporting date, as appropriate.

## Question 8

Should other assets be tested for impairment before goodwill?

## Staff Response

Yes. Consistent with ASC 350-20-35-31, if other assets in the reporting unit are being tested for impairment at the same time, the other assets should be tested for impairment before goodwill. For example, if a long-lived asset is impaired, the impairment loss on the long-lived asset should be recognized before the impairment test for goodwill.

**Facts** On December 31, 20X1, Bank A acquired Bank B in a business combination and recognized goodwill. Bank A manages Bank B as a reporting unit. Bank A has historically determined the fair value of the reporting unit annually. Two years have now passed since the acquisition, and Bank A has not experienced any significant adverse factors related to the acquisition.

## Question 9

Is Bank A required to determine the fair value of the reporting unit each year for goodwill impairment testing?

## Staff Response

Not necessarily. If the latest valuation indicates that the fair value of the reporting unit substantially exceeds its carrying amount, Bank A may be able to carry forward the valuation for the next year. Bank A must also be able to conclude, however, that the assets and liabilities of that reporting unit have not changed significantly since the most recent fair value determination, and that the likelihood that the fair value from a new valuation would be less than its carrying amount is remote. If there have been no significant changes to Bank B's operations, its competition, or other adverse conditions that would indicate that the previous fair value was no longer appropriate, Bank A would not be required to obtain an updated fair value of Bank B annually.

## Question 10

Is Bank A allowed to consider a control premium, the excess amount a buyer is willing to pay to gain control of an entity, in its fair-value determination of the reporting unit?

## Staff Response

It depends. The fair values used to test goodwill for impairment should be based on the measurement principles of ASC 820-10. Acquiring banks may be willing to pay more for an equity investment that represents a controlling interest than for an investment in a similar number of equity securities that do not represent a controlling interest. As part of the determination of the fair value of the reporting unit, a bank may need to consider the impact of the control premium based on the value of the reporting unit in the marketplace. Because it is being valued as a whole, the marketplace typically places additional value on the ability to gain control of an entity. Therefore, individual prices by themselves need not be the sole measurement basis for the fair value of a reporting unit.

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**Facts** A privately held bank recorded goodwill as part of an acquisition on June 30, 20X1. The bank elected the PCC accounting alternative for amortizing goodwill at the time of the acquisition. The bank determined that goodwill would be amortized over 10 years. Goodwill amortization was recorded in 20X1 and 20X2. The bank is considering a change in accounting principle in 20X3 to reverse its PCC accounting alternative election.

## Question 11

Is it permissible for a privately held bank that previously elected the PCC accounting alternative to revert to accounting for goodwill in accordance with ASC 350-20-35-1, which precludes amortization and requires testing of goodwill at a reporting unit level?

## Staff Response

A privately held bank that has previously elected to apply the PCC accounting alternative for amortizing goodwill may revert to the ASC 350-20-35-1 method of accounting for goodwill if the entity can satisfy the preferability requirements in ASC 250-10-45-2 for a change in accounting principle.

If the preferability requirements are met, the bank would need to retrospectively apply ASC 350-20-35-1. This would include determining whether impairment was present in prior reporting periods in 20X1 and 20X2. Goodwill impairment evaluations for prior periods would need to be completed without using hindsight and would be based on facts and circumstances available at the prior reporting date. Previously filed call reports may need to be amended and refiled if the effects of the change in accounting principles, including the reversal of previously recognized amortization expense and any changes to previously recorded impairment charges, are material.

# 10C. Pushdown Accounting

## Question 1

What is pushdown accounting?

## Staff Response

Pushdown accounting is the establishment of a new accounting basis of an acquired bank in its separate financial statements. An acquired bank that retains its separate corporate existence may elect pushdown accounting when an acquirer obtains a controlling financial interest in the bank. A controlling financial interest in the acquired bank is usually obtained when the acquirer obtains ownership of a majority voting interest (i.e., greater than 50 percent).

When pushdown accounting is elected, the acquired bank must report in its separate financial statements the new basis of accounting established by the acquirer. That is, the acquired bank's identifiable assets, liabilities, and noncontrolling interests are restated to their acquisition-date fair values (with limited exceptions as specified in ASC 805). Any goodwill arising from the acquisition is reported in both the acquired bank's separate financial statements and the acquirer's consolidated financial statements. Any bargain purchase gain from the acquisition, however, is reported in the acquirer's financial statements as earnings but in the acquired bank's financial statements as surplus.

The election to apply pushdown accounting to an acquisition of a controlling financial interest is irrevocable.

If the acquired bank has subsidiaries, any subsidiary of the acquired bank is also eligible to make an election to apply pushdown accounting to its separate financial statements, regardless of whether the acquired bank elects to apply pushdown accounting.

The majority of push-down accounting guidance is contained in ASC 805-50 and call report instructions.

## Question 2

What is the regulatory policy for pushdown accounting?

## Staff Response

Banks are expected to follow the accounting and reporting guidance in ASC 805 and in the call report instructions. The OCC reserves the right, however, to require or prohibit the bank's use of pushdown accounting for call report purposes based on the OCC's evaluation of whether the election best reflects the facts and circumstances of the business combination.

**Facts** A holding company acquires a controlling financial interest in a bank. The holding company incurs debt in connection with the acquisition. The debt is secured by the acquired bank's stock. The acquired bank does not assume or guarantee the holding company's debt.

## Question 3

Should the holding company's debt be pushed down to the acquired bank's financial statements if pushdown accounting is elected?

## Staff Response

No. ASC 805 requires acquisition-related debt incurred by an acquirer to be recognized in an acquired bank's separate financial statements only if the acquired bank is required to recognize a liability for that debt in accordance with other applicable GAAP guidance.

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**Facts** Holding Company A owns 100 percent of Bank A's voting stock. In the current period, an acquirer obtains control of Holding Company A by obtaining more than 50 percent ownership of Holding Company A's voting stock.

## Question 4

Can Bank A apply pushdown accounting when the change-in-control event is due to change in ownership of Holding Company A's stock?

## Staff Response

Yes. Pushdown accounting can be applied whenever there is a change in control, which can result from a direct or indirect change of ownership of the bank.

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**Facts** Corporation X acquires 51 percent of Holding Company B. Holding Company B owns 100 percent of Bank B. Corporation X accounts for the transaction as a business acquisition. The bank's assets represent substantially all of Holding Company B's consolidated assets.

## Question 5

Is Bank B permitted to use pushdown accounting in its call report?

## Staff Response

Yes. Consistent with ASC 805, Bank B, as a subsidiary of the acquiree (Holding Company B), is eligible to make an election and apply pushdown accounting to its call report regardless of whether Holding Company B elects to apply pushdown accounting. As noted in the response to question 2, the OCC reserves the right to require or prohibit Bank B's use of pushdown accounting for call report purposes based on the OCC's evaluation of whether the election best reflects the facts and circumstances of the business combination.

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**Facts** An existing holding company acquired all of the stock of a bank in a transaction that was accounted for by the acquisition method and resulted in a bargain purchase gain. The acquired bank retains separate corporate existence and elects to apply pushdown accounting.

### Question 6

How should the bargain purchase gain be reflected on the bank's separate financial statements?

## Staff Response

Under pushdown accounting, the acquired bank restates its identifiable assets, liabilities, and any NCI to their respective fair values (with limited exceptions as specified in ASC 805) as of the acquisition date. The excess of the fair value of the net assets acquired over the purchase price paid by the holding company represents a bargain purchase gain to the holding company and is recognized in income by the holding company. The bargain purchase gain should be reflected in the balance sheet of the acquired bank as part of surplus. Recognition of bargain purchase gain in the acquired bank's income statement is prohibited.

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**Facts** Corporation Y acquired 51 percent of the voting stock of Bank C via a purchase transaction. Bank C did not elect to apply pushdown accounting when Corporation Y acquired the controlling financial interest in Bank C.

### Question 7

Can Bank C elect to apply pushdown accounting in a subsequent period?

## Staff Response

Yes. Bank C can elect to apply pushdown accounting in a subsequent period, as a change in accounting principle, as long as Corporation Y retains a controlling financial interest in Bank C. Pushdown accounting shall be applied retrospectively as of the date Corporation Y acquired the controlling financial interest (i.e., acquisition date).

### Question 8

If Bank C has elected pushdown accounting, can the bank subsequently revoke that election?

## Staff Response

No. Bank C’s election to apply pushdown accounting is irrevocable.

# 10D. Corporate Reorganizations

## Question 1

Must a corporate reorganization that involves the combination of two or more banks under common control be accounted for at fair value?

## Staff Response

Generally, no. A combination between two or more banks under common control is accounted for in accordance with ASC 805-50. This requires that such combinations be accounted for at historical cost in a manner similar to pooling-of-interest accounting. The staff believes this accounting is appropriate when net assets from one entity that constitute a business are transferred to another entity under common control. Refer to Subtopic 10A, question 19, for description of the definition of a business.

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**Facts** A holding company owns all of the stock of Institution A, a federal savings association. Institution A, in turn, owns all of the stock of two other federal savings associations (Institution B and Institution C). The holding company desires to convert these three federal savings associations to national banks. It plans to transfer the stock of Institution B and Institution C to the parent holding company, so that after the transaction the holding company will own all of the stock of the three financial institutions (now national banks).

## Question 2

How should the bank account for the transfer of stock (of Institutions B and C) from Institution A to the parent holding company?

## Staff Response

The transfer of stock should be accounted for as a corporate reorganization among entities under common control, which is exempt from the general requirements of ASC 805-10. Furthermore, because this transfer of assets involves all of the target institution's assets, it is accounted for in accordance with ASC 805-50, at historical cost, similar to a pooling-of-interests.

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**Facts** Two national banks owned by the same holding company are merged to form one national bank in a corporate reorganization. Under the requirements of ASC 805-50, the combination is accounted for at historical cost. As a result, the financial statements of the two affiliates were combined at historical cost similar to pooling-of-interests treatment.

## Question 3

In accordance with 12 USC 60(b) and 12 CFR 5.64 (national banks) or 12 CFR 5.55 (federal savings associations), how should the retained net income amounts be determined when computing dividend limitations?

## Staff Response

As the combined bank's financial statements represent the combination of the financial statements of the two banks at historical cost, the retained net income (net income less dividends paid in each year) for both entities should be combined when computing the dividend limitations. Therefore, the applicable retained net income and current-year net income for both banks would be considered in the calculation.

# 10E. Related Party Transactions (Other Than Reorganizations)

## Question 1

How should a bank account for transfers of an individual asset or group of assets that does not constitute a business between the bank and its parent holding company or other related party?

## Staff Response

The transfer between a bank and a related party of assets that do not constitute a business should generally be accounted for at fair value when fair value is objectively determinable and the transaction has economic substance.

Consistent with call report instructions, each bank reports as a separate legal and accounting entity. Therefore, as a separate entity, the bank must record each transaction based on its economic substance. The use of fair value accounting maintains consistency in accounting for transactions involving affiliated and nonaffiliated parties. However, there have been situations where carrying amount is viewed as appropriate, such as with long-lived assets. If the substance of the transaction is a dividend, national banks are subject to 12 CFR 5.66 stating that noncash dividends should be transferred at their current value. Current value has been interpreted to mean fair value. There is currently no similar provision for federal savings associations. All institutions are expected to follow the call report instructions for property dividends and record property dividends at the fair value of the asset on the date of dividend declaration.

When fair value accounting is appropriate, any resulting profit or loss on the transaction is based on the fair value of the asset involved. If a difference between the contract price and the fair value exists, the difference is recorded as either a dividend or capital contribution, as appropriate. The bank should record a gain or loss for the difference between the carrying amount of the asset transferred and fair value.

The accounting guidance in this area is not always clear. Accordingly, when reporting events and transactions not covered in principle by GAAP or call report instructions, banks are encouraged to discuss the event or transaction with the OCC. Additionally, banks should be mindful of the requirements of sections 23A and 23B of the Federal Reserve Act (12 USC 371c and 371c-1) and Regulation W (12 CFR 223).

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**Facts** The bank sold a previously charged-off loan to related parties (i.e., members of the board of directors and stockholders). The sale price of the loan was its face value of $800,000. An appraisal has determined that the fair value of the charged-off loan is $100,000.

## Question 2

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

## Staff Response

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

## Question 3

Assume the same facts as in the previous question, except that the fair value of the charged-off loan cannot be reasonably determined. How should this transaction be accounted for?

## Staff Response

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

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**Facts** The bank sold a previously charged-off loan to related parties (i.e., members of the board of directors and stockholders) at its face value of $800,000. It is not possible to determine if the charged off loan has any value. Further, because of a lending limit violation, the directors are liable legally to purchase the loan at its face value.

## Question 4

How is this transaction accounted for?

## Staff Response

This transaction is accounted for in the same way as if the lending limit violation had not existed. Therefore, the entire amount ($800,000) is considered to be a capital contribution and is credited to capital surplus.

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**Facts** The bank is a wholly owned subsidiary of a holding company. The bank buys loans at face value from unrelated parties introduced to the bank by a loan brokerage company. The loan broker is wholly owned by related parties (persons related to the key management personnel of the bank). The related parties also own a voting interest in the holding company. As a fee for introducing the unrelated parties to the bank, the loan brokerage company receives 20 percent to

30 percent of the face amount of the loans from the seller (unrelated party). The loans have contractual rates approximating market yields and have demonstrated good repayment histories.

## Question 5

How should the bank record the purchase of the loans?

## Staff Response

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

In this case, the fee appears to significantly exceed a normal fee expected for an arm's-length transaction for services of the type provided by the loan brokerage company. Further, it supports the presumption that the face amount of the loans is not their fair value. Therefore, in substance, they represent a dividend, with the fair value of the loans represented by the net proceeds received by the seller.

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**Facts** A bank maintains escrow balances on deposits for loans serviced by certain mortgage banking affiliates of the bank's parent holding company. The bank retains income earned on such deposits.

The mortgage banking affiliates borrow funds from the bank, paying the market rate of interest. The interest rate does not recognize the benefit of the escrow funds deposited with the bank. Furthermore, no other arrangements exist to compensate the mortgage banking affiliates for the loss of the escrow account income.

## Question 6

How should the bank account for the earnings from the use of the mortgage escrow balances?

## Staff Response

Earnings from the bank's free use of the mortgage escrow balances provided by the mortgage banking affiliates should be credited to capital surplus as a contribution rather than recorded as income.

This response presumes that the mortgage banking affiliates can realize the benefit associated with the escrow balances. Earnings from escrow deposits provide a significant source of income to a mortgage banking operation. This income source is a significant part of the inherent value of mortgage servicing rights and a key consideration when servicing is acquired. Further, servicers often recognize part of this inherent value by negotiating a reduced interest cost on their borrowings as a result of these deposits.

Differences between the terms that prevail in the marketplace and those entered into by related parties is accounted for as a capital transaction (i.e., capital contribution or dividend). This policy is based upon the need to maintain consistency in accounting policy for transactions between affiliated and nonaffiliated parties.

**Facts** A one-bank holding company has entered into deferred compensation agreements with its six executive officers, who are also officers and employees of the bank. When the officer terminates employment, he or she is entitled to receive the vested amount in cash. The amount is paid by the holding company. Dividends from the bank are the holding company's only source of funds.

## Question 7

Should the compensation expense under the deferred compensation agreements be recorded on the books of the bank?

## Staff Response

The compensation expense resulting from these deferred compensation agreements should be recorded on the book of the entity for which the officers-employees perform services. If the holding company is a shell with little activity of its own, the compensation likely relates to services performed for the bank.

In this situation, the holding company has the contractual obligation to pay the deferred compensation to the officer-employee. However, the holding company is incurring this obligation on behalf of the bank. Therefore, the bank should record the expense and a liability for reimbursement to the holding company. If the holding company does not require or forgives reimbursement from the bank, a capital contribution from the holding company is recorded by the bank.

**Facts** The bank has a $5 million loan to a borrower that is experiencing financial difficulty. The bank has the loan classified as substandard. The bank has established an allowance of $1.525 million measured in accordance with ASC 326-20. Seven bank directors who are unrelated to the borrower signed personal guarantees on the loan. The borrower is not aware of the guarantee. The signing of the guarantees was intended to reduce the bank's ratio of classified loans to capital and to eliminate the need for the $1.525 million allowance. The directors have substantial net worth.

## Question 8

How should the bank account for this transaction?

## Staff Response

The loan should remain classified substandard with an appropriate allowance. The allowance should be estimated without consideration of the guarantee by the bank's seven directors, because the guarantee was obtained subsequent to origination and independent from the contractual relationship between the borrower and the bank. Upon execution of the guarantee, accounting entries are not required, because the guarantee is considered a contingent capital contribution. If/when the directors perform on the guarantee, the amounts received by the bank should be recorded as a capital contribution and should not affect the accounting for the loan.

The economic substance of the guarantee by the seven directors is a contingent purchase of the note. The purchase of the note is contingent on the loan defaulting and the bank taking action to enforce the guarantee. To the extent the directors will be paying the bank a purchase price in excess of fair value, the excess represents a contingent capital contribution (see Subtopic 10E, question 2). The contingent capital contribution should not be recorded until it is realized.

# Topic 11 Miscellaneous Accounting

## 11A. Asset Disposition Plans

**Facts** On January 10, 20X1, a bank's shareholders approved a plan to liquidate the bank. Concurrently, the bank received the supervisory non-objection related to the liquidation from the OCC. The bank's business is not expected to continue as a result of the liquidation. The likelihood is remote that the bank will abandon its plan of liquidation. The plan will result in the sale or disposition of all noncash assets of the bank.

### Question 1

What is the appropriate accounting for the bank on December 31, 20X0?

### Staff Response

Consistent with ASC 205-30, before the date when liquidation is imminent (i.e., January 10, 20X1), the bank should prepare its financial statements under the assumption that it will continue to operate as a going concern. Therefore, the bank's 20X0 financial statements should be prepared on a going-concern basis.

ASC 855-10-25 establishes two types of subsequent events:

- Recognized subsequent events provide additional evidence for conditions that existed as of the balance-sheet date. The effects of these events are required to be recognized in the current period financial statements.
- Nonrecognized subsequent events provide evidence on conditions that did not exist as of the balance-sheet date. These events do not result in adjustments to the face of the financial statements but may require footnote disclosure.

The approval of the liquidation plan 10 days after the year end would be a nonrecognized subsequent event for which the bank should not recognize the effects in its 20X0 financial statements. Adequate disclosure should be made, however, in the notes to the 20X0 financial statements about the liquidation plan and the impact on the bank's ability to continue as a going concern.

### Question 2

When should liquidation-basis accounting begin at the bank and how are the values determined?

## Staff Response

In accordance with ASC 205-30, the bank should apply liquidation-basis accounting starting January 10, 20X1 (when the liquidation is imminent). In determining the timing for the adoption of liquidation-basis accounting, the bank should consider all relevant facts and circumstances.

The bank's assets under liquidation basis are measured at the amount of cash proceeds expected from the disposal of the assets. In some cases, fair value may approximate the amount the bank expects to collect, but the bank should not presume this to be true for all assets.

The bank's liabilities (excluding the accrual of disposal or other costs) under liquidation basis are generally accounted for in accordance with the GAAP guidance that would otherwise apply; they should be adjusted, however, to reflect changes in assumptions that are a result of the decision to liquidate (e.g., timing of payments).

Both expenses and income expected to be incurred or earned through the date of final liquidation are required to be recorded when reasonably estimable. The bank should re-measure its assets, liabilities, and the accruals of expenses and income at each financial statement reporting date during the liquidation.

# 11B. Hedging Activities

**Facts** A bank borrowed $30 million from the FHLB with interest due monthly at one-month SOFR plus 15 basis points, and principal due at maturity in three years. At maturity, the bank expects the FHLB borrowing to be rolled over into a new borrowing with similar terms. The bank elected to use hedge accounting for this instrument. To hedge the risk associated with potential increasing interest rates, the bank purchased a three-year interest-rate cap.

## Question 1

Does the hedge using an interest-rate cap qualify for the short-cut method set forth in ASC 815-20-25?

## Staff Response

No. The use of the shortcut method is only available to interest-rate swaps.

## Question 2

Even though the shortcut method does not apply, should the bank still assume that the hedge is perfectly effective?

## Staff Response

Possibly, provided the following four criteria outlined in ASC 815-20-25-129 have been met:

1. The critical terms of the hedging instrument (such as its notional amount, underlying, and maturity date) completely match the related terms of the hedged forecasted transaction (such as the notional amount, the variable that determines the variability in cash flows, and the expected date of the hedged transaction).
2. The strike price (or prices) of the hedging option (or combination of options) matches the specified level (or levels) beyond (or within) which the entity's exposure is being hedged.
3. The hedging instrument's inflows (outflows) at its maturity date completely offset the change in the hedged transaction's cash flows for the risk being hedged.
4. The hedging instrument can be exercised only on a single date, its contractual maturity date.

## Question 3

If the interest rate cap meets the ASC 815-20-25-129 criteria and is assumed to be perfectly effective, should the bank perform and document an assessment of hedge effectiveness continually?

## Staff Response

Yes. For an interest rate cap that meets the ASC 815-20-25-129 criteria, a bank should perform and document a qualitative assessment of hedge effectiveness at least quarterly that includes

- verifying and documenting whether the critical terms of the hedging instrument and the forecasted transaction have changed during the period in review.
- determining that the forecasted transaction is still probable of occurring at the same time and location as originally projected.
- assessing whether there have been adverse developments regarding the risk of counterparty default.

If there are no such changes in the critical terms or adverse developments regarding counterparty default, the bank may conclude that the hedging relationship is perfectly effective.

If there are changes in the critical terms or adverse developments regarding counterparty default, however, the bank must assess whether the hedging relationship is expected to continue to be highly effective using a quantitative assessment method (either a dollar-offset test or a statistical method such as regression analysis).

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**Facts** ASC 815 requires hedging strategies to be highly effective in achieving offsetting fair values or cash flows attributable to the hedged risk to qualify for hedge accounting.

## Question 4

What criteria and documentation are necessary to support that the highly effective threshold is met?

## Staff Response

The term highly effective is not explicitly defined within ASC 815. Rather, practice has developed wide acceptance for a range of 80 to 125 percent offsetting between the hedged item (or forecasted transaction) and the hedging instrument. Quantitatively, documentation of achieving the highly effective range is supported by mathematical models including correlation and regression analysis, at inception and, where required, on an ongoing basis at least every quarter. A qualitative assessment is, however, permitted at inception when a hedge qualifies for the shortcut or critical terms match method or otherwise qualifies under 815-20-25-3.

ASC 815 provides opportunities to perform qualitative assessments of hedge effectiveness subsequent to hedge inception. A qualitative assessment is permitted when conditions noted in ASC 815-20-35-2A are met.

A bank may perform subsequent assessments of hedge effectiveness qualitatively even for hedging relationships that initially require quantitative hedge effectiveness testing. Quarterly qualitative assessment documentation should assert that the facts and circumstances related to the hedging relationship have not substantively changed and the hedge continues to be highly effective.

## Question 5

What is the appropriate accounting for an excluded component of a derivative hedging instrument in a cash flow hedging strategy?

## Staff Response

An excluded component must be documented at the inception of the hedge and recorded as part of the hedging derivative at fair value, if any. Documented allowable excluded components, which include time value of an option, forward points, and cross-currency basis spreads may be omitted from the bank's assessment of hedge effectiveness for a qualifying accounting hedge strategy.

The total change in fair value of the hedging derivative designated in a cash flow hedge is recognized in other comprehensive income for both the effective and ineffective portions of the hedge associated with components included in the hedge effectiveness assessment, and earnings for the change in fair value of the excluded component.

The excluded component is subsequently accounted for through either the fair value approach or a systematic and rational amortization approach. The fair value approach requires the change in fair value of the excluded component to be recognized through earnings each reporting period. Under a systematic and rational amortization approach, in each subsequent reporting period the initial fair value of the excluded component is amortized into earnings over the life of the hedge. Additionally, the difference between the excluded component's change in fair value as measured subsequently each period and the amortization recognized in earnings for the same period is recorded within other comprehensive income. For both the fair value approach and the systematic and rational amortization approach, ASC 815 requires the impact on earnings to be recorded to the same line item on the income statement as the effect of the hedged item.

# 11C. Financial Statement Presentation

## Question 1

May banks have a fiscal year-end financial reporting period that differs from the calendar year-end financial reporting period required for call report reporting purposes?

## Staff Response

Yes. Banks are not restricted in their choice of a fiscal year-end financial reporting period. For call report purposes, however, banks must report financial information at the end of each calendar quarter with December 31 as their year-end.

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**Facts** A bank has publicly held stock and is registered under the Securities Exchange Act of 1934. Accordingly, in addition to filing call reports, the bank also files with the OCC Forms 10-K and 10-Q under the Securities Exchange Act.

During a regulatory examination, the OCC determined that certain adjustments were required for the bank's financial statements to be in accordance with GAAP. The bank disagreed and asked for a review by the OCC's Ombudsman. The Ombudsman's decision supported the position of the OCC examination staff, and the bank amended its call reports. The bank, however, did not amend its Securities Exchange Act filings filed with the OCC.

## Question 2

Must the bank also amend its Forms 10-K and 10-Q filed with the OCC under the Securities Exchange Act to record the adjustments required by the OCC examination staff and the Ombudsman?

## Staff Response

Yes. The general instructions to the call reports note that the instructions include reporting guidance that falls within the range of acceptable practice under GAAP. The instructions also note that when the supervisory agency issues an interpretation of GAAP application to a specific transaction, the supervisory agency may require the bank to prepare its call reports in accordance with that interpretation.

Further, the Securities Exchange Act requires that financial statements included under the act be prepared in accordance with GAAP. Therefore, bank financial statements prepared in accordance with GAAP and included in filings under the Securities Exchange Act filed with the OCC must be prepared using the same accounting interpretations or guidance as was used in the call reports.

# 11D. Fair Value Accounting

## Question 1

How does ASC 820-10 define fair value?

## Staff Response

ASC 820-10 provides a comprehensive definition of fair value. ASC 820-10 states that "fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date" and further clarifies that fair value represents an exit price, not an entry price. In other words, fair value is the price that would be received to sell an asset as opposed to the price that would be paid to purchase an asset.

ASC 820-10-35 also clarifies that the exit price should be based on the price that would be received in the bank's principal market for selling that asset. The principal market is the market the bank has historically sold into with the greatest volume. If the bank does not have a principal market for selling that asset, the exit price should assume the asset is sold into the most advantageous market. The most advantageous market is the market in which the bank would receive the most value, considering the transaction costs in the respective markets.

## Question 2

ASC 820-10 specifies that fair value represents the price that would be received in other than a forced or distressed sale. What does this mean?

## Staff Response

When estimating the price that would be received to sell an asset, the bank should base its analysis on the price that would be received in an orderly transaction. An orderly transaction is a transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets. Sales that are not consistent with this time frame when the seller is experiencing financial difficulty might be considered forced sales and would not represent orderly transactions. Judgment must be used in determining whether specific observable transactions represent forced or non-orderly sales.

ASC 820-10-35-54I provides guidance in determining whether specific observable transactions represent forced or non-orderly sales. Factors to be considered in making this determination include lack of adequate exposure to the market to allow for customary marketing activities, or a seller near bankruptcy or receivership required to enter into a sales transaction for legal or regulatory purposes.

## Question 3

Does GAAP provide guidance explaining how to estimate the exit price (fair value) of an asset as of the measurement date?

## Staff Response

ASC 820-10-35 requires that banks look first to current quoted market prices, when available, in estimating fair value. The standard establishes a fair value hierarchy that prioritizes the use of inputs used in valuation techniques in the following three levels:

**Level 1:** Quoted prices in active markets for identical assets and liabilities.
**Level 2:** Observable inputs other than quoted prices in active markets for identical assets and liabilities.
**Level 3:** Unobservable inputs (i.e., internally generated assumptions).

Banks must use quoted prices in active markets for the identical asset (Level 1) if they are available. When determining a value, the measurement method should maximize the use of observable inputs and minimize the use of unobservable inputs. If quoted prices are only available for similar (but not identical) assets or based on markets that are not active, those prices would be considered Level 2 inputs. The measurement of fair value for an asset with only Level 2 inputs available may include adjustments to the observable prices that are needed to arrive at the best estimate of the exit price for that particular asset. Banks should support the adjustments made to observable prices for similar assets or in markets that are not active, as further discussed in question 4.

## Question 4

Is there any specific guidance for modeling fair value?

## Staff Response

ASC 820-10-35 provides general, but not specific, guidance when models are used. When Level 1 inputs are not available, a bank generally needs to use a valuation technique. To the extent possible, banks should base the assumptions used in modeled valuations on observable, market-corroborated inputs. If observable market data cannot be gathered without unreasonable cost and effort, a bank should use assumptions that represent the bank’s best estimate of the assumptions that it believes a market participant would use. In estimating these assumptions, banks should not ignore information about market participant assumptions that is reasonably available. Although internally generated assumptions may need to be used, the fair-value measurement objective remains the same: that is, an exit price from the perspective of a market participant. To the extent a bank needs to use valuation models that include unobservable inputs, ASC 820-10-35 requires the bank to factor into the fair-value measurement any adjustment for risks related to the valuation technique and inputs that a market participant would include in determining the price that a market participant would pay to acquire that asset.

## Question 5

What guidance is available regarding when observable transactions should not be considered reflective of fair value or regarding what should go into valuation modeling?

## Staff Response

ASC 820-10-35-54I provides guidance for institutions to evaluate if observable transactions have occurred as part of transactions that are not orderly or if the volume and level of activity in that market has significantly decreased. Even though activity levels may have declined and there may be transactions that are not orderly, the objective of providing a fair-value measurement does not change and should represent the price received to sell an asset or the amount paid to assume a liability in an exchange between willing market participants.

ASC 820-10-35-54C provides a listing of several factors that may indicate that the volume and level of activity in a given market has significantly declined. If the bank concludes that observable transactions have occurred in such a market, the quoted prices or observable transactions may not necessarily be representative of fair value (e.g., if the observable transactions were forced sales). The bank needs to further analyze these transactions and quoted prices and may be required to make significant adjustments or change the valuation technique used to measure fair value.

ASC 820-10-35-54I further explains that a transaction is not necessarily a forced transaction just because the volume or level of activity has declined. The bank must review the facts and circumstances of each transaction in the market to determine if the transaction is not orderly. Factors that indicate a transaction is not orderly include

- insufficient time to allow for marketing activities that are usual and customary in similar transactions.
- the seller is in bankruptcy or receivership.
- the transaction price is an outlier compared with other recent transactions.

If the transaction is determined to not be orderly, then little weight should be placed on the transaction price when estimating fair value. Otherwise, the transaction price should be considered in determining fair value.

## Question 6

Does ASC 820-10 provide any specific guidance on measuring liabilities at fair value?

## Staff Response

Yes. If a bank's liability is reported at fair value, ASC 820-10-35 states that fair value is the price that would be paid to transfer the liability in an orderly transaction to a market participant at the measurement date. The fair value of the liability should reflect the effect of nonperformance risk, including the bank's own credit risk (credit standing) and any other factors that might influence the likelihood that the obligation will or will not be fulfilled. The fair value concept also assumes that the nonperformance risk related to the liability does not change before and after the transfer of the liability.

A bank could use the quoted market price for the identical liability or a similar liability when the liability is traded as an asset. If either of these techniques is used, the quoted price may need to be adjusted for factors that are present in the identical asset (e.g., because of an asset sale restriction) or similar asset but are not present in the bank's liability.

Often there is no active market with quoted prices for an identical liability that allows an entity to readily determine the fair value of a liability. In these circumstances, another valuation technique consistent with ASC 820-10-35 is appropriate. A present value technique may be applied to estimate the fair value of the liability. No matter which technique is used, the bank should maximize the use of observable inputs and minimize the use of unobservable inputs.

## Question 7

What are the financial reporting implications when a bank elects the FVO for a liability?

## Staff Response

When a bank elects the FVO for a liability, the bank reports the FVO liability on the balance sheet at fair value as of the end of each reporting period. The portion of the total gain or loss resulting from a change in instrument-specific credit risk is reported in other comprehensive income, consistent with ASC 825-10-45-5 to 45-7, with the remaining portion of the total gain or loss reported in earnings.

Absent changes in all other factors, the bank's increasing credit risk can reduce the fair value of the bank's debt, resulting in a gain; conversely, if all else is equal, the bank's decreasing credit risk can increase the fair value of the bank's debt, resulting in a loss.

**Facts** A bank, in its capacity as a market maker, holds a portfolio of credit derivatives in its trading book that are measured at fair value (categorized within Level 2) with changes in fair value recorded in earnings. The bank obtains bid and ask prices (e.g., broker quotes), on each derivative position on a daily basis to measure its fair value. Historically, to measure the fair value of the individual positions within the portfolio, the bank used the mid-point of the bid- ask spread (mid-market pricing convention), adjusted for appropriate valuation adjustments consistent with market participant assumptions. These included assumptions about risks (e.g., counterparty credit valuation adjustments, own credit valuation adjustments, and liquidity adjustments). In the recent quarter, the fair value of certain credit derivative positions in the entity's credit derivative portfolio began to move adversely as calculated in accordance with its documented policies using mid-market pricing convention (after considering appropriate valuation adjustments to the mid-market prices).

## Question 8

Is it appropriate for the bank to measure the fair value of the individual positions using a different point within the bid-ask spread (e.g., a more advantageous point within the bid-ask spread) to achieve a desired reporting outcome?

## Staff Response

No. It is inappropriate to change a valuation methodology that would result in a fair value estimate not representative of a derivative position's exit price by migrating from a mid-market pricing convention to using a price within the bid-ask spread that is more advantageous to the entity to offset the impact of adverse changes in market prices or otherwise mask losses.

An entity should determine the price within the bid-ask spread that is most representative of fair value, which is the price that would be received to sell the asset or paid to transfer the liability (i.e., an exit price), based on assumptions a market participant would use in a similar circumstance. However, when measuring the fair value of a derivative position that has a bid-ask spread, ASC 820-10 does not preclude the use of mid-market pricing or other pricing conventions as a practical expedient for measuring the fair value within the bid-ask spread. An institution should maintain documented policies for determining the point within the bid-ask spread that is most representative of fair value and consistently apply those policies.

An entity is expected to apply its valuation policies and techniques for measuring fair value consistently over time. Nevertheless, ASC 820-10 acknowledges that a change in valuation technique from one methodology to another that results in an equally or more representative measure of the fair value of a derivative position may be appropriate. However, it would be inappropriate for an entity to alter its valuation methodology or policies to achieve a desired financial reporting outcome.

# 11E. Grants Received by Banks

## Question 1

What accounting standard applies to grants received by a bank?

## Staff Response

As required by GAAP, non-governmental grants received by banks are accounted for in accordance with ASC 958-605, "Not for Profit Entities – Revenue Recognition." While Topic 958 applies specifically to not-for-profit entities, the guidance on accounting for non-governmental contributions (such as grants) received applies to all entities, including banks and other for-profit entities. If ownership is exchanged as part of the transaction (e.g.., the donor becomes a shareholder), the transaction should be treated as a purchase of shares. If other consideration is given, banks should apply the revenue recognition guidance in Topic 606, "Revenue From Contracts With Customers."

Banks that receive governmental grant proceeds, such as grants from the Community Development Financial Institution (CDFI) fund, should apply ASC 958-605 by analogy for call report purposes. Although the scope of ASC 958-605 excludes contributions made by governmental entities to business (for-profit) entities, the FASB staff has acknowledged that entities scoped out of that guidance are not precluded from applying it by analogy when appropriate. Regulatory reporting instructions require all grants received to be accounted for consistently as "other non-interest income" under ASC 958-605 regardless of the source of the grant, as permitted by GAAP.

## Question 2

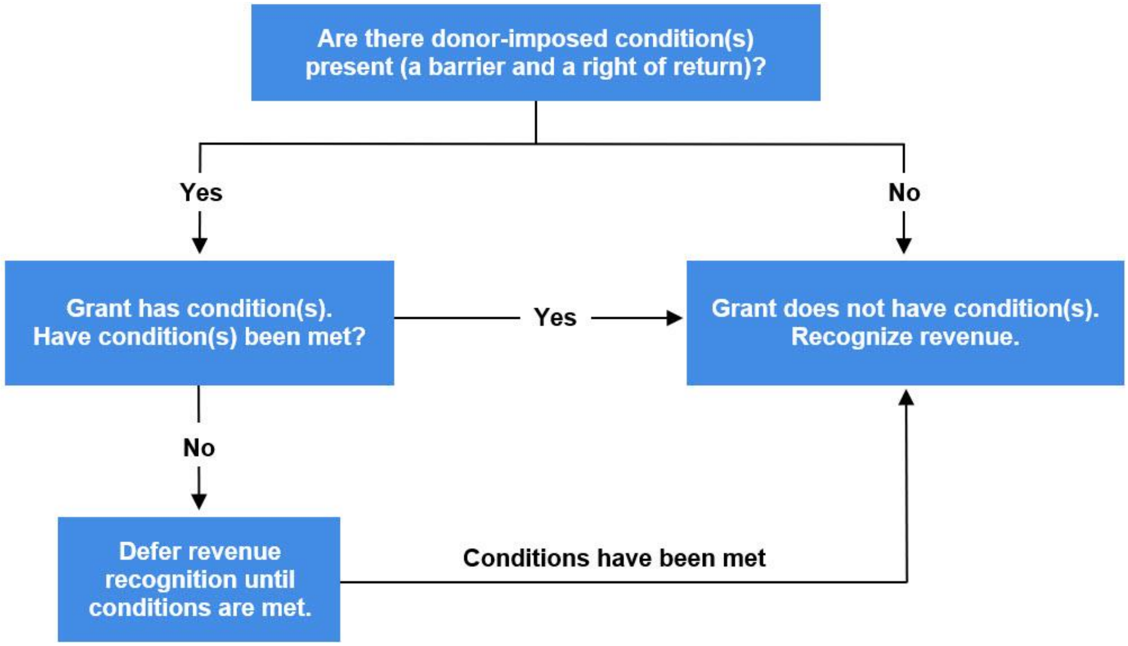
How should a bank account for grants received under ASC 958-605?

## Staff Response

When accounting for a grant received under ASC 958-605, the recipient bank should first determine if there are any donor-imposed conditions.

Revenue is recognized for grants without conditions when received. When donor-imposed conditions exist, revenue is deferred until those conditions have been substantially met. A donor-imposed condition represents a barrier that must be overcome before the recipient bank is entitled to the grant assets. When a donor-imposed condition exists, the grant should be recognized as deferred revenue with a related receivable, cash, or other contributed asset recognized. Once the donor-imposed condition has been satisfied, revenue would no longer be deferred but recognized as revenue earned.

The following flowchart can be used to determine the appropriate accounting for grant proceeds.




For call report purposes, grant revenue should be included in Schedule RI, "Other Non-Interest Income," and, if thresholds are met, disclosed on Schedule RI-E, "Explanations." Unearned grant revenue should be included in Schedule RC-G, "Other Liabilities."

# Topic 12 Credit Losses Under ASC Topic 326

## 12A. Credit Losses on Debt Securities

### Question 1

Under ASC 326, are credit losses for AFS and HTM debt securities accounted for differently?

### Staff Response

Yes. HTM securities are subject to the CECL methodology in ASC 326-20, which is also applicable to loans, while AFS securities are subject to a separate credit loss methodology in ASC 326-30.

The assessment of expected credit losses for HTM securities under CECL must be performed on a collective basis when similar risk characteristics exist, and expected credit losses must be recognized upon initial recognition (i.e., at the time of purchase). CECL requires the consideration of credit losses even when the risk of loss is remote.

In contrast, the assessment of expected credit losses for AFS securities must be done at the individual security level, as defined in ASC 326-30-35-4, and is only performed when the amortized cost of an AFS security exceeds its fair value. Credit loss recognition is limited to the fair value of the security (referred to as “the fair value floor”), any additional amount of loss is referred to as noncredit, and is recognized through AOCI, net of applicable taxes.

In addition, expected credit losses on AFS securities must be measured using a discounted cash flow approach, whereas the expected credit losses for HTM securities can be measured using any reasonable approach consistent with the measurement objectives of ASC 326-20.

### Question 2

How should a bank account for the decline in fair value on an AFS debt security?

### Staff Response

An AFS debt security is impaired if the fair value of the security declines below the amortized cost basis.

If the bank intends to sell the AFS security or it is more likely than not that the bank will be required to sell the security before recovery of its amortized cost basis, the bank must write down the amortized cost basis of the security to its fair value. Any previously recorded ACL, if applicable, is written off and any incremental impairment is recognized through earnings. Once an individual debt security has been written down, the previous amortized cost basis less charge-offs including non-credit-related impairment reported in earnings shall become the new amortized cost basis of the investment. That new amortized cost basis shall not be adjusted for subsequent recoveries in fair value.

If the bank does not intend to sell the AFS security and it is not more likely than not that the bank will be required to sell the security before recovery of its amortized cost basis, the bank must determine whether any of the decline in fair value has resulted from a credit loss, or if it is entirely the result of noncredit factors.

Impairment of an AFS security related to a credit loss is recognized by establishing an ACL through a provision expense. The expected credit losses must be measured using a discounted cash flow approach and are limited by the fair value floor, as referred to in question 1.

Impairment related to noncredit factors is recognized in AOCI, net of applicable taxes.

## Question 3

What factors indicate that an AFS debt security impairment may be due to a credit loss?

## Staff Response

There are numerous factors to be considered when determining if impairment is due to a credit loss. As described in ASC 326-30-55-1, all of the following factors should be considered when making that determination (this list is not meant to be all-inclusive):

- Extent to which the fair value is less than the amortized cost basis.
- Adverse conditions specifically related to the security, an industry, or a geographic area (for example, changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, changes in the financial condition of the underlying loan obligors).
- Payment structure of the debt security (for example, backed by loans with nontraditional terms) and the likelihood of the issuer being able to make payments that increase in the future.
- Failure of the issuer of the security to make scheduled interest or principal payments.
- Any changes to the rating of the security by a rating agency.

If, after considering these factors, along with any other relevant factors, the bank determines some or all of the impairment is due to a credit loss, the bank should calculate the credit loss in accordance with question 4. A bank should not wait until the security has been impaired for a set period of time before considering whether impairment is due to credit.

**Facts** A bank holds a fixed-rate AFS debt security whose fair value of $90 is less than its amortized cost of $100. Bank management has determined that at least a portion of the unrealized holding loss is due to credit loss. The bank does not intend to sell nor believes it is more likely than not that it will be required to sell the security before the recovery of its amortized cost basis.

## Question 4

How should the bank determine the amount to be recognized as a credit loss at the end of the reporting period?

## Staff Response

ASC 326-30-35-6 through 35-8 requires the credit loss to be measured using a discounted cash flow approach. The bank should make its best estimate of the cash flows expected to be collected based on past events, current conditions, and reasonable and supportable forecasts. The cash flows expected to be collected should be discounted at the EIR implicit in the security at the date of acquisition. The bank is permitted to make an accounting policy election to adjust the contractual EIR for prepayment expectations. If elected, this accounting policy is required to be applied consistently at the major security type level.

The difference between the discounted expected cash flows and the security's amortized cost is deemed to be the credit loss, limited by the amount that the fair value is less than amortized cost. The bank would not recognize any credit loss that exceeds the $10 difference between fair value and amortized cost. If the credit loss calculated using the discounted cash flow method is less than the $10 difference between the fair value and amortized cost, the remaining unrealized holding loss represents noncredit impairment to be recognized in AOCI, net of applicable taxes.

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## Question 5

Will a bank be expected to record an ACL for HTM debt securities?

## Staff Response

Generally, yes. ASC 326-20 applies to HTM debt securities because they are financial assets carried at amortized cost. CECL requires an ACL for expected credit losses, even if the risk of loss is remote. While an individual investment grade security may not show risk of credit loss, historical data covering pools of investment grade securities could show that credit losses may occur, even within pools of highly rated investment grade securities. Because the ACL for HTM debt securities must be determined by collectively evaluating expected credit losses for securities that share similar risk characteristics, this risk of loss must be captured in the bank's ACL.

Refer to question 6 for HTM debt securities that may not require an ACL.

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**Facts** ASC 326 does not require an ACL on HTM debt securities for which the expectation of nonpayment of the amortized cost basis is zero based on historical credit loss information, adjusted for current conditions and reasonable and supportable forecasts. ASC 326-20-55-48 through 55-50, example 8, is an example of how a bank might determine that U.S. Treasury securities meet the expectation of zero credit losses. The example explicitly states it is not intended to only be applicable to U.S. Treasury securities.

## Question 6

Are there any HTM debt securities that may have an expectation of zero credit loss, based on historical credit loss information adjusted for current conditions and reasonable and supportable forecasts?

## Staff Response

Yes. The following securities may have an expectation of zero credit losses:

- U.S. Treasury securities.
- Mortgage-backed securities guaranteed by the Government National Mortgage Association (GNMA).
- Mortgage-backed securities issued by the Federal Home Loan Mortgage Corporation (FHLMC).
- Mortgage-backed securities issued by the Federal National Mortgage Association (FNMA).

This list is not exhaustive and should be used as a tool and not a bright line. For accounting purposes, it is not appropriate for a bank to assume that these securities will always have zero credit loss.

## Question 7

What factors were considered to determine that there might be zero expectation of nonpayment of the amortized cost when assessing securities mentioned in question 6?

## Staff Response

The factors that were considered in reaching the conclusions noted in question 6 include the following:

- Each of these securities has a long history, which includes the most recent financial crisis, of zero credit losses. This performance is expected to continue when considering current entity-specific and economic conditions and reasonable and supportable forecasts.
- Each security has been assigned a high credit rating by ratings agencies, and available information does not indicate that future downgrades are probable.
- Principal and interest payments on these securities are guaranteed (either directly or indirectly) by the U.S. government, or an agency of the U.S. government, a sovereign entity with high credit quality.
- The securities' issuer, guarantor, or sponsor (i.e., the U.S. government) can print its own currency and its currency is commonly held by other central banks and viewed as a reserve currency.
- The interest rate on U.S. Treasury securities is widely recognized as a risk-free rate. While the interest rates on GNMA, FHLMC, and FNMA mortgage-backed securities are generally priced above risk-free rates, this is generally considered to be attributable to non-credit-

related risks, such as prepayment and liquidity factors. Market participants generally do not price these instruments with the expectation of a credit loss.

It is important that banks have appropriate credit loss evaluation procedures to determine whether any credit losses for these securities should be recorded for the period.

**Facts** Bank A has a debt security classified as AFS with an amortized cost of $10 million and an associated ACL of $1 million recorded. The debt security has a fair value of $8.5 million. The bank's effective tax rate is 20 percent. At the current reporting date, the debt security is recorded on the balance sheet as follows:

| | Dr/(Cr) |
|---|---|
| AFS debt security | $10,000,000 |
| AFS fair value adjustment (non-credit) | (500,000) |
| ACL | (1,000,000) |
| AOCI | 400,000 |
| Deferred tax asset | 100,000 |

Subsequent to the reporting date, the bank has made the decision to reclassify the security as HTM. After the reclassification, the bank determined that the HTM security did not share similar risk characteristics with other HTM securities. As such, the bank evaluated the HTM security on an individual basis for credit impairment and determined that an ACL of $2 million was necessary in accordance with ASC 326-20.

## Question 8

How should Bank A account for the transfer?

## Staff Response

The bank should first reverse any ACL previously recorded against the AFS security at the transfer date through earnings. The bank should then reclassify the security from AFS to HTM at its amortized cost, less the security's AFS fair value adjustment (non-credit) at the time of transfer to HTM. Once transferred, the bank would record an ACL on the security determined in accordance with ASC 326-20 (see question 5). Journal entries for the transfer are as follows:

| | | |
|---|---|---|
| ACL – AFS securities | $1,000,000 | |
| PCL – AFS securities | | 1,000,000 |
| | | |
| HTM securities | 10,000,000 | |
| AFS fair value adjustment (non-credit) | 500,000 | |
| AFS securities | | 10,000,000 |
| HTM transfer fair value adjustment (non-credit) | | 500,000 |
| | | |
| PCL – HTM securities | 2,000,000 | |
| ACL – HTM securities | | 2,000,000 |

The bank's decision to reclassify the security as HTM does not affect the amounts recorded in AOCI or as a DTA. Under ASC 320-10-35-16, the $500,000 HTM fair value adjustment is accreted to interest income over the remaining life of the security. In accordance with ASC 320-10-35-10B(d), the unrealized holding loss amount in AOCI is amortized simultaneously against interest income. Those entries, net of taxes, offset or mitigate each other on the income statement. If any amount is deemed uncollectible, it should be charged off against the ACL.

For regulatory capital purposes, the unamortized AOCI related to the security is treated in the same manner as a net unrealized holding gain or loss on an AFS debt security. See Subtopic 1A, question 2, for further discussion on transfers of debt securities.

# 12B. Loan Modifications

## Question 1

What constitutes a modification that should be reported as a loan modification to a borrower experiencing financial difficulty in the call report?

## Staff Response

Management should assess all loan modifications, refinancings, and renewals to determine if the borrower is experiencing financial difficulty at the time of the event. A loan modification should be reported as a loan modification to a borrower experiencing financial difficulty if the borrower is experiencing financial difficulty and the terms of the loan were modified in the form of one or more of the following:

- Principal forgiveness
- An interest rate reduction
- An other-than-insignificant payment delay
- A term extension

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

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

## Question 2

Should the loan modification be reported as a loan modification to a borrower experiencing financial difficulty in the call report because the interest rate was reduced?

## Staff Response

Yes. Per ASC 310-10-50-42, a modification of a loan is disclosed as a loan modification to a borrower experiencing financial difficulty when there is a modification in the form of principal forgiveness, an interest rate reduction, an other-than-insignificant delay in payment, or a term extension (or a combination thereof) to a loan to a borrower experiencing financial difficulty.

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

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

In this case, the borrower was experiencing financial difficulty because the primary source of repayment (cash flows from the shopping center) was insufficient to service the debt without relying on the guarantors. Further, it was determined that the borrower could not have obtained similar financing from other sources at this rate, even with the increase in the guaranteed percentage. Because the borrower was deemed to be experiencing financial difficulty and the bank granted an interest rate reduction, this loan modification would be reported as a loan modification to a borrower experiencing financial difficulty in the call report.

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**Facts** A borrower obtained a $500,000 CRE loan with a five-year maturity and payments based on a 15-year amortization period. The interest rate on the loan was 5 percent. The loan has matured, and the borrower approaches the bank to renew the loan for the remaining balance due. During the bank's analysis to evaluate whether to refinance the loan, management determines that the borrower has been using cash reserves to make timely payments on the loan. The borrower's current financial statements do not show the ability to generate sufficient cash flow to service the debt at market terms nor sufficient liquid assets to make payments for more than two months at a market rate of interest. The bank determines that this borrower will not be able to obtain financing elsewhere. The bank extends another five-year loan with an interest rate of 4 percent to give the borrower time to sell the property to repay the note or return to an operating status in which the borrower is able to generate sufficient cash flows to service the debt.

## Question 3

Is the renewal of the loan at, or near, maturity required to be reported as a loan modification to a borrower experiencing financial difficulty in the call report?

## Staff Response

Yes. Modifications may occur before, at, or after the stated maturity of the debt, and time may elapse between the original loan agreement's end date and effective date of the modified loan terms. The borrower is experiencing financial difficulty and the renewal includes an interest rate reduction, so the loan modification should be reported as such in the call report. Simply delaying a modification of a loan to a borrower experiencing financial difficulty until the original maturity date or later does not exempt the loan modification from reporting.

## Question 4

Is it possible that a modification of a performing loan is reported in the call report as a loan modification to a borrower experiencing financial difficulty?

## Staff Response

Yes. A borrower may be contractually current when the bank modifies the loan. The loan modification will be reported in the call report if it meets the disclosure requirements in ASC 310-10-50 (see question 1 and question 2).

**Facts** A borrower has a first lien residential mortgage with Bank A and a second lien residential mortgage with Bank B. The borrower is experiencing financial difficulty and Bank A modified the borrower's first lien mortgage. At the time the first lien mortgage is modified with Bank A, the borrower is current on the second lien mortgage with Bank B. Bank B has not modified the borrower's loan but is aware of the modification agreement made by Bank A.

## Question 5

How should Bank B account for the second lien mortgage after the first lien mortgage was modified?

## Staff Response

The second lien mortgage has not been modified by Bank B and is therefore not reported as a loan modification to a borrower experiencing financial difficulty. However, the bank should recognize that the second lien mortgage loan borrower is facing financial difficulty and that the second lien mortgage has different risk characteristics than other second lien mortgage loans that have not had their first lien mortgage modified or are not suffering financial difficulties. Bank B should consider segmenting the loan into a pool that reflects the increased risk associated with this loan. If this loan does not share risk characteristics with other loans in the portfolio, the bank must measure the expected credit loss on this loan individually. If, however, in a subsequent reporting period, the bank determines that the loan shares similar risk characteristics with other loans, the expected credit loss will be evaluated on a pool basis.

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

## Question 6

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

## Staff Response

No. It is not appropriate to conclude the delay in payments is insignificant simply because the modification is short term (e.g., 12 months or less). Rather, the bank must collectively consider the following factors in determining whether the delay is insignificant:

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

An entity shall consider the cumulative effect of modifications made within the prior 12-month period when determining whether a delay in payment resulting from the most recent modification is insignificant.

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**Facts** A borrower obtained a $10 million 12-year amortizing loan at a 7 percent interest rate from the bank (original loan). At the end of year two, the original loan has a balance of $9.5 million and is modified because of the borrower's financial difficulty. The original loan is modified into two notes:

- Note A is a $7 million 10-year amortizing note at a 7 percent interest rate.
- Note B is a $2.5 million 10-year interest-only (non-amortizing) note at a 2 percent interest rate with a balloon payment due at maturity.

Note B is charged off by the bank but not forgiven.

## Question 7

Is the modified loan reported as a loan modification to a borrower experiencing financial difficulty in the call report?

## Staff Response

Yes. Note A, as the only remaining loan on the bank balance sheet, should be reported as a loan modification to a borrower experiencing financial difficulty on the call report. The bank should consider Note A and Note B together, in totality, to determine whether the modified notes include a modification of the original loan resulting in principal forgiveness, an interest rate reduction, an other-than-insignificant delay in payment, or a term extension, even if the original loan is split into two notes and one of the notes was subsequently charged off.

Note B includes an interest rate reduction and a more-than-insignificant delay in payment of $2.5 million. Therefore, the entire modification of the original loan into two notes constitutes a loan modification to a borrower experiencing financial difficulty. Because Note B was charged off, however, only the amortized cost basis of Note A is reported as a loan modification to a borrower experiencing financial difficulty in the call report.

## Question 8

Assuming the bank forgives Note B, how would this affect the reporting requirements in the call report?

## Staff Response

The answer would not change if the bank had forgiven Note B. The amortized cost basis of Note A would continue to be reported as a modification to a borrower experiencing financial difficulty in the call report. As noted in question 7, the bank should consider both Note A and Note B together, in totality, to determine whether the restructured notes include a modification of the original loan resulting in principal forgiveness, an interest rate reduction, an other-than-insignificant delay in payment, or a term extension.

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**Facts** A bank originated an SFR mortgage that is HFI. At origination, the borrower's income was the primary source of repayment and the underlying collateral was the secondary source of repayment. There is no other source of repayment. The borrower files for Chapter 7 bankruptcy. The bankruptcy court discharges the borrower's obligation to the bank and the borrower does not reaffirm the debt. Accordingly, after the bankruptcy proceedings are completed, the bank's only recourse is to take possession of the collateral. Therefore, if the bank does not receive contractual mortgage payments, it can foreclose on the property, but the bank cannot pursue the borrower personally for any deficiencies. Even if the borrower has been making payments, the borrower's continued ability and willingness to make voluntary payments is uncertain.

## Question 9

Should the bank report the discharged debt as a loan in the call report?

## Staff Response

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

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

## Question 10

Is the secured consumer loan discharged in Chapter 7 bankruptcy required to be reported as a loan modification to a borrower experiencing financial difficulty in the call report?

## Staff Response

Generally, no. While the bankruptcy filing indicates that the borrower is experiencing financial difficulty (see question 2), the release of the borrower's personal liability (the discharge) as ordered by the bankruptcy court is a type of modification that is not one of the four types of modifications that require reporting (see question 1). If, after the bankruptcy court order, the borrower reaffirmed the debt and the reaffirmed debt resulted in one of the four types of modifications that require reporting as a loan modification to a borrower experiencing financial difficulty, then the debt would be required to be reported as a loan modification to a borrower experiencing financial difficulty in the call report.

## Question 11

How should the bank account for the discharged debt?

## Staff Response

The discharged debt is a collateral-dependent loan. The bankruptcy court "removed" the borrower (the primary source of repayment) from responsibility to continue to make payments called for by the original loan agreement. The loan is collateral-dependent because repayment depends substantially on the collateral. The bank should, therefore, establish an ACL in accordance with ASC 326-20 and charge off the excess of the loan's cost basis over the fair value of the collateral as uncollectible. The bank should place the remaining loan balance on nonaccrual.

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**Facts** A bank modifies a secured loan to a borrower experiencing financial difficulty and individually measures the allowance using the present value of the expected future cash flows discounted at the loan's post-modification effective interest rate. The loan is not collateral-dependent and does not share similar risk characteristics with other loans. The modified contractual terms require a balloon payment at maturity. The current collateral value is less than the scheduled balloon payment.

## Question 12

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

## Staff Response

No. When a contractual balloon payment is required at maturity under the modified terms of a non-collateral-dependent loan to a borrower experiencing financial difficulty, significant uncertainty may exist regarding the borrower's ability to refinance or repay the debt at maturity.

In accordance with ASC 326-20-30-7, when estimating expected future cash flows for ACL measurement purposes, the bank should consider all available information relevant to assessing the collectability of cash flows. The staff believes that greater weight should be given to evidence that can be verified objectively. When no sources of cash flows are reasonably expected to be available to support the assumption that the borrower will be able to repay or refinance the secured loan at maturity, an acceptable approach for estimating expected future cash flows can be to base the expected payment at maturity on the projected fair value of the collateral at maturity, less estimated costs to sell.

The projected fair value of the collateral should be supported by a current appraisal, or other similar timely evaluation, with adjustments for potential future changes in collateral values based on the nature of the collateral and historical loss information for financial assets secured with similar collateral. Using the projected fair value of the collateral, less selling costs, in lieu of the balloon payment due at maturity, does not suggest a 100 percent probability of default at renewal. Rather, using the projected fair value recognizes the value inherent in the collateral to satisfy repayment should refinancing efforts prove unsuccessful.

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

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

## Question 13

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

## Staff Response

Consistent with ASC 310-20-35-9 through 11, management's assessment of whether the loan modification results in the continuation of the existing loan or a new loan determines the accounting for the direct costs and modification fee.

If the effective yield of the modified loan is at least equal to the effective yield for comparable loans to other customers with similar collection risks who are not refinancing or restructuring a loan with the lender or the modifications of the original loan are more than minor, the bank should account for the modification as a new loan. Management will recognize any unamortized net loan fees/costs related to the original loan in interest income at the time of modification. The direct loan origination costs and any fees received associated with the modification should be netted and amortized over the life of the modified loan in accordance with ASC 310-20-25-2.

If the effective yield of the modified loan is less than the effective yield for comparable loans to other customers with similar collection risks who are not refinancing or restructuring a loan with the lender or the modifications of the original loan are minor, the bank should account for the modification as a continuation of the existing loan. Any unamortized net loan fees/costs related to the original loan continue to be amortized over the remaining life of the modified loan if the loan is in accrual status. Additionally, direct loan origination costs and any fees received associated with the modification should also be included as part of the net investment in the modified loan according to ASC 310-20-35-10.

In determining if a modification is more than minor, the 10 percent cash flow test described in ASC 310-20-35-11 should be performed by comparing discounted cash flows under the modified terms with discounted remaining cash flows under the original terms using the EIR of the original loan. If the change in the present value of cash flows is less than 10 percent, the lender should evaluate whether the modification is more than minor based on the specific facts and circumstances (and other relevant considerations) surrounding the modification. If the change in the present value of cash flows is 10 percent or more, the modification is considered to be more than minor.

## Question 14

How should a bank measure expected credit losses for modified loans to borrowers experiencing financial difficulty?

## Staff Response

ASC 326-20 does not require a specific ACL measurement method for modified loans to borrowers experiencing financial difficulty. If the modified loan shares similar risk characteristics with other loans in the portfolio, the expected credit losses should be measured on a collective (pool) basis. If a bank determines that the modified loan does not share risk characteristics with other loans in the portfolio, the bank should measure expected credit losses on an individual basis. Whether calculated on an individual or collective basis, the ACL for non-collateral-dependent modifications can be determined using various methods. For example, a bank may use a DCF method, loss rate method, roll-rate method, probability-of-default method, or other appropriate method.

Upon execution of a loan modification to a borrower experiencing financial difficulty for which foreclosure is probable, or for which repayment is expected to be provided substantially through the operation or sale of the collateral, a bank should determine the ACL based on the fair value of the collateral as of the reporting date.

For repayment expected through sale of collateral, the ACL amount should be based on the fair value of the collateral less costs to sell. The bank should not adjust the value of the collateral for expected future changes in the collateral's fair value; rather, changes in the fair value of the collateral should be recognized in the period in which the change occurs.

**Facts** A borrower owes the bank $100,000. The debt is modified because of the borrower's precarious financial position and inability to service the debt. In partial satisfaction of the debt, the bank accepts preferred stock of the borrower with a face value of $10,000 but with only an estimated $1,000 fair value. The bank agrees to reduce the contractual amount outstanding by the face amount of the preferred stock ($10,000) and reduce the interest rate from 10 percent to 5 percent on the remaining $90,000 of debt. The bank measures the allowance using a discounted cash flow method, and the present value of the expected future cash flows is discounted at the effective interest rate in the post-modification loan agreement, as required by ASC 326-20-30-4.

## Question 15

How should the bank account for this transaction?

## Staff Response

The preferred stock received in exchange for the reduction of the loan should be recorded at fair value. In this fact pattern, the preferred stock has a fair value of $1,000 but the bank reduced the amount owed by the borrower by $10,000 (the face amount of the preferred stock). As such, the additional $9,000 reduction in the amortized cost basis of the loan should be charged off against the ACL.

Any ACL on the remaining recorded balance of the modified loan would be measured according to the requirements of ASC 326-20. In this case, the remaining loan balance of $90,000 would be compared with the present value of the expected future cash flows, discounted at the post-modification EIR.

Refer to question 13 for the accounting of any fees and costs incurred in the loan modification.

Additionally, in the call report, the loan would be disclosed as a loan modification to a borrower experiencing financial difficulty.

## Question 16

For loan modifications to borrowers experiencing financial difficulty, how should expected future cash flows be estimated when the present value of expected future cash flows method is used to measure the ACL?

## Staff Response

The estimate of expected future cash flows (timing and amount) should be based on reasonable information, including current "environmental" factors (e.g., industry, geographical, economic, and political factors) that affect the loans' collectibility, as well as reasonable and supportable forecasts about future conditions.

The key assumptions the bank should consider include prepayments, defaults, loss severity, and recoveries. If applicable, the bank should also consider the estimated timing and amount of cash flows expected from the borrower's collateral disposition, net of estimated costs to sell. The assumptions should be developed with greater weight placed on assumptions supported by verifiable, objective evidence.

As required by ASC 326-20-30-2, the ACL should be determined on a collective basis, unless modified loans do not share similar risk characteristics with other modified loans or other loans in the portfolio. When aggregating loans with similar risk characteristics and using the DCF method to determine the ACL, the bank may use historical statistics, such as average repayment period and average amount collected, along with a composite EIR. Given the unique characteristics of modified loans, some historical statistics, such as prepayment rates for performing loans, may not be a reasonable basis for projecting expected future cash flows.

Borrowers granted modifications are likely to have reduced ability and financial incentive to prepay because, by definition, they have experienced financial difficulty and were provided a modification (implying more favorable loan terms than those available in the open market).

## Question 17

What discount rate should be applied to estimate the present value of expected cash flows for loan modifications?

## Staff Response

In accordance with ASC 326-20-30-4, a bank shall use the post-modification EIR as the discount rate when using a DCF method.

For a bank that adopted ASU 2022-02, "Financial Instruments – Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures," using the prospective method, loans identified as TDRs before adoption will continue to use the pre-modification EIR as the discount rate when using a DCF method. This approach will continue for loans previously identified as TDRs until such loans are paid off, charged off, or modified further.

## Question 18

Can a loan be collateral-dependent immediately following a loan modification?

## Staff Response

Yes. A loan can be collateral-dependent at the time of or immediately after a loan modification. A loan is collateral-dependent if repayment of the loan is expected to be provided substantially through the operation or sale of the collateral when the borrower, based on management's assessment, is experiencing financial difficulty as of the reporting date. A modified loan requiring only a nominal monthly payment from the borrower without support that the borrower can repay the contractual amounts due may indicate that the borrower is experiencing financial difficulty and result in a loan that ultimately is repaid substantially through the liquidation of the underlying collateral. Management judgment of a borrower's specific facts and circumstances is required to determine if this is the case.

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

If the loan is determined to be collateral-dependent, the amount of confirmed loss (i.e., the amount deemed uncollectible) should be charged against the ACL in a timely manner. Generally, the amount deemed uncollectible is the excess of the recorded investment in the loan over the current fair value of collateral less costs to sell, if applicable.

# 12C. Acquired Loans

**Facts** Bank A acquires Bank B in a business combination accounted for under ASC 805. Bank A does not elect the FVO to account for the acquired HFI loans.

## Question 1

How should Bank A account for the acquired loans at the acquisition date?

## Staff Response

Assets and liabilities acquired in a business combination, including the loans, should be recorded at fair value as of the acquisition date. Fair value should be determined in accordance with ASC 820-10 (see Subtopic 11D), which states that fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date.

The bank also should determine whether the acquired loans are PCD or non-PCD (see question 3). An ACL should be recorded for these acquired loans, although how the ACL is established will depend on whether the acquired loans are PCD or non-PCD.

An ACL for non-PCD loans should be determined and recorded in a manner consistent with originated loans. That is, the ACL should be calculated based on the loan's amortized cost basis (i.e., the acquisition date fair value in the business combination) and be established through a charge to PCL at the acquisition date.

ASC 326-20-30-14 allows for some flexibility in calculating the ACL for PCD loans. If an institution chooses a method other than the DCF, the estimated expected credit losses should be based on the loan's unpaid principal balance. The ACL at the acquisition date should be recorded as an addition to the purchase price (i.e., the acquisition date fair value in the business combination), rather than through PCL. The acquisition date fair value plus the ACL equals the loan's new amortized cost basis as of the acquisition date. The difference between the new amortized cost basis and the unpaid principal balance of the loan represents the non-credit purchase discount/premium recorded. See question 4 for an illustration.

## Question 2

Should the fair value of the acquired loans be determined on a loan-by-loan basis or may it be determined on a pool basis?

## Staff Response

The fair value of the acquired loans should be determined on a loan-by-loan basis as of the acquisition date. The staff will not object to a bank determining the fair value of a pool of loans consisting of loans with similar risk characteristics and then allocating the fair value adjustment to the individual loans within the pool. When allocating the fair value adjustment, the bank should consider the remaining maturity of the loans and the current loan balance, along with any other relevant factors, to ensure interest income recognition in future periods is not misstated.

## Question 3

What factors might a bank consider when determining if acquired loans should be accounted for as PCD?

## Staff Response

PCD loans are acquired loans that, as of the acquisition date, have experienced a more-than-insignificant deterioration in credit quality since origination. Judgment must be exercised in making this determination as "more-than-insignificant deterioration of credit quality" is not explicitly defined in the accounting standard.

As noted in ASC 326-20-55-59 (example 11), some indicators of loans that have experienced more-than-insignificant deterioration of credit quality since origination may be loans

- that are delinquent at the acquisition date.
- that have been downgraded since origination.
- that have been placed on nonaccrual status.
- for which, after origination, credit spreads have widened beyond the thresholds stated in the bank's policy.

These indicators represent only a few of the possible indicators a bank may consider in this determination. There are likely other acceptable considerations and policies to identify PCD loans.

When assessing whether credit quality has deteriorated, a bank must compare the credit quality of the loans at the time they were originated with the credit quality at the time of acquisition. A loan that was originated with lower credit quality should not be accounted for as PCD if there has been no further deterioration in its credit quality since origination.

Additionally, PCD accounting cannot be applied by analogy to non-PCD loans.

**Facts** A bank pays $750,000 to acquire a loan with an unpaid principal balance of $1 million. The loan will be HFI and measured on an amortized cost basis. The acquired loan has experienced more- than-insignificant deterioration in credit quality since origination. At the time of purchase, the bank estimates the ACL on the unpaid principal to be $175,000.

## Question 4

Should the bank recognize a PCL as of the acquisition date for this loan?

## Staff Response

No. Because the loan has experienced more-than-insignificant deterioration in credit quality since origination, it should be accounted for as a PCD loan. For a PCD loan, the ACL at the acquisition date is recorded as an addition to the loan's purchase price rather than through a PCL.

The acquisition date journal entry is as follows:

| | | |
|---|---|---|
| Loan (HFI) – unpaid principal balance | $1,000,000 | |
| Loan (HFI) – non-credit purchase discount | | $75,000 |
| ACL | | $175,000 |
| Cash (purchase price) | | $750,000 |

The amortized cost basis of the loan as of the acquisition date is $925,000, which is equal to the purchase price plus the ACL (or looked at differently, the par amount less the non-credit discount).

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**Facts** Assume the same facts as in question 4. At the end of the year, the bank now estimates the ACL on this PCD loan should be $200,000 because of further credit deterioration since the acquisition date. Further assume this PCD loan does not share similar risk characteristics with other financial assets.

## Question 5

How should the bank account for this subsequent credit deterioration?

## Staff Response

Similar to the changes in the ACL on all other loans, subsequent changes to the ACL on PCD loans should be recognized through the PCL. As such, the bank would record the following entry to increase the ACL from $175,000 to $200,000:

| | | |
|---|---|---|
| PCL | $25,000 | |
| ACL | | $25,000 |

The change in the estimate of expected credit losses on the PCD loan does not affect the remaining balance of the $75,000 non-credit discount that was calculated at the purchase date. Consistent with accretion/amortization of other yield adjustments under ASC 310-20, the non-credit purchase discount is accreted into interest income over the life of the PCD loan on a level-yield basis (provided the loan remains on accrual status).

## Question 6

Is it appropriate for a bank to use the credit portion of a fair value mark on acquired non-PCD loans to reduce the ACL recorded on those loans?

## Staff Response

No. The entire fair value mark is accounted for as a purchase premium or discount that will ultimately be amortized or accreted into interest income over the remaining lives of the loans. In accordance with ASC 310-20-35-17, the accretion or amortization related to an individual loan should cease, however, if that loan is placed on nonaccrual. The unaccreted discount or unamortized premium is part of the amortized cost of the loan against which the need for the ACL is evaluated. The full amount of credit losses must be recognized through a PCL.

**Facts** A bank purchases a portfolio of loans at a discount. The purchase is not part of a business combination. The bank determines that none of the acquired loans have experienced a more-than-insignificant deterioration in credit quality since origination, so none of the loans are designated as PCD.

## Question 7

How should a bank account for the purchase discount recorded at the acquisition of the loan portfolio?

## Staff Response

Because the loans are not PCD, the bank should record the purchase of the loans in accordance with ASC 310-20. Per ASC 310-20-30-5, the bank can either allocate the initial investment to the individual loans or account for the initial investment in the aggregate. The purchase discount is recognized as an adjustment of yield over the life of the loan.

## Question 8

When does a modification of a PCD loan require reporting as a loan modification to a borrower experiencing financial difficulty in the call report?

## Staff Response

The determination of whether a modification is reported as a loan modification to a borrower experiencing financial difficulty is the same for PCD loans as it is for non-PCD loans. Disclosure requirements for modifications to borrowers experiencing financial difficulty are described in ASC 310-10-50-38 through 50-44. Modifications to borrowers experiencing financial difficulty should be reported in the call report in accordance with call report instructions. See Subtopic 12B for more information on loan modifications.

**Facts** A bank pays $1 million to acquire a portfolio of severely delinquent credit card loans with an aggregate unpaid outstanding balance of $10 million. Every loan in the acquired loan portfolio is greater than 180 days past due as of the purchase date. At the time of purchase, the bank determines that all the loans are PCD, share similar risk characteristics, and are evaluated collectively for ACL purposes using a non-DCF method. The bank estimates it will ultimately be able to collect $1.5 million of the $10 million outstanding balance.

## Question 9

How should the bank account for this transaction?

## Staff Response

The acquisition date journal entry is as follows:

| | | |
|---|---|---|
| Loan (HFI) | $10,000,000 | |
| Loan (HFI) – non-credit purchase discount | | $500,000 |
| ACL | | $8,500,000 |
| Cash (purchase price) | | $1,000,000 |

As the credit card loans are each greater than 180 days past due, the bank should charge off each loan on an asset-by-asset basis consistent with OCC Bulletin 2000-20, “Uniform Retail Credit Classification and Account Management Policy: Policy Implementation.”

One example of a journal entry a bank could record to recognize the charge-off is as follows:

| | | |
|---|---|---|
| PCL | $1,000,000 | |
| Loan (HFI) – non-credit purchase discount | 500,000 | |
| ACL | | 1,500,000 |
| | | |
| ACL (i.e., charge-off) | $10,000,000 | |
| Loan (HFI) | | 10,000,000 |

Although the loans are considered uncollectible on an individual asset basis, the bank can reasonably estimate a recovery of $1.5 million when the loans are measured collectively. As such, the bank should record its best estimate of the amount expected to be collected. Management is precluded, however, from recording the amount of non-credit discount as a negative ACL because credit conditions have not changed since acquisition and management is calculating the ACL using a non-DCF method. Refer to ASC 326-20-30-13A.

The journal entry to record expected recoveries on the pool of loans is as follows:

| | | |
|---|---|---|
| ACL | $1,000,000 | |
| PCL | | $1,000,000 |

# 12D. Allowance for Credit Losses

## Question 1

What is meant by "lifetime" in the context of lifetime expected credit losses?

## Staff Response

Lifetime expected credit losses are the amounts the bank does not expect to collect over the loan's contractual life. When determining the contractual life, a bank should consider the impact expected prepayments will have on the contractual term but is generally precluded from extending the contractual term for expected extensions, renewals, or modifications unless the borrower has an unconditional right to extend the loan.

## Question 2

How should a bank measure lifetime expected credit losses?

## Staff Response

A bank will need to apply judgment to select an estimation method(s) that is appropriate and practical for its circumstances to measure expected credit losses. Various methods that reasonably estimate the expected collectibility of the bank's loans and that are applied consistently over time can be used. Acceptable methods include, but may not be limited to, loss rate, roll-rate, vintage, discounted cash flow, and probability of default/loss given default methods. No specific method is required for estimating expected credit losses. Additionally, a bank may use different methods for different groups of loans.

When measuring lifetime expected credit losses, the bank must consider available information that is relevant to assessing the collectibility of its loans. This information may include internal information, external information, or a combination of both relating to past events, including historical credit loss experience on loans with similar risk characteristics, current conditions, and reasonable and supportable forecasts that affect the collectibility of the loans over their remaining contractual terms.

## Question 3

When should a loan be charged off?

## Staff Response

A loan that meets the federal banking agencies' loss classification definition should be charged off in the period in which it is classified as loss. CECL did not affect the loss classification definition, which states: "Assets classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future."

For consumer loans, the loss classification, and thus the timing of the charge-off, typically follows established thresholds (i.e., a specific number of days past due). For commercial loans, the loss classification and timing of the charge-off is likely the result of the bank obtaining specific adverse information about a borrower.

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**Facts** A bank evaluates an individual commercial real estate loan for expected credit loss as the loan does not share risk characteristics with other loans in the bank's portfolio. The loan was made during a recent boom period for the local real estate industry. The real estate market has since declined, and the borrower is experiencing financial difficulty. Management expects that loan repayment will come substantially from the eventual sale of the collateral. An appraisal indicates that the value of the property is 95 percent of the outstanding loan balance. The properly performed appraisal is dated near the reporting date, the assumptions in the appraisal remain reasonable, and the appraisal complies with Interagency Appraisal and Evaluation Guidelines.

Three real estate cycles have occurred in the last 25 years. In each cycle, local real estate values fluctuated significantly. Based on these observed cycles, the bank forecasts that local real estate will experience an additional decline in value of 5 percent between the reporting date and the date the collateral is ultimately expected to be sold.

## Question 4

How should the bank determine the ACL on the loan?

## Staff Response

Consistent with the call report instructions, the loan is collateral-dependent because the borrower is experiencing financial difficulty and repayment of the loan will come substantially from the eventual sale of the collateral.

To determine the ACL on a collateral-dependent loan, the bank should use the collateral's fair value as of the reporting date, less estimated costs to sell, since the cash flows available to repay the loan are expected to be reduced by these amounts. The bank should not adjust the appraised value for expected future changes in the collateral's fair value; rather, changes in the fair value of the collateral should be recognized in the period in which the change occurs.

## Question 5

When determining the ACL, is it appropriate for a loan to be evaluated for expected credit losses on a collective (pool) basis as well as on an individual basis?

## Staff Response

No. Including a loan in a pool of loans and performing an individual assessment results in recording an ACL twice for the same loan. If the loan shares similar risk characteristics with other loans in the portfolio, the ACL should be determined using a pool assessment, and no individual assessment should be performed. If the loan does not share risk characteristics with other loans in the portfolio, it should not be included in a pool assessment, and the ACL should be determined using an individual assessment.

**Facts** A bank removes a classified loan from a pool of pass-rated loans because it determines that the classified loan no longer shares risk characteristics with the pass-rated loans. The bank estimates expected credit losses on classified loans on an individual basis or with a pool of other classified loans that share similar risk characteristics. Ultimately, the classified loan is charged off.

## Question 6

Should the bank include the charge-off from the classified loan in the historical loss rate for the pass-rated loan pool?

## Staff Response

Yes. The net charge-off on the classified loan that was removed from the pool of pass-rated loans should be included in the historical lifetime loss rate applied to the pool of pass-rated loans. Although the net charge-off on the classified loan is included in the historical lifetime loss rate applied to the group of pass-rated loans, the classified loan balance is no longer included in the pass-rated pool for purposes of calculating the ACL.

**Facts** A bank has historical loss data that include multiple economic cycles. The data also cover a period of time in excess of the contractual term of its entire loan portfolio. The data show that the bank has experienced a very low level of credit losses. The characteristics of the bank’s current portfolio are similar to the characteristics of the portfolios that generated the historical loss data.

## Question 7

Does the bank need to supplement its historical loss experience with external (i.e., peer or market) data when determining its ACL?

## Staff Response

No. A low level of credit losses over an extended time period is not, by itself, a condition that would necessitate a bank defaulting to, or supplementing its loss experience with, external data. The bank may have a sufficient loss history to use its own experience as a starting point for its ACL, even though its credit losses have been minimal.

In this fact pattern, the bank compared the characteristics of its current loan portfolio with the portfolio characteristics that generated its historical loss data. Because the nature, terms, volume, and underwriting standards of the current portfolio, as well as the bank's expectations about future economic conditions, were similar to the portfolios and economic conditions that generated the loss experience, the bank will not need to supplement its historical loss experience with external data.

Conversely, if the characteristics of the current portfolio or the bank's expectations about future economic conditions differ significantly from the portfolios and economic conditions that generated the loss experience, the bank would need to consider whether the use of external data, or appropriately supported qualitative adjustments to its own data, is necessary to appropriately reflect the bank's expected credit losses.

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**Facts** Assume the same facts as in question 7, except the bank's historical loss data cover only the most recent five years. The most recent five years did not include a full economic cycle. Additionally, the remaining contractual term of the bank's portfolio exceeds five years.

## Question 8

Should the bank supplement its historical loss experience with external (i.e., peer or market) data or qualitative factors when determining its ACL?

## Staff Response

Yes. The bank would likely need to obtain external loss data, or employ qualitative factors, to estimate the expected credit losses that will occur subsequent to the five-year period covered by the loss history, but before the end of the portfolio's contractual term. Although the bank's historical credit loss experience may be used as a starting point for estimating expected credit losses, the most recent five-year period of loss experience is not, by itself, a sufficient basis to determine the ACL, as the length of time covered by the historical loss information is not reflective of the remaining contractual term of the portfolio.

Because the contractual term of the bank's portfolio exceeds the time period covered by the bank's historical loss experience, the bank likely does not have sufficient internal data to estimate lifetime expected credit losses.

Additionally, the bank will need to consider whether current and forecasted economic conditions are consistent with the economic conditions that generated the historical loss experience. If current or forecasted economic conditions differ from the conditions covered by the bank's historical loss experience, adjustments to the bank's historical loss experience will need to be made to account for the change that these conditions are expected to have on the expected credit losses. These adjustments can be made by supplementing the bank's historical loss data with external data or by applying appropriately supported qualitative adjustments.

## Question 9

Is there a specific period of time that should be used when developing the historical loss experience for groups of loans to estimate the ASC 326-20 portions of the ACL?

## Staff Response

There is no fixed period of time that banks should use to determine the historical loss experience. Banks should consider if the time period used to determine the historical loss experience includes a full economic cycle and the contractual term of the loans in each portfolio or segment. For some banks, the length of time used varies by product; high-volume consumer loan products generally use a shorter period than more specialized commercial loan products.

A bank should maintain supporting documentation for the techniques used to develop its loss rates. Such documentation includes evidence of the average and range of historical loss rates (including gross charge-offs and recoveries) by common risk characteristics (e.g., type of loan, loan grade, and past-due status) over the historical period used. A bank's supporting documentation should include an analysis of how the current conditions compare with those conditions during the period used in the historical loss rates for each group of loans assessed under ASC 326-20. This helps ensure that the appropriate historical experience is captured and is relevant to the bank's current portfolio.

**Facts** Bank A's primary business model is to originate and sell SFR mortgage loans into the secondary market. Recently, in an effort to improve asset quality ratios, the bank sold some of its non-performing SFR mortgage loans in its HFI portfolios within the same quarter it made the decision to sell. After the NPL sale, when calculating the loss history used in its allowance estimation process, the bank removed from its loss history the actual charge-offs in connection with the sale.

## Question 10

Is it appropriate to exclude the actual charge-offs related to the NPL sale from the loss history used in the bank's ACL methodology?

## Staff Response

No. The history of actual credit losses (charged-off loans) for each portfolio segment should be an objective measurement supporting the bank's ACL estimation under an ASC 326-20 approach. Removal of the actual charge-offs of the sold loans from the loss history will distort the loss history and understate credit losses. The bank may adjust for the impact of the NPL sale, however, through use of qualitative factors. Such adjustment is appropriate only to the extent that the bank can substantiate that its remaining portfolio has significantly improved in credit quality post-sale and the characteristics that gave rise to the charge-offs are no longer present in the remaining portfolio.

## Question 11

Must bank management review the appropriateness of the ACL quarterly?

## Staff Response

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

## Question 12

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

## Staff Response

Yes. The OCC emphasizes an ACL evaluation process that is safe, sound, comprehensive, well documented, consistently applied, and compliant with GAAP. Even if the examination team determines a bank's current ACL balance is appropriate for the bank's loan portfolio and level of credit risk, the process could be considered deficient if management does not have a sound basis for determining an appropriate level for the ACL on an ongoing basis.

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

## Question 13

Should the bank consider the borrower-paid, individual PMI when determining the ACL?

## Staff Response

Yes. Individual loan PMI that is legally attached to the mortgage loan and not separately exercisable, regardless of who owns the loan, should be considered in determining the bank's ACL. In determining the PMI's effect on the ACL, the bank must assess the insurer's willingness and ability to pay the loss claim in the event of the borrower's default. For example, the bank must analyze the insurer's history and timeliness for paying claims and the insurer's financial condition. If evidence suggests the bank may not be able to fully recover claims submitted to the insurer or would require legal action to enforce the contract, the bank should make adjustments to reflect that evidence when determining an appropriate ACL. For further discussion of accounting for mortgage insurance receivables, see Subtopic 5A, questions 30-31.

## Question 14

Would the staff response to question 13 be different if, rather than borrower-paid PMI, the bank obtained mortgage insurance on a pool of loans at or near the origination date of the loans in the pool and a loan would no longer be covered under the bank's insurance policy if sold to another institution? The mortgage insurance does not meet the scope of a credit derivative under ASC 815-10-15, nor is it required to be accounted for under either ASC 340-30 (insurance contracts that do not transfer risk) or ASC 944-20 (insurance).

## Staff Response

Yes, because the characteristics of the mortgage insurance in this question are different from the mortgage insurance described in question 13. The mortgage insurance described in this question is legally detachable from the mortgage loans and is a separate freestanding contract that serves to mitigate credit losses on the pool. ASC 326-20-30-12 does not allow a bank to consider freestanding contracts when estimating the ACL.

Similarly, the timing and amount of charge-offs recorded against loans covered by freestanding contracts should not contemplate the effect of the insurance policy. Further charge-offs should not be reduced by potential or pending insurance settlements.

Refer to Subtopic 5A, question 31, for the methods that a bank can elect to account for the mortgage insurance receivable.

## Question 15

Is a bank's reasonable and supportable forecast period expected to cover a specific amount of time?

## Staff Response

No. ASC 326 does not prescribe a specific method for estimating the reasonable and supportable forecast period, nor does it include "bright lines" establishing a minimum length for the reasonable and supportable forecast period. As such, the determination of an appropriate forecast period requires management's judgment. ASC 326 requires reversion to historical loss information for periods beyond the reasonable and supportable forecast period, commonly referred to as the reversion period.

Because of the judgment involved in forecasting, the reasonable and supportable forecast periods are expected to vary among banks. Some banks may be able to develop or obtain a reasonable and supportable forecast that covers the entire contractual life of their financial assets, while other banks may not. Nevertheless, it would be inappropriate for a bank to assert that it cannot develop a reasonable and supportable forecast of any length and, therefore, rely solely on historical loss information to estimate expected credit losses. It would also be inappropriate for the bank to artificially curtail its reasonable and supportable forecast period and ignore available information that is relevant to the expected credit loss estimate.

Each bank should document and support the appropriateness of the reasonable and supportable forecast period(s) selected. The length of the reasonable and supportable forecast period is not an accounting policy election. Thus, each bank should periodically review its reasonable and supportable forecast period(s) and make any necessary changes to the period(s) being used to properly estimate expected credit losses.

The reasonable and supportable forecast period is one element of the forward-looking information in a bank's ACL methodology, and it should not be determined in isolation, without considering the other forward-looking elements in the bank's methodology. Other forward-looking elements may include the reversion period, the method of reversion, and the historical loss information applied in the reversion period, if applicable.

## Question 16

What information should a bank consider when developing or obtaining a reasonable and supportable forecast?

## Staff Response

Reasonable and supportable forecasts are one of the essential components that must be considered when developing estimates of expected credit losses. When developing such estimates, the bank should consider available information relevant to assessing the collectibility of cash flows. This information may include internal information, external information, or a combination of both, that relates to past events, current conditions, and reasonable and supportable forecasts.

A bank does not need to incur excessive costs or undue burden in obtaining all information that may be relevant to future economic conditions. A bank should not, however, ignore available information that is relevant to assessing expected credit losses. Each bank may consider information currently used to develop financial budgets, strategic plans, or capital plans. Other available internal or external data may enhance the quality of forecasts used to determine the best estimate of expected credit losses. The bank should determine that any variables used in the forecast are applicable to and appropriate for the bank's portfolio and product offerings.

While a bank may use multiple forecasts across the bank, such as for budgeting, capital planning, or stress testing, if the forecast used for CECL varies materially from forecasts used in other areas of the bank, management should understand and support the reason for such variances.

## Question 17

How should a bank, as lessor, determine the ACL on its portfolio of sales-type or direct financing leases?

## Staff Response

The ACL for sales-type or direct financing lessor leases should be determined in accordance with CECL, as net investments in leases are within the scope of ASC 326-20. Operating lease receivables are excluded from the scope of ASC 326-20 and should be evaluated for impairment under ASC 842.

**Facts** A bank appropriately measures expected credit losses using the fair value of collateral for a loan with an amortized cost basis of $120,000 for which foreclosure is probable. The bank recognized a charge-off of $20,000 to write the loan down to its appraised collateral amount less estimated costs to sell. As the amount was deemed uncollectible, the amortized cost basis was reduced to $100,000.

At a later date, the bank obtains a new appraisal and now estimates that fair value less costs to sell is $130,000.

## Question 18

How should the bank account for the partially charged-off loan with an increase in appraised value of the collateral?

## Staff Response

The bank should use the new appraised amount less costs to sell when measuring the carrying amount of the loan under the collateral-dependent practical expedient in ASC 326-20-35-4 through 35-5. In this case, the fair value of the collateral less costs to sell of $130,000 exceeds the amortized cost basis of $100,000 as of the reporting date, thus the calculated difference is

$30,000. The bank should only record a debit to the ACL of $20,000 with a corresponding credit to the PCL because the recovery is limited to the amount previously written off.

## Question 19

Should a bank consider extension options (excluding those that are accounted for as derivatives in accordance with ASC 815) embedded in a loan agreement in the determination of a loan's contractual life?

## Staff Response

It depends on whether the extension or renewal options are unconditionally cancellable by the bank. Generally, the loan life for purposes of calculating the ACL is defined as the loan's contractual term without consideration for expected extensions, renewals, or modifications. However, if the original (or modified) contract includes extension or renewal options that are not unconditionally cancellable by the bank, these option period(s) must be considered in the loan's contractual term per ASC 326-20-30-6.

**Facts** Bank A originated a $1 million loan. Interest is due monthly, with all principal due in 36 months. Included in the loan agreement is an option for the customer to extend the loan for an additional 24 months at the same loan terms, provided that the customer maintains an adequate debt service coverage ratio. The option is not revocable by the bank. The bank determined that the extension option should not be accounted for as a derivative.

## Question 20

What should Bank A use as the loan's contractual term when calculating the ACL?

## Staff Response

Although the customer must maintain a certain debt service coverage ratio, the customer has a right to extend the loan that cannot be unconditionally cancelled by Bank A. As such, the contractual term should include the 36-month original term and consider the likelihood of the borrower exercising the 24-month extension option.

## Question 21

How should a bank capture extension options as discussed in question 20 in the ACL?

## Staff Response

Banks should develop a rational and systematic methodology to capture extension options embedded in loan agreements that are not unconditionally cancellable by the bank. For example, a bank could estimate a probability that a customer will meet any covenants required to renew and a probability that the customer will exercise the option to extend or renew.

As another example, a bank could assume that the probability that a customer will both meet all required covenants and will exercise the option to extend or renew is 100 percent. Subsequent to this decision, the bank should apply supportable pool-based prepayment assumptions to the loan in determining the ACL.

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**Facts** Bank A makes a loan with a 20-year amortization that reprices at year five and matures at year 10. The bank anticipates renewing the loan at maturity, but the decision to renew involves underwriting and a credit decision by the bank. The repricing in year five includes no modifications or change in terms other than the change in the loan's interest rate to an agreed-upon benchmark plus spread. The bank does not anticipate any prepayment on this loan.

## Question 22

Does the loan repricing at year five represent the end of the contractual life for purposes of evaluating the ACL?

## Staff Response

No. When a loan repricing is an automatic feature embedded in the original contract and occurs without any required action on the part of the bank, it would not constitute a renewal or modification as noted in ASC 326-20-30-6. The life of this loan is 10 years, as the maturity at year 10 would trigger the end of one loan and the beginning of another loan for ACL evaluation purposes.

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**Facts** A bank is generally able to forecast the effects of macroeconomic conditions on its retail loan portfolio for one year. As such, the bank's reasonable and supportable forecast period on its retail loan portfolio is generally one year. After this reasonable and supportable forecast period, the bank reverts to historical loss experience over the remaining life of the portfolio.

The bank becomes aware of a factory closure in its footprint that is expected to affect the collectibility of the bank's retail portfolio. The bank can forecast the effect of the factory closure over the next two years, rather than one year.

## Question 23

Should the bank include the incremental losses related to the factory closure when estimating the ACL?

## Staff Response

Yes. Even though the reasonable and supportable forecast period for other inputs including macroeconomic conditions is generally one year, the bank should not ignore the incremental expected losses related to the factory closure.

Use of a shorter forecast period for some inputs does not preclude a bank from estimating and recording expected credit losses for other inputs that it can estimate and reasonably support for a longer period. See question 15 for additional discussion on reasonable and supportable forecast periods.

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**Facts** Assume the same facts as in question 23, except that the bank has also identified that it has loosened underwriting standards for recently originated loans compared with the loans from which the bank's historical loss experience is derived.

## Question 24

Should the bank include the incremental losses in its ACL that it expects related to the loosened underwriting standards beyond its one-year reasonable and supportable forecast period?

## Staff Response

Yes. Under ASC 326-20-30-8 through 30-9, the bank is not limited to including the impact of current asset-specific risk characteristics in its ACL for the reasonable and supportable forecast period used for expectations of future economic conditions. The bank has identified a credit risk factor that will affect the amount the bank expects to collect beyond the one-year reasonable and supportable forecast period. The bank should estimate the impact of the current asset-specific risk characteristic for the remainder of the contractual lives of the loans and include the incremental losses in its ACL.

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## Question 25

May a bank elect not to measure an ACL on AIR in accordance with ASC 326-20-30-5A if the bank has an accounting policy with charge-off requirements that are consistent with the glossary entry for "nonaccrual status" in the call report instructions?

## Staff Response

Yes. ASC 326-20-30-5A allows entities to make an accounting policy election, at the class of financing receivable or the major security-type level, not to measure an ACL for AIR if the entity writes off uncollectible AIR "in a timely manner." Charging off AIR in accordance with the glossary entry for "nonaccrual status" in the call report instructions is generally considered to be done "in a timely manner" for regulatory reporting purposes.

## Question 26

How should a bank account for AIR not expected to be collected?

## Staff Response

It depends. ASC 326-20-30-5A allows banks to make an accounting policy election, at the class of financing receivable or the major security-type level, not to measure an ACL for AIR if the bank writes off uncollectible AIR "in a timely manner." See question 25. If a bank does not make this policy election, the bank will need to measure an ACL on AIR for that class of financing receivable or major security type.

Separately, ASC 326-20-35-8A allows banks to make an accounting policy election, at the class of financing receivable or the major security-type level, to write off AIR by either reversing interest income, recognizing the loss as a PCL, or through a combination of both methods.

If a bank elects to write off AIR by reversing interest income, the bank will debit (reduce) interest income for the amount of uncollectible AIR being charged off. Alternatively, a bank may charge off uncollectible AIR against an ACL by debiting (reducing) the ACL.

**Facts** On December 31, 20X0, a bank determines that a loan is a "collateral-dependent financial asset" in accordance with ASC 326-20-35-5 and measures the loan's ACL using the fair value of the collateral (less selling costs, if applicable) as required by call report instructions. On June 30, 20X1, the bank determines that the borrower is no longer experiencing financial difficulty.

## Question 27

On June 30, 20X1, should the bank account for the loan as a collateral-dependent financial asset?

## Staff Response

No. ASC 326-20-35-5 defines a loan as a collateral-dependent financial asset when (1) repayment is expected to be provided substantially through the operation or sale of collateral and (2) the borrower is expecting financial difficulty based on the entity's assessment as of the reporting date. The borrower is no longer experiencing financial difficulty at the balance-sheet date; therefore, the bank should no longer account for the loan as a collateral-dependent financial asset and should no longer measure the loan's ACL using the fair value of the collateral (less selling costs, if applicable).

## Question 28

How should a bank measure expected credit losses on a collateral-dependent loan for which foreclosure is not probable?

## Staff Response

For regulatory reporting purposes, banks should use the fair value of the collateral (less selling costs, if applicable) for determining the ACL for a collateral-dependent loan, even if foreclosure is not probable.

If a bank determines that a loan is not or is no longer collateral-dependent, the bank should not use the fair value of the collateral (less selling costs, if applicable) for determining the ACL.

## Question 29

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

## Staff Response

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

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

## Question 30

Does a materially excessive ACL also pose a problem?

## Staff Response

Yes. A materially overstated ACL misstates both the earnings and condition of the bank and may constitute a violation of 12 USC 161 (national banks) or 12 USC 1464(v) (federal savings associations). Elimination of such excess ACL should be accounted for as a credit to (or reduction in) the PCL. If an improper estimate or error is discovered after a call report is filed, the glossary entry for “Accounting Changes – Corrections of accounting errors” in the call report instructions should be consulted.

**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 31

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 ACL. In accordance with the call report instructions, accounts that are overdrawn should be reclassified as loans and should, therefore, be evaluated for collectibility as part of the evaluation of the ACL. Because the bank's ACL methodology is required to consider the overdraft accounts, the subsequent charge-offs of the overdraft accounts would be charged against the ACL.

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

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**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 date, the bank has overdraft account balances of $2 million (excluding associated fees), of which $200,000 is deemed to be uncollectible.

## Question 32

How should the bank account for uncollectible overdraft protection fees?

## Staff Response

The bank may provide an ACL 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 ACL only if such fees are recorded with overdraft account balances as loans, and the estimated losses on the fees are provided for in the ACL.

**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 33

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

## Staff Response

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

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

**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.

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

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

## Question 34

Should these losses be charged against the ACL?

## 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.

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

## Question 35

Does the settlement represent an operating or a credit loss?

## Staff Response

The settlement is an operating loss that should be recorded as an "other noninterest expense," because the bank settled with the borrower in lieu of incurring litigation-related expenses. Credit losses arise from the borrower's failure to pay according to the terms of the loan agreement (see question 33 for further discussion). In this situation, the borrower was paying in accordance with the contractual terms, and there were no indications the borrower would not be able to continue such payments.

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

## 12E. Off-Balance-Sheet Credit Exposures

**Facts** A bank has off-balance-sheet credit exposures, such as commitments to extend credit, guarantees, and standby letters of credit, including off-balance-sheet credit exposures where the counterparty is also a borrower of the bank. These off-balance-sheet financial instruments are not accounted for as insurance contracts under ASC 944 or as derivatives under ASC 815. The bank has not elected the FVO for these off-balance-sheet credit exposures.

### Question 1

Should the bank estimate expected credit losses on the off-balance-sheet credit exposures?

### Staff Response

The bank should estimate expected credit losses on off-balance-sheet credit exposures that are not unconditionally cancellable by the bank as they are within the scope of ASC 326-20 (i.e., CECL). When estimating expected credit losses for off-balance-sheet credit exposures, the bank should consider both the likelihood that funding will occur and the amount expected to be funded over its contractual life. The bank should not estimate credit losses for credit exposures that are unconditionally cancellable by the bank. See Subtopic 12D for a discussion of estimating credit losses under ASC 326-20.

### Question 2

How should the bank record and report the expected credit losses on the off-balance-sheet credit exposures in the call report?

### Staff Response

Consistent with ASC 326-20-30-11, the estimate of expected credit losses related to off-balance-sheet credit exposures should be reported as a liability on the balance sheet (not as a contra-asset reported as part of the ACL on loans and leases) because the credit exposures being measured for expected credit losses are not currently recorded on balance sheet. For call report purposes, this should be reported in Schedule RC-G, item 3, “Allowance for credit losses on off-balance-sheet credit exposures,” not as part of the “Allowance for credit losses on loans and leases” in Schedule RC, item 4.c.

The estimate of expected credit losses related to the off-balance-sheet credit exposures should be recorded as a PCL on the income statement (schedule RI of the call report).

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**Facts** A bank has off-balance-sheet credit exposures that are unconditionally cancellable, such as credit lines in the bank’s credit card portfolio. Although the credit lines are cancellable at any time, borrowers experiencing financial difficulty often make substantial draws before the bank identifies the borrower’s financial difficulty and cancels the line of credit.

## Question 3

When evaluating and estimating the expected credit losses associated with these off-balance-sheet credit exposures, should the bank include commitments that are unconditionally cancellable at the bank's discretion when it is likely the bank will fund future charges or draws?

## Staff Response

No. Expected credit losses on unconditionally cancellable off-balance-sheet credit exposures should not be recorded. A bank that has discretion to unilaterally cancel the commitment to lend should not record a liability for credit losses related to the unconditionally cancellable commitments.

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## Question 4

Is the unfunded commitment associated with a HELOC unconditionally cancellable?

## Staff Response

Generally, no. The unfunded commitment associated with a HELOC is not typically considered unconditionally cancellable in accordance with GAAP. For an unfunded commitment to be considered unconditionally cancellable for GAAP purposes, the bank must be able to, at any time, with or without cause, refuse to extend credit.

Under Regulation Z (12 CFR 1026), HELOC contracts typically require that certain conditions be met before the bank can cancel or reduce the line of credit. Those conditions include, among others, deterioration in the value of the real estate or the financial condition of the borrower since the HELOC was originated. For GAAP purposes, these types of requirements disqualify the unfunded commitment from being unconditionally cancellable as they contain conditions that are not in the control of the bank (lender).

However, under regulatory capital rules, the unfunded commitment associated with a HELOC may be considered unconditionally cancellable if the bank is able to, at any time, with or without cause, refuse to extend credit, *to the extent permitted by law* (for example, notwithstanding Regulation Z). Meeting the definition of unconditionally cancellable for regulatory capital purposes does not make the contract unconditionally cancellable for GAAP purposes.

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## Question 5

How should a bank account for a commitment to lend when a bank does not elect the FVO under ASC 825?

## Staff Response

It depends. Commitments to originate mortgage loans that will be HFS are derivatives and are accounted for in accordance with ASC 815-10. Commitments to originate mortgage loans that will be HFI, however, are not derivatives and should be evaluated for credit losses under ASC 326-20.

Commitments to originate non-mortgage loans, regardless of whether the loans will be HFS or HFI, are not subject to ASC 815-10 and thus are not accounted for as derivatives. Rather, these commitments should be evaluated for credit losses under ASC 326-20.

| Bank's intention for the commitment once funded | Mortgage | Non-mortgage |
|---|---|---|
| Held for sale | Derivative under ASC 815-10 | Not a derivative, follows CECL for off-balance-sheet credit exposures under ASC 326-20 |
| Held for investment | Not a derivative, follows CECL for off-balance-sheet credit exposures under ASC 326-20 | Not a derivative, follows CECL for off-balance-sheet credit exposures under ASC 326-20 |

Refer to question 1 for discussion of when and how to estimate credit losses for loan commitments accounted for under ASC 326-20.

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**Facts** Bank A issued a non-mortgage loan commitment letter to a borrower. If not signed and returned by the borrower, the commitment letter expires 30 days after the bank's issuance of the letter. Bank A cannot rescind the commitment to lend once the bank sends the letter to the borrower.

## Question 6

Before the borrower signs and returns the commitment letter, should Bank A evaluate the loan commitment for expected credit losses and include its estimate of credit losses as a liability for credit losses on off-balance-sheet credit exposures?

## Staff Response

Yes. Although the borrower has not executed the contract, Bank A has an obligation to extend credit at the date the bank delivered the letter to the borrower. This off-balance-sheet credit exposure is not unconditionally cancellable by the bank, and as such the bank should evaluate the off-balance-sheet credit exposures for credit losses under ASC 326-20-30-11 over the period in which the bank is exposed to credit risk.

# Appendix

## Appendix A. Commonly Used Abbreviations and Terms

| Abbreviation or term | Definition |
|---|---|
| ACL | allowance for credit losses |
| AFS | available-for-sale |
| AICPA | American Institute of Certified Public Accountants |
| AIR | accrued interest receivable |
| AOCI | accumulated other comprehensive income |
| ASC | Accounting Standards Codification |
| ASU | Accounting Standards Updates |
| BAAS | Bank Accounting Advisory Series (OCC) |
| Banks | national banks and federal savings associations |
| BOLI | bank-owned life insurance |
| Call report | The combined Reports of Condition and Income: the “Report of Condition” encompasses Schedules RC and RC-A through RC-V, and the “Report of Income” encompasses Schedules RI, and RI-A through RI-E. |
| Cost basis | Amortized cost basis of an asset. |
| CECL | current expected credit losses |
| CFR | Code of Federal Regulations |
| CMO | collateralized mortgage obligation |
| DCF | discounted cash flows |
| DTA | deferred tax asset |
| DTL | deferred tax liability |
| EIR | effective interest rate |
| FASB | Financial Accounting Standards Board |
| FDIC | Federal Deposit Insurance Corporation |
| FHLB | Federal Home Loan Bank |
| FRB | Federal Reserve Bank |
| FIFO | first in, first out |
| FVO | fair value option |
| GAAP | generally accepted accounting principles (United States) |
| GNMA | Government National Mortgage Association (Ginnie Mae) |
| HELOC | home equity line of credit |
| HFI | held for investment |
| HFS | held for sale |
| HTM | held-to-maturity |
| IO | interest-only |
| IRS | Internal Revenue Service |

| Abbreviation or term | Definition |
|---|---|
| LIFO | last in, first out |
| LIHTC | low-income housing tax credit |
| MBS | mortgage-backed security |
| MSR | mortgage servicing right |
| NCI | noncontrolling interest |
| NOL | net operating loss |
| NPL | nonperforming loan |
| OCA | Office of the Chief Accountant |
| OCC | Office of the Comptroller of the Currency |
| OREO | other real estate owned |
| PBE | public business entity |
| PCC | Private Company Council |
| PCCR | purchased credit card relationships |
| PCD | purchased financial assets with credit deterioration (purchased credit deteriorated) |
| PCL | provision for credit losses |
| PMI | private mortgage insurance |
| RC | call report schedule RC — “Balance Sheet” |
| RC-B | call report schedule RC-B — “Securities” |
| RC-F | call report schedule RC-F — “Other Assets” |
| RC-G | call report schedule RC-G — “Other Liabilities” |
| RC-M | call report schedule RC-M — “Memoranda” |
| RC-N | call report schedule RC-N — “Past Due and Nonaccrual Loans, Leases, and Other Assets” |
| RC-R | call report schedule RC-R — “Regulatory Capital” |
| RI | call report schedule RI — “Income Statement” |
| RI-E | call report schedule RI-E — “Explanations” |
| ROU | right-of-use |
| SBA | Small Business Administration |
| SEC | U.S. Securities and Exchange Commission |
| SFR | single family residential |
| SOFR | Secured Overnight Financing Rate |
| TDR | troubled debt restructuring |
| USC | U.S. Code |
| VA | U.S. Department of Veterans Affairs |
| VIE | variable interest entity |